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The Liscio Report

On the Economy

For John Liscio 1949-2000

Can you say, "Housing, gas, and food prices"?

•*extending the holiday season didn't help much*

• *mood darkens further*

• *flow of funds analysis: housing bust visible, but not the credit crunch*

• *stagflation hits the hot dog*

In February things were little changed on the state sales tax receipt front. Thirty-six percent of the states in our survey met or exceeded their collection targets, basically flat with January's 35%, and 49% of the states reported some growth year-over-year, up from January's 41%. (Sales tax collections are lagged so collections in a given month reflect both the beginning of the current month and the end of the prior month.)

Last month we reported that it is unusual for over half of our contacts to report actual declines over the year, and that we last saw stretches of such weakness back in 2002–3. February's 49/51 split is a bit of an improvement but is weak enough to lift the possibility that this is the beginning of an unfortunate trend. Currently there are only a few states in our survey reporting strong sales tax receipts, one a large fast growing state, one a large Midwestern state that has been down so long it's finally looking up by comparison, and several other small states scattered around the country. As we have mentioned, in recent month even sates outperforming the country are now showing signs of serious slowing. Our contact in one such state reports they are still positive over the year but that a "significant slow-down is evident in our economy-based taxes." Another is just finishing up the analysis of 2007Q4 sales receipts, which fell to just 1.6% from +4.7% in 2006Q4.

Our contacts now have the results of the new "extended" holiday season. It has been weak pretty much all around, for some distressingly so. Our contact in a large Midatlantic state reports that there have only been two other instances when the entire holiday season fell below that of the prior year in 40+ years, once in Christmas 1990 and once in Christmas 2002. He added that one was during the Gulf War, the other right before we went to war in Iraq, and suggested a correlation between the related anxiety and the weak

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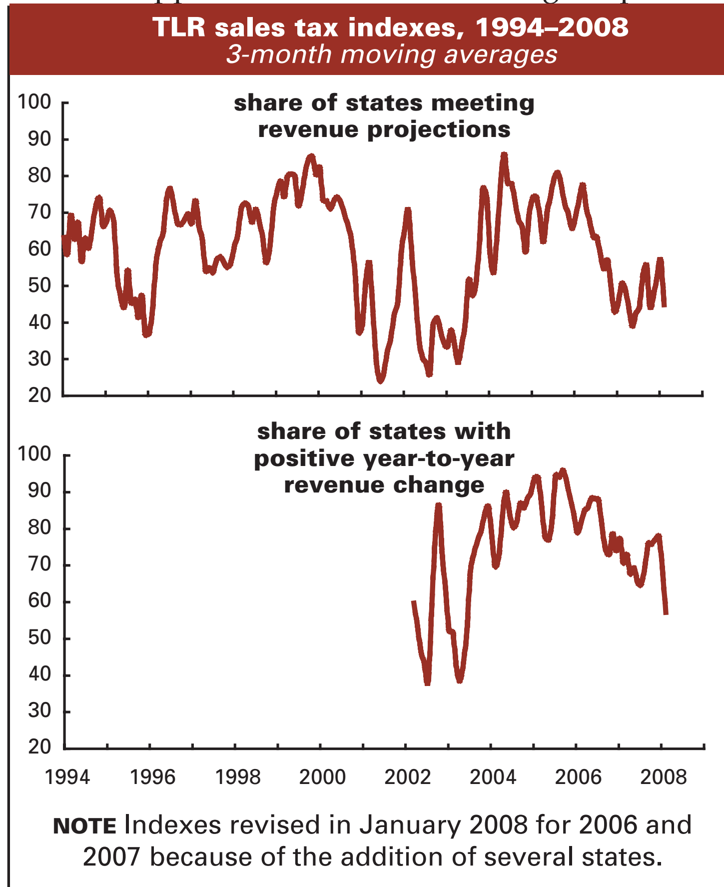
holiday season. His explanation for this one, not surprisingly: "Housing, food and gas prices."

