SL Sightlines Bulletin
Tracking the American Economy

January 2014

BUMPY, FRUSTRATING EXPANSION RETAINS ITS CHARACTER

Although many indicators, and our surveys of state tax receipts, ended the year on a steady note, the December employment report was surprisingly weak, with no real offsets. This is yet another unneeded reminder that the recovery from a financial crisis is a halting process. This recovery is the bumpiest, most frustrating expansion in modern history, but we are, believe it or not, doing a bit better than the historical average of such recoveries in job growth. State tax receipts ended the year at the low end of healthy, an inauspicious portent for 2014.

- Withheld collections looked quite good in December, especially considering that many revenue officials expected them to be very weak and even negative over the year (read tax-driven behavior in 2012). Sales tax colelctions took a beating in December, and we believe that is where the weather-effect is showing up.

- Midwestern states: we're still adding manufacturing jobs, but at a slower pace.

- Sagging labor force participation: The details are not what you'd think reading the mainstream press: prime-age workers are dropping out at worrisome rates, and an increase in diability only explains about half the recent decline in participation.

- Upward revisions to GDP help close the gap with auto sales, although auto sales remain historically weak. An underappreciated factor behind sagging auto sales: Americans spending less time behind the wheel.

- Diesel fuel sales suggest continued employment growth, and a manufacturing pickup even. But despite the slow healing of the job market, it's far from fully recovered, and income and credit constraints are putting a damper on consumption.

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NOT A BAD YEAR, BUT SOME SLIPPAGE AT YEAR-END

DECEMBER EMPLOYMENT

December's headline payroll gain of 74,000, reported by the Bureau of Labor Statistics (BLS) was the weakest initial print since May 2012, and the weakest final print since January 2011. Three-quarters of the gain came from retail, up 55,000; other gainers included mining and logging, up 4,000; manufacturing, 9,000; wholesale trade, 15,000; finance, 4,000; professional and business services, 19,000 (well under half its average over the last year—with more than all of it coming from a 40,000 gain in temps); and leisure and hospitality, 9,000. Losers included construction, off 16,000 (mostly from nonres specialty trades—the two residential subsectors were up 6,000 combined); transportation and warehousing, off 1,000; and information, down 12,000 (more than all of it motion pictures). Government was off 13,000, led by local education, which was down 15,000; Uncle Sam shed 2,000 workers.

Diffusion indexes confirmed the impression a narrow distribution of gains across sectors, with the one-, three-, six-, and twelve-month measures all down. All but the three-month are below their 2012 averages.

The household survey had one bright spot on first glance: an 0.3 point decline in the unemployment rate to 6.7%, which puts us very close to the taper trigger level. (As happens every December, household seasonal factors are adjusted going back five years; November's 0.3 point decline in the unemployment rate is now an 0.2 point decline.) Part of the decline came for a good reason: a 490,000 decline in the number of unemployed (most of it because of a reduction in the number of job losers). But the labor force fell by 347,000. Had it risen in line with population, and had all those who withdrew been counted as unemployed, the unemployment rate would have been unchanged at 7.0%. The broad U-6 rate was unchanged at 13.1%. The average duration of unemployment was unchanged at 37.1 weeks. A reminder of just how high that remains: it's three times the 2000 level, and more than twice 2007's.

The participation rate fell 0.2 point to 62.8%, its lowest level since 1978, when many fewer women were working for pay. (Back then, women accounted for 40% of total employment; it's now 49%.) The employment/population ratio was unchanged at 58.6%, 0.8 point lower than it was when the recession ended in June 2009

The workweek fell 0.1 hour to 34.4, at the low end of its range over the last couple of years. Manufacturing was unchanged, but services were off 0.1. Aggregate hours were off 0.2% for the month and up just 1.6% for the year, the lowest since September 2010.

Earnings growth was weak—just 0.1%, which brought the three-month moving average down to 0.1%. Aggregate weekly payrolls were down by 0.2% for all workers, and 0.1% for production workers.

The Bureau of Labor Statistics' report on December state-level employment was quite flat and weak as well. Only 6 states reported statistically significant changes in their employment levels, generally it's at least 13, with declines of 0.5% in Kansas and New Jersey, and increases of 0.5% in Hawaii, and 0.3% in Massachusetts, Minnesota, and North Carolina.

The state data series is very noisy and there is evidence of ongoing issues with the seasonal adjustment process. A big question we were hoping the state detail might answer is the effects of the winter weather on employment, but because of the seasonal noise it's

hard to make a case for that. But the detail does back up what we thought about the national report: nasty weather probably depressed employment, mainly in construction and perhaps leisure and hospitality, by about 20,000.

The news on state-level unemployment rates continues to be modestly positive. In December all 22 statistically significant over-the-month changes in unemployment rates were declines, but close to half of the states around the country reported real labor force withdrawal. All told, 39 states and DC reported declines in their unemployment rates, 9 had no change, and only 2 states, Hawaii and Rhode Island reported increases, 0.1pp each.

Our diffusion indexes, the share of states adding jobs, slid as well. The total declined to 30 from November's 43, and only finance (16 to 21) professional/business services (23 to 25), and trade/transport (28 to 39) showed increases. Over the month, construction took the steepest dive, from +0.4% to -0.6%, with largest increase in trade, transport and utilities. Manufacturing employment was quite flat in December.

STATE TAX RECEIPTS

Withheld tax receipts at the state level held up in December. Sixty percent of the states in our survey met or exceeded their forecasted withheld collections, down from November's 67%, while the percentage of states reporting growth over the year rose to 90% from November's 70%, and the average rate of change to 4.2% from November's 1.9%. (See graphs on p. 4.)

This was surprisingly good news to a number of our state revenue contacts who had expected December collections would be weak year-over-year because of accelerated bonus payments in December 2012. And for the first time a contact in a state that is not home to large energy extraction operations called the economy in his state "good."

