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The Great Savings Surprise

It is well known that personal savings in the U.S. (and Canada)—defined as personal income minus consumption—have fallen to a record low, and have moved into negative territory for the first time in post-war history. In other words, people are spending more than they earn. There has been no net new ‘active’ savings for almost a year even as household net worth is rising as a percent of income.

To be sure, the national accounts measure of savings is imperfect. Income does not include unrealized capital gains on homes, stocks and employee pensions. And, consumption does include expenditures for asset enhancements such as education and training. Nevertheless, it can safely be said that most baby boomers are woefully unprepared for the financial burdens of retirement, all the more so given the quickening demise of the defined benefit pension plan.

Pinched Households

The United States has enjoyed an unprecedented period of strong productivity growth, which has reduced inflation pressure and increased corporate profitability. Globalization, by strengthening competitive pressure, has forced American business to maximize their cost efficiencies, especially given the strong—though now weaker and weakening—U.S. dollar. The widening trade deficit, especially with China, has lowered goods inflation in the U.S., while it has made many import-competing producers struggle for their future. China’s competitive advantage is its cheap labor and its willingness to buy global market share at the expense of profits. In order to compete, many American companies are producing, at least in part, in China.

Normally, a rise in productivity growth benefits both labor and management. Profits increase, but so do wages. Global forces—labor arbitrage across countries—have kept the lid on wage gains and many businesses are struggling to further reduce employment costs by cutting health care insurance, and other benefits. Labor’s share of GDP, in terms of wages and salaries, has fallen to near a record-low of around 45%.

This cycle, though labor markets are tight in many sectors, American job growth has been far less robust than in previous upswings. The combination of sub-par job creation and real wage stagnation has constrained the income growth of the world’s most aggressive consumer.

Average hourly earnings are rising at a 3.1% annual rate, below the 3.5% pace of headline inflation. A broader measure of compensation, the Employee Cost Index, is showing an even more dramatic pattern. The wage and salary component of the index has increased by a mere 2.3% year-over-year rate as of 2005Q3, just about enough to cover core inflation. This is the smallest annual increase in the nearly 25-year history of this wage series.

What may be even more restrictive is the massive cutback in employee benefits as businesses pare their coverage of health care and pension costs. Compound this with the surge in energy prices, the reduced level of housing affordability, and the rising property tax burden, and it is not surprising that some measures of household financial strain are rising. Credit card delinquency rates are on an uptrend, personal bankruptcy rates have surged to record highs, partly to beat October's regulatory changes, and past due loans are at historically high levels. And, all of this is before the full effect of rising mortgage rates is felt on the enormous volume of Adjustable Rate Mortgages, now representing 30% of all mortgage debt outstanding. Many of these loans were made to sub-prime borrowers where loan-to-value ratios are very high and the tolerance for rising monthly payments is negligible.

At the same time, U.S. personal bankruptcy laws have been stiffened and the minimum monthly payments on credit cards have, in some cases, doubled. Yet, over the past several years, consumption growth has been strong. The explanation is mortgage equity withdrawal, which is estimated to have amounted to more than \$800 billion in the year ended 2005Q3. Much of this money was likely spent on home renovations, consumer durable goods and college and university tuition; as well, some went to finance ever-unaffordable lifestyles.

It is true, however, that household net worth is well above the historical average at 5.7 times personal disposable income; but the largest components of that wealth are homeowner equity and pensions. The growth of both of these components is vulnerable. Housing markets are peaking all over the U.S., and if retiring boomers were to attempt to realize the value in their homes all at the same time, that equity could well quickly diminish.

Pensions and Retirement Savings

Perhaps even more troubling for the future is that the financial security of pensions is sliding fast. Businesses in ailing industries such as airlines, steel and autos have gone into bankruptcy and turned over their insolvent pension plans to the federal government. Union contracts have been broken in an effort to save the company, and therefore at the cost of some of the union members' jobs.

Now, however, with the recent pension freezes and shifts to 401(k)-type plans by some of the strongest, most stable companies in America—Verizon, Lockheed Martin, Motorola, IBM, and most recently, Alcoa—the death knell of the defined benefit pension plan is ringing loud and clear.

Even cash-rich profitable companies are shifting the burden of retirement security on to the worker. Firms are facing longer lifespans, looming regulatory and accounting changes, and heightened global competition. Unlike the old-fashioned defined benefit pension plans that guaranteed an income stream to retiree and spouse based on the top earnings years, 401(k) plans make workers responsible for ensuring that they have adequate funds for retirement and expose them to the volatility and uncertainty of the financial markets.

Households are vulnerable to far more risk than a few decades ago. No longer can they count on the guarantee of a job, health care and a pension. In addition, in most situations, 401(k) plans are optional, contribution levels are up to the employee, and matching funds by the employer are limited and tied to worker contributions. Most people do not know just how vulnerable they are. Indeed, most people have no idea how large a nest egg they will need in retirement to assure their own financial security. The lucky ones are the relatively few American workers near retirement that are covered by defined benefit pension plans.

The rest of us have no guaranteed income stream aside from Social Security, which is woefully inadequate for households accustomed to above-median-income lifestyles. Having suffered the blow-out following the stock market bubble of the late 1990s, financial planners now suggest that assumed pension withdrawal rates of more than 4%-to-5% are imprudent. That means that for a given level of desired before-tax retirement income, 20-to-25 times that level must be saved the day you stop working. For example, for \$100,000 in pre-tax income over and above Social Security, a relatively liquid nest egg of \$2 million to \$2.5 million is recommended. Withdrawing income at a rate much more than 5% annually might lead you to outlive your money, especially if you hit a bear market early in retirement. To be sure, you can withdraw more rapidly the older you are, especially if you want to die poor, leaving no inheritance; but cutting it too close is risky given the high cost of long-term health care, health insurance, and uncertain inflation.

Bottom Line

Clearly, most baby boomers are inadequately saving for retirement. Most have no idea just how much capital they must accumulate in investable assets. Most rely on an inadequate 401(k) plan and their ability to realize the value in their businesses or their homes. Such reliance is risky given that business liquidation requires a buyer, and, if house prices remain high, chances are the cost of a retirement home will be higher than you realize. If house prices fall, then the equity is lower.

Over the next decade, we are likely to see a meaningful rise in active savings if boomers awaken to reality. This could well mean that trend economic growth could decelerate from a 3½% pace. Otherwise, boomers will attempt to work longer, and be forced to dramatically reduce spending in their golden years.

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