Our survey is weaker than it appears on the surface. Since it's based on actual versus forecasted collections, downward revisions to those forecasts, the result of a slowing economy, often a stronger survey make. Recent revisions mean that one big Midwestern state beat their estimate with just +0.8% y/y growth; the estimate going forward is a puny +0.5%. Many states were meeting or barely exceeding forecasts well below current inflation rates, others expected no growth or outright declines in February, with little improvement going forward.



NOTE Indexes revised in January 2008 for 2006 and 2007 because of the addition of several states.

mood indigo

It's not just the collections realm that's looking darker. Gallup has been doing daily tracking polls of consumer attitudes about the economy, something they haven't done before. When we last visited them a month ago, they'd stabilized; they've since fallen further. They show a notable deterioration since the beginning of the year. In early January, 73% of respondents said that the economy was getting worse, and 20% said it was getting better, a spread of –53 points. At our last visit, in mid-February, the spread had widened –64 points. In the latest read, an average of polls taken from March 7–10, the spread widened further, to –70 points. At the beginning of January, 30% rated the economy as excellent or good, and 24% as poor, a spread of +6. In mid-February, the spread was –10. The latest spread is –18. Gallup only started asking these questions with any frequency in 2000, so there's not a long history on the series, but they did ask it periodically throughout the 1990s. Current evaluations of the present situation are above the depths of the early 1990s recession/jobless recovery, but expectations for the future are worse—and both present and future measures are considerably worse than they were during the

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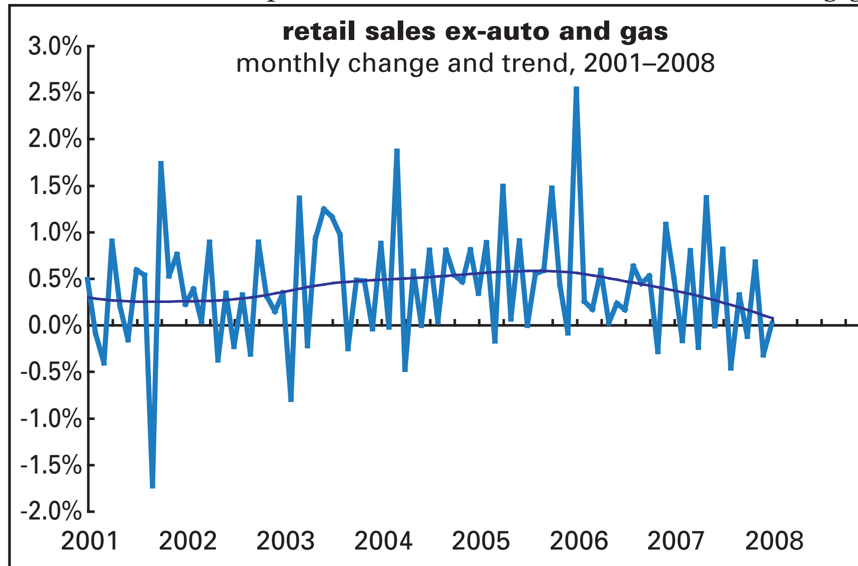
2001 recession and its jobless aftermath. If housing and the job market continue to deteriorate, these numbers could plumb new depths.