Our contacts in Midwestern manufacturing states believe they are still adding jobs but at a "slower" to "markedly slower" pace, with one contact noting that recent employment statistics are now "concerning, although withholding is still growing at a pretty decent clip." We noted back in November that auto sales were running above what would be predicted by GDP, so it was encouraging to see upward revisions to GDP bring the two closer together, but that engine of job growth, if you will, may be slowing down. (See discussion p.9.)

Comments from recovering housing bubble states were mixed. Our contact in one such state, where there is no withholding tax, is starting to "draw the conclusion that we are on solid footing right now, as long as the national economy holds up." He is not seeing, or expecting, spectacular growth, but most things are moving in a "consistently positive direction." We've reported that news from another state recovering from a housing bubble has been worrisome, and after a weak December revenue officials in that state dropped their forecast for withholding collections in the coming year. This is the first lowered forecast we have heard about in some time. Collections remain "quite strong," in the other housing-bubble state in our survey.

We heard several comments about strong corporate tax receipts, but framed as coming from weak investment and hiring, and therefore lower deductions, not the fruits of

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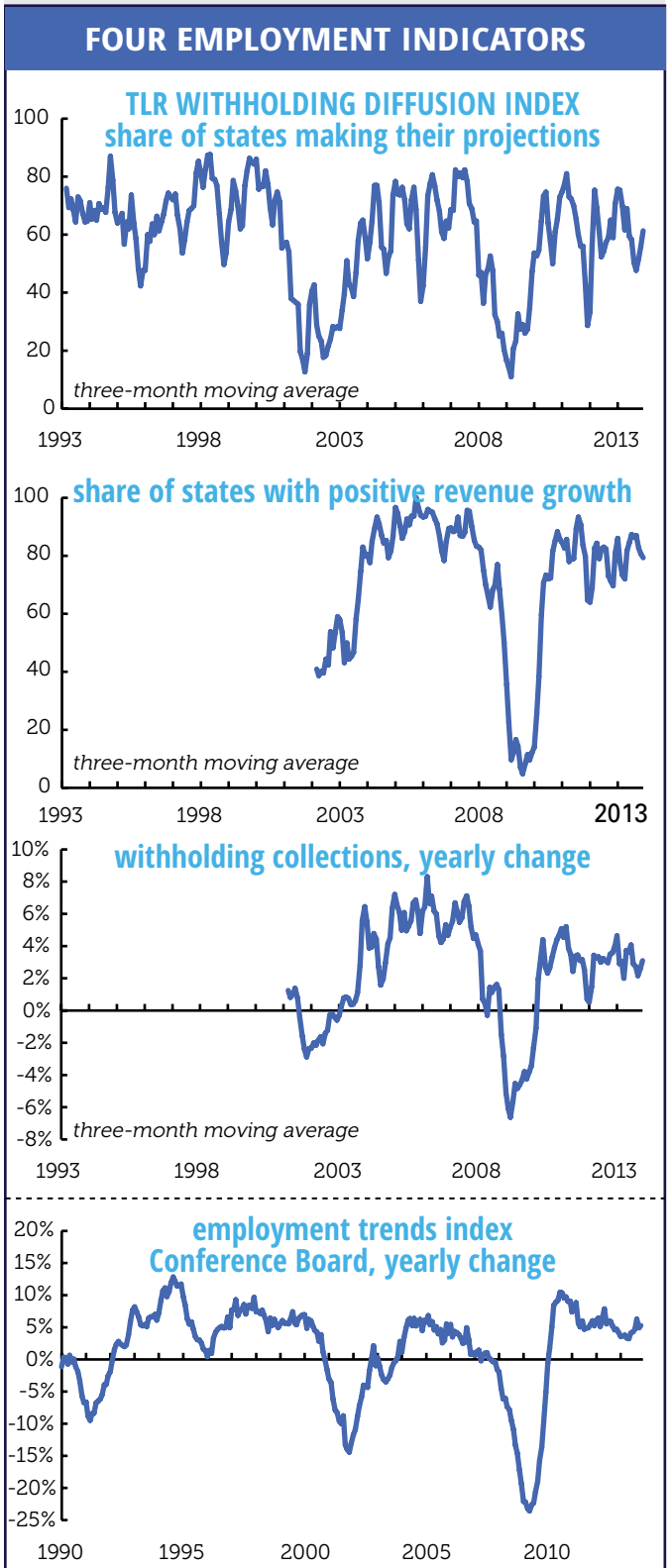


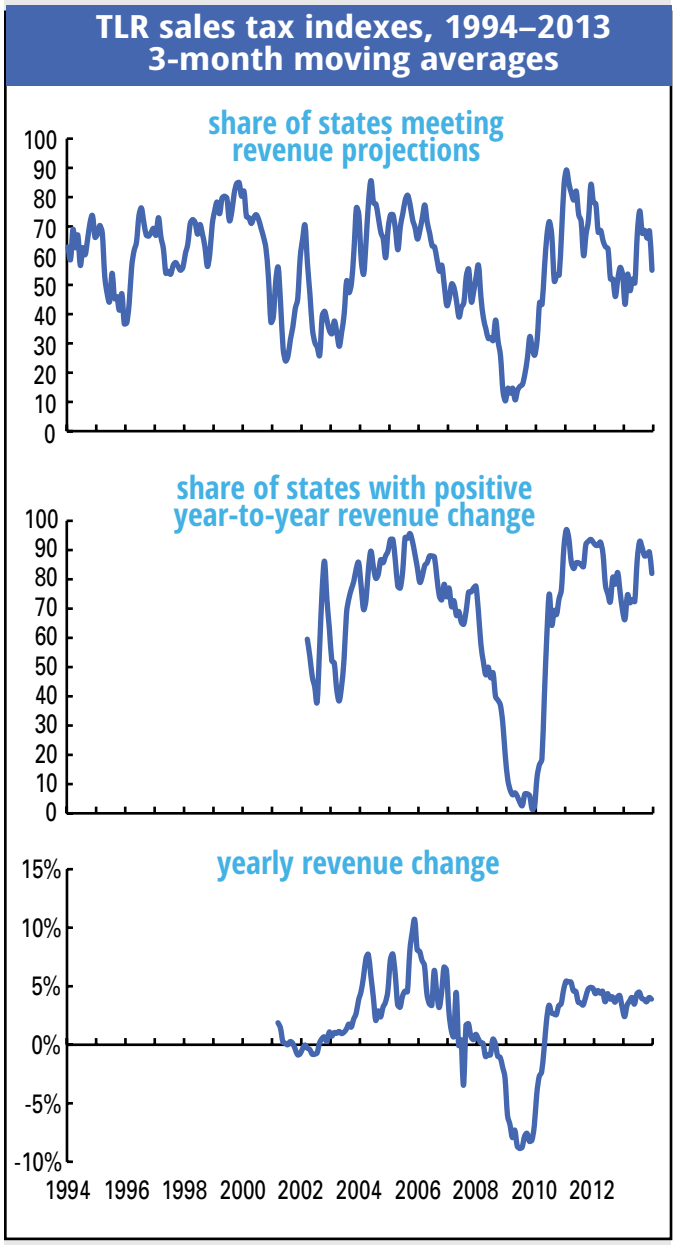
The Conference Board's ETI leads payroll growth by about three months. It appears here with permission.

