

# Flow of Funds

September 25<sup>th</sup> 2007

## Second Quarter 2007

- Business debt growth continued during the second quarter of 2007
- Currently the market for commercial paper is “dry” and corporations might rely on either cash reserves or equity for financing
- Household net worth losses momentum and real estate equity reaches the lowest level since 1991

Corporations had a small increase in inventories, which rose less than two tenths of a percent reaching 12.6 trillion, but corporate business net worth rose in 2Q07. The household sector is the principal contributor to the slowdown in non-financial sector borrowing; this deceleration in household debt is consistent with the pattern observed in the last four quarters. Under current conditions, households are not curbing their credit for consumption, such as credit cards, but rather downsizing the growth in the demand for credit used for real estate investments as the housing market continues to adjust. At the same time that households are slowing down their borrowing relative to disposable income, corporations are increasing significantly their borrowing while maintaining their other liabilities unchanged; most of this increase in corporate borrowing is explained by the commercial paper market dryness derived from the sub-prime mortgages spillover effects.

Currently the market for commercial paper is “dry” and corporations might rely on either cash reserves or equity for financing. This could reverse the pattern of “massive” retirement of equity via buy-outs and/ or mergers observed during the last two years. Also, corporate borrowing during 2Q07 increased significantly from 1Q07; this change in corporate borrowing might be explained also, at least in part, by the dryness of the commercial paper market.

During the late 1990s corporations used the market for commercial paper to retire some of their own equity; however, during the current economic expansion most of the retirement of equity was done using after tax profits rather than commercial paper. Under a scenario of moderate economic growth corporate profits might also slowdown putting an end to the buy-out frenzy, in which case the stock market might turn bearish as equity becomes again the preferred financing vehicle.

Household net worth losses momentum and real estate equity reaches the lowest level since 1991. Also, mortgage equity withdrawal (MEW) continues to slow significantly; it fell to 3.0% y-o-y of disposable income. In addition, owner's equity growth continues to fall, this trend added to the falling (MEW) are consistent with our expectations of gradual moderation in households consumption.

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### U.S. Business Balance Sheet

US\$ trillions

	Q207	Q107	Q406	YoY % change
<b>Total assets</b>	26.4	25.8	25.4	4.0
Tangible assets	13.8	13.4	13.1	5.7
Real Estate	8.3	7.9	7.7	7.8
Equipment and Software	1.7	1.7	1.7	3.0
Inventories	12.6	12.4	12.4	2.1
Financial assets	0.1	0.0	0.1	-19.2
<b>Total Liabilities</b>	6.1	5.9	5.7	5.8
Credit market instruments	0.2	0.1	0.1	36.2
Trade payables	0.1	0.1	0.1	9.3
Taxes payable	3.4	3.5	3.6	-7.0
Other	15.1	14.6	14.2	6.3
<b>Net worth (market value)</b>	20.4	20.0	19.7	-1.8

Source: Fed; Nonfarm Nonfinancial Corporate Business

### U.S. Household Balance Sheet

US\$ trillions

	Q207	Q107	Q406	YoY % change
<b>Total assets</b>	71.7	70.2	69.2	3.5
Tangible assets	27.4	27.1	26.7	2.4
Real Estate	23.2	22.9	22.6	2.5
Other tangible assets	4.2	4.1	4.1	2.2
Financial assets	44.3	43.1	42.5	4.2
Checkable deposits and money funds	1.2	1.1	1.2	3.7
Time and savings deposits	5.4	5.4	5.2	3.8
Credit market instruments	0.2	0.2	0.2	5.4
Equities (direct)	5.1	4.8	4.6	11.8
Mutual funds	1.2	1.2	1.2	3.2
Life insurance/pension reserves	8.6	8.3	8.1	5.3
Equity in unincorporated business	13.8	13.5	13.4	3.5
Other financial assets	25.9	25.2	25.0	3.8
<b>Total Liabilities</b>	10.1	10.0	9.8	3.8
Mortgages	0.2	0.2	0.2	5.3
Consumer credit	0.1	0.1	0.1	4.8
Other	9.8	9.6	9.5	3.8
<b>Net worth</b>	0.3	0.3	0.3	0.2
<b>Financial net worth</b>	34.1	33.1	32.7	4.3

