CHART 1
HOUSING ATM OUT OF CASH
United States (US$ blns : s.a.a.r.)
Home Equity Extraction

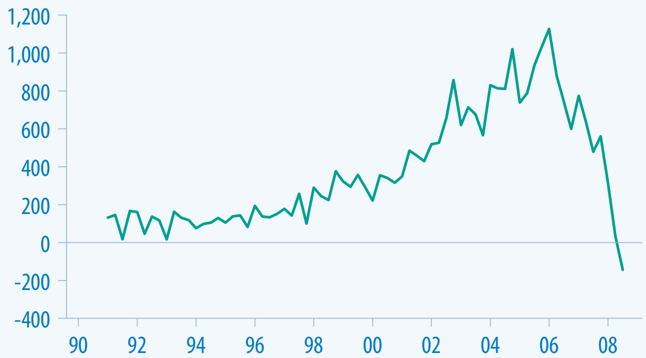


CHART 2
SAVING FACE
United States (percent)

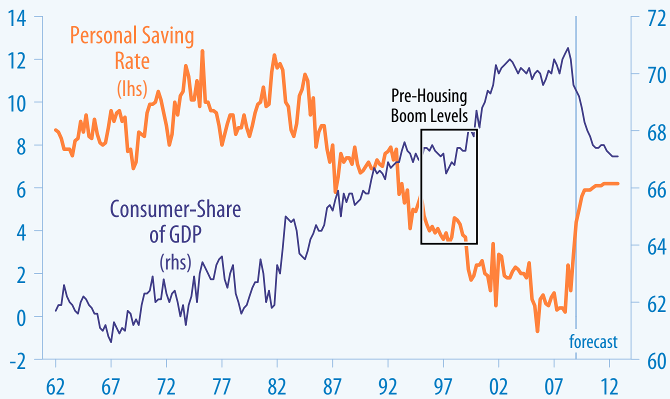
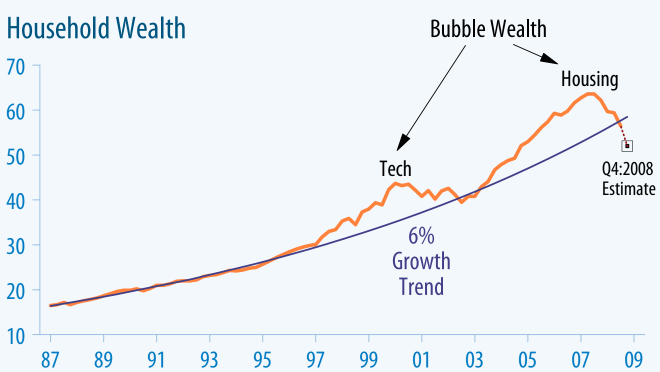


CHART 3
IN BAD WEALTH
United States (US$ trillions)
Household Wealth



Growth Trend = Based on the Period 1987-1996

Thrifty Future

Earl Sweet and **Sal Guatieri**, Senior Economists

There is much uncertainty about the depth and length of the current recession and the pace of the eventual recovery. Besides not knowing when housing will stabilize, this uncertainty stems from how long it will take American consumers to rebuild their puny savings. Amid onerous debts and severely impaired wealth, consumers are likely to hunker down for some time.

Consumer deleveraging is already well underway. Notwithstanding an unsustainable increase in January retail sales, real consumer spending likely declined for the third straight quarter in Q1, which has never occurred in at least 62 years. The personal savings rate has gone from almost nothing in 2007 to 1.7% in 2008 (and 3.6% in December). Meantime, household debt is falling for the first time since record-keeping began in 1952.

Americans should continue to pinch pennies until their dilapidated fiscal houses return to pre-boom levels. From 1997 to 2006, demand was supported by inflated wealth stemming from the equity and housing bubbles, with the latter also fuelling excessive borrowing through home equity extractions (*Chart 1*). Now it's payback time, meaning the savings rate will likely climb to mid-1990 levels (and long-run norms) of 6% and remain there for some time (*Chart 2*).

The transition to a higher savings rate would mark the biggest shift in American shopping habits in the post-war period. It would reduce the share of personal spending from 70% of GDP to pre-boom levels of 67% by 2011. It would also generate $2 trillion of household savings over three years, which, along with some upturn in equity markets, should help restore personal wealth to long-term trends (*Chart 3*). Importantly, the extra savings (alongside a cumulative 6% increase in income) should reduce household debt from 130% of disposable income to 105% by 2011, in line with its trend (*Chart 4*). This would reduce debt-service payments to pre-boom levels (and long-run norms) of 11% of disposable income by 2011. Debt could fall even faster than expected owing to mortgage write-downs and the limited appetite for borrowing to purchase assets, like houses and cars.