successful business plans. With job growth moving at an improved but still-weak pace, we understand that it's a risky time for businesses to wave the hiring baton, but until they do, we're stuck between a rock and a hard place.

In December the percentage of states that met or exceeded their forecasted sales tax collections slipped to 34% from November's 71%, and the percentage reporting growth over the year to 63% from November's 90%. The average over-the-year rate of change came in at 3.8%, down from 4.7% in November, and the margin from forecast fell to -3.1%, down from November's +1.0%. (See graph, p. 5.)

Sales-tax collections in some big states were weak enough to worry our contacts. With gift cards flying around and people waiting until after Christmas to take advantage of sales, state revenue estimators won't pass judgment on the strength of the holiday shopping season until February receipts are tallied, but for the most part, this was not how they wanted to wrap up the year. That's something we'll be watching, of course. There were pockets of strength in the Midwest, and in two of the housing recovery states, including one in which withholding is now falling consistently below the mark, but this was trumped by some large misses in a couple of big states.

Sales taxes are not due for some time after purchases are made, and we suspected some of this weakness derived from the late Thanksgiving, meaning collections in December 2012 may have included a bigger chunk of Black Friday purchases. That was borne out by the Advance Retail Sales report, which, stripping out a bad month for auto sales, showed healthy growth of 0.7% over November's pace. Strong gains were reported by outfits selling food and beverage, clothing and accessories, and gas



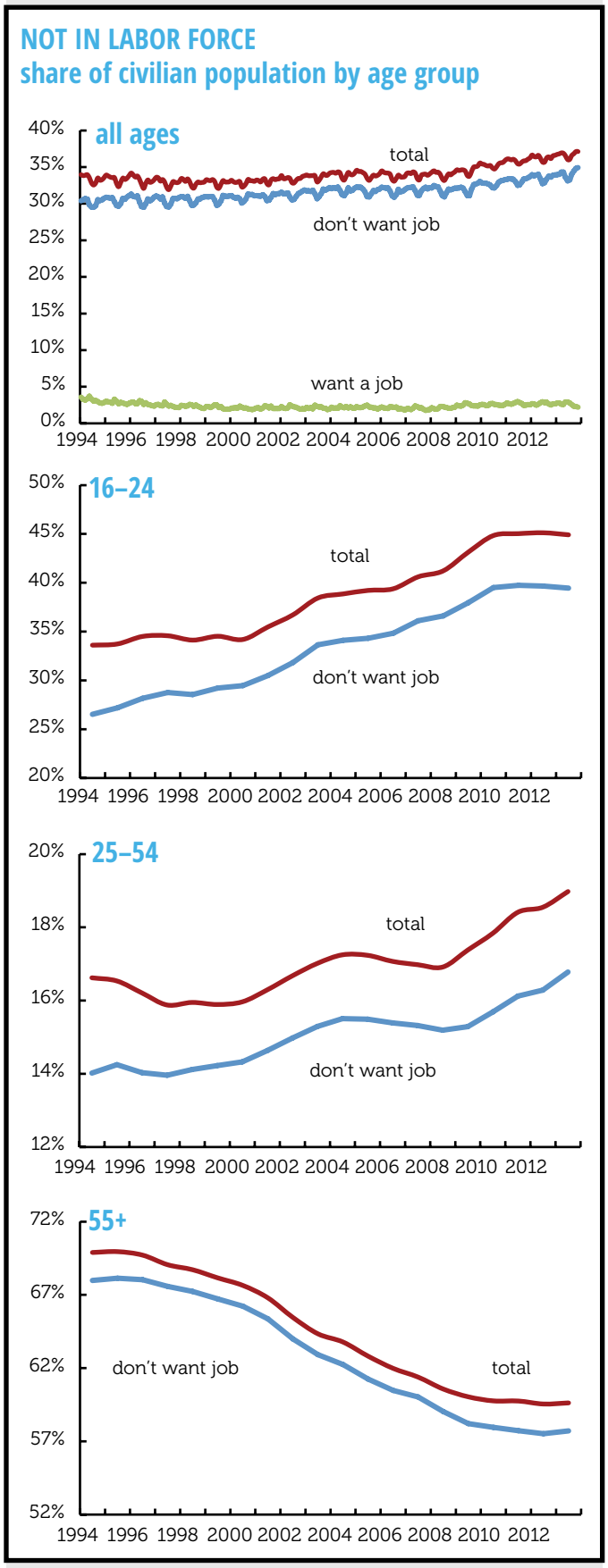
stations. Electronics had a bad month, as did building materials, the latter probably weather related. Stripping out autos, gas, and building materials, which is what goes into GDP calculations, growth was a healthy 0.7%

YEAREND THOUGHTS

Using three-month averages, both our Withholding Diffusion Index and our Sales Diffusion Index ended 2013 at the low end of what we would consider their healthy ranges. The behavior of the two series confirms the typical, uneven nature of this expansion: both have dipped below a healthy range during this recovery, something that did not happen in the expansion of the late 1990s. On the other hand, as we remarked at the time, the WDI sagged below this range several times during the housing boom, but sales receipts held up until 2007 when they began a long decline, two worrisome signals with long leads from state revenue offices.

