SL Sightlines Bulletin
Tracking the American Economy

February 2014

U.S. ECONOMY SLOWS; SNOWED OUT, OR STRUCTURAL?

The U.S. economy slowed as the year turned, and some of our revenue contacts were flirting with worry but not yet embracing it. It could be weather—it's been a nasty winter in much of the country, and then there's California's drought to worry about. Looking beyond the winter lull, there are some important structural things to consider: the slow pace of business startups, which is not only bad news for the job market, but also makes you wonder where the entrepreneurial energy has gone. And the CBO is telling us we face some grim growth numbers in the coming years—that, despite the enormous hit to GDP relative to its long-term trend, a hit of over $6,000 per capita.

- Two months may not a trend make, but with both December and January employment gains decidedly below average, you do have to wonder what's going on. Maybe it's the weather, and the clouds will blow away by spring.

- January retail sales were very weak, and the annual gain is back to 2010 territory, but it's quite likely that weather was the culprit there. That, and very stretched paychecks: a new paper shows how important credit was to sustaining the consumption of the bottom 95%. And how the lack of easy credit is holding back recovery.

- The Congressional Budget Office is out with its long-term economic and budget projections. No one's talking about it, but the growth projections are awful—a third below the 1950–2013 average. From Great Recession to Eternal Stagnation?

- New business formation is recovering, but not by much—which is important, since young firms are the real job creators.

- Diesel consumption strong, which suggests this slowdown is temporary.

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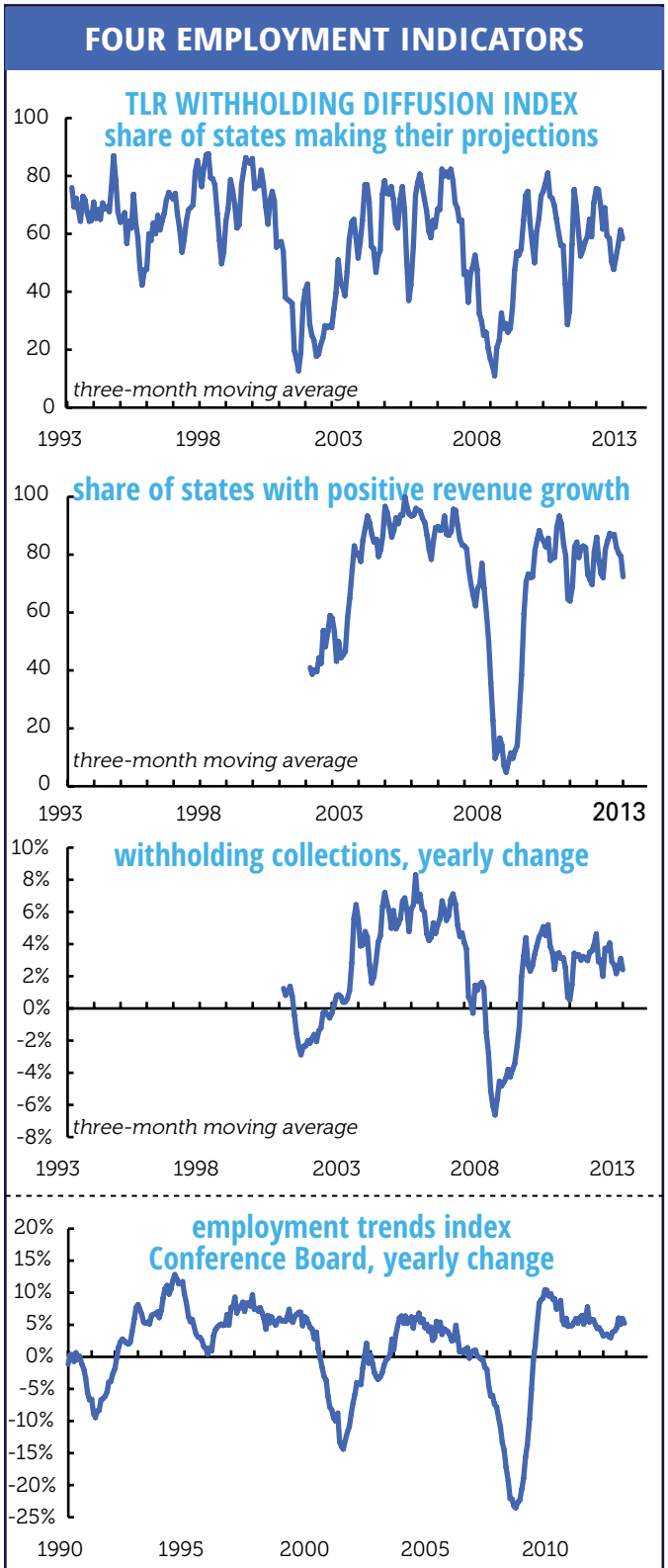
NOT WORRIED, BUT "ALERT TO POSSIBLE WEAKNESS"



