

CONSUMER LIQUIDITY SPECIAL REPORT

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Real Median Household Income in 2008 Fell Below 1973 Level

Income Dispersion Intensified in 2008

Restricted Income and Credit Expansion Inhibit Economic Growth

Economic Crisis Is Far from Over

OVERVIEW

Structural Problems Intensify for U.S. Economy. The structural problems impairing consumer liquidity are getting worse and impose severe constraints on U.S. economic activity. Accordingly, the current economic downturn -- already the longest and deepest since the first downleg of the Great Depression in the 1930s -- will continue to be particularly protracted and deep, as well as unresponsive to traditional stimuli (see <http://www.shadowstats.com/article/depression-special-report>).

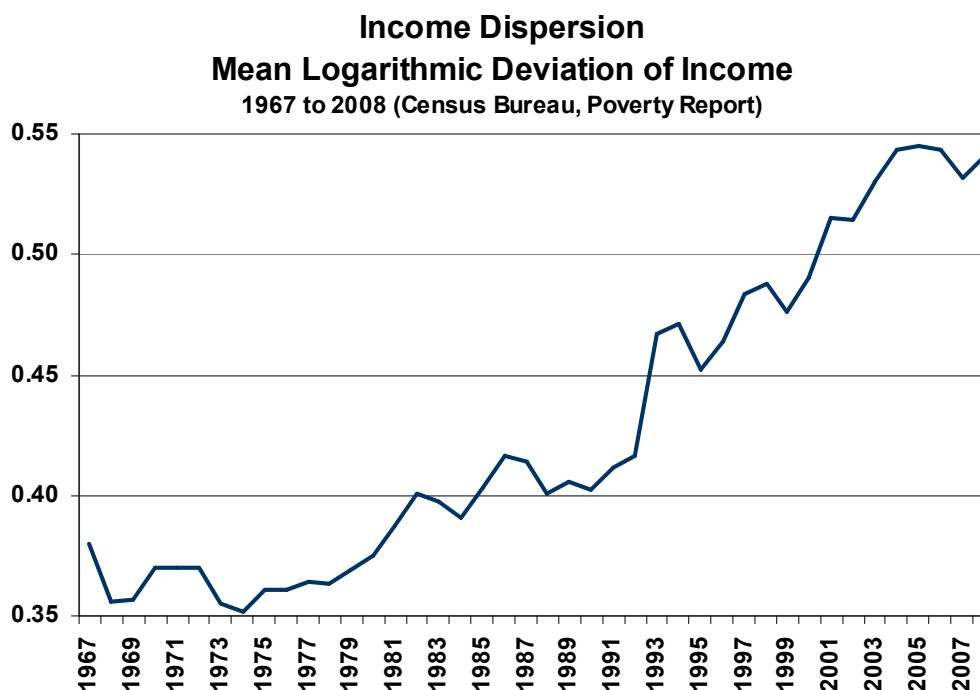
Income drives consumption, and sustainable real, or inflation-adjusted, growth in economic activity requires sustained real growth in consumer income. Shy of income growth, temporary economic growth can be supported by debt expansion or liquidation of savings. Recent economic reporting has shown not

only that real growth in household income has failed to keep up with inflation, but that consumer debt and net worth are contracting at paces previously not seen in the post-World War II era.

The Census Bureau's annual survey of *Income, Poverty, and Health Insurance Coverage in the United States: 2008* (Poverty Report), published on September 10th, updated key consumer income measures as of the 2008 calendar year, showing rising income dispersion and declining inflation-adjusted estimates of median and mean household income. At present, those trends appear likely to be repeated when 2009 data are made available one year from now.

Rising Income Dispersion Usually Foreshadows Economic and Financial Market Turmoil.

Measures of income dispersion, or variance, indicate how income is distributed within a population. A low level of income dispersion indicates that income tends to be concentrated in the middle, while a high level of dispersion indicates heavier income concentrations in the extremes of low and high income, with less in the middle. The higher the deviation of income is in the graph, the greater the income dispersion.