One could argue that the performance of withheld tax receipts in 2011/12 mimicked their performance in the 1995 slow-down. We didn't take a double dip but, as Kenneth Rogoff & Carmen Reinhart point out in their recently released, "Recovery from Financial Crises: Evidence from 100 Episodes," that was a bit of good luck. They note that the "protracted nature of the [typical] recovery" from a banking crisis resulted in 43 of the 100 episodes they evaluate recording double dips. They point out that it's too early to measure the severity of the 2007-09 crises because, well, it's continuing in a number of countries. In their concluding remarks they express real concern that the tilt toward austerity in current official policy, predicated on the belief that high-income countries are "completely different" from their emerging market counterparts, increases the odds that by the time this is over the severity of the crisis in a "large number" of countries may surpass that of the Great Depression.

NOT IN LABOR FORCE—WHY?



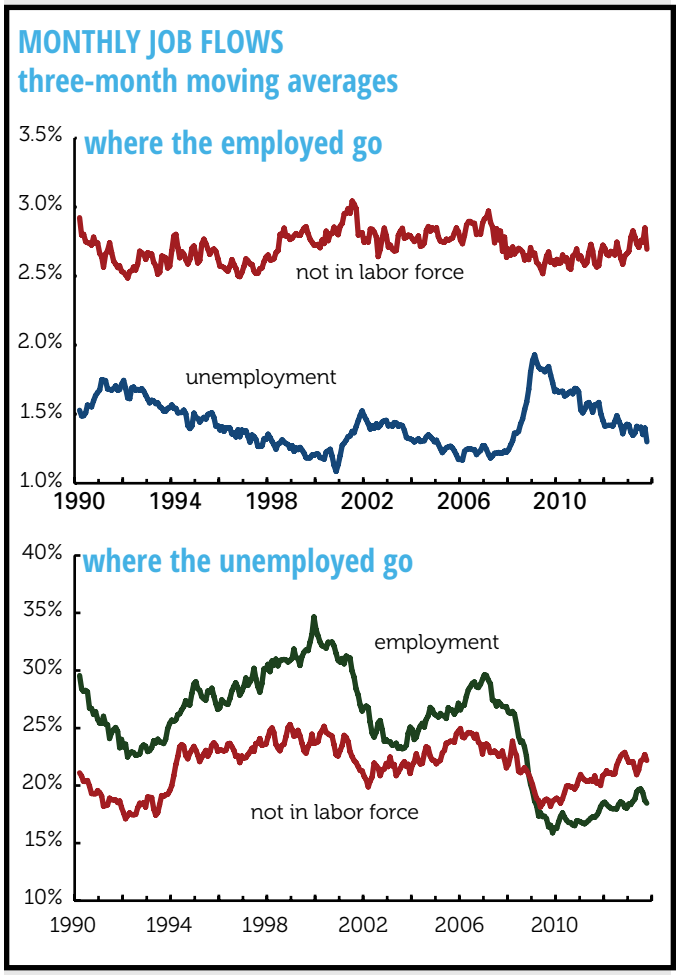
One place the unusual nature of the recent recession and recovery is starkly visible in the job flow data published by the BLS (see the graphs on p. 7). Before early 2009, the unemployed were much more likely to find work than to drop out of the labor force. Recently, although the share of the unemployed moving into employment has risen off its 2010 lows, it remains well below the share dropping out of the labor force—the gap is actually widening--and well below the lows set in the early 1990s and early 2000s recessions.

This is another way of looking at the stagnation in the labor force participation rate: though the unemployment rate has come down, a great deal of the improvement has come from labor force withdrawal, not vigorous hiring.

So who are these people who are dropping out of the labor force, and why? We thought it worth a little investigation, and we were genuinely surprised by the results: a surprisingly large portion of labor force dropouts say they don't want to work.

The patterns are summarized in the graphs to the left. The first graph shows the steady uptrend, with some cyclical bumps, over the last two decades in the share of the population not in the labor force (NILF). Not only is it up 4.2 percentage points from the employment peak in April 2000, it's 1.8 points from the post-recession low in February 2010. But note that the line marked "don't want job" has moved in almost perfect parallel. The share of those not in the labor force who don't want a job has risen 4.0 points since April 2000, and 2.1 points since February 2010. The line marked "want job" looks remarkably flat and insignificant next to those above it, and that's not just a matter of perspective imposed by the scale of the axis.

The next three graphs break down the NILF



population by age groups. Both young (16–24) and prime-age (25–54) workers show a long uptrend—and with no significant widening of the gap between the two lines. And it's not like the young ones are going to school in large numbers: the share of that cohort that lists school or training as a reason for being out of the labor force has wavered over the years, but has stayed well below 1%, with no discernible trend. Overall, the share of the population that's counted as NILF because they're discouraged, have family responsibilities or transportation problems, or report disability or illness, has stayed flat at around 1% since the BLS started asking the question in its current form in 1994.