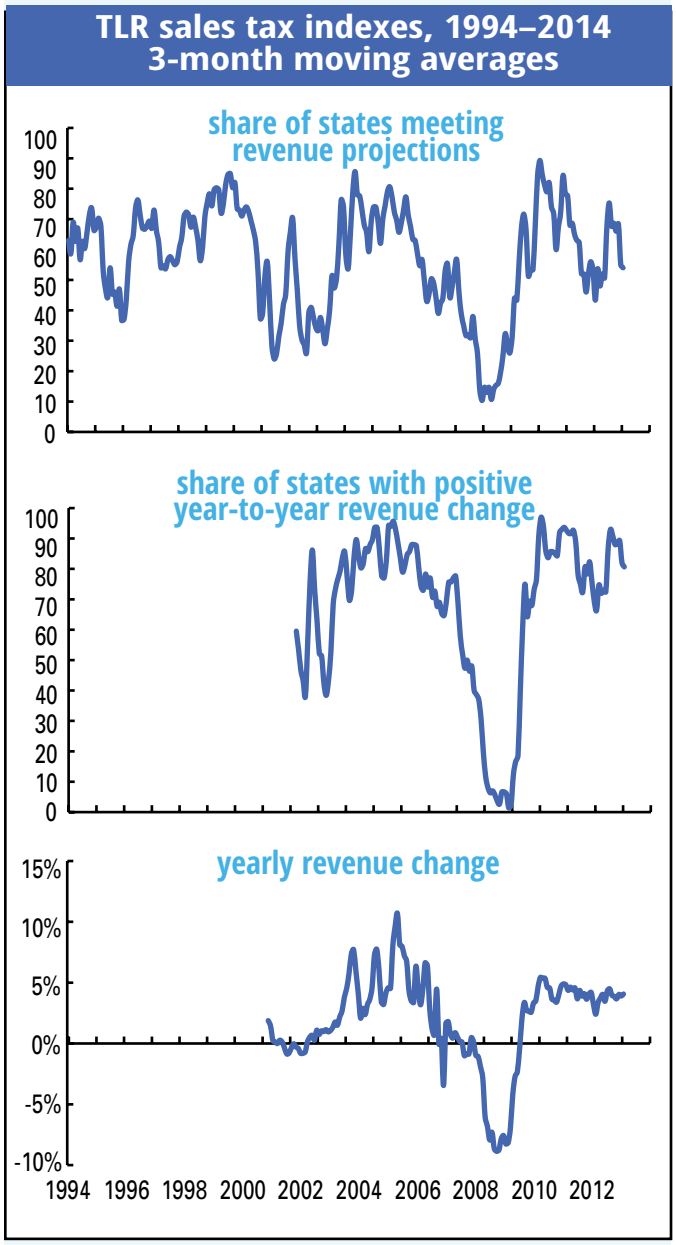
The Conference Board's ETI leads payroll growth by about three months. It appears here with permission.

In January, just over half the states in our survey met or exceeded their forecasted withheld collections, down from 61% in December. The average growth rate fell to 1.2% from December's 4.2%, and the margin from forecast held steady at 1.2%. (All averages weighted by state populations.) As we mentioned last month, tax-driven behavior in late 2012 exacerbated the already noisy year-end. (See graphs to left.)

It's not a good idea to form longer term outlooks during the volatile bonus season, but in general our contacts continue to evidence a bit more concern about weakness. One wrote, "same old story continues," (actually in solid caps, but we won't shout at you), and as has been the case since the recovery began to materialize back in February 2009, many penned qualifiers like "fairly consistent," and "relatively weak." And a contact in a generally stable state wrote our headline.

Although our contacts in the Midwestern manufacturing states are concerned about some weakening in receipts, we've heard some encouraging anecdotes from our contacts about regional manufacturing outfits, including new export contracts, and the Institute of Supply Management noted that many respondents cited weather as a factor in their weak responses in the January manufacturing survey. This will all be clearer as we move beyond bonus season and confusion brought on by the year's end.

The official retail sales print for January was negative but, again, we need to wait to see how much of this was the result of the weather. We know that is often advanced as a lame excuse, but considering that the severity of the storms, and the relentless media attention to road hazards, it's likely that some "elective" shopping was postponed. What people bought supports that theory:



bars and restaurants were negative, as hobby shops (including book stores), department stores, furniture outlets, and autos. Gainers included a price related increase in gasoline sales, electronics, grocery stores, and a pretty strong gain in building materials and garden supplies, read storm damage.

State sales tax collections are lagged, revenues include the latter part of the prior month and the early part of the current month so some of the strength we saw in January receipts was already reported in the December retail sales print.

In January, 57% of the states in our survey met or exceeded their forecasted the forecast sales tax collections, up from December's 34%, and 89% reported growth over the year, another improvement from December's 63%. The average over-the-year rate of change was basically steady at 3.7%, and the margin from forecast narrowed to -0.9% from December's average 3.1% miss. (All averages weighted by state population.)

Weather isn't the whole story. Some of the biggest misses in January were outside the regions where weather should have had the greatest impact—for instance pockets of weakness in the west and southwest. And there were some strong collections in the hard-hit Midwest, and in the Midatlantic, our contact in the latter reporting a solid holiday season with all but two of the major retailers reporting growth over last year.

We also heard comments from a number of our contacts that people seem to be spend-

SL

Philippa Dunne, Doug Henwood,
Mike Lipsman, co-editors
255 South 41st Street, Unit 150
West Des Moines, Iowa 50265

www.sightlinesbulletin.com
515-223-0611

ing more cautiously in recent months. In a large Midwestern manufacturing state, withheld receipts are holding up, but sales receipts have plummeted in the past two months. Our contact there suspects that strength in fall shopping may have been enabled by workers "spending their bonuses before they got them," moving the buying power of better wage out of the holiday shopping season, a trend exacerbated by the weather. Our contact in a large Eastern state said his department was considering lifting the sales tax forecast for 2014, having just raised the withholding forecast, but was prevented from doing so by "dismal" December," and continued weakness in January. He is concerned that the base is weakening, especially since it appears to him that strength in restaurants and hotels is driven by foreign tourists, and the anticipated holiday shopping season "never materialized."