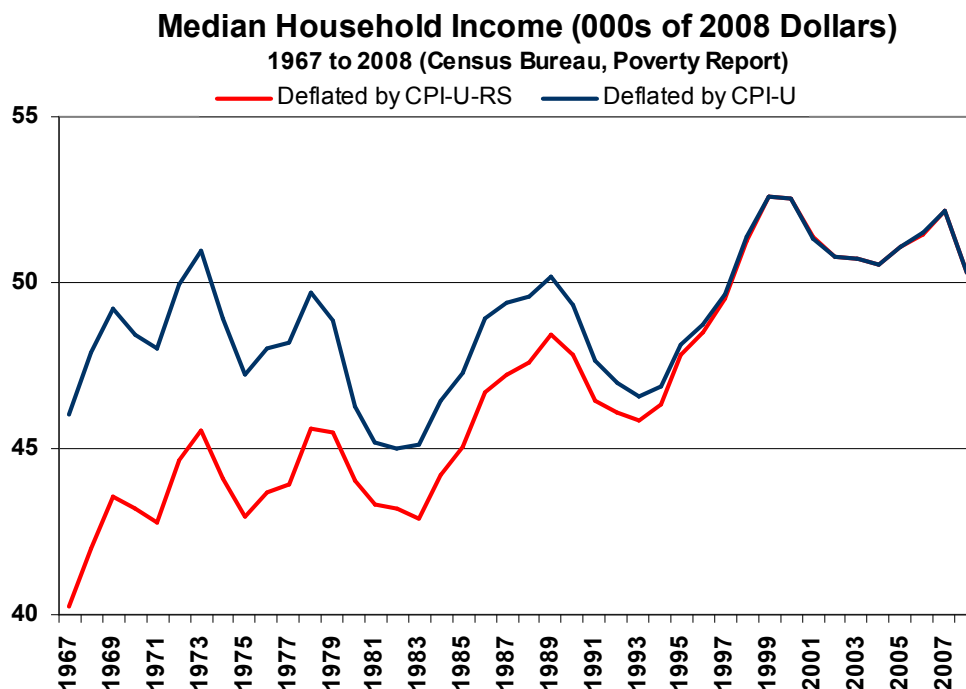
Generally, the more moderate the income variance is, the stronger the middle class is, and the healthier the economy will be. Conversely, the greater the variance in income is, the more negative are the longer term economic implications. A person earning \$100,000,000 per year is not going to buy proportionately more automobiles than someone earning \$100,000 per year.

Conditions surrounding extremes in income variance usually help to fuel financial-market bubbles, followed by financial panics and economic depressions. The sequence of those factors tends to redistribute income in a manner that usually lowers income variance. Other than for a brief dip following

the 1987 stock crash, however, U.S. income variance since 1987 has been higher than has been estimated for the economy going into the 1929 stock crash and the Great Depression, and its current reading remains nearly double that of any other "advanced" economy.

The increase of income dispersion in 2008, despite the economic and systemic liquidity crises, suggests that the greatest negative impact of that turmoil has been on those in the middle-income area. It also is suggestive of ongoing financial crises still ahead.

Real Household Income Never Recovered Its Pre-2001 Recession Peak. The next two graphs show inflation-adjusted median and mean levels of household income from 1967 through 2008. The median measure is the middle measure of the survey and likely is a better reflection of how the average household is doing. When the income dispersion measure is high, the mean, or average, measure tends to be skewed (in this case to the upside). Nonetheless, both measures showed sharp, inflation-adjusted declines in 2008, and neither series has topped the annual high levels seen before the 2001 recession, with real median and mean household incomes hitting their respective tops in 1999 and 2000.