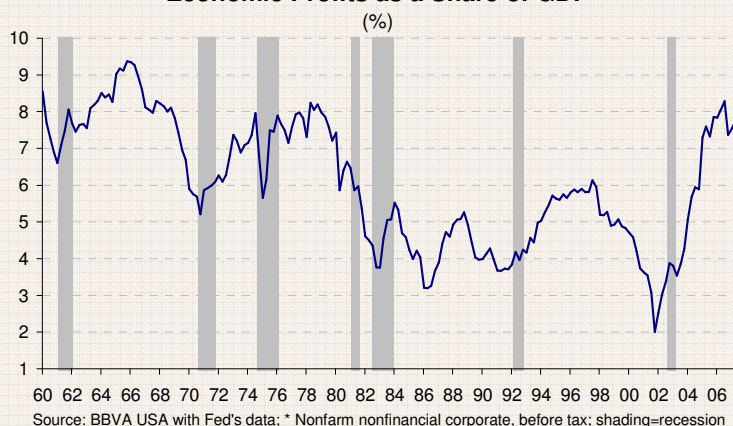
(financial assets minus total liabilities)

Source: Fed; includes nonprofit organizations

## Business Sector

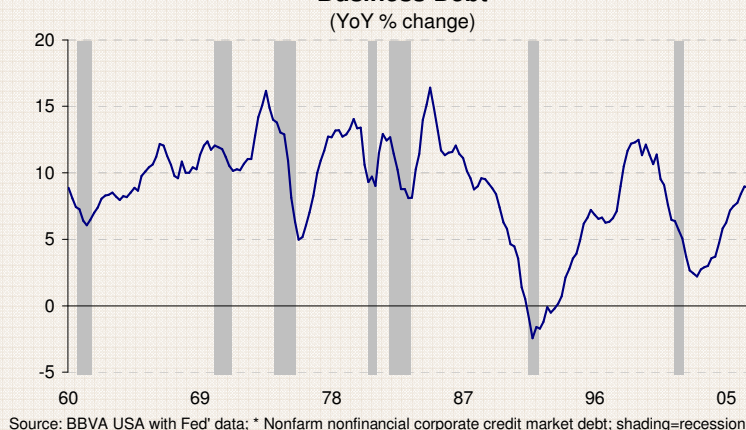
Corporate profits rebounded during Q2-2007 compared to the previous quarter, but the levels are lower than Q4-2006

**Economic Profits as a Share of GDP**



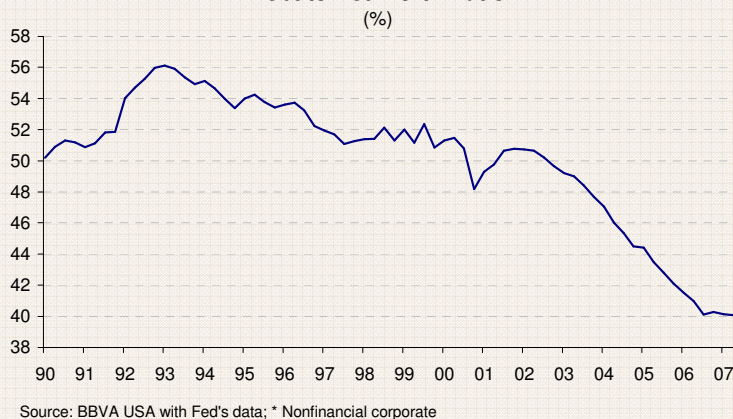
Business debt growth continues during Q2-2007.

**Business Debt**



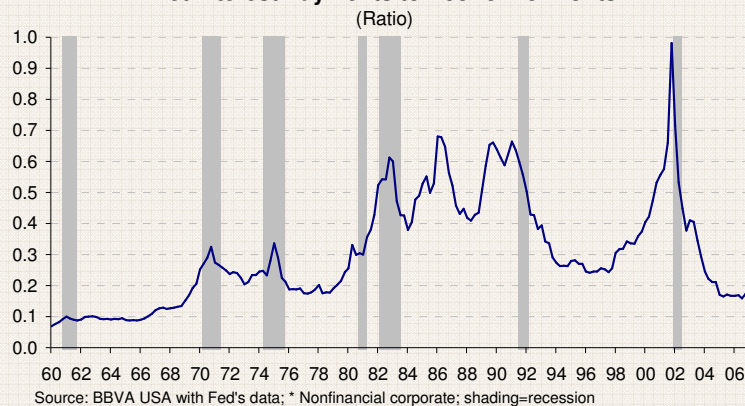
The debt to net worth ratio remains low at around the same value from 1Q07 and 4Q06.

