



# Flow of Funds

September 19<sup>th</sup> 2008

## 2Q08 Flow of Funds

- Credit supply for businesses remains solid
- However, profitability is under pressure
- As a result, we expect private investment to slow down
- Personal consumption will decelerate as personal savings increase and households' net worth decreases

### Businesses under increasing pressure

In 2Q08 business debt growth remained solid at 10.1% year-over-year (yoy). However, it was the lowest rate since 3Q06 and around 2 percentage points lower than in the first quarter. Thus, while firms have been able to find funding, total availability appears to be shrinking. In addition, credit supply experienced high volatility in some segments. For example, commercial paper decreased 9.4%, the first decline in almost two years, while corporate bonds slowed to 7.9%, the lowest rate in five quarters. In contrast, trade payables rose 11.9%, the highest rate since 1Q06, while bank loans increased 19.9%, the highest since 4Q73. These trends reflect ongoing financial distress and higher risk perception.

In 2Q08 business profits declined 15.2% year-over-year following a 13.6% drop in the previous quarter. This was the sixth consecutive decrease and the largest in six years. Negative readings of this magnitude are typically associated with economic recessions. The ratio of profits to GDP declined further to 6.6%, almost 2.4 percentage point below their recent peak in 3Q06. These trends suggest that firms have less internally-generated funds to finance their investment needs. Therefore, downside risks on private investment have increased significantly. Firstly, as credit supply becomes scarcer and costlier, and secondly, as firms adjust their capital investment plans to lower profitability.

### PCE will moderate significantly

Households' net worth declined 5.2% yoy, following a drop of 1.5% in the previous period. This was mainly the result of ongoing losses in the value of real estate assets and a 2.4% decrease in financial wealth, the first since 1Q03. In fact, owners' equity in real estate fell 11.2% setting a new record low. As a result, net mortgage equity withdrawal fell for the first time in eight years. Net worth was also dragged down by a 4.3% increase in total debt; nonetheless, this was the slowest pace in more than 25 years. In fact, the quarterly increase in mortgage debt was the lowest since 1Q95.

Meanwhile, the personal savings rate increased to 2.6%, the highest since 3Q98. This probably reflected that a large share of tax rebates was not spent. In fact, this was the first quarter in six years that the increase in savings surpassed that of debt. Going forward, lower wealth and higher savings will result in lower personal consumption growth during 2H08 and probably throughout 2009.

**Nathaniel Karp**  
nathaniel.karp@bbvausa.com

**Marcial Nava**  
marcial.nava@bbvausa.com

### U.S. Nonfarm Nonfinancial Business Balance Sheet

US\$ trillions

	2Q08	1Q08	2Q07	YoY % change
<b>Total assets</b>	29.0	28.8	27.2	6.8
Tangible assets	14.9	14.8	13.8	8.0
Real Estate	9.0	9.0	8.3	9.0
Equipment and Software	4.0	3.9	3.8	4.5
Inventories	1.9	1.9	1.7	10.7
Financial assets	14.1	14.0	13.4	5.5
<b>Total Liabilities</b>	12.9	12.8	12.2	5.2
Credit market instruments	7.0	6.9	6.4	9.4
Trade payables	2.2	2.1	1.9	13.4
Taxes payable	0.1	0.1	0.1	1.4
Other	3.6	3.7	3.8	-5.9
<b>Net worth (market value)</b>	16.2	16.1	15.0	8.0