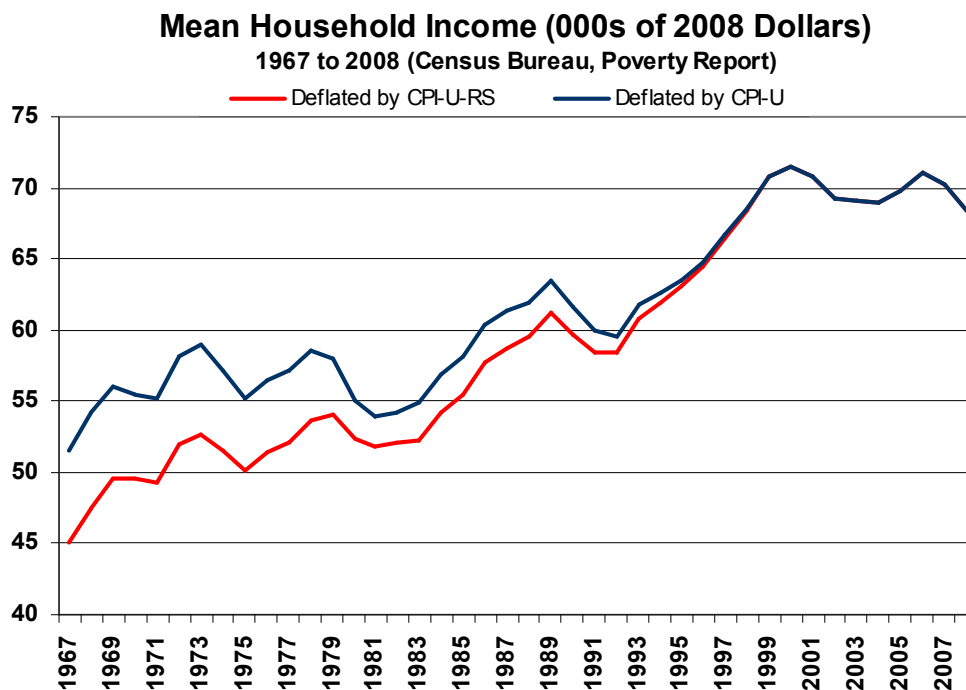


Please note that both series are shown with household income deflated using two Bureau of Labor Statistics (BLS) inflation measures, the CPI-U and the CPI-U-RS. Using the SGS-Alternate CPI for deflation, both series topped in 1973.

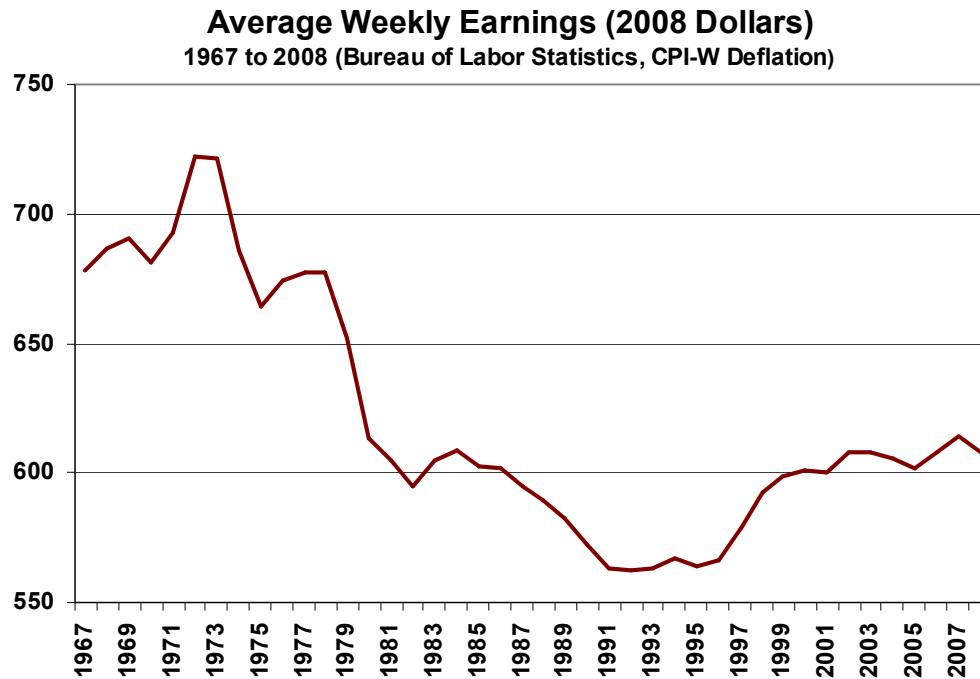
The CPI-U (All Urban Consumers) is the headline consumer inflation number published by the BLS and the one most commonly used in deflating consumer-related dollars. The CPI-U-RS (Current Methods) is a special version of the CPI-U with its history restated so as to reduce earlier-year inflation by imputing what it would have been using today's "advanced" CPI reporting methodologies. The CPI-U-RS is the index used by the Census Bureau in deflating income numbers in the Poverty Report.

