

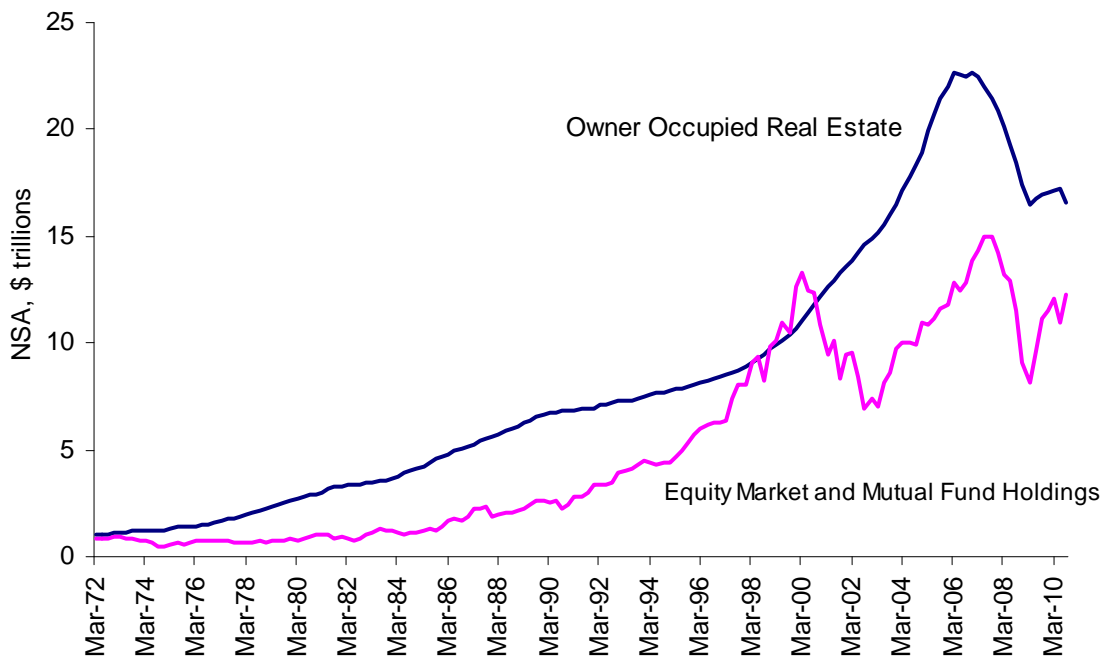
December 9, 2010

Third-Quarter Household Net Worth Grew With Equities, But Home Values Fell

The third quarter flow of funds data from the Federal Reserve (released today) showed a \$1.9 trillion increase in household financial net worth and a \$1.2 trillion increase in overall net worth. The increases were mostly due to equity gains of \$1.3 trillion. The weaker increase in overall net worth was mostly due to a \$0.7 trillion decline in the value of houses, which aren't included in financial net worth.

Two major fluctuating components of household net worth are equity holdings and the value of houses. Other large components include cash, pension and life insurance and, on the negative side, mortgage debt. In the 2000 bust, equities went down but not houses. After the 2008 crash, houses and equities both went down sharply. Equities have had a substantial recovery.