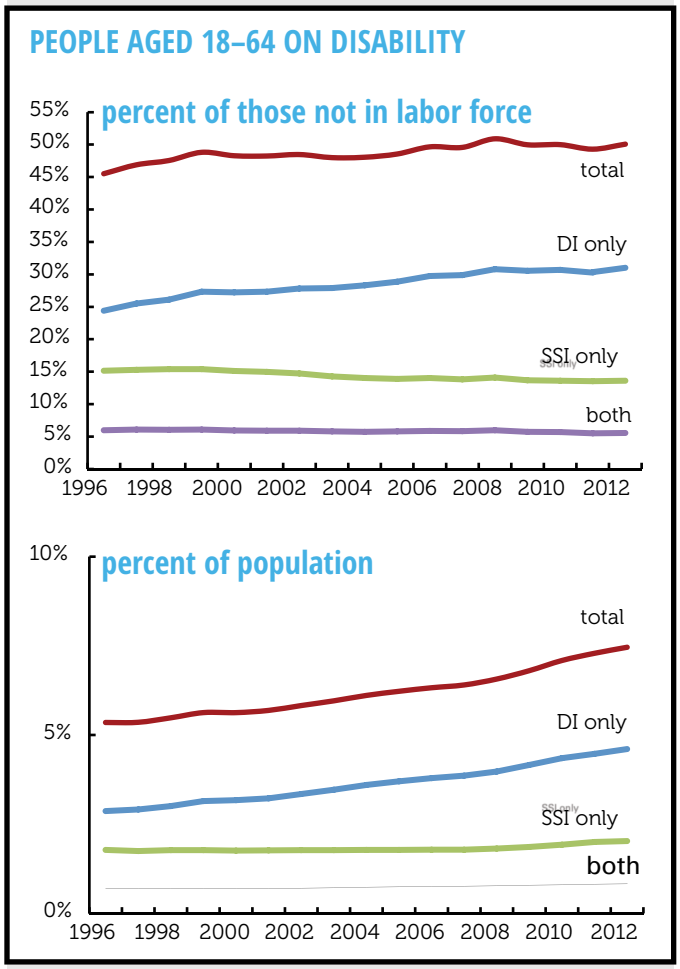
DISABILITY & THE LABOR FORCE

What about the contribution of disability to the large proportion of those outside the labor force who say they don't want to work?

The short answer is that the increase in the number of people on disability seems to explain about half the recent decline in labor force participation—which is significant, but still leaves a lot to be explained. And even that needs to be put into perspective.

A few definitions. There are two major programs that offer income support to people who are too disabled to work. The bigger one is the Disability Insurance (DI) component of Social Security. To qualify, you need to have had a substantial work history before becoming disabled. The smaller one is Supplemental Security Income (SSI), which is administered by the Social Security Administration, but financed out of general federal revenues. SSI is for people with very spotty work histories at best. A small number of people draw benefits from both programs.

As the graph on p. 8 shows, the number of people drawing from either program (or both) has risen from 45.5% of those classed



as not in labor force (NILF) in 1996 to 50.1% today. In numerical terms, the rise in the number drawing benefits has accounted for just over half of the growth of the NILF population through 2012, whether you take 2000 (employment peak), 2007 (cyclical peak), or 2009 (cyclical trough) as your baseline. Those on DI—people who used to work regularly but who don't any longer—account for 35–40% of the increase. Most of the balance, are on SSI. While the increase is striking, still, 50.1% is not a world of difference from 45.5%.

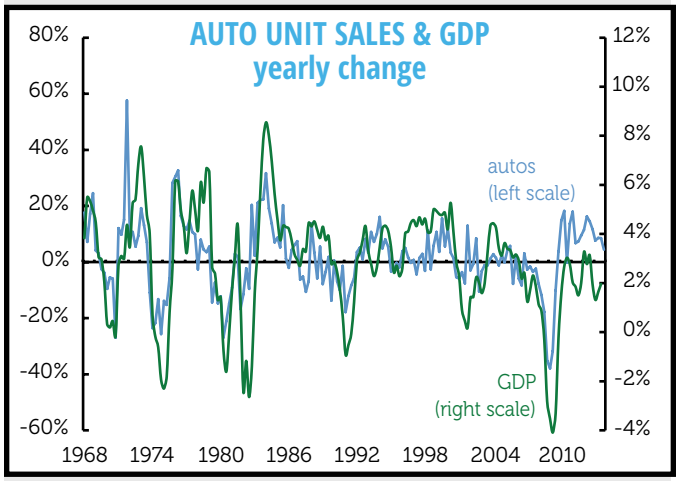
The bottom graph shows recipients as a share of the 18–64 population. It too shows a rising trend—from 5.3% of the total in 1996 to 7.5% in 2012. For DI alone, it's risen from 2.9% to 4.6%.

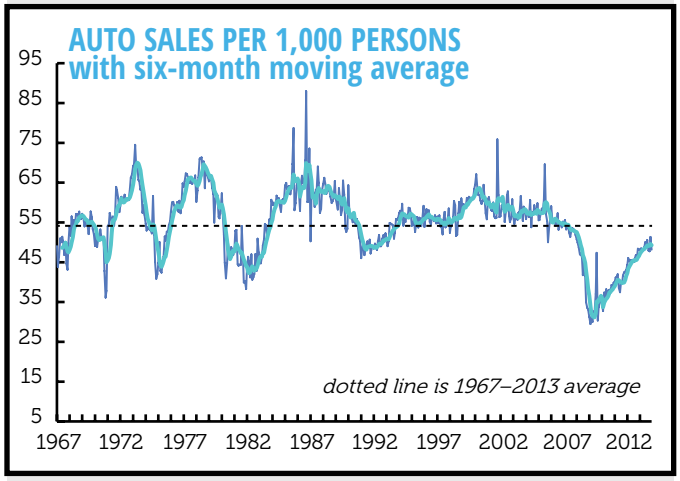
Many people conclude from this that there's a huge population of fakers and layabouts drawing benefit checks they don't deserve. There's no doubt that there is a nontrivial number of those.

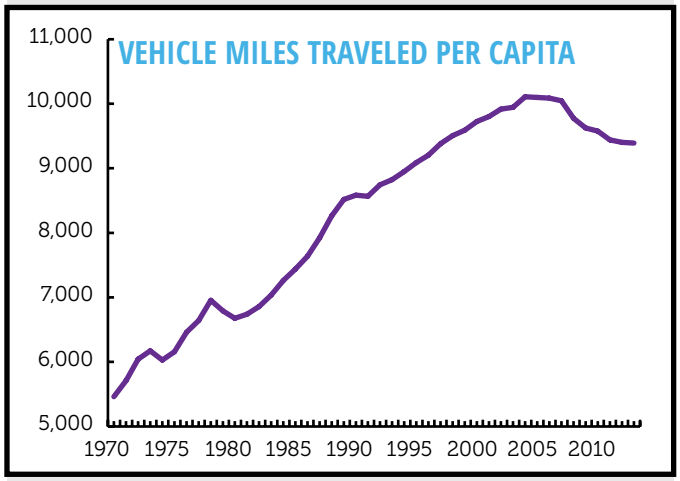
But that's far from the whole story. It's not easy to get on DI. The application process can go on for many months, even years. About half of all recipients are rejected—and of those rejected, fewer than half ever get a job. The average DI benefit in 2012 was $1,207 a month, or 34% of the average monthly wage. It amounts to $14,485 a year—not easy to live on.