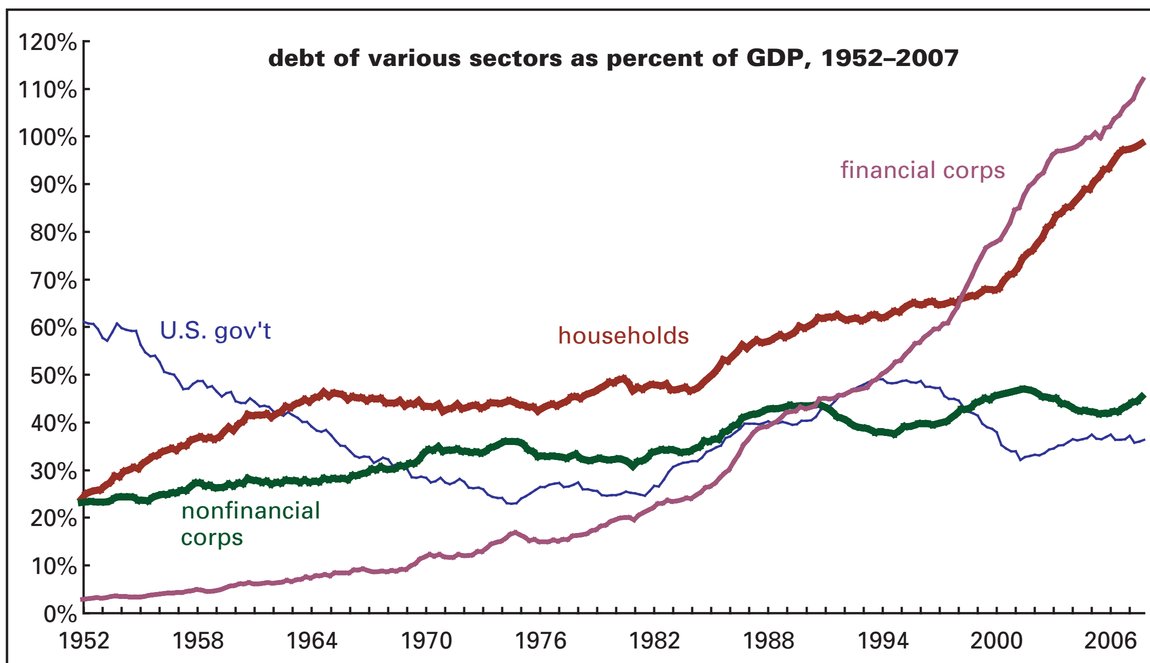
flow of funds in 2007Q4

It's that time of year again: our quarterly flow of funds analysis. Some macro trends, notably the housing bust, are quite visible in this invaluable series. But others, like the credit crunch, have yet to make an appearance.



debt picture

While an hour hardly passes without someone talking about the breakdown of the credit markets, that's not yet visible in the flow of funds accounts. Total credit market debt outstanding grew at an 8.6% annualized rate in the fourth quarter, only slightly behind the pace of 2005 and 2006. Household debt grew at a 5.8% rate, about half the pace of 2005–6 (and faster than nominal GDP), but nonfinancial and financial corporate debt growth was higher in the fourth quarter than in those earlier years, as was federal, state, and local government debt growth. If a credit crunch is going to hit the real economy, we haven't really felt anything yet. As a result, all the sectors graphed on p. 3 rose



