Copyright 2006, TLR II All rights reserved. Volume 15, Number 10

May 10, 2006

The Liscio Report

On the Economy

For John Liscio 1949-2000

Edgy debtors & a history book

Our survey of state sales tax receipts took a dive in April, with just 51% meeting or beating their projection collections, down from 77% in March, and 77% in positive territory year over year, down from 97% in March. April is a small month for sales tax collections, and the March/April pair, with Easter shifting back and forth, can be difficult to target correctly. As we often mention, the current month's sales tax collections reflect both the prior month and the current month's activity, so the already reported weakness in March national retail sales is probably showing up in our April survey. But it may be more than that.

- ***landscape is changing***
- ***long-term gain on housing: 0.6% a year***
- ***consumers turning prudent?***

For the most part our contacts are taking a wait-and-see attitude to this month's weakness, and we're passing along some comments that bear watching. First off, the established disparity between the performance of the Midwest and the other regions is beginning to break down. The Midwestern manufacturing states remain weak, but some of the large states outside the region are reporting a sharper decline in sales tax collections.

Two big coastal and two large Midwestern states missed their sales tax projections, one by a wide margin. This is somewhat perplexing since three of these states collect sales tax on gasoline purchased at the pump. Recent price increases alone should have boosted them over their bars, so this could mean that consumers are reining in discretionary fuel spending. And the national Energy Department figures for gasoline volume look like they're going into negative territory; though the numbers are very volatile, the trend in the year-to-year change (as measured by our new statistical trend-finding friend, the Hodrick–Prescott filter; see also p. 6) is now negative for the first time since the series began in 1992.

The housing angle

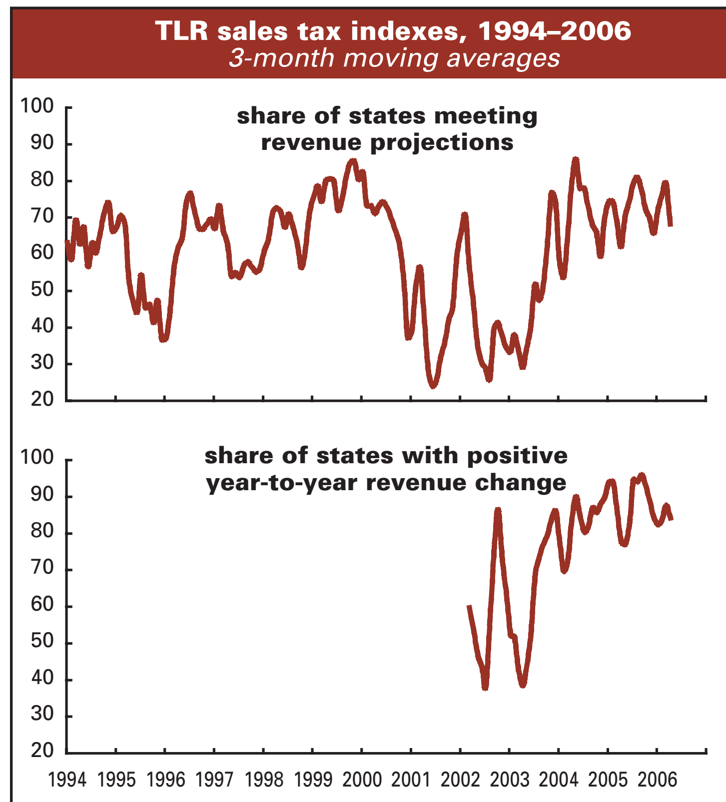
The majority of our state tax contacts reckon that close to 30% of the growth in sales tax receipts flows directly from the housing boom, and have generally projected moderation in sales tax growth in the coming quarters. Although it is likely too soon to see the effects of cooling hous-

fidarsi é bene; non fidarsi é meglio

Call: 917-408-0368

Copyright 2006, TLR II. All rights reserved.

ing markets on sales tax collections, we may be seeing the first glimmer of evidence in this month's sales tax index. James R. Hagerty's April 26 *Wall Street Journal* piece, "Housing Strength in New Markets," compared employment outlooks and change in housing inventory in 18 major real estate markets. (He also points out that even as inventories in Miami, Boston, San Francisco, New York and Los Angeles rise, the markets in Houston, Dallas and Atlanta are picking up steam.)



There does appear to be a loose relationship between the regions cited by Hagerty as having the fastest rising inventories and those where sales tax collections are slowing most rapidly. And, not surprisingly, there is definitely a correlation between regions with continued strength in housing, especially in the Southeast, even if not identified by Hagerty, and strong sales tax collections. We will compile this data for next few months and present it as soon as a picture emerges.