Source: Fed; Nonfarm Nonfinancial Corporate Business

### U.S. Household Balance Sheet

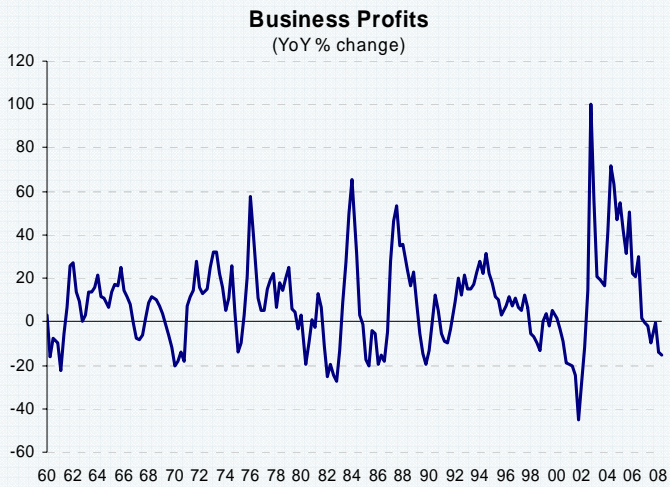
US\$ trillions

	2Q08	1Q08	2Q07	YoY % change
<b>Total assets</b>	70.5	70.9	72.0	-2.0
Tangible assets	26.1	26.3	26.5	-1.5
Real Estate	21.8	22.0	22.3	-2.5
Other tangible assets	4.4	4.3	4.2	4.2
Financial assets	44.3	44.6	45.4	-2.4
Checkable deposits and money funds	1.5	1.5	1.4	9.7
Time and savings deposits	5.9	6.0	5.6	4.6
Credit market instruments	4.1	4.1	3.9	6.7
Equities (direct)	4.9	5.0	6.1	-20.1
Mutual funds	4.9	5.0	6.1	-20.1
Life insurance and pension reserves	13.5	13.5	14.3	-5.9
Equity in unincorporated business	7.8	7.8	7.6	2.8
Other financial assets	1.7	1.7	1.4	19.9
<b>Total Liabilities</b>	14.5	14.5	13.9	3.9
Mortgages	10.6	10.6	10.3	3.7
Consumer credit	2.6	2.5	2.4	5.4
Other	1.3	1.4	1.3	3.1
<b>Net worth</b>	56.0	56.4	58.0	-3.5
<b>Financial net worth</b> (financial assets minus total liabilities)	29.8	30.1	31.5	-5.2

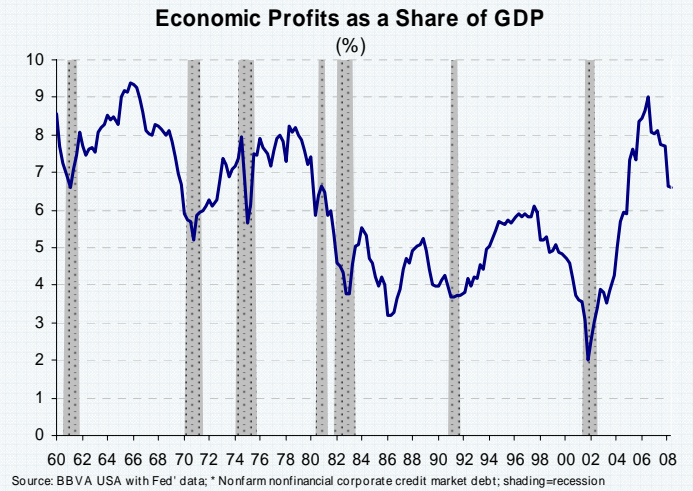
Source: Fed; includes nonprofit organizations

# Business Sector

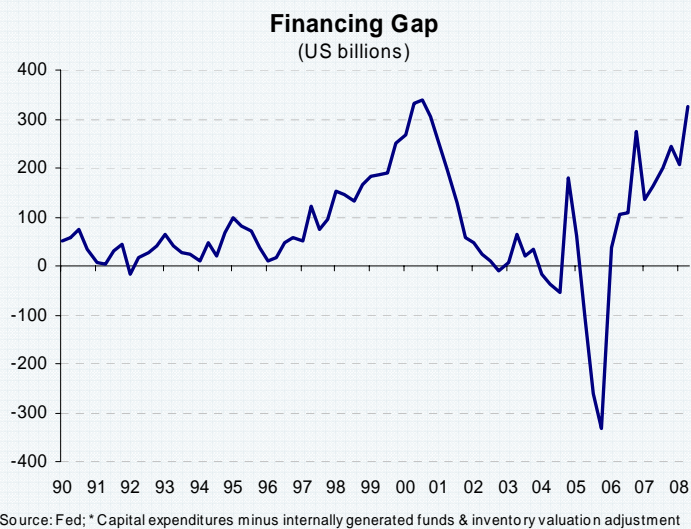
Business profits continue declining



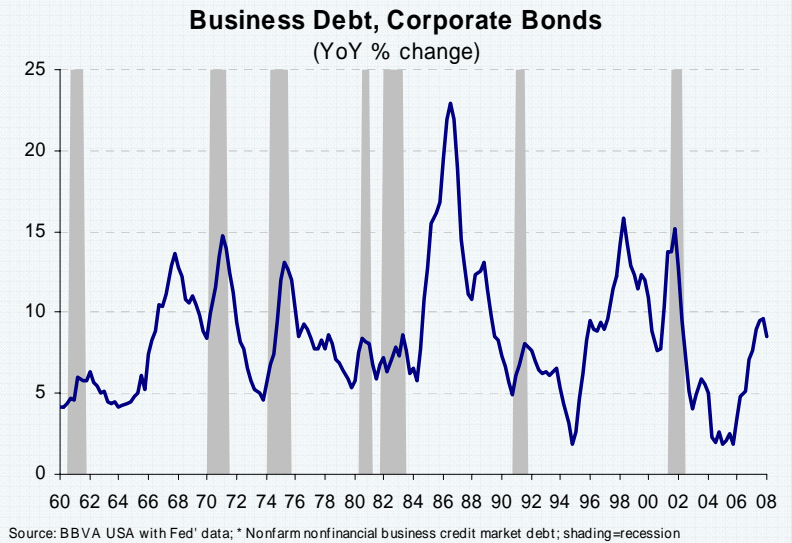
As a result, the share of profits to GDP will adjust further