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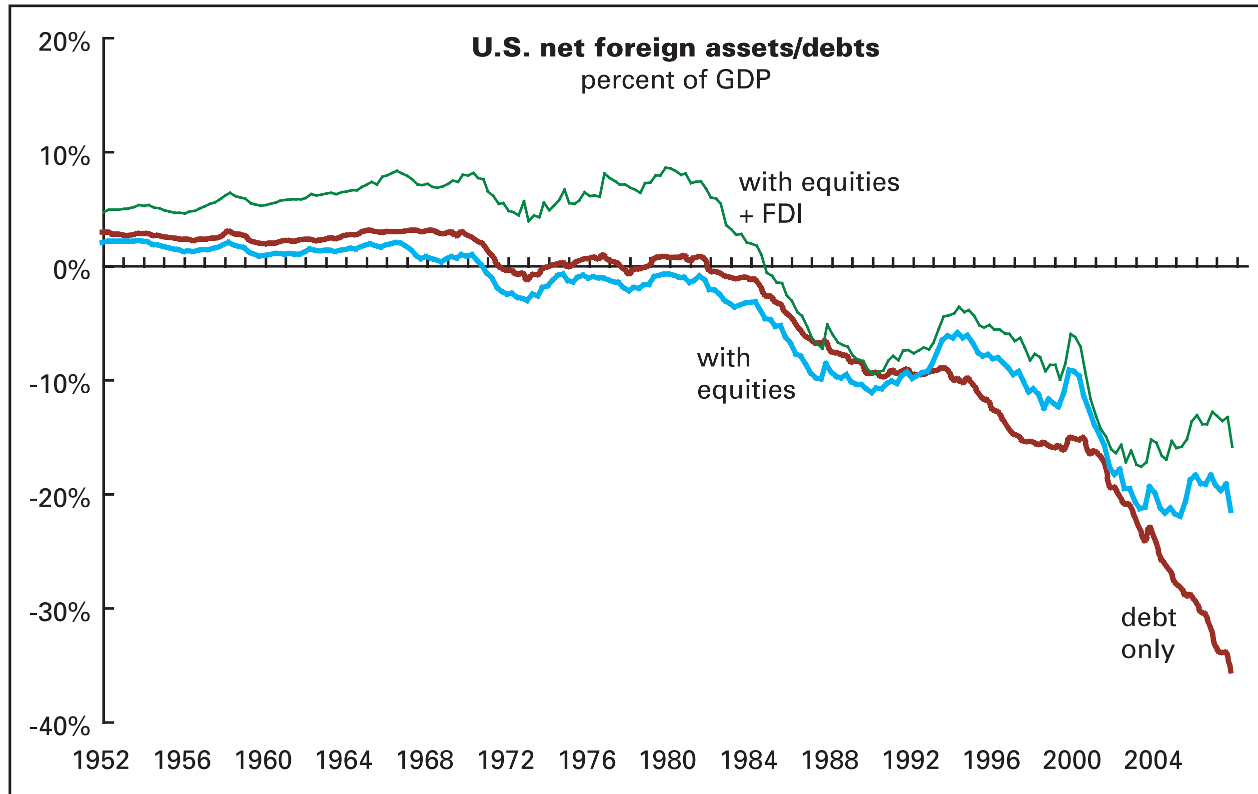
relative to GDP, with households and financial corps both setting new records, and nonfinancial corps hitting a five-year high.

As with the credit crunch, if this is the time when the chickens are coming home—when the seemingly endless river of foreign credits is going to go dry—it's not yet visible in the flow of funds accounts.



And since the savings rate hit 0% in the fourth quarter, much of this fresh borrowing had to be financed abroad, with the pace of foreign borrowing accelerating compared to 2005, 2006, and early 2007. U.S. net debt to the outside world came close to 36% of GDP at the end of last year, up almost 4 points in a year, and almost 10 points in three. The non-debt position of the U.S.—net equity and FDI holdings—did offset the debt somewhat, though less than in the past, as the value of foreign equity holdings by U.S. owners declined more than did the value of foreign holdings in the U.S., and foreign direct investment in the U.S. exceeded U.S. direct investment abroad.

households

Household net worth declined in the fourth quarter for the first time in more than five years, though the rate of decline was slower than it was in 2001 and 2002. Although the major culprit was housing, of course, nonresidential net worth excluding durables also declined as a percentage of disposable income. (The Fed oddly counts consumer durables as assets. Yes, durables do provide useful services over time, but they don't throw off income, and are generally rapidly depreciating assets, as anyone who's ever tried to