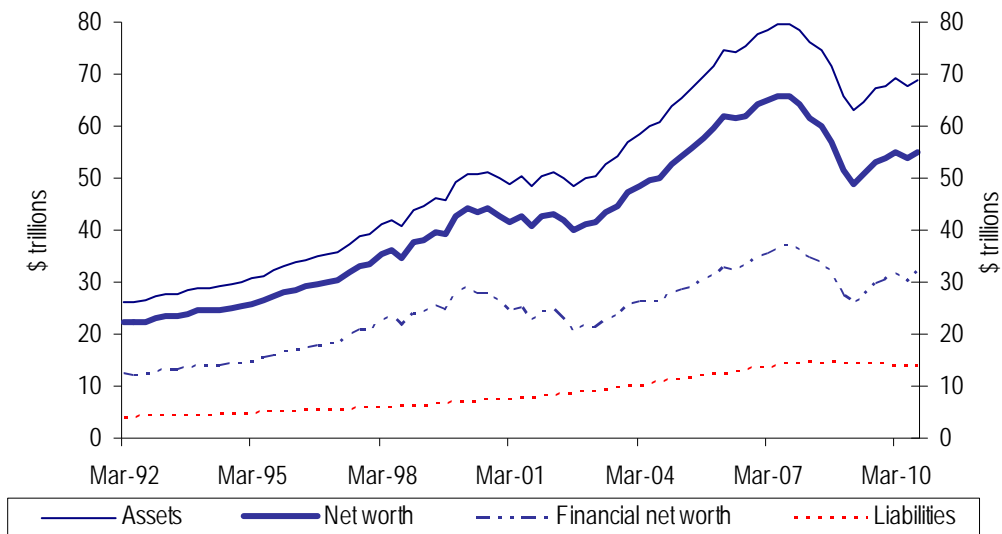
Equity Market Assets and Owner Occupied Real Estate (last obs. Q3 2010)



Source: Federal Reserve: Flow of Funds; Encima Global

- Third quarter household net worth stood at \$54.9 trillion, up from the \$53.7 trillion in the second quarter. Net worth first reached this level in the second quarter of 2005. Peak net worth was \$65.7T in Q2 of 2007. These are nominal dollars, so compared to gold or real dollars, household net worth, even after recent gains, is barely comparable to levels reached in the late 1990s. Factor in the big increase in the population, and the result is that per capita real wealth has fallen back to the 1990s or even late 1980s levels while much of the rest of the world is much higher than in those years.
- Stating the obvious, those with large home assets, often older people, have suffered the most in terms of net worth. However, the redistribution aspect isn't as large as the \$6.1 trillion decline from the 2006 peak suggests. For those who can reduce their mortgage or walk away, some of the loss is transferred to the mortgage holder, often the government, with the burden of the loss falling on higher-income people (who own mortgages or will be responsible for the national debt.) In addition, the elderly have tended to benefit from the generational transfer from social security, Medicare and pensions.
- Our view is that fluctuations in household net worth are not as critical to future consumption as the labor environment -- jobs are most people's greatest asset. Thus, while U.S. household net worth has underperformed many foreign countries (we built too many big houses), global consumption trends will be determined more by job growth and value-added than by net worth.
- Household assets stood at \$68.8 trillion in September, up from \$67.7 trillion in June. Household liabilities stood at \$13.94 trillion in September, down \$7.6 billion from \$13.95 trillion in June.

Household Balance Sheet (last obs. Q3 2010)



Source: Federal Reserve: Flow of Funds; Encima Global

- The Fed's measure of household financial net worth (which excludes houses in assets but includes mortgages in liabilities) rose to \$31.7 trillion in September from \$29.9T in June. The peak was \$37.1 trillion in September 2007.
- U.S. household liquid assets totaled \$24.1 trillion on September 30, down from the \$26.1T peak in the third quarter of 2007. The September total included \$6.3T of time deposits, \$7.8T of directly owned equities, \$4.4T of mutual funds, and \$5.5T of checking deposits, money funds and credit market instruments.
- In September direct holdings of equities (\$7.8 trillion) and mutual fund shares (\$4.4 trillion) totaled \$12.2 trillion. This was up \$1.3 trillion from June. Pension fund reserves stood at \$13.6 trillion, up \$0.7 trillion from \$12.9 trillion in September. These gains accounted for most of the increase in the overall value of the household balance sheet during the third quarter.