CHART 4

DEBT BINGE...

United States (% of personal disposable income)

Household Debt

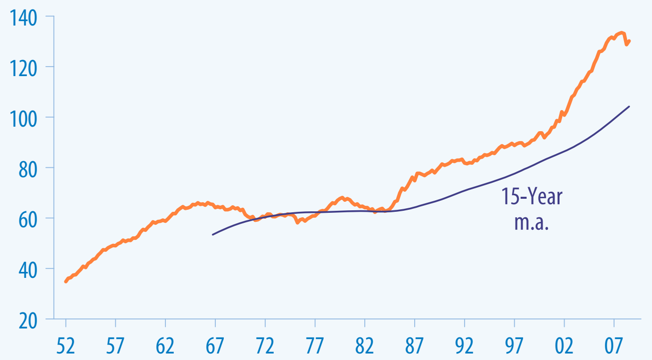


CHART 5

...CONSUMER HANGOVER

United States (y/y % chng : annual)

Personal Consumption Expenditures

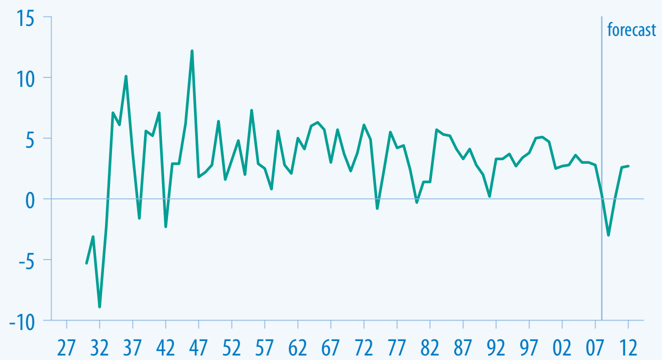
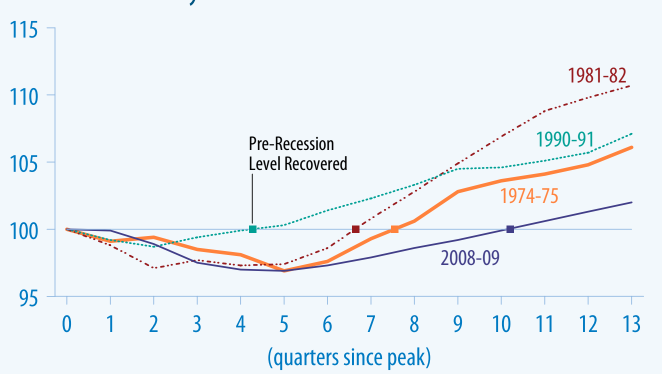


CHART 6

DANCING PEAK TO PEAK

United States (index : pre-recession peak of real GDP = 100)

Economic Recovery Paths of Last Four Recessions



Consumer belt-tightening will reduce the level of real GDP an estimated 5% over the next two years, compared with a scenario in which the savings rate stays at 2008 levels. Personal consumption is expected to contract this year at the fastest rate since 1932 (*Chart 5*), leading to the worst economic performance since the Depression, as measured by the length and depth of the current recession and the ensuing shallow recovery (*Chart 6*). The economy is not expected to return to full employment until around 2015, keeping a tight grip on inflation despite massive money growth.

A key risk to the economic outlook is that savings could climb even more than we assume. The $10 trillion collapse in household wealth in the past year has seriously drained retirement nest eggs just when senior baby boomers are poised to retire. If they choose to spend less over working longer, the economy could operate below capacity for many years, echoing Japan's "lost decade".

With households stretched and the economy operating well below capacity, manufacturers of durable goods and business equipment face daunting market conditions. Sellers of big-ticket discretionary items (like autos, furniture and travel packages) in particular will feel the pinch. Declining sales-tax revenue will carve further into state budgets. Commercial property owners will see rising vacancy and delinquency rates.

Americans are no longer the consumer of last resort to a struggling global economy, which explains why Japan recently shrank the fastest in 34 years and China is slowing sharply. Prolonged global weakness will limit the upside to commodities and related investments. Canada is in its first recession in 17 years, and a subdued recovery is expected next year. On the bright side, interest rates should remain very low for another year at least.

Bottom Line: For over a decade Americans shopped 'til they dropped. They will likely stay down for the count, prolonging the recession and damping the eventual recovery.