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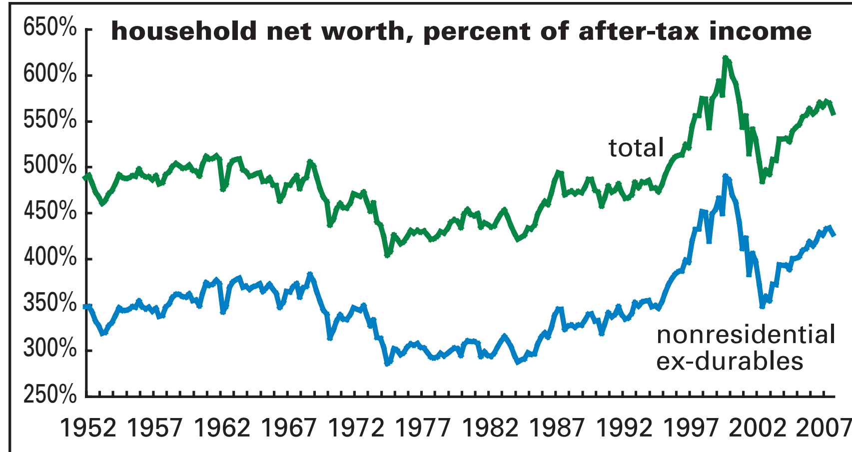
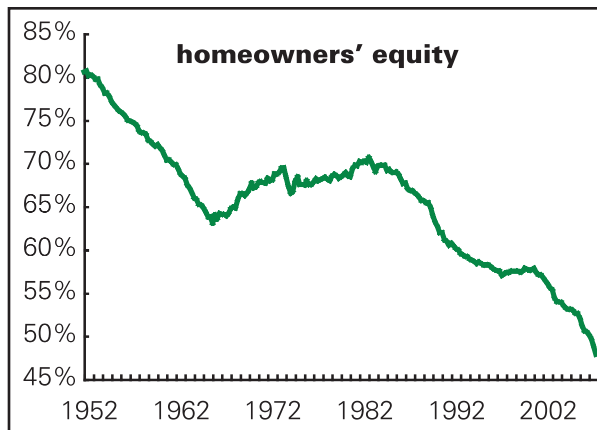
sell one on Craigslist knows all too well.) The major reason for the decline in that narrower measure was a decline in the value of directly held stock (again, relative to disposable income), though the value of other financial assets also declined modestly, and nonmortgage debt rose.



It's no surprise, though, that the major action was in housing. In real terms, the value of housing declined, while the mortgage debt increased, though at a slower rate than in previous quarters. That meant a further decline in homeowners' equity, to 47.9% of the value of underlying property. That extends a long slide that began in the early 1980s, when it was in the low 70s. It's remarkable that the greatest housing boom in U.S. history was accompanied by a rapid decline in equity, as growth in mortgages outstanding far outstripped appreciation in underlying properties.



News that equity had declined below 50% did get fairly wide coverage in the media. Less noticed were the revisions to previous quarters, the second set of major alterations the series has received in recent years. Back in early 2006, the stats showed home equity in a three-year uptrend. That was revised away very dramatically with the 2006Q2 flow of funds release (see graph, p. 6). The latest release revises the equity numbers down further, by about 6–7% in recent quarters, almost entirely because of downward revisions to the asset side of the balance sheet. These numbers are almost certain to continue to slide in coming quarters—and it looks like mortgage debt still has some catching up to do.

Real house prices have finally gone negative, down 2% from a year earlier (see graph, p. 6). This is in the neighborhood of earlier housing busts, though well short of the mid-1970 disaster; it's not unrealistic to expect something on the order of 1974's 10% decline, consider the length and extremity of the recent bubble. The growth in mortgages, as the graph shows, is not yet matching earlier lows, so we might expect that number to go negative sometime soon.

Another way of measuring how far along we are in the housing retrenchment would be the five-year change in real housing values. As of the fourth quarter, it was still strongly positive, at 34%—higher than it's been through most of modern history, with the exception of a few

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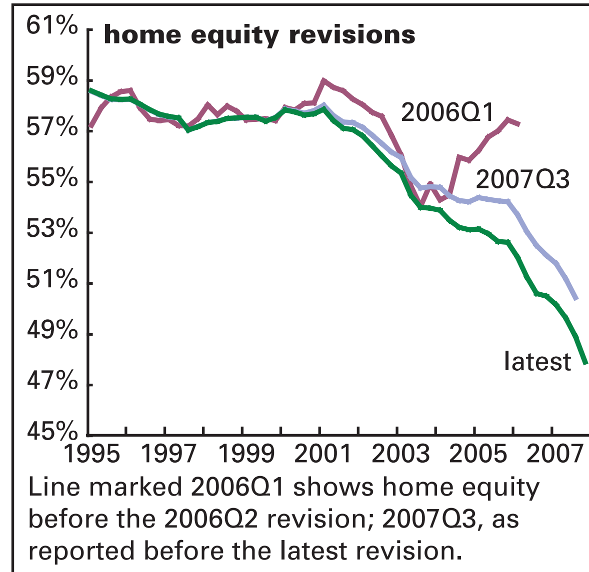
booms. At major housing bottoms, it's fallen to between 0–20%. Since the peak was 51%, we're about halfway there, at least by the law of averages.