Selected Components of U.S. Household Balance Sheet (last obs. Q3 2010)

	2010 Q3 (\$ trill)	2010 Q2 (\$ trill)	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Total assets	\$68.8	\$67.7	2.3%	-5.9%	-10.4%
Tangible assets	\$23.2	\$23.8	-1.3%	-8.0%	-10.8%
Real Estate	\$18.3	\$19.0	-2.1%	-9.8%	-13.6%
Other tangible assets	\$4.9	\$4.9	1.7%	-0.1%	3.9%
Financial assets	\$45.7	\$43.8	4.3%	-4.8%	-10.2%
Checkable deposits & money funds	\$1.3	\$1.3	-20.7%	6.0%	14.3%
Time and savings deposits	\$6.3	\$6.3	5.6%	-1.6%	5.7%
Credit market instruments	\$4.2	\$4.3	0.1%	1.4%	5.3%
Equities (direct)	\$7.8	\$6.9	9.5%	-4.9%	-26.9%
Mutual funds	\$4.4	\$4.0	11.5%	-0.1%	-15.5%
Pension reserves/life insurance	\$13.6	\$12.9	6.2%	-1.8%	-12.0%
Equity in unincorporated business	\$6.5	\$6.6	-1.4%	-16.8%	-11.2%
Other financial assets	\$1.5	\$1.5	4.7%	-17.4%	20.6%
Total Liabilities	\$13.9	\$13.9	-1.2%	-3.1%	3.0%
Mortgages	\$10.1	\$10.2	-2.6%	-1.6%	1.5%
Credit card	\$0.8	\$0.8	-9.8%	-8.2%	5.7%
Nonrevolving consumer credit	\$1.6	\$1.6	0.0%	-0.7%	2.2%
Other	\$1.4	\$1.4	16.0%	-13.6%	15.1%
Net worth	\$54.9	\$53.7	3.3%	-6.6%	-13.3%
Financial net worth (financial assets minus total liabilities)	\$31.7	\$29.9	6.9%	-5.5%	-15.3%

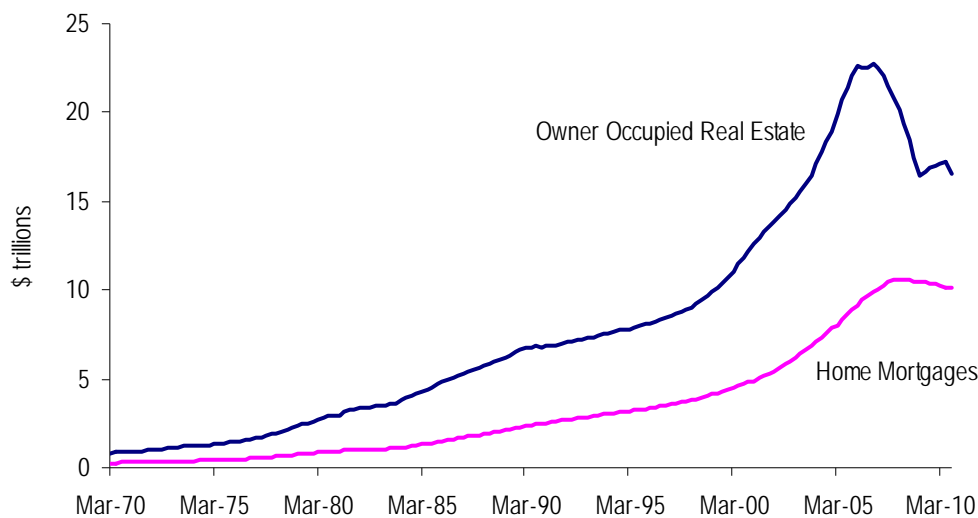
Source: Federal Reserve: Flow of Funds; Encima Global

Fall in Home Equity in Third Quarter

The Fed data found that owner-occupied real estate fell to \$16.6T in September, down \$648.8 billion from \$17.2T in June. Home mortgages stood at \$10.1T in September, down \$64.4 billion from \$10.2T in June.

- Owner-occupied real estate peaked at \$22.7T in December 2006. Since then, the asset side has fallen \$6.1T, or 27.1%, while home mortgages are up \$0.3T or 2.6% (to \$10.1T from \$9.9T at the asset peak.)