And the growth in the number of DI recipients relative to the NILF population was faster during the 2006–2009 peak/recession period than it's been in the 2009–2012 recovery/expansion period. It was also faster in the eight years leading up to 2004 than it was in the eight years after.

So, disability explains some of the growth in the NILF population, but far from all of it. There remain many mysteries to be explained.







CAR CULTURE: DOWNSHIFTING?

As we said last November, auto unit sales have tracked GDP growth fairly closely over the decades—and, according to that relationship, they were running ahead of where they "should" have been. As the top graph to the left shows, that gap has now closed some.

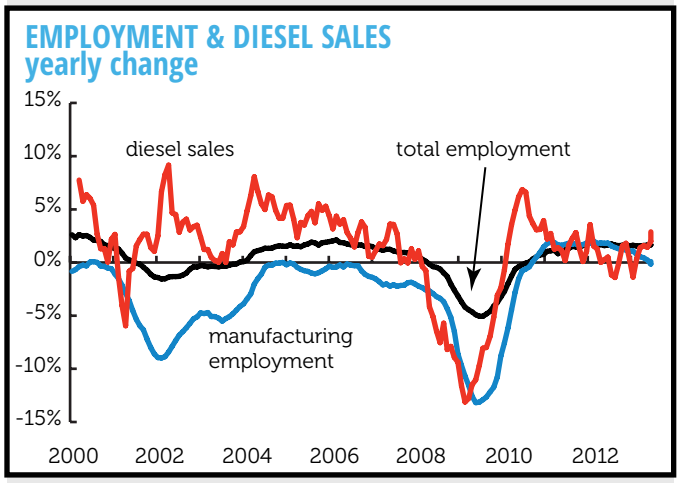
Auto sales are still recovering from the recession. In February 2009, they fell to a record 42% below their long-term (1967–2013) trendline. That came after nearly 15 years of above-trend sales, so some correction was in order! They've since come back to that trendline. One might normally expect sales to continue to rise above trend and stay there for a while, but maybe not.

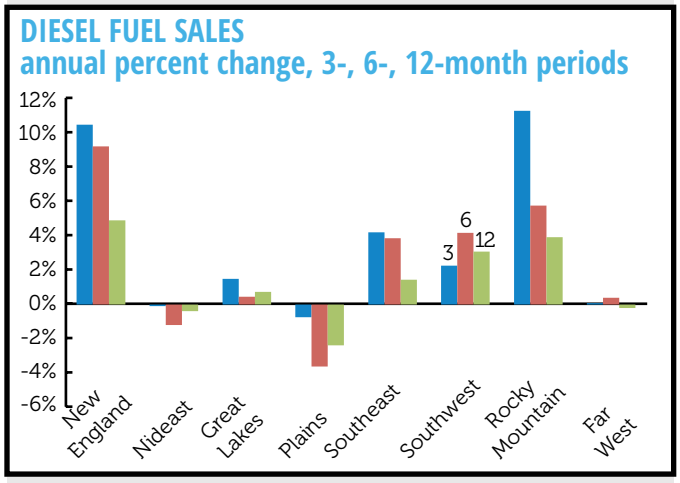
The middle graph shows unit sales per 1,000 population. Sales were above their long-term average for much of the 1990s and early 2000s, and sank deeply during the recession—but they still haven't recovered to average levels. It looks like there are some structural shifts underway.

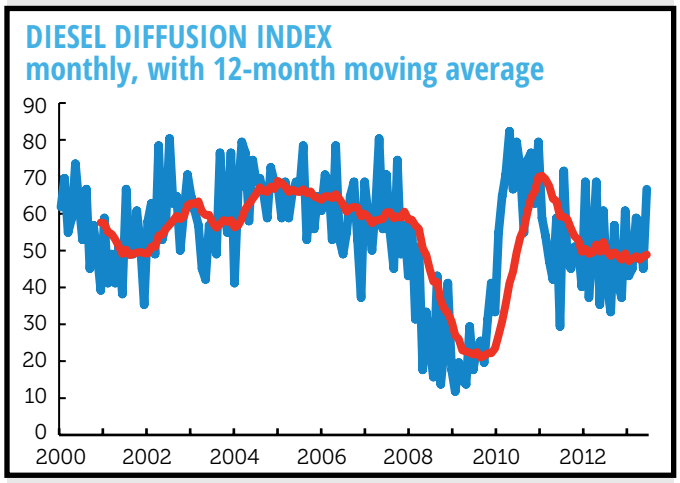
One reason for declining sales: faced with competition from overseas manufacturers, Detroit made the decision some years ago to build cars to last. The auto fleet keeps getting older—the average car was 11.4 years old in 2013, up from 8.4 in 1995.

And another: Americans are driving less. Graphed at the bottom left is the number of vehicle miles traveled (VMT) per person per year. It peaked in 2004, and has fallen since. Some of this is because of the rise of gas prices, which puts a crimp in all but the most affluent households' driving. Even so, a model that predicts VMT based on gas prices broke down around 2006; people are driving much less than they "should" based on price. Part of this is an aging population—older people drive less than younger. But younger people are driving less than previous cohorts. It's not the car-driven economy it once was.

DIESEL SALES IN REBOUND







The Federal Highway Administration's (FHWA) most recent release of sales data for diesel fuel shows year-over-year sales during August increased by 1.8% nationally. Twenty-seven states reported sales increases. As the first graph shows, the 1-month diffusion index decreased to 52.9 in August from 66.7 in July. Since this is a noisy series, it's best to look at the 12-month moving average. While off its recovery high, the index has averaged around 50 with a slight upward trajectory.