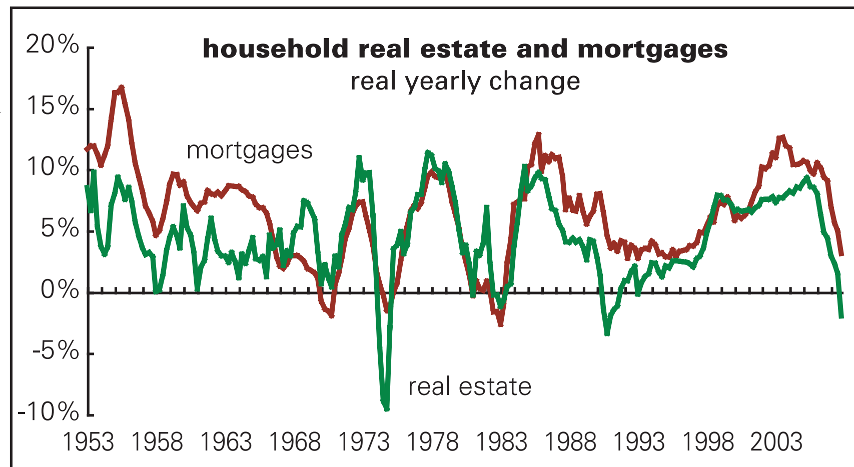
nonfinancial corps

We won't have the fourth quarter NIPA profit figures until March 27, so we can't present our usual profitability chart yet. But the outstanding feature of the nonfinancial corporate components of the flow of funds release is the increase in the amount of cash that firms have been shoveling into the pockets of shareholders.



Line marked 2006Q1 shows home equity before the 2006Q2 revision; 2007Q3, as reported before the latest revision.

In the flow of funds accounts, the sum of after-tax profits plus depreciation equals internal funds. After several years of plenty—basically 2002–2006—internal funds have been drying up of late. But firms didn't spending that gusher on capital equipment; as the graph on p. 7 shows, for most of that period, capital expenditures lagged internal funds. That was the reverse of the late 1990s, when capex ran well ahead of internal funds for the first time since the late 1970s/early 1980s. As internal funds have turned south, so has capex.



That hasn't stopped firms from passing along cash to shareholders. There are several ways to do that, starting with conventional dividends. From 1952–79, dividends averaged 43% of after-tax profits (by the flow of funds measures, which differ from the NIPAs). In the 1980s, the payout ratio rose to 63%; in the 1990, it was 77%; so far this decade, it's averaged 84%. In the fourth quarter, firms paid out 73% of their earnings as dividends.

But that's not all, as they say on the cable TV ads. Firms also distribute cash to shareholders via buybacks and takeovers, which enter the flow of funds accounts as negative equity raised. Put it all together—that negative equity plus dividends—and you get what might be called transfers to shareholders. That measure reached 184% of internal funds (yes, firms handed out more than twice as much as was available internally) in the fourth quarter, an all-time record, breaking the record of 140% set in the previous quarter, which itself