As discussed in prior writings (see <http://www.shadowstats.com/article/special-comment>), methodological shifts in CPI reporting of the last several decades generally have moved reporting of official CPI inflation away from common experience, as well as away from the concept of CPI inflation as a measure of the cost of living of maintaining a constant standard of living. In an attempt to restate the CPI of today as it would have been if 1980's methodologies were in use today, I reverse-engineered the CPI-U-RS so as to provide estimates of annual adjustments needed to offset the impact of the changes. The resulting SGS-Alternate CPI currently adds about seven percentage points to the official annual CPI, of which roughly five percentage points come directly from the CPI-U-RS.

Any way the official government inflation numbers are used, the basic tale told here is the same as would be told using the SGS-Alternate CPI, so I am concentrating on using the government numbers in these charts, without introducing any controversy as to the SGS inflation estimates. The case obviously would be more severe using deflation with the SGS estimates. Using the CPI-U for deflation, rather than the CPI-U-RS, the median household income in 2008 was below the pre-1973 to 1975 recession high.



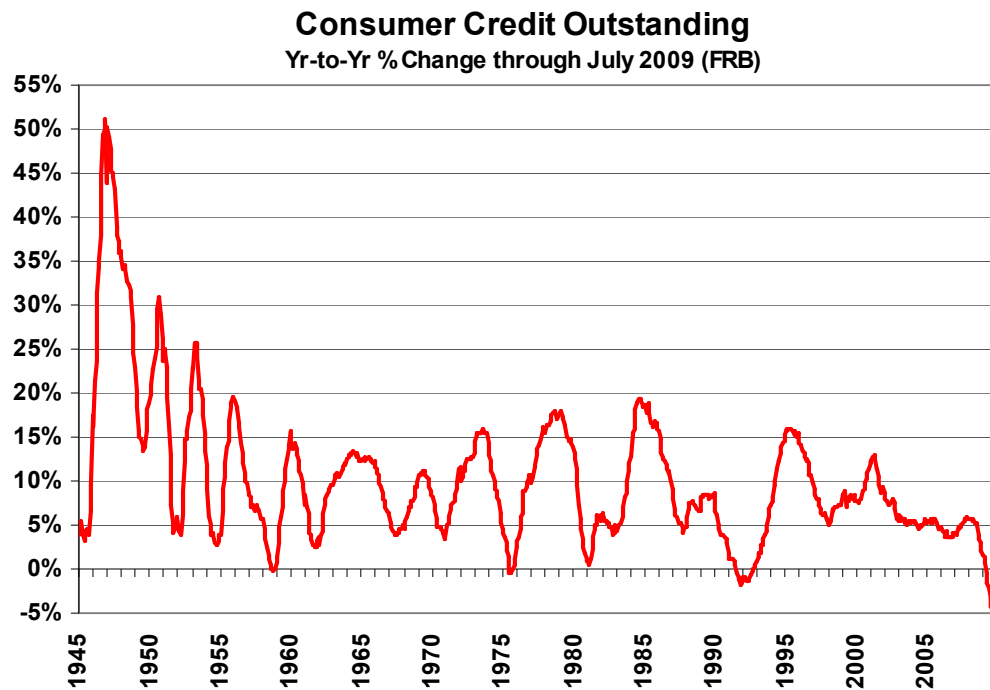
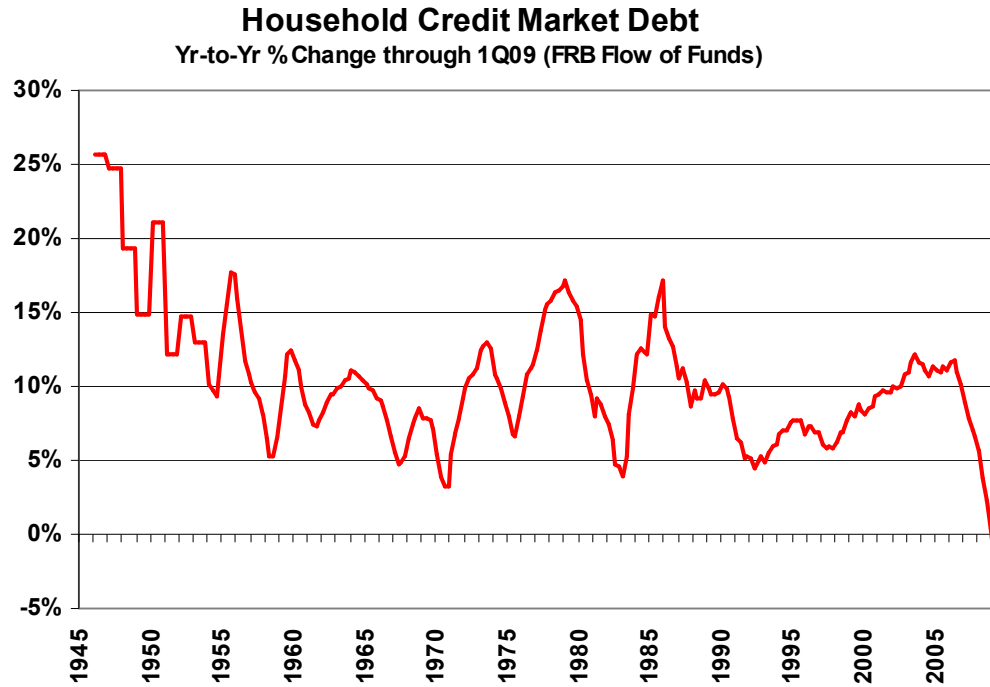
Minimally, households have been seeing lower inflation-adjusted income for a decade or so. Yet, as suggested by the CPI-U-deflated median household income (and the SGS deflation of both series), real income has been an increasing problem for consumers since before the 1973 to 1975 recession. Consider the following graph of the annual level of average weekly earnings, shown in 2008 dollars, as deflated by the CPI-W (CPI for Urban Wage Earners and Clerical Workers, a somewhat narrower measurer than the CPI-U, used by the BLS in deflating average weekly earnings). As of 2008, real earnings were down 15.8% from their 1972 peak.