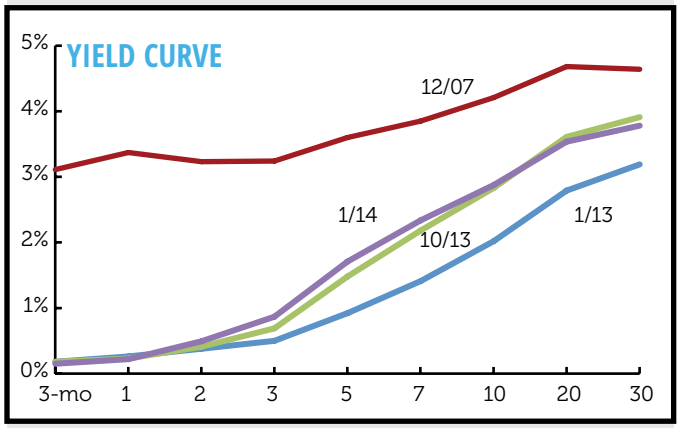
Strength outside Plains. The second chart shows regional sales trends in the yearly rate of change over the most recent 3-month, 6-month, and 12-month periods. Growth has been strongest in the Rocky Mountain and New England regions, with both showing signs of acceleration. Something similar can be said for the Great Lakes and Southeast regions. The Plains have been lagging, but less so lately.

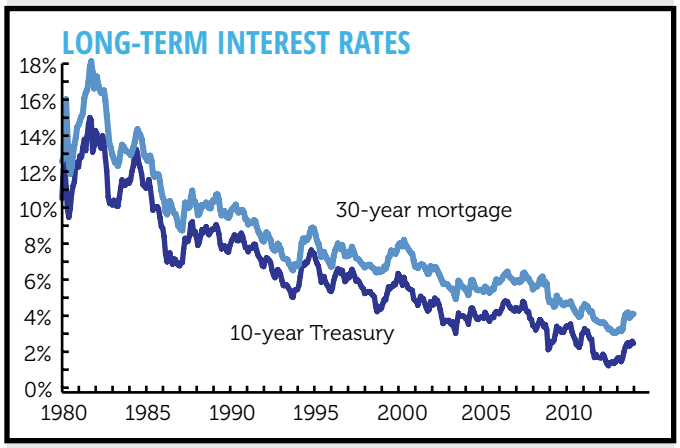
Diesel still forecasting labor market strength. Diesel sales have been a good leading indicator of employment, as the third graph shows—especially in manufacturing. The recent trend in diesel sales suggests a pickup in employment in the first quarter of 2014.

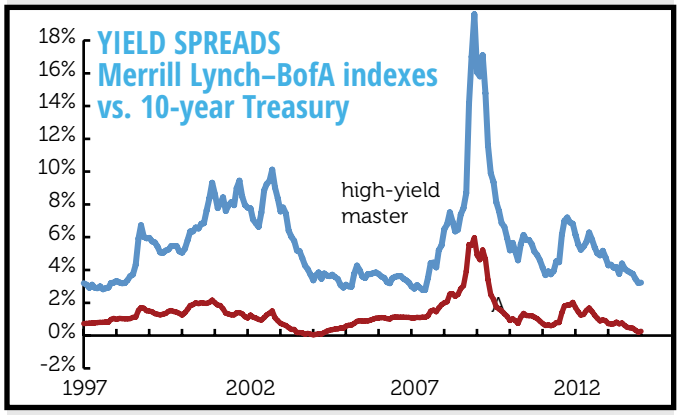
State data. Some states publish their own fuel stats ahead of the FHWA. They're graphed to the left. (Most data are for October, except California, which is September, and Iowa and Oregon, November.)

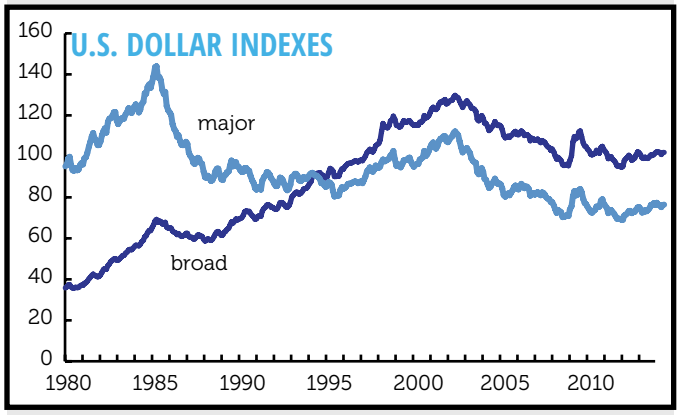
The uptick in diesel consumption in these seven states represents a significant improvement over the past few months. These increases imply that these states will likely experience increased manufacturing activity over the coming months. Also, given that these states are spread across the country (or at least across the northern half of the country) manufacturing growth is likely to be more widespread than in just these states.

FINANCIAL INDICATORS









The Fed's tapering of asset purchases has begun. January purchases will be $75 billion down from the $85 billion rate that has prevailed since the end of 2008, with a further reduction to $65 billion expected next month. Minutes of the last FOMC meeting indicate concern that continuation of the QE program may lead to excess speculation in financial markets. There was also worry about exposing the Fed to capital losses as long rates continue their likely rise.