It will be a big relief to get this winter behind us, both so we can make better sense of economic and revenue data, and because for many of us it's awfully cold.

JANUARY EMPLOYMENT DISAPPOINTS

The Bureau of Labor Statistics released another disappointing employment report. January's headline payroll gain of 113,000 was 77,000 below the average of the previous five months. The combined two-month gain of 188,000 was the weakest in three years. The overall number was dragged down by a weak government sector—but private employment's gain of 142,000 was 46,000 below the average of the previous five months.

The goods sector was unusually strong 76,000—7,000 of it in mining and logging, 48,000 in construction (three times its average over the last year), and 21,000 in manufacturing. It's unusual, and encouraging to us Made in America advocates, to see goods producing outpace the service section, which gained 66,000 jobs.

Services gainers included wholesale trade, up 14,000; transportation and warehousing, 10,000; professional and business services, 36,000 (a third less than its average over the last year); and leisure and hospitality, 24,000 (also a third under average). In the loser column were retail, off 13,000; finance, -2,000; education and health, -6,000 (with health up just 2,000—its yearly gain is the weakest in 14 years, suggesting that a structural shift is underway); and government, -29,000.

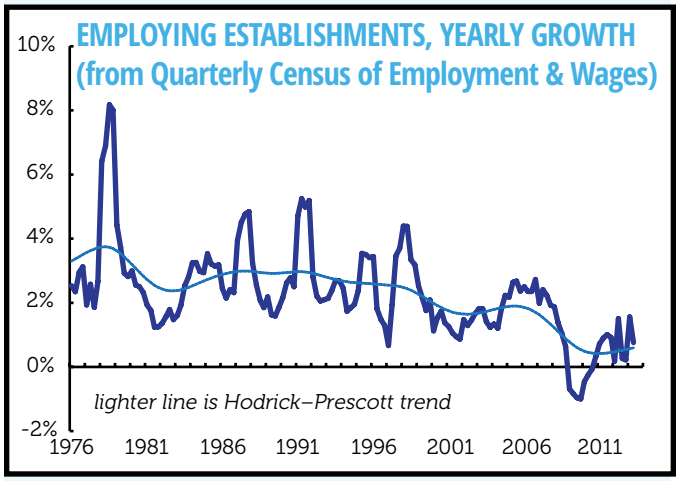
Average hourly earnings rose 0.2%, taking the three-month moving average up to 0.2% as well.

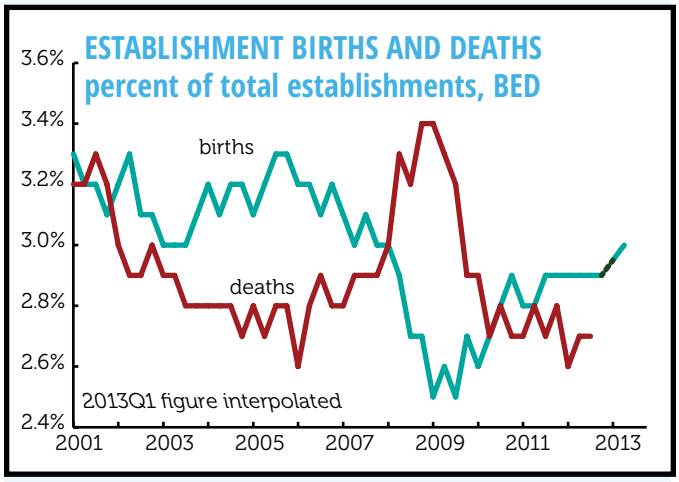
This month's release came with the annual benchmark revisions to the establishment survey. Total employment for March 2013 was revised upward by 369,000—but this was more than entirely the result of reclassifying 466,000 home health care workers who were previously not covered by the survey. Without them, the revision was -119,000, or -0.1% of total employment, a very small revision by historical standards.

The household survey was stronger than its establishment cousin. Total employment was up 616,000—or 901,000 when adjusted to match the payroll concept. Big numbers but this series is extremely volatile. The participation rate and the employment/population ratios both rose by 0.2 point.

The number of unemployed fell by 117,000, and the unemployment rate fell 0.1 point to 6.6%, its lowest level since October 2008. "Hidden" unemployment was also down, with the number working part time for economic reasons down by 520,000, and the broad U-6 unemployment rate was down 0.4 point to 12.7%, its lowest level since November 2008.

NEW BUSINESSES NOT GETTING THE JOBS DONE





NEW BUSINESSES NOT FORMING

From time to time we've noted the slowdown in business formation—which is a major damper on employment growth, since most job creation happens at younger firms. The latest readings are not encouraging—startups have recovered, but not by much.

Both the Quarterly Census of Employment and Wages (QCEW) and Business Employment Dynamics (BED) programs of the BLS report on the number of employing establishments. The QCEW data go back to 1975, while the BED figures only start in 2001. The BED series has the advantage of showing establishment births and deaths separately, while the QCEW just reports the number of establishment.

The top graph on the left, drawn from the QCEW, shows the recovery in the rate of growth in employing establishments from the recession lows has pretty much stalled out. In the second quarter of 2013, the number of establishments was up just 0.8% from a year earlier. That's considerably less than the 2.5% average of the 1980s and 2.8% average of the 1990s—but it's also well below the 1.5% average of the 2000–2009 period, which included two recessions and a weak recovery. The trend rate of growth is just 0.6%, a quarter of the average that prevailed from 1976 onwards.