Declining profits force firms to seek external funding

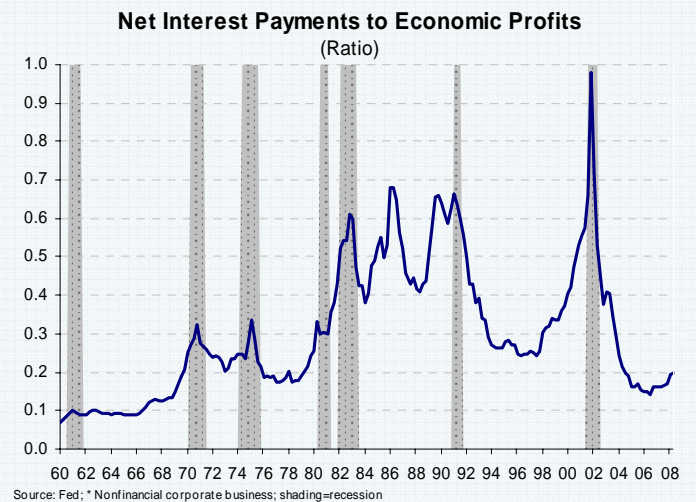
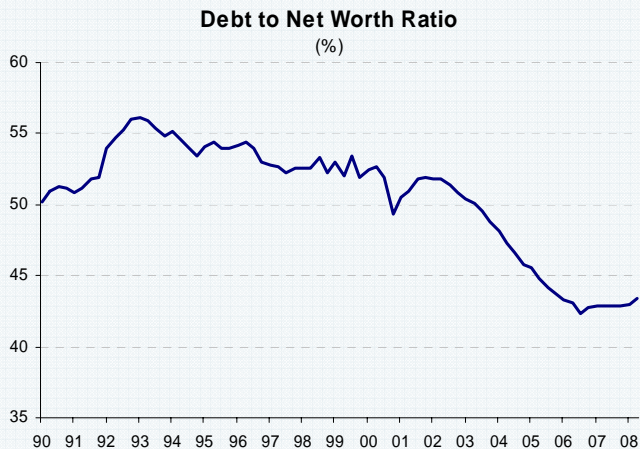


However, businesses face tighter credit conditions



Despite these trends, the debt burden remains contained

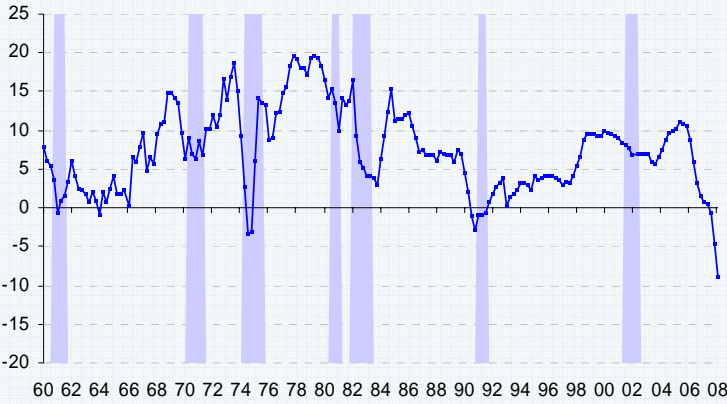
And solvency is under control



# Household Sector

Declining home prices impact real estate assets

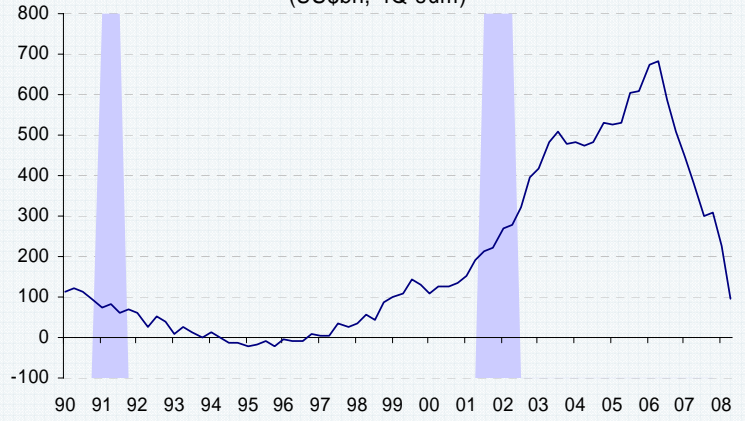
**Owners' equity in household real estate**  
(YoY % change)