**Debt to Net Worth Ratio**



The coverage ratio (interest payments to corporate profits) remains low but stable with almost no changes compared to the previous quarter

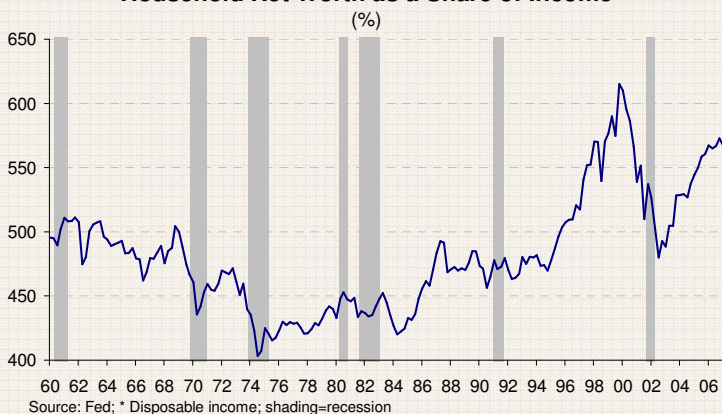
**Net Interest Payments to Economic Profits**



## Household Sector

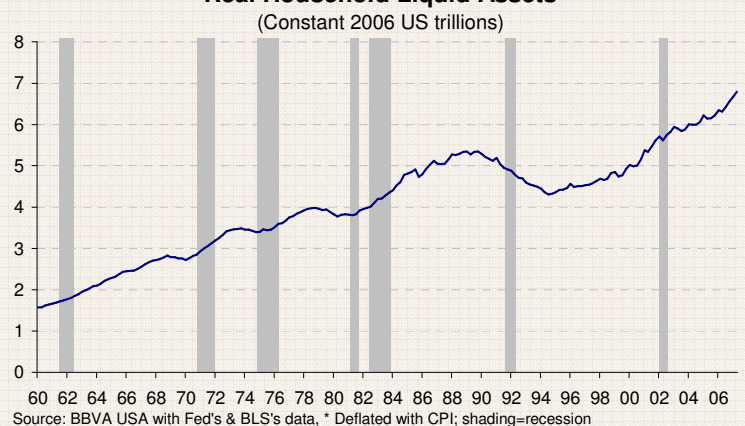
Household net worth grew 0.8% y-o-y consistent with the pattern of deceleration observed during previous four quarters.

**Household Net Worth as a Share of Income**

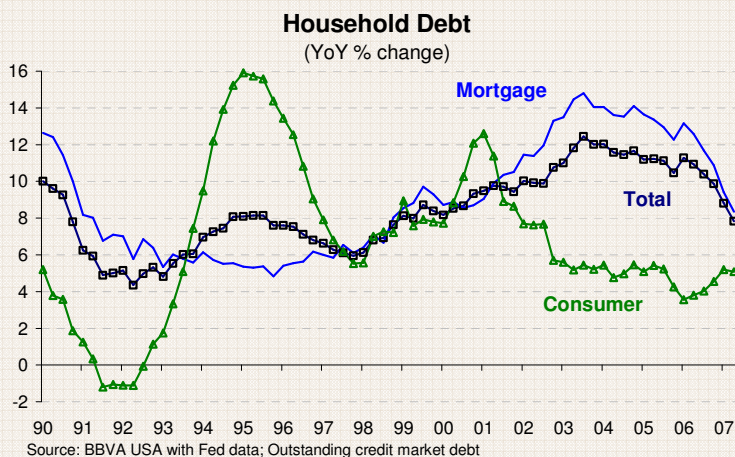


Liquid assets sustained growth continues reaching the highest historical level in 2Q07