The BED version, the bottom graph, looks more sprightly—in part because of its relatively recent start date, meaning there can be no unfavorable comparisons with the 1980s and 1990s. Business births are up—but still below the fertility rates of the mid-2000s. And deaths are way down—though the mortality figures only run through the end of 2012, since it takes a two quarters to pronounce an establishment truly dead. The

picture is similar to that of the labor market: much of the recovery in net job growth over the last few years has come from fewer job losses, not more aggressive hiring.

That impression was supported by the Job Openings and Labor Market Survey (JOLTS) data for December. Hiring fell from 3.3% of employment in November to 3.2% in December, with most major sectors down except for professional and business services. Openings were also down 0.1 point. And separations were up by 0.1—again, with only professional and business services bucking the trend. The quit rate—a measure of confidence in the labor market that's closely followed by the FOMC—fell 0.1 point, reversing November's gain. Though some Fed hawks like Charles Plosser are talking about labor market improvements, those improvements remain modest, and there's a lot of damage that still needs to be undone—and that's what Fed chair Janet Yellen underscored in her Congressional earlier in the month.

INEQUALITY AND (SLOW) GROWTH

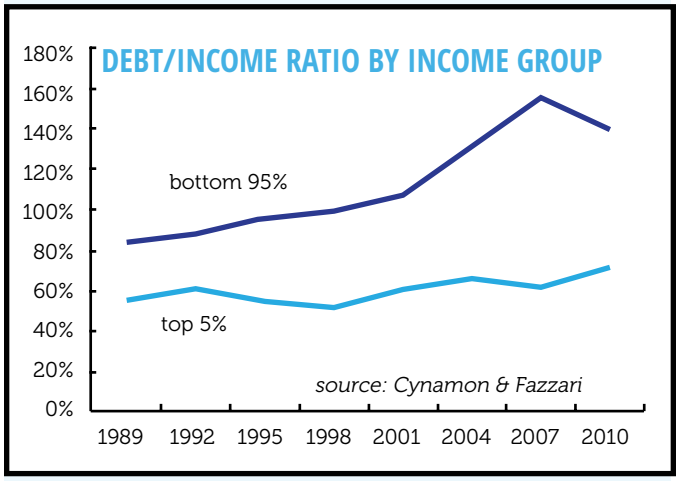
We know the story of how vigorous household borrowing leading to excessive debt loads laid the groundwork for the Great Recession—but which households, exactly, and why? In a new paper, Barry Cynamon and Steven Fazzari of Washington University (and, in Cynamon's case, also of the St. Louis Fed), decompose household borrowing by income grouping and find that growing inequality had a substantial role in laying the groundwork for the bust. In a phrase, the bottom 95% of households borrowed to offset stagnant income growth—and when the bust came, their inability to borrow more made the recession deeper and the recovery weaker.

No one publishes regular data on household balance sheets by income group. To fill that gap, Cynamon and Fazzari use a technique developed by Dean Maki and Michael Palumbo in a 2001 Federal Reserve paper. They combine data from the Fed's triennial Survey of Consumer Finances (SCF) and the quarterly flow of funds data to estimate household balance sheets by income group.

At first glance, you might think that increasing concentration of incomes at the top should lead to a slowdown in consumption growth, since richer households consume a smaller share of their income than poorer ones. And concentrate they did: while the income share of the top 5% stayed relatively steady at just over 20% from 1960 until the early 1980s, it began a steady rise to just over 35% in 2010. (This was the result of income for the top 5% growing at nearly twice the rate of the bottom 95%—5.0% vs. 2.6%.) Despite that disparity, the consumption share of GDP rose, and consumption rose relative to after-tax income over the same period that inequality was increasing dramatically.

The reason that the upward shift in income to a group that consumes a smaller share of it didn't lead to a slowdown in consumption growth—and led to quite the opposite, in fact—was that the bottom 95% borrowed a lot. As the graph on p.7 shows, the debt/income ratio for the bottom 95% nearly doubled between 1989 and 2007, while it rose only slightly for the top 5%. (They report that finer disaggregations of the bottom 95% show similar trends.) And when the credit machinery froze, the whole borrow-to-spend approach hit a wall. All the deleveraging that went on during the recession—and much of the collapse in consumption—happened in the lower 95%.

Since the income of the top 5% has grown far more rapidly than that of the bottom 95% since the recession ended, while credit growth remains subdued, the weakness of the recovery is in large part the constricted purchasing power of the lower and middle



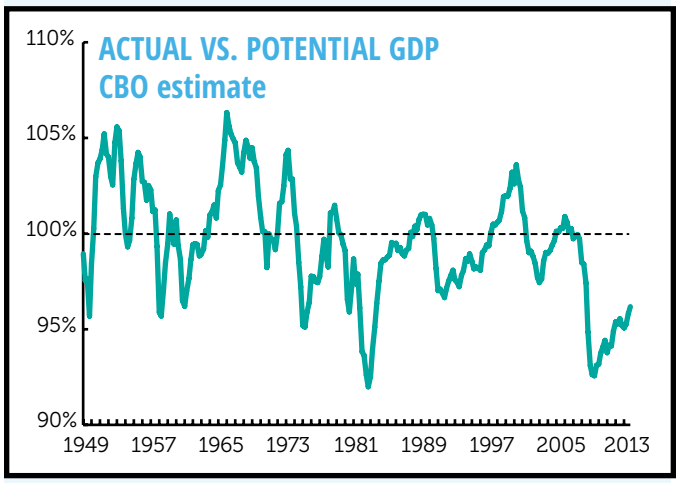
ranks. While deleveraging sounds virtuous, in the absence of income growth for the majority of the population, it will be impossible for economic growth to accelerate without a return to aggressive borrowing—and we know where that leads. Growing inequality, then, has clear macroeconomic effects—as Yellen noted in her Congressional testimony. Of course the thorny question is what to do about it. But increasing inequality is now much more than a philosophical issue.