Source: BBVA USA with Fed's data; shading=recession

As a result, MEW continues falling

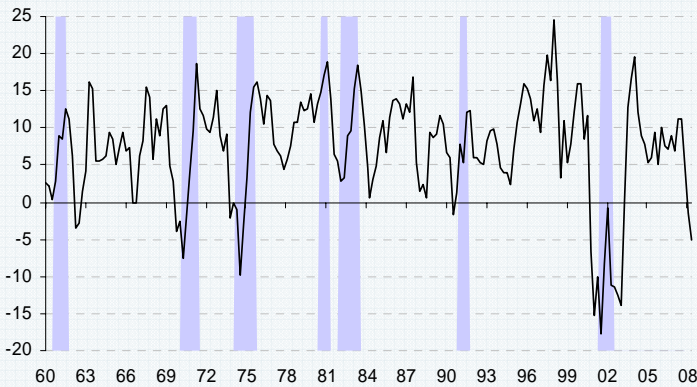
**Mortgage Equity Withdrawal**  
(US\$bn, 4Q sum)



Source: BBVA USA with Fed's data; shading=recession

Market turmoil is reducing financial wealth

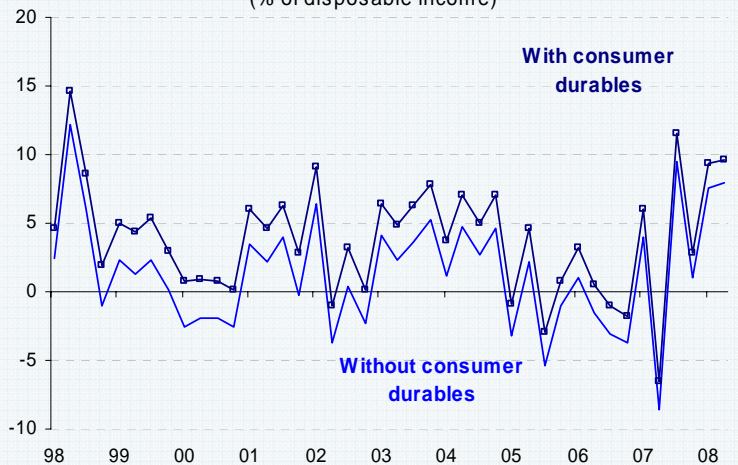
**Financial net worth**  
(YoY % change)



Source: BBVA USA with Fed's data; shading=recession

Tax rebates incentive savings...

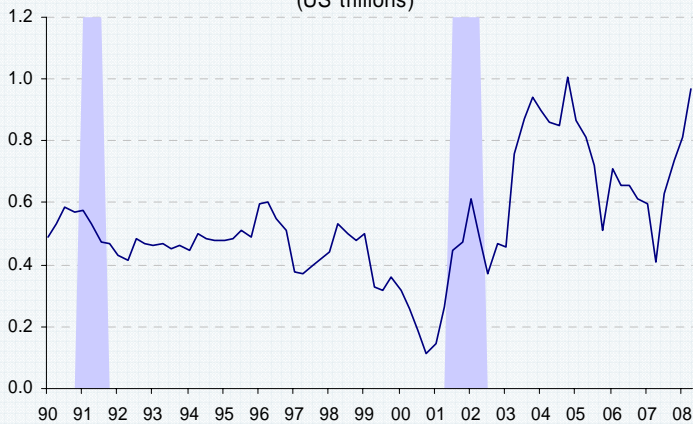
**Personal Savings Rate**  
(% of disposable income)



Source: BBVA USA with Fed data

...mostly used to acquire financial assets

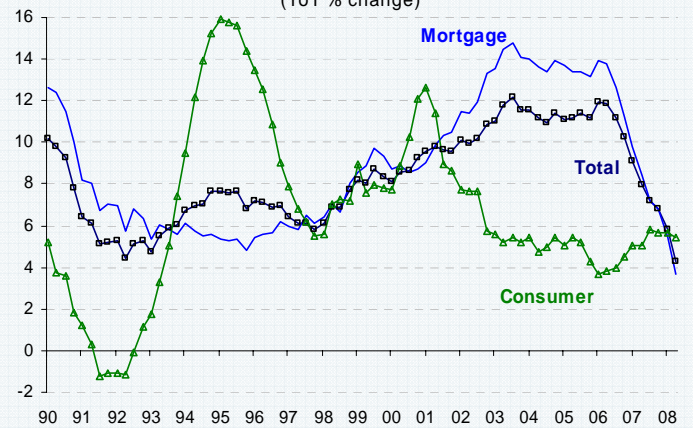
**Net Acquisition of Financial Assets**  
(US trillions)



Source: BBVA USA with Fed's data; shading=recession

Household debt is likely to shrink further

**Household Debt**  
(YoY % change)



Source: BBVA USA with Fed data; Outstanding credit market debt