Housing exuberance

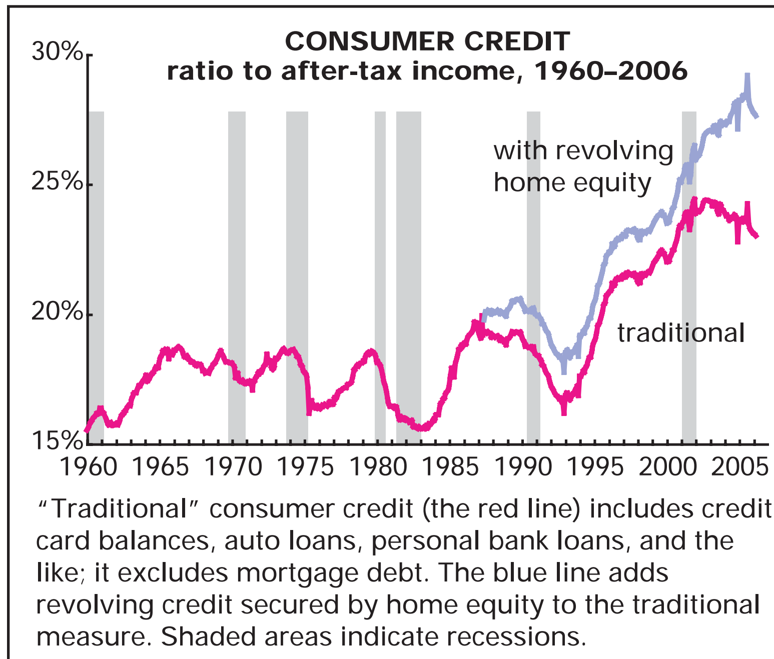
Given how central the housing market is to our economy—not to mention our politics, culture, and even our fantasy life (there's a reason we call homeownership The American Dream)—it's remarkable that we don't have good long-term price indexes like the Dow or the S&P 500. Yes, there's the OFHEO index, but it only goes back to 1975. And while the new and existing house price measures, from the Census Bureau and the National Association of Realtors, go back to the 1960s, the cover different universes and often tell different stories.

But recently Yale economist Robert Shiller has done some heroic work putting together a single house price index for the U.S. going back to 1890, one that's adjusted, like any proper price index, for changes in quality. It's the topic of a chapter in the second edition of his book *Irrational Exuberance,* which came out in hardcover last year from Princeton University Press, and is just out in paper from Broadway Books. His analysis got some attention when the hardcover came out, but it's apparently since receded from memory, and some aspects of his work were largely overlooked. This is a good time to take a fresh look.

The title *Irrational Exuberance* comes from Greenspan's infamous speech in December 1996, which he delivered two days after meeting with Shiller; Shiller didn't utter those two words, but they did summa-

Copyright 2006, TLR II. All rights reserved.

rize his message to the Fed chair. A few years later, in March 2000, Shiller published the first edition of the book, which diagnosed the stock market as suffering from exactly that condition. The Nasdaq duly peaked almost at the moment Shiller's book was hitting the shelves. And now that the paperback of the second edition is hitting the shelves, it looks like the housing bubble is starting to leak serious air.



"Traditional" consumer credit (the red line) includes credit card balances, auto loans, personal bank loans, and the like; it excludes mortgage debt. The blue line adds revolving credit secured by home equity to the traditional measure. Shaded areas indicate recessions.

Shiller made his academic reputation in the early 1990s with a paper that argued that stock prices moved around far too much to be justified by underlying fundamentals (like dividends and earnings). At the time, efficient market theory reigned in financial economics; it held that market prices fully reflected all available information, and were fully rational. Shiller's paper forced economists and financial analysts to think about the role of emotion, cultural trends, and "mob psychology" in setting prices. Of course this wasn't news to a lot of market practitioners, but it was a shock to a lot of academics.

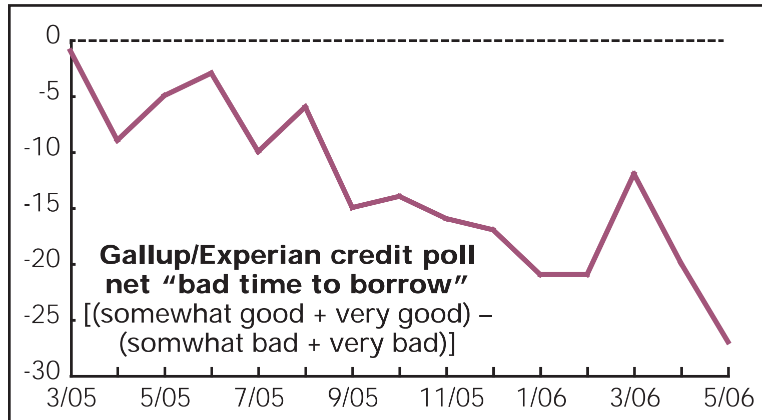
It's often said that there's no national housing market, only a collection of local ones. That's partly true, but, as Shiller notes, less and less so; over the last decade, there seems to be more correlation among the local markets. But what does Shiller's index tell us about the recent boom in the context of the long-term trajectory of house prices?