An interesting aside: Cynamon and Fazzari cite supporting work by Atif Mian and Amir Sufi showing that zip codes with the largest income declines relative to the national average had the largest increase in mortgage originations between 2002 and 2005. That was an anomaly—in no other period since 1990 has there been a negative correlation between income growth and mortgage originations. The culprit looks to be the growth in non-government-sponsored enterprise mortgage securitization, namely the packaging of subprime loans. They found that during the bubble, existing homeowners borrowed 25 to 30 cents against every dollar of rising home equity—and the most aggressive borrowers were those in subprime zip codes.

GDP ETC.

The Congressional Budget Office (CBO) is just out with its latest long-range economic and budget projections. Fiscal matters have gotten plenty of attention, but the economic projections have gotten less. We're here to remedy that.

It's not a bubbly picture. They forecast potential GDP growth averaging 2.1% a year over the next decade, 1.2 points below the 1950–2013 average. They see productivity growing at 1.6% a year, 0.2 point below the 1950–2013 average. (That may not sound like much, but it makes a difference of 2.3 percentage points when compounded over a decade.) They see



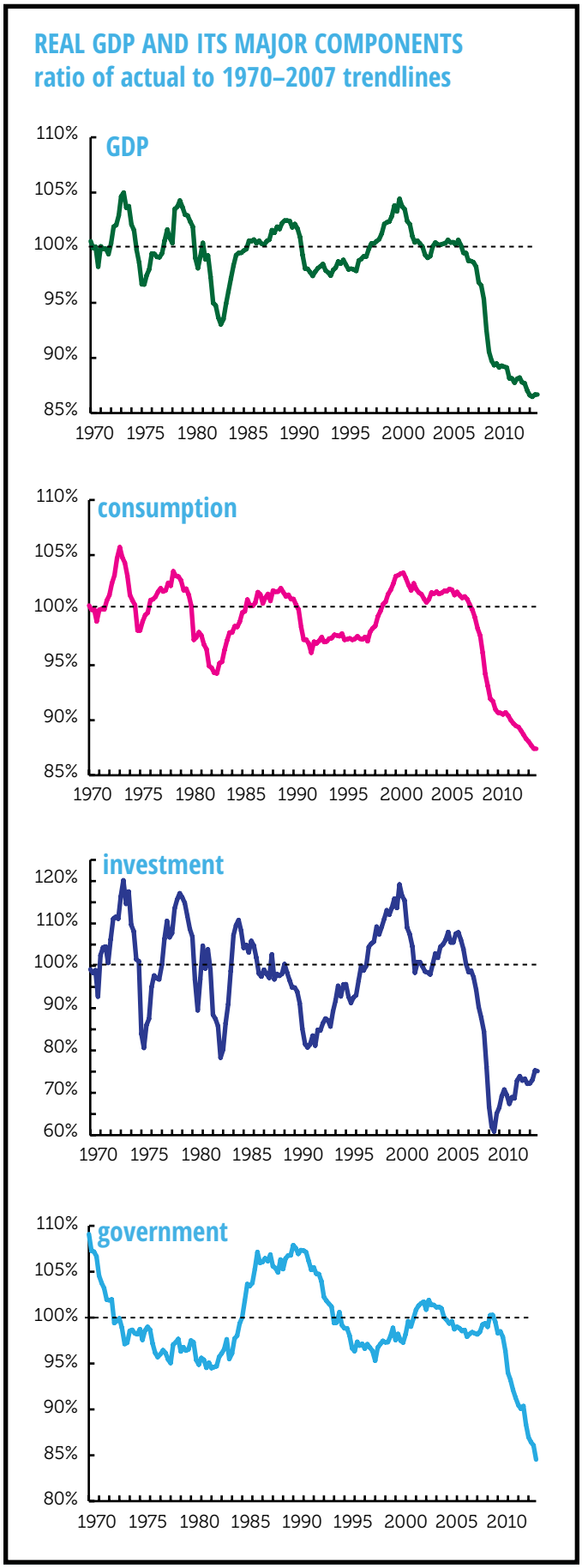
labor force growth of 0.5% a year, a third the 1950–2013 average. They've got the employment/population ratio falling another point over the next decade, and the participation rate falling by 3 points. If they're anything like right, both the participation rate and employment/pop ratio will be about 7 points below their 2001 peaks.

But by their estimate of potential GDP, which is based on a "natural" unemployment rate of 6.0%, we could be doing a lot worse. As of the fourth quarter of 2013, actual GDP is just 3.8% below potential. (See graph, to left.) Yes, the recovery has been slow. In the 18 quarters since the end of the recession, the ratio of actual to potential GDP has risen by 3.6 percentage points. The recovery from the 1982 trough was much sharper: 18 quarters after that bottom, the ratio of actual to potential GDP had risen 7.1 points, almost twice as much.

Another way to measure where GDP is relative to where it "should" be is by comparing the actual level to its long-term trend. That's what's graphed on p. 9—actual real GDP and its major components (consumption, investment, government spending) relative to their 1970–2007 trends.