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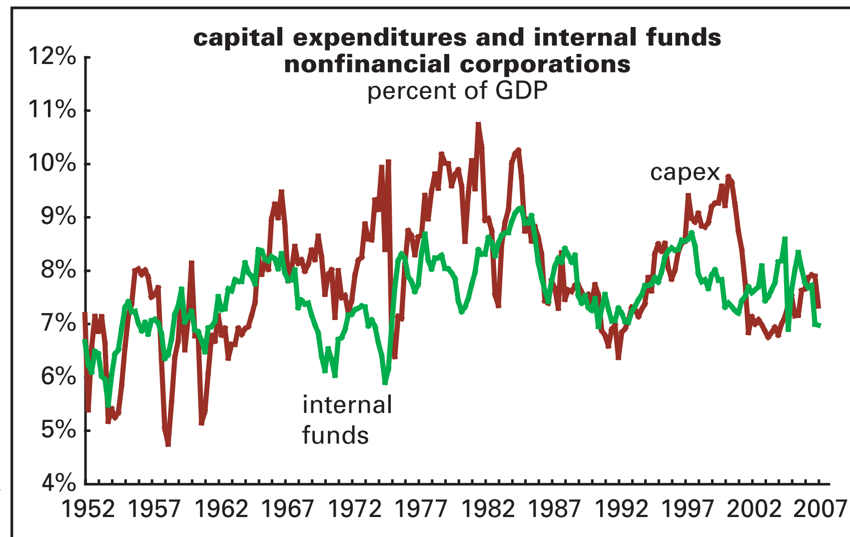
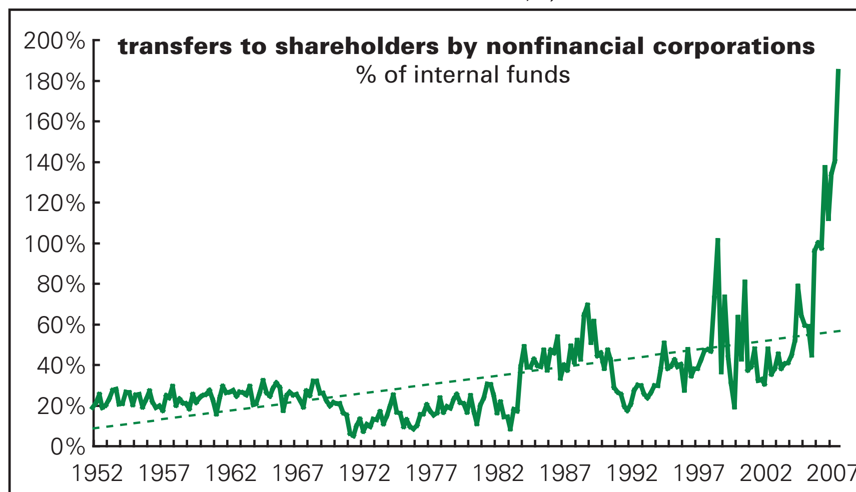
broke a record set at the end of 2006. (See graph, below right. A chart showing these transfers as a percent of GDP would look very similar; they hit 12% of GDP at the end of 2007, five times the long-term average.) Needless to say, these transfers have provided enormous support to the stock market, and it seems very unlikely they'll continue at this level.



In sum, if there's going to be a rebuilding of the national balance sheet, it hasn't really started yet.

Thursday's retail numbers

As we have pointed out many times, the Advance Retail Sales print is among the noisiest of statistics, wildly revised with little relationship from one month to the next. The non-farm payroll report, for instance, has a serial correlation of +0.61, whereas the retail sales report's are all negative: -0.36 on the headline, -0.27 on the ex-auto, and –0.33 less autos and gas. That noise tends to obscure the underlying trend which, graphed on p. 3, is heading toward zero, in line with our survey.



Gas and food prices are hitting hard, but people have to eat, and so far they feel compelled to drive. (Pollster Britt Beamer just finished a survey indicating that Americans have yet to begin carpooling.) And a surprising tidbit from our survey puts a number on the effect of food prices: our contact in a state with a small local tax on food items reports that this tax, which usually grows at 2 to 3% y/y is currently racing ahead at 10%, "all inflation."

Price increases in necessities will likely further erode discretionary spending as the months roll by, but we suspect they bolstered nominal retail sales in February, bringing them in line with January's advance print of +0.3 for both headline and ex-auto. As one of our tax contacts noted when reporting February receipts higher than expectation: Don't take this to mean we'll be seeing much growth in coming months.

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Auto sales are a real wild card though. They were up 0.6% in January even though unit sales were down. We suspect January will be revised down a bit, but if February is payback time, that will weaken the headline considerably.

And Nicholas Gray, owner of New York fixture Gray's Papaya, is raising the price of the hot dog emporium's famous recession special: "It's every damn thing," he says. Stagflation comes to street level.

— Philippa Dunne & Doug Henwood

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