Looking at the charts on p. 6 based on his index, two things stand out: first, there is no strong uptrend in house prices over the last century, and the recent boom is a real anomaly, with almost no historical precedent. (We've extended Shiller's index into 2006, by assuming no real change in house prices this year, which is a reasonable projection based on the information we have so far. In any case, our estimate has no bearing on the long-term appreciation data to follow.) While the second may not be that much of a surprise (and was what attracted the most attention when the hardcover came out last year) the first point certainly is; everyone "knows" that real estate is a winner over the long term. But Shiller's index is strong evidence to the contrary. From 1890 to 2006, real house prices appreciated 0.6% a year. Based on the trendlines (see caption for explanation), there have basically been two extended bull runs in housing: from 1920 to 1950, when prices rose an average of 1.6% a year, and 1980–2006, when they've risen 1.8%. Of course the 1997–2006 period is the real star: up an average of 6.1% a year. Take that away from the post-1980 runup, and you see that prices actually *declined*

Copyright 2006, TLR II. All rights reserved.

by 0.4% a year between 1980 and 1997.

In fact, Shiller and his research team, who've read through reams of old newspapers in the Yale library, have found no historical precedent for a housing bubble before the 1980s. Yes, there have been many local booms over the decades, but nothing as broad and as intense we've seen in the last few years.



According to Shiller, it's hard to explain the post-1997 boom on economic or demographic fundamentals; there's been nothing unusual about the behavior of interest rates, population, or building costs over the period. It is, then, largely a bubble, a function of mass psychology. And so Shiller argues it's unlikely to end with the hoped-for soft landing; with no underpinning fundamentals, the mob is likely to reverse direction.

Prudence update

As we've noted here in the past, borrowing binges can get really interesting when they come to an end. That was certainly the case the last time the American consumer suffered an outbreak of prudence (as did American business) after the athletic borrowing of the late 1980s petered out; the long stagnation of the early 1990s was the result. We never saw a slowing of consumer borrowing in the recession of 2001 (or we'd never have had a housing boom). But that looks to be changing now. Shown on p. 3 is a graph of the ratio of consumer credit (traditional plus home equity) to after-tax income; after peaking last August, the broader debt ratio has rolled over and now is heading lower.

While it's too early to say that down is the new trend, the signs for the future suggest caution. Shown on the graph to the left is a measure derived from the Gallup/Experian consumer credit poll. Though the series is just 14 months old, it's been heading pretty much in one direction: down. A year ago, 27% of consumers said it was good time to borrow money; that's now down to 15%. And over the same period, the share of those judging it a bad time to go into hock has increased from 32% to 42%.

One reason for the gloom is gas prices, which are apparently having the effect they've been long expected to. Two-thirds of consumers now say they've had to cut back on discretionary spending, and a third of those say they're experiencing "a great deal" of hardship. Sure enough, Wal-Mart sales are once again lagging the retail averages—but the level of distress may well be creeping up the economic ladder.

Thursday's retail numbers

Easter note: The Census Bureau seasonally adjusts for the Easter holiday and there is no good evidence that they are not doing this correctly. The monthly chain-store re-

Copyright 2006, TLR II. All rights reserved.

ports do not adjust for the holiday, and in his statements both this month and last, Mike Niemera of the International Council of Shopping Centers suggests that their surveys were weak in March and strong in April owing to the moveable feast's shift from March last year into April this year.