This technique shows the economy in a much deeper hole than the CBO does. By this method, actual GDP at the end of 2013 was 86.7% of its trend value. That's actually 3 points below where it was when the recession ended. Consumption was 87.4% of its trend value; investment, 75.1%; and government, 84.5%. (Note that government, despite perceptions to the contrary, has been falling, not rising, relative to its trend.)

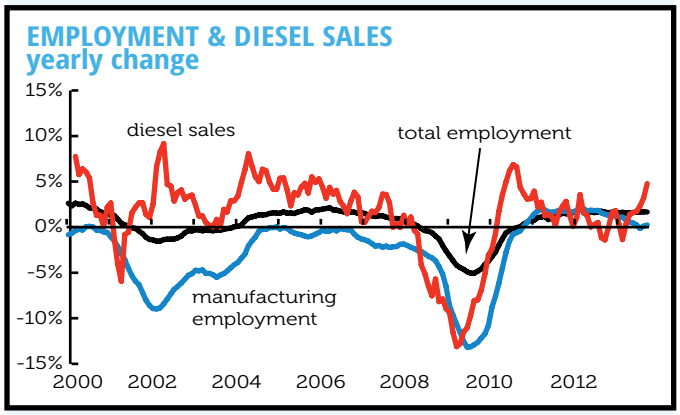
These are huge gaps. In nominal dollar terms, per capita GDP is $8,278 below its 1970–2007 trend. Using the CBO's less dramatic gap estimate works out to an actual per capita GDP $2,141 below its potential. Either way, that's a

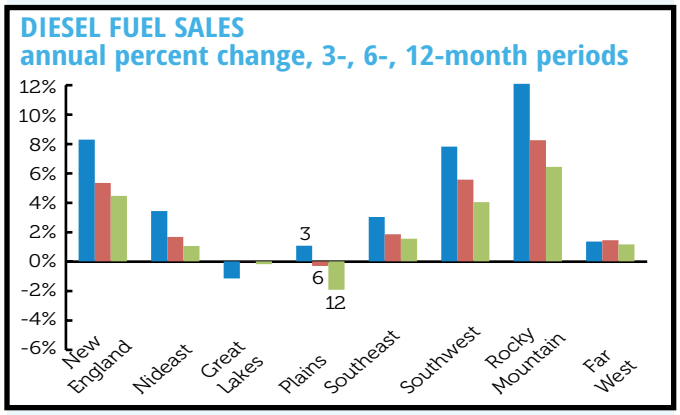


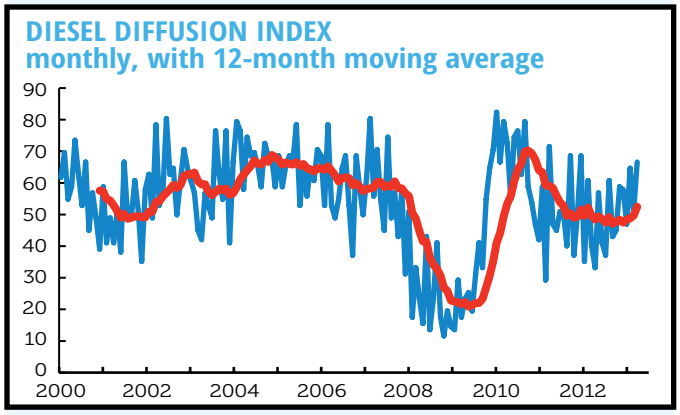
lot of money.

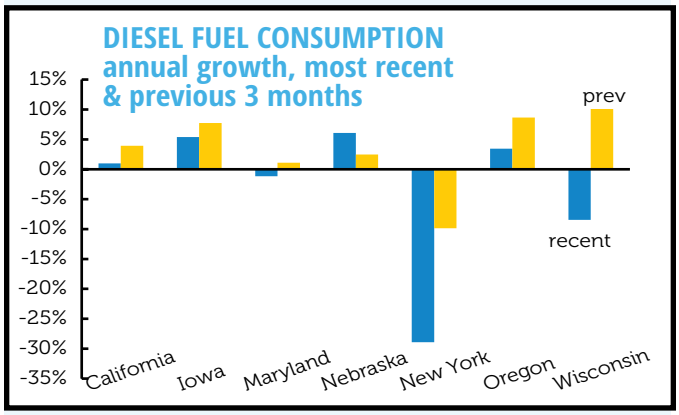
One way of reconciling the $6,137 disparity between the figures derived from CBO's method and the trend method is by pointing to the long-term economic damage done by the financial crisis and recession. The hit to investment, productivity, and labor force participation is enormous and long-lived. To put that $6,137 number in perspective, it's very close to the per capita GDP of China. That is not small, and if the CBO is even half right, it's not going away any time soon.

DIESEL SALES ACCELERATE









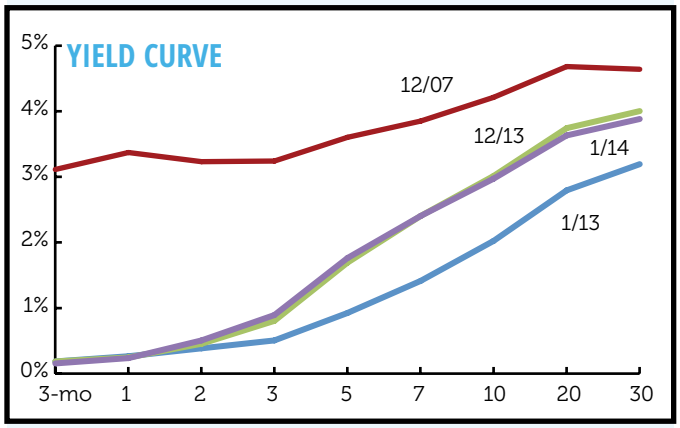
Diesel sales growth accelerates. The Federal Highway Administration's (FHWA) most recent release of sales data for diesel fuel—actually special fuel, which is predominantly diesel fuel—shows sales up 6.4% for the year ending September 2013, up from August's 1.8%. Thirty-four states reported sales increases. As the graph to the left shows, the one-month diffusion index rose, and the moving average of this noisy series is in a clear uptrend, and is above 50 for the first time since July 2012.