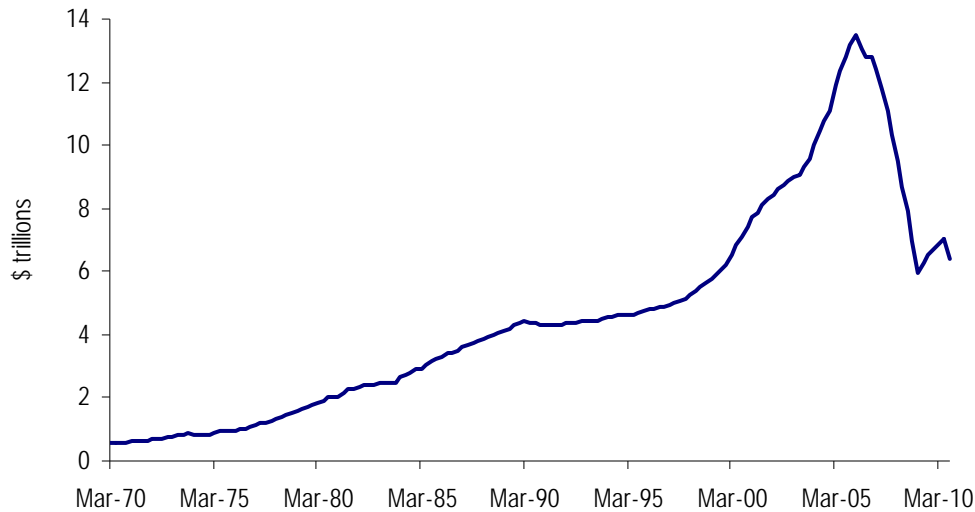
Owner Occupied Real Estate and Mortgages (\$ trillions, last obs. Q3 2010)



Source: Federal Reserve: Flow of Funds; Encima Global

- Owners' equity in real estate fell to \$6.4T in September, down from \$7.0T in June. The owners' equity is down 52.3% from the \$13.5T equity peak in March 2006. **The peak to trough (March 2009) decline in home equity was 55.6%.**

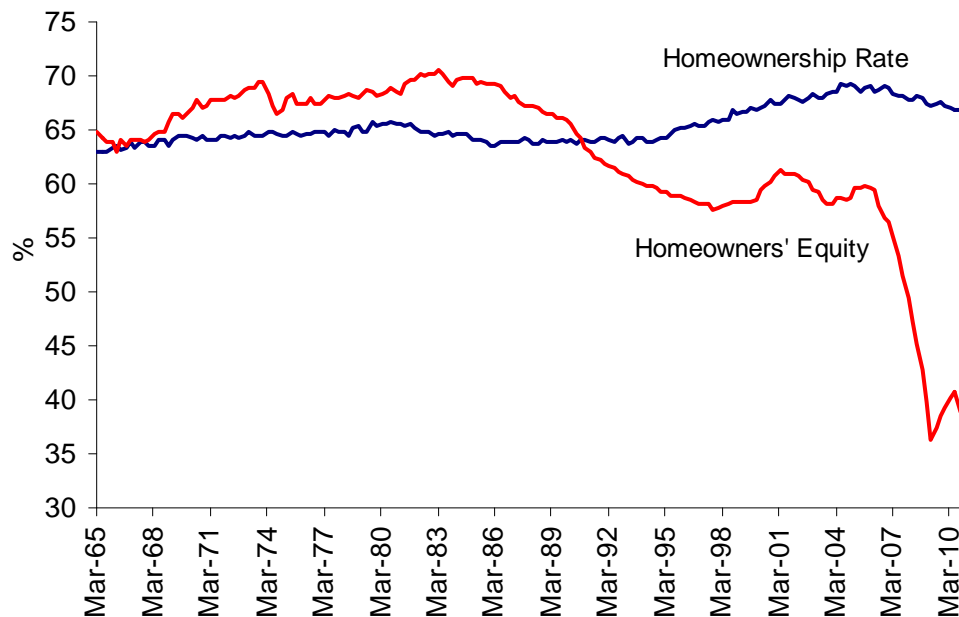
Equity in Homes (\$ trillions, last obs. Q3 2010)