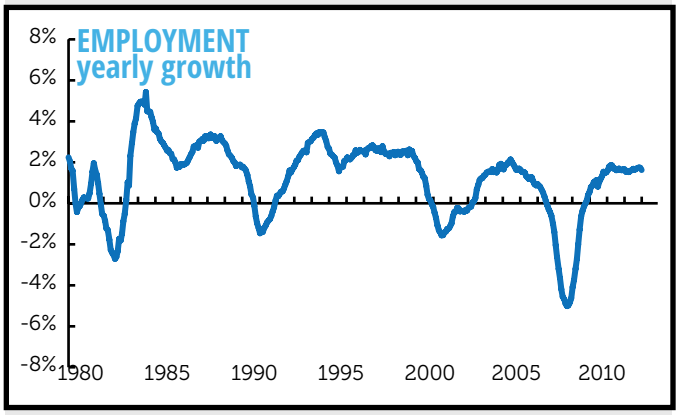
The yield curve continued its outward rotation, though Treasury yields overall were little affected by the taper. It's interesting that yields on the 10-year increased more than the 30-year throughout 2013. After a slight downtick in October, the yield curve has been steepening, which is consistent with an improving economy (though the 0% fed funds rate may be distorting this indicator).

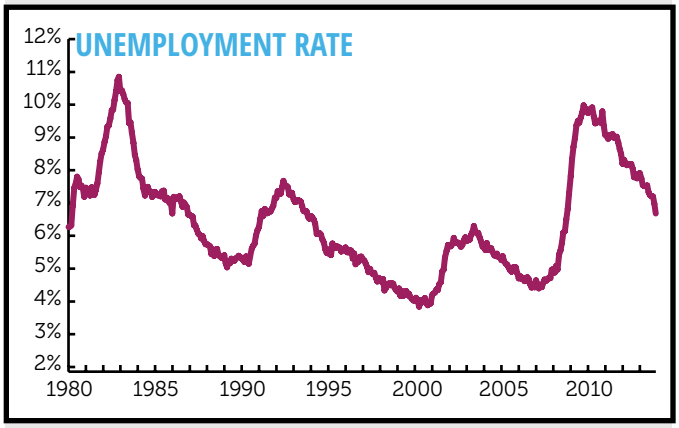
Mortgage rates rose slightly in December, extending November's rise. December's 30-year mortgage rate averaged 4.46%, up 111 basis points from December 2012's 3.35% average. For the 15-year, the rise was 66 basis points. These increases have been a drag on existing house sales, which declined by 9.5% from July (their recent peak) through December. For the year ending in December, sales were down by 0.6%.

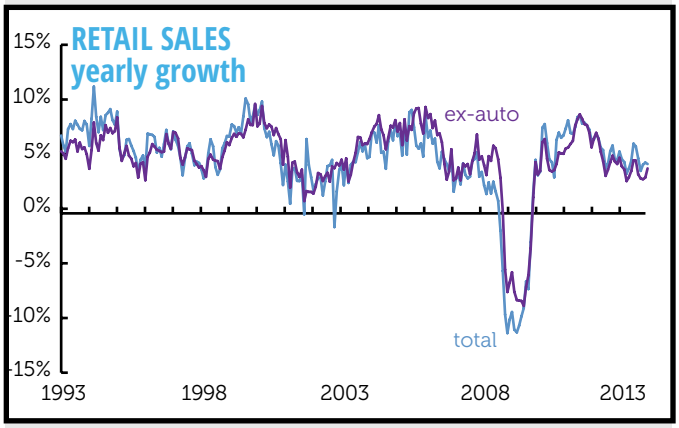
Risk premia continued their long decline from financial crisis peaks, as yields on higher-rated corporate debt rose and low-rated debt fell. In December, $69 billion in new corporate bonds were issued, 41% of it high-yield. For the year, corporate debt issuance totaled $1.36 trillion, down 0.4% from 2012.

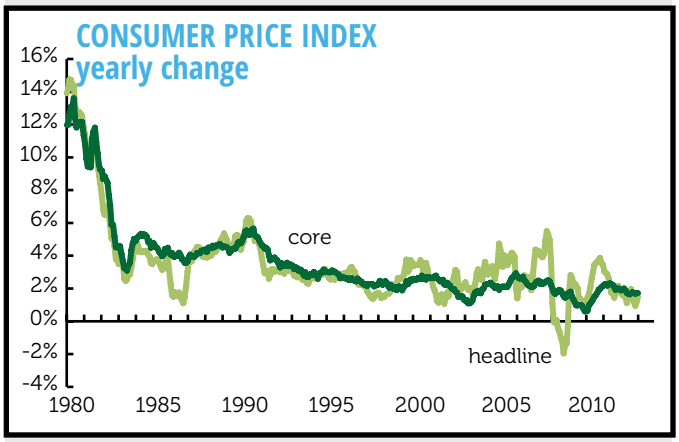
The dollar remains quite stable. The two indexes graphed to the left rose a hair in December, but you could hardly see any signs of a financial crisis in their recent history. The U.S. has yet to lose its safe haven role in the world, despite worries to the contrary.

REAL INDICATORS









Despite December's disappointing payroll figures (discussed on p. 2 of this issue), the annual rate of job growth has settled in to a pace of around 1.7%. That's about where it was during the mid-2000s expansion, though it's a point or more below the best rates of the 1980s and 1990s (and below the 2.1% long-term average). But this decently moderate pace of growth is still not enough to offset the steep losses of the recession.

The unemployment rate continues its long decline—but as the graph to the right shows, remains at or above the peaks of the 1990s and early 2000s. At 6.7%, it is, however, getting close to the Fed's 6.5% target, meaning that the FOMC is going to have to clarify its intentions should the jobless rate hit that magic number. Unemployment declined on average by 0.1 point a month during 2013, so we could be at 6.5% by February. Continued weakness in labor force participation means that a 6.5% today describes a labor market with more hidden slack than a 6.5% rate did in 1994, when the participation rate was more than three points higher.

As noted on p. 4 of this issue, retail sales ex-autos and gas had a good month, but the annual rate of growth, which is hovering around 4% for the various measures, is 2–3 points below the rate that prevailed from late 2010 through early 2012, not to mention the 6-ish average that prevailed from 1993 through 2007. Clearly, modest employment and wage growth coupled with still-constrained credit availability are putting a damper on consumption—and then there's the apparent structural shift in driving habits analyzed on p. 9 of this issue.

Inflation remains very subdued, with overall consumer prices up 1.5% for the year ending in December, and core at 1.7% (where it was for most of 2013). For now, inflation-phobes have little to base their worries on.