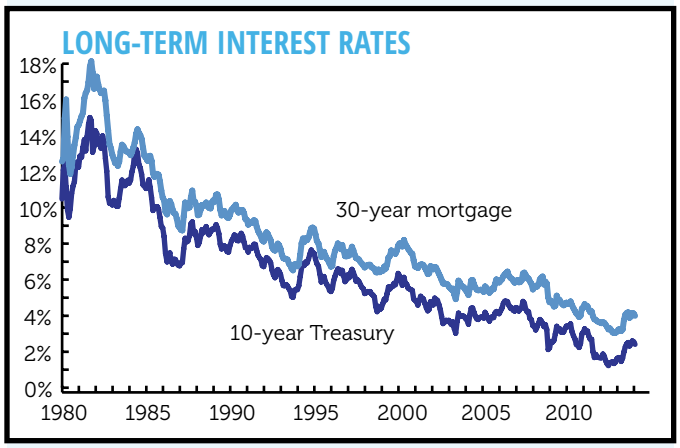
Sales accelerate in all but two regions. The second chart shows sales growth by BEA region. Growth was strongest in Rocky Mountain, New England, and Southwest regions. Decreases in the Great Lakes region may be taken to indicate a weakening of production in the motor vehicle manufacturing sector, but on closer examination the weakness in diesel fuel sales in this region can largely be attributed to Wisconsin. Growth in the Plains region remains weak, but at least it's moved from negative to positive.

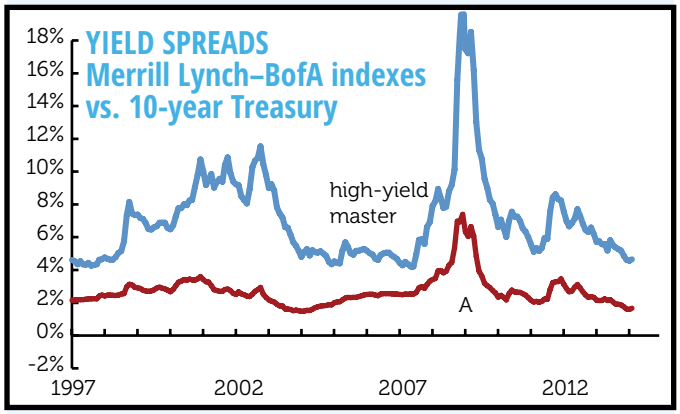
Diesel foreshadows stronger job growth. Nationally, diesel fuel sales perform well as a forward indicator of changes in employment, as the graph to the left shows. It suggests accelerating job growth in the coming months.

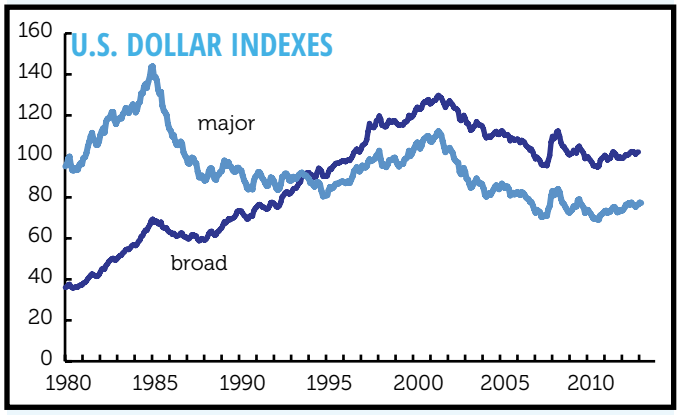
State data. Some states publish their own fuel tax and consumption statistics prior to the release of the FHWA data. (California data is through October; Maryland, Nebraska, and New York, through November; the remainder, through December.) California growth slowed down in the most recent month; one has to wonder what impact drought will have on the state's economy. New York's sharp decline looks like an anomaly compared to previous months. The uptick in diesel (and other special fuels) consumption in six of the seven states over the past three months signals continued economic growth and increased manufacturing activity.

FINANCIAL INDICATORS









Fed continues to reduce asset purchases. At its January 28–29 meeting, the FOMC decided to continue the scaling back of asset purchases. The targets are now $30 billion per month of mortgage-backed securities and $35 billion per month of Treasury securities. The total is now $65 billion per month, down $20 billion from two months earlier. The FOMC took no action on interest rates. While some members raised the issue of when the Fed should begin to raise the target, it probably won't happen until mid-2015.

