Irrational Exuberance Strikes Again!

April 27, 2020
by Mark Martella

In 1996, Federal Reserve Board Chairman Alan Greenspan used the phrase **“irrational exuberance”** to address the then-burgeoning internet bubble in the stock market. Today, I believe that same phrase can undoubtedly be used to describe **American consumers’ addiction to credit and their “irrational exuberance” mindset** when it comes to the use of credit, whether we are examining mortgages, credit cards, car loans or student loans.

Household Debt by the Numbers

Total household debt in the United States increased in the fourth quarter of 2019 by $193 billion to reach a total of **$14.15 trillion for the end of 2019**. This marks the 22nd consecutive quarter that there has been an increase. To get some perspective on this amount of debt, these five and a half years of continued growing debt has put us **$1.5 trillion dollars higher** than our total previous high debt in the third quarter of 2008. We all remember what happened back then.

By trade, I am not an economist. My practice primarily consists of consumer bankruptcy representation and debt negotiation. The statistics I cite above are put out by the New York Federal Reserve on a quarterly basis. However, in my 32 years of practicing, I have lived through two economic downturns before, and the tea leaves seem to be pointing in that direction again based upon what I am seeing in my practice, despite the record highs in the stock markets and real estate sales. *(I would note that as this article was being written, the Dow closed down 3,583 points for the last week in February 2020, its worst week since October 2008 according to a CNN Business report, due to fears about the spread of the coronavirus. The S&P and Nasdaq had similar declines.)*

Grim Consumer Debt Statistics

Here are some more sobering numbers from the fourth quarter 2019 New York Federal Reserve report:

- New mortgage loans jumped to their highest volume since the fourth quarter of 2005. As I will explain in more detail below, my concern is that this increase was driven by a big increase in refinances.
- There were $159 billion new auto loans in the fourth quarter, increasing the total balance by $16 billion
- Credit card debt increased by $46 billion
- Student loan debt increased by $10 billion to $1.51 trillion

The Fallout from Growing Debt

The negative repercussions of this growing debt as stated in the report include:

- Transition of mortgages into serious delinquency (more than 90 days late) increased by 17.4%
- 11.1% of student loan are in default
- 5.32% of credit cards are more than 90 days late
- 202,000 consumers had a bankruptcy notation added to their credit report, up 7000 for the same quarter in 2018

According to the U.S. Bankruptcy Court statistical reports for the Middle District of Florida, after several years of declining filings, bankruptcy filings are up the past two calendar years. These trends are alarming to me based upon my past experience.

Main Causes of Financial Crisis

These are the three biggest problems I see with my clients' finances that lead to disaster:

1) **Spending vs affordability** - Too many consumers are living based upon their maximum earnings. They spend every dime of their paycheck and buy the biggest house or fanciest car ***the bank*** says they can afford. Just because a bank is willing to give someone a loan, especially a car loan, doesn't mean they can afford it. For example, a couple making $80,000 a year with two kids under 12, cannot reasonably afford two $500 car payments with all their child rearing expenses, even though they will qualify for the loans. Nevertheless, I see it all the time with my bankruptcy clients. The problem with this kind of spending is that all it takes is for one party to lose a job, or get hours cut, or overtime eliminated, and now they can't afford all their expenses and start relying on high interest credit cards.
2) **No monthly budget** - Many people fail to create a monthly budget or, if they do, they don't follow it and track it on a daily basis. I have even had some clients meet with me at their initial consultation where I have them do a budget. They realize for the first time that, even if we eliminate all their credit card debt, they still can't pay all their bills because of their high fixed expenses. That realization becomes a very sobering moment for these couples.
3) **No emergency fund** - I consistently meet with consumers who do not have an emergency fund or even a plan to create an emergency fund, of at least three months of monthly expenses, but preferably, six months. Having this type of savings can help them through some of the rough waters should the economy change and their income decrease. Unfortunately, due to the lack of emphasis on savings vs. using credit, most people don't have an emergency fund. Again, without this emergency fund, they turn to high interest credit cards to get by when their income unexpectedly decreases.

Financial Mistakes to Avoid

In turn, when faced with a cash flow shortfall because of outside economic forces, I see my clients make these mistakes to try to recover:

- **High interest credit cards** - As stated above, many people rely on high interest credit cards to make ends meet. This leads to a vicious cycle of making minimum payments where it will take 20 years to pay the debts off. The banks love minimum payment makers!
- **Second mortgage** - Consumers will pull out the equity in their home to pay off high interest credit cards. This is foolish, especially in Florida, because of the Florida Constitution's homestead exemption that protects one's homestead from judgment creditors. By taking out a second mortgage to payoff credit cards, one is converting an "unsecured claim" into a "secured claim" and, if they can't pay the second mortgage, they can now lose their home to foreclosure, when before, the house was protected from a credit card judgment.
- **Retirement account withdrawal** - Clients often take money out of their 401(k) or other retirement accounts. Depending on a consumers age, this can be expensive money with 20% penalties plus income taxes to be paid on the withdrawal. If a consumer is over the age of 50, they may never have the ability to make up the lost retirement savings.

Recovering from a Financial Crisis

How does one avoid these disasters and not have to seek protection under the U.S. Bankruptcy Code?

- **Pay down debt** - Consumers should start paying down any debt that have, especially high interest credit cards, beginning <u>today</u>.

- **Eliminate nonessential expenses** - Get rid of all unnecessary expenses, and create and follow a budget. Someone should not go out to eat five days a week and charge it on a credit card if they are concerned about a downturn in income.
- **Establish an emergency fund** - Start creating an emergency fund today if there is not one in place.

Again, I am not an economist. However, based upon what I have seen in my practice the last 32 years and, based upon the axiom that "history repeats itself," **now is the time to prepare** for an economic downturn.

###

Mark Martella is an experienced authority in business law and business practices, real estate matters, bankruptcy, foreclosure, and estate planning. In over 30 years as an attorney both in New Jersey and Florida, he has helped thousands of clients facing business and personal financial challenges. He has written dozens of articles on these topics, and has published his first book: "Bankruptcy in Plain English: The Ultimate Layman's Guide to Taking the Fear and Mystery out of the Bankruptcy Process." He has published special reports for consumers and small businesses.

Mark Martella
phone // 941.206.3700
fax // 941.206.3701
mmartella@icardmerrill.com