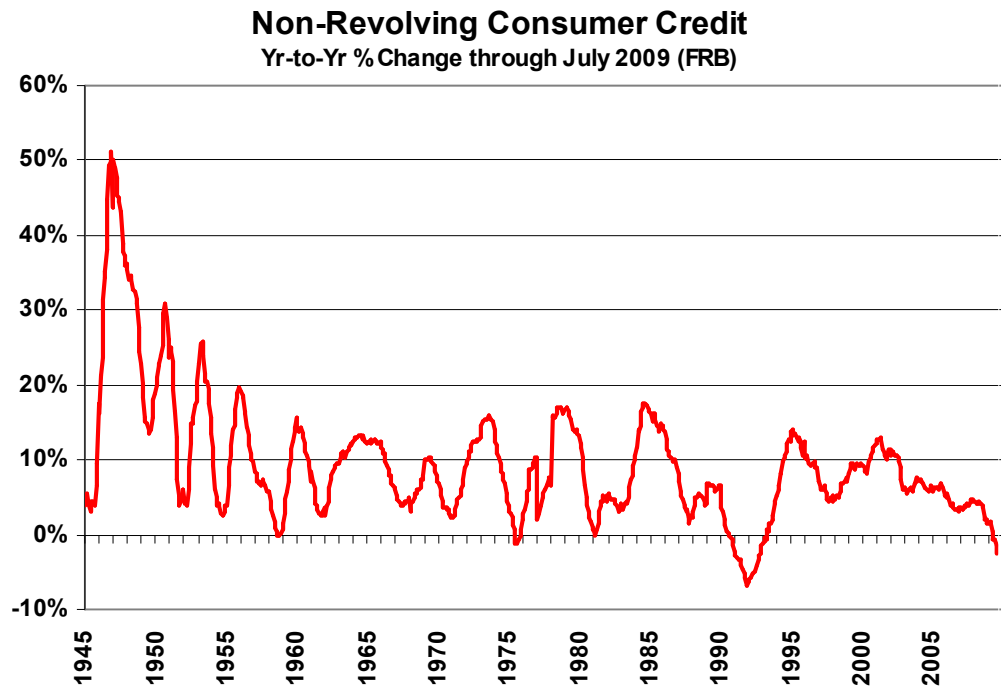
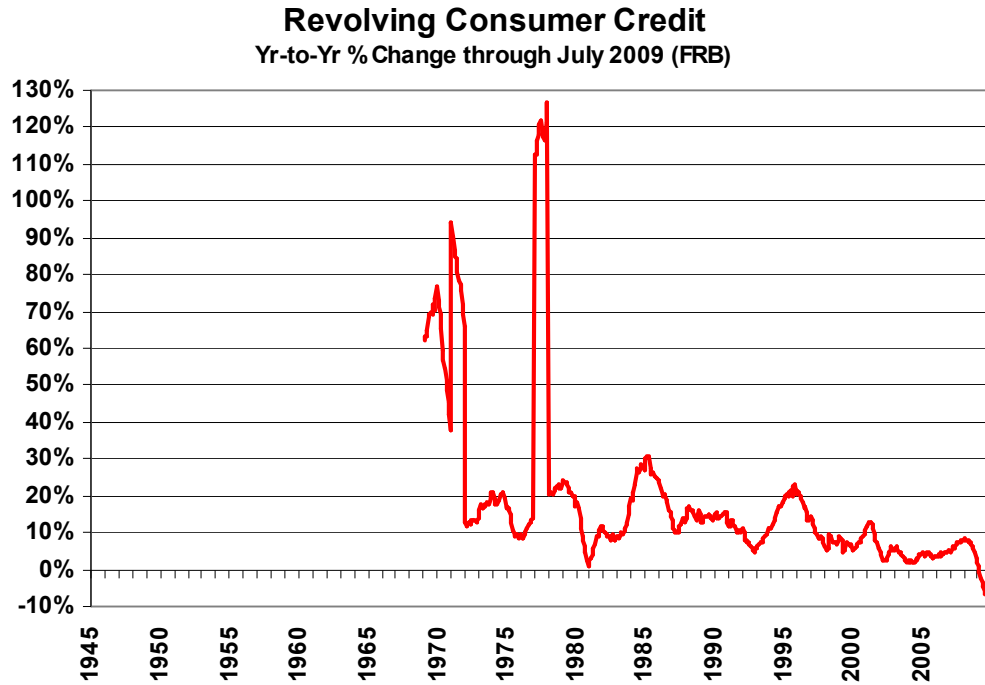


As the U.S. trade deficit exploded, and higher paying U.S. production jobs were lost to offshore competition, the household of the early 1970s began to change. Increasingly, homes where one person worked (usually the husband, with the wife staying home with the children) shifted to having two or more people in the household working, in order to make ends meet.

Even so, the official numbers show households struggling to make ends meet for at least the last decade. Without adequate income growth, consumers met their consumption needs and/or desires through expanded debt. Such activity was encouraged openly by Federal Reserve Chairman Alan Greenspan, and the bulk of economic growth in recent years, as a result, was due largely to debt expansion, not to healthy growth in consumer income.