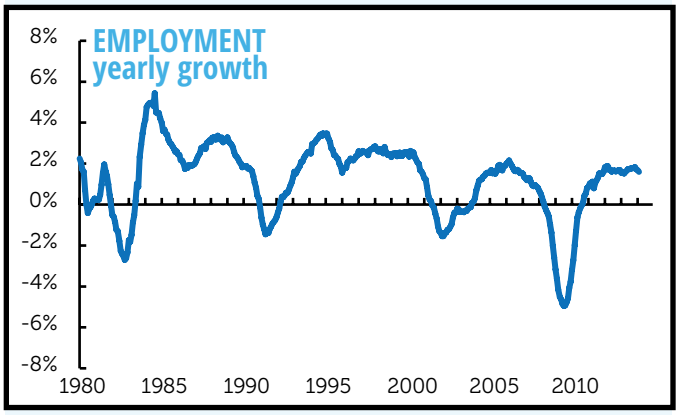
Yield curve in a twist. Treasury yields were little affected by the scaling back of asset purchases. During January, mid-maturity Treasury rates moved up slightly, while for longer maturities the rates decreased. This caused sort of a twisting of the yield curve.

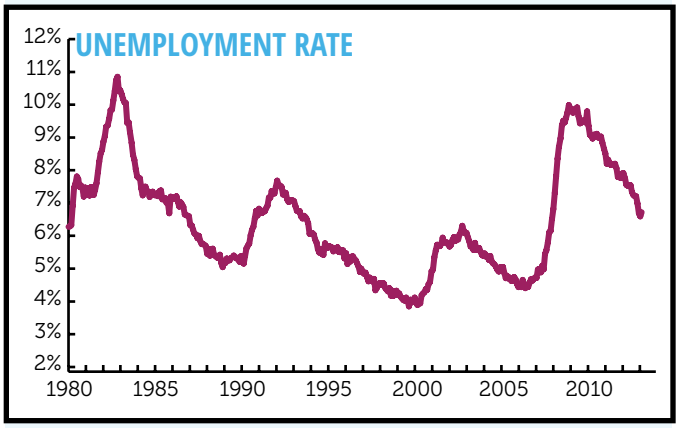
Yield spread signals faster growth. Although the spread between 3-month and 10-year Treasury yields declined by 1bp during January, it remains at a level that signals an improving economy. As the Fed scales back on asset purchases while maintaining the federal funds target near zero the spread will likely increase during 2014. Thus, going forward the signals being provided by this indicator may be somewhat overstated.

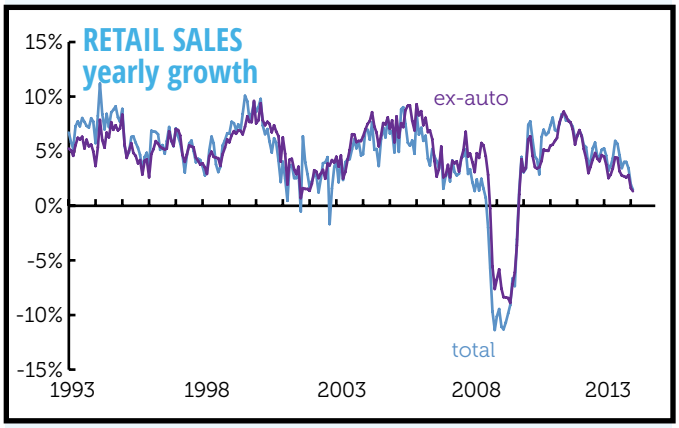
Yields on all corporate debt down. Yields declined slightly in January across the ratings spectrum, with CCC declining the most. During January $128.1 billion in new corporate debt was issued, 20% of it high-yield. The value of January issues of new debt far exceeded December's but was down from a year earlier.

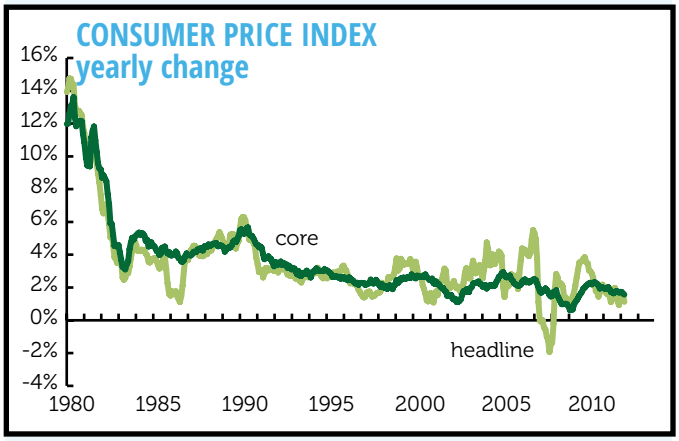
Mortgage rates on hold. Average interest rates on conventional 15- and 30-year mortgages barely changed in January. Also, during January sales of existing homes dropped by 5.1%—the largest decrease in 18 months. Weather more so than rising mortgage rates is the likely cause of the drop.

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 left shows, remains at or above the peaks of the 1990s and early 2000s. At 6.6%, it couldn't get much closer to the Fed's 6.5% target, meaning that the FOMC and the Fed's new chair are going to have to clarify its intentions should the jobless rate hit that magic number. Given recent rates of decline, we could hit 6.5% any month now. 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—but if many of those workers are out of the labor force forever, "adjusting" the unemployment rate to reflect that is a dicey business.

Retail sales had a bad month, with the headline figure down 0.4%, ex-auto flat, and ex-auto and gas down 0.2%. The yearly gains in in the headline and ex-auto measures are just above 2%, the weakest they've been since 2010. It may be weather, or it may be that consumers are tired from all the paycheck-stretching they've been doing.

Inflation remains very subdued, with both overall and core consumer prices up 1.6% for the year ending in January. Both are below their 2012–2013 averages of 1.8% and 1.9% respectively, and below the Fed's long-term target of 2.0%. The stability of core inflation since the mid-1990s is a striking feature of the graph to the left.