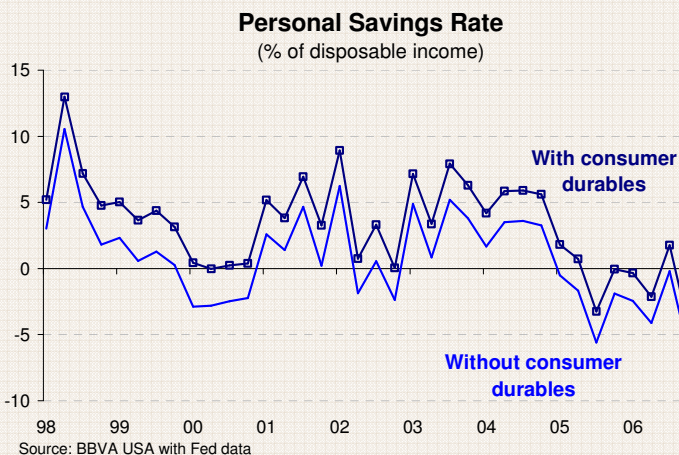
**Real Household Liquid Assets**



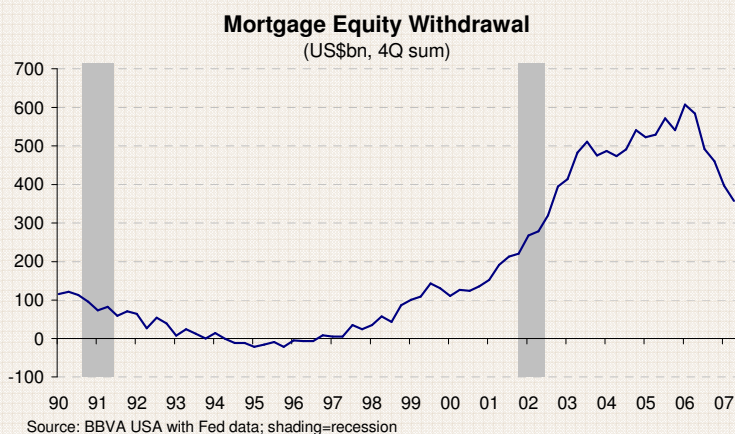
Household debt deceleration continued during 2Q07 consistent with the pattern observed in the last four quarters



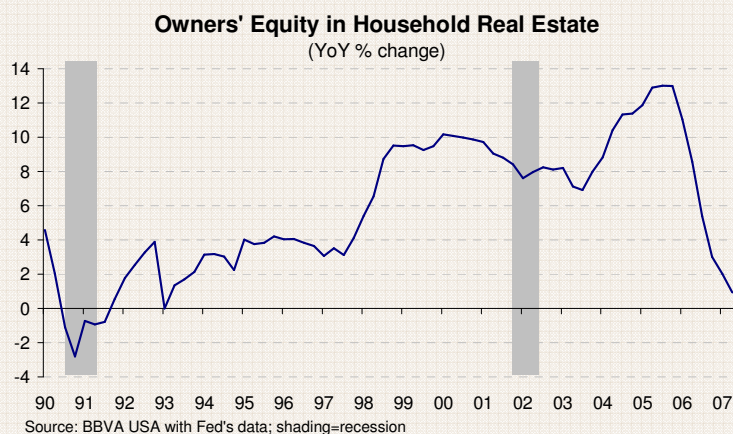
The personal savings rate remains low on 2Q07 losing the ground gained during 1Q07



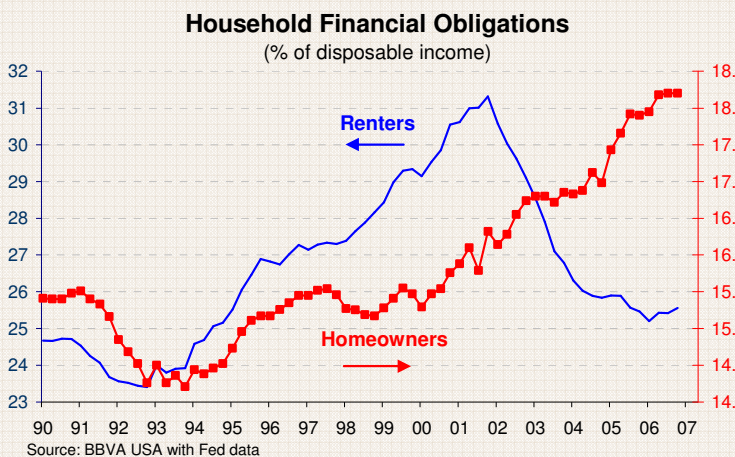
Mortgage equity withdrawals (MEW) continues to slowdown and it is back to the level observed in 2Q02.



The correction in house prices continues and the negative effects on owners' equity are expected to increase.



There is no change in Homeowner's financial obligations; renters' financial obligations are increasing compared to the previous quarter.



Net acquisition of financial assets is stabilizing from the sudden decrease observed during 1H05 and 2H06