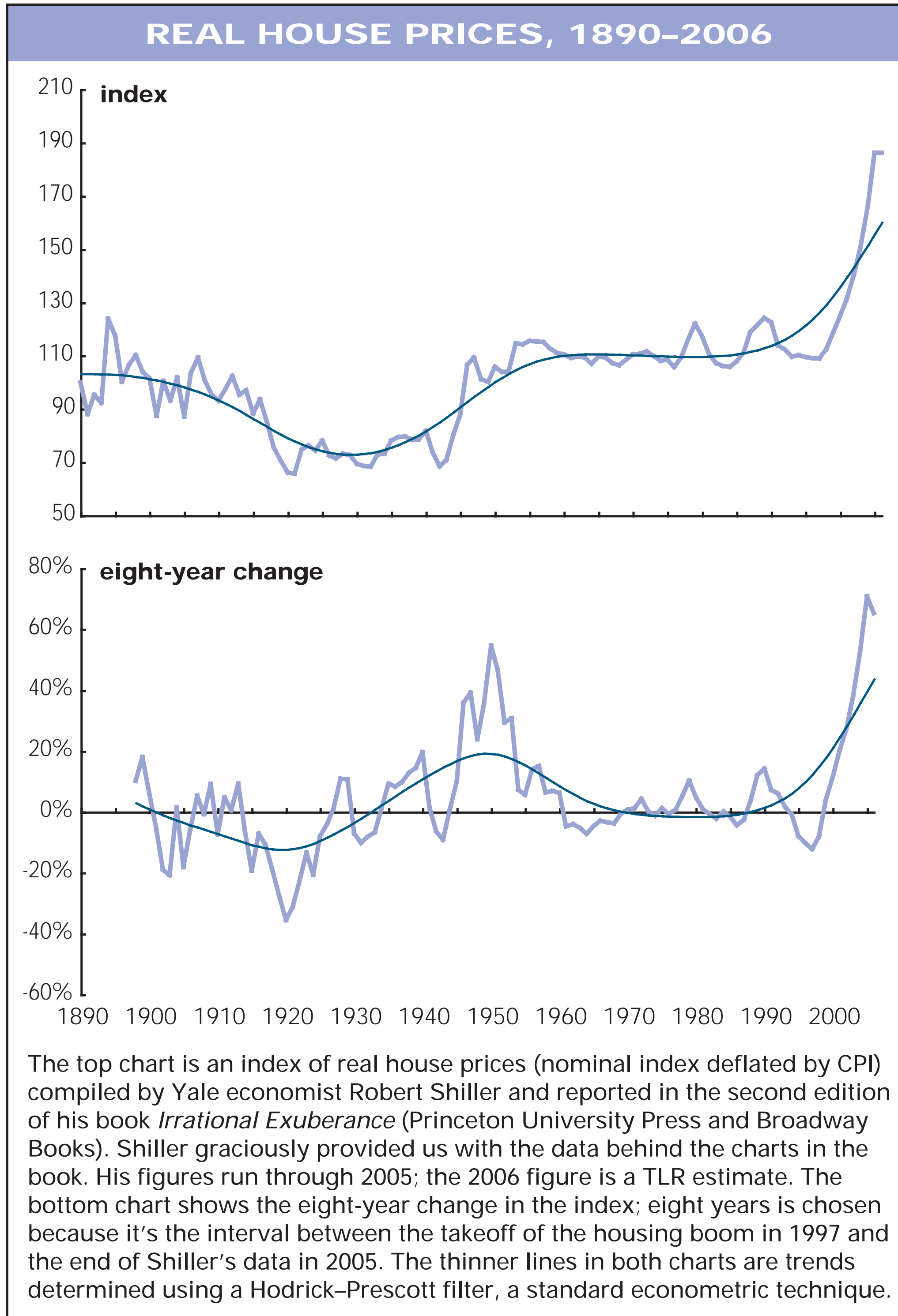
Our models are projecting that both the headline and the ex-auto component of Thursday's Advance Retail Sales print will come in at +0.9%. A lot of that comes from gasoline prices; ex-auto and ex-gas we're looking for a below-trend gain of +0.4%. But some of that projected headline lift from gas prices is based on the assumption that rising prices don't affect demand very much. Most of the time that's true—but if we're finally seeing a serious hit to demand, then the retail numbers could look less exuberant.

by Philippa Dunne and Doug Henwood

house prices

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or any part of this publication or its contents by facsimile, xerography, scanning or any other means. The Copyright Act imposes liability of up to $100,000 per issue for such infringement. *The Liscio Report* does not authorize reproduction by subscribers or anyone else. However, multiple copy discounts and limited (one-time) reprint arrangements are available. Copyright 2006, TLR II. All rights reserved.

Copyright 2006, TLR II. All rights reserved.



The top chart is an index of real house prices (nominal index deflated by CPI) compiled by Yale economist Robert Shiller and reported in the second edition of his book *Irrational Exuberance* (Princeton University Press and Broadway Books). Shiller graciously provided us with the data behind the charts in the book. His figures run through 2005; the 2006 figure is a TLR estimate. The bottom chart shows the eight-year change in the index; eight years is chosen because it's the interval between the takeoff of the housing boom in 1997 and the end of Shiller's data in 2005. The thinner lines in both charts are trends determined using a Hodrick–Prescott filter, a standard econometric technique.