Unprecedented Contractions in Consumer Borrowing. The next series of four graphs reflects the history of consumer borrowing in the post World War II period. Household credit market debt (including mortgages) is total consumer debt as reported in the quarterly flow-of-funds analysis published by the Federal Reserve. The first-quarter 2009 showed the first post-war annual contraction in the series. Consumer credit outstanding which includes credit cards, auto loans and other revolving and non-revolving credit (not mortgages) showed its steepest post-war decline in July 2009.

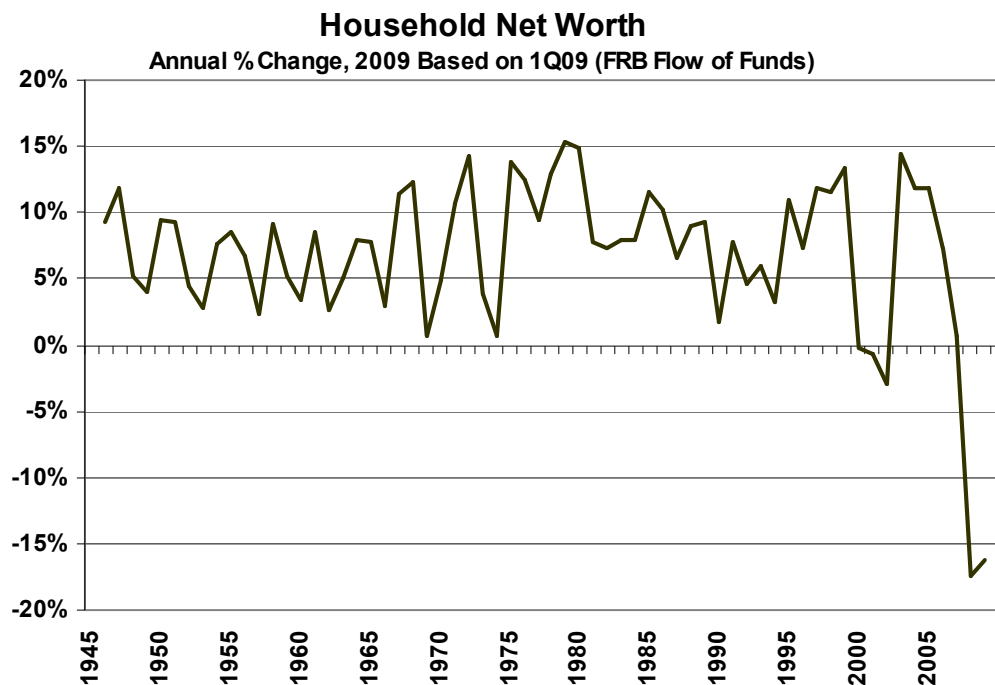




The Fed tracks credit cards (revolving credit) since the late-1960s. The current annual decline in credit card debt outstanding is the first for the series and, in conjunction with a smaller annual decline in non-revolving credit, has pulled overall consumer credit annual growth to its historic low.

Unfortunately for the U.S. economy, its engine of growth has stalled. Weak real incomes and contracting consumer credit are not the stuff of which economic booms, let alone recoveries, are made. Ahead, with rising unemployment, with rising inflation prospects from weak-dollar-induced higher oil prices, with bank lending contracting, how can the economy be rebounding other than for occasionally manipulated blips?

Consumers have and still can liquidate their savings -- their net worth -- in order to make ends meet, but even here there prospects are not happy. Consider the following graph of household net worth from the Federal Reserve's flow-of-funds data. The growth includes not for profit institutions but is dominated by households. Despite quality issues with the Fed's data, the estimates are the best available.



The record annual decline seen in household net worth includes declining equity and real estate values. While equity values have jumped sharply in recent months, Treasury Secretary Geithner's hope of rekindling economic activity with higher stock prices does little to stimulate consumer income, and it is not likely to be durable, as horrendous economic, U.S. dollar and fiscal fundamentals take their eventual tolls on the equity market.