Source: Federal Reserve: Flow of Funds; Encima Global

- The aggregate homeowners' equity percentage (equity in the home divided by the value of the home) fell to 38.8% in September from 40.8% in June. **The record low for the homeowners' equity percentage was 36.3% in March 2009.**

Homeowners' Equity and Homeownership Rate (last obs. Q3 2010)



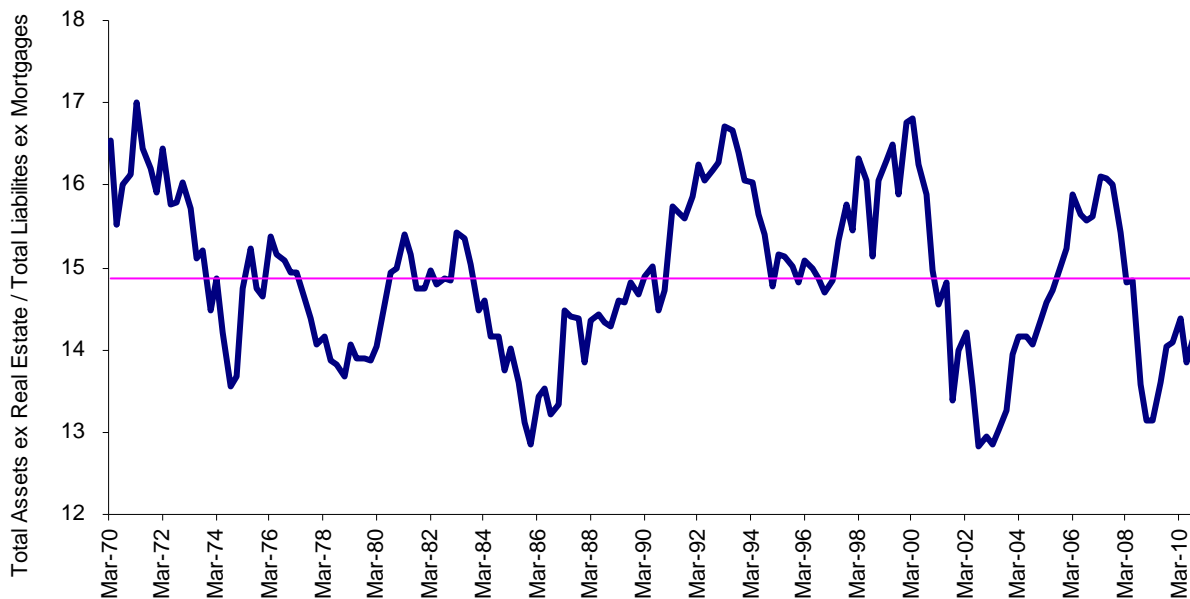
Source: Federal Reserve: Flow of Funds; Census Bureau; Encima Global

- The steady shallow decline in homeowners' equity percentage from 1985 through 2006 reflected the tax preference for mortgage debt over other forms of debt, low mortgage

rates in this decade, lax lending standards, and smaller down payments. Since 2006, weak house prices have driven the homeowners' equity percentage much lower.

- Through 1995, the homeownership rate was steady around 64%. It then rose rapidly to 69.2% in December 2004 in response to the Community Reinvestment Act, low mortgage rates, low down payments and other ownership encouragements. It stood at 66.9% in September, having given up part of those gains in recent years with the decline in the attractiveness of housing as an investment.
- Almost all of the aggregate leveraging of the household sector was in home mortgages (which grew at a faster rate than the value of houses.) Excluding houses from assets and mortgages from liabilities, the household sector has increased assets and liabilities at about the same rate over four decades – for every \$1 in debt, assets grew about \$14.

Assets ex houses / Liabilities ex mortgages (last obs. Q3 2010)



Source: Federal Reserve: Flow of Funds; Encima Global

Notes

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