

December 12, 2007

# *The Liscio Report*

## On the Economy

For John Liscio 1949-2000

### The Italians are coming...to buy Prada!

In November the percentage of states in our survey that met or exceeded their projected sales tax collections shot to 67% from October's dismal 14%. The comments of our contacts, though, seem to confirm market talk that the early Thanksgiving and Hanukkah boosted November sales at the expense of December; our contacts suggest that owing to shifting shopping patterns we won't have real information on the holiday season until January receipts are final. And they are concerned that December will indeed suffer from November's strength.

Additionally, November 2006 was a very poor month for sales tax collections. Just 27% of the states in our survey made their projections, with some sharply negative. In fact, a couple of states did so poorly in November 2006 that strong receipts in November 2007 brought them just to 2005 levels. So no one is suggesting that the strength in the survey indicates a change in trend.

And the geographic pattern has "weak dollar" written all over it. States along the Eastern Canadian border did remarkably well, including those that have been really struggling these days, and this has to be Canadians dropping below the border to flex their loonies. There's ample anecdotal evidence of this, perhaps topping the list is BJ's Discount Club's recent comment that beleaguered upstate New York was their strongest performing region in November—the Southeast the weakest. We'll note here

that web-businesses around the country report sales to foreign buyers have doubled and even quadrupled this year on the back of the weak dollar, and resale merchants have ever more merchandise on hand as strapped home-owners strive to supplement income. Here in New York City a friend joked, "You know there's a problem when Italians are coming here to buy Prada."

- ***collections pick up, but it's calendar quirks (and some foreigners)***
- ***the Fed and the markets: who is not listening?***
- ***flow of funds: housing bust only beginning to show, corporate profitability peaks, investors shun U.S. assets***

*fidarsi é bene; non fidarsi é meglio*

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Outside the region mentioned above, growth rates were generally modest, in many cases just around 2%. In the words of one contact, "Sales tax receipts continue to be right on our expectations of extremely soft inflation-based growth." And another in a Western state with a hard-hit housing market, "Relatively speaking a very good month for sales tax, with growth of 2.6%." The South has weakened substantially, and one of the stronger states in the Midatlantic region is now reporting some moderation. A few states in the Midwest with mixed economies continue to report solid year-over-year growth. So, although the Sales tax Diffusion Index—SDI—shows drastic improvement, the details continue the sluggish trend.

### Fed gets a raspberry

It's no revelation to say that Wall Street didn't like the stinginess of the rate cut or the caution of the FOMC statement. But we don't understand the surprise. As we've been saying ever since Hurricane Katrina didn't prompt the Fed to ease, Wall Street has been wrongly expecting more indulgence from the central bank than they've been willing to extend.

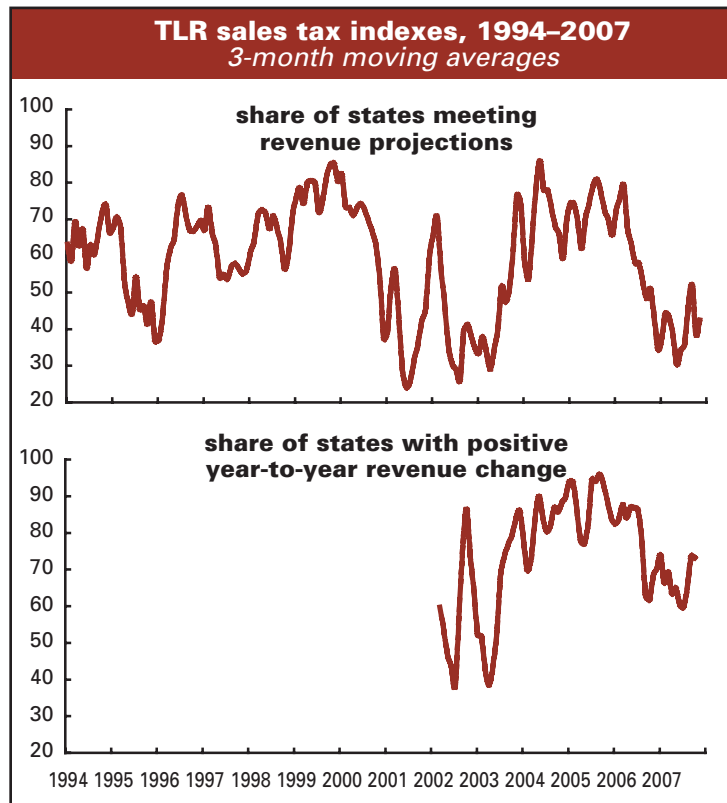
Many have suggested that the Fed's econometric model is flawed, which may be why they're not easing more aggressively. But a look at the Fed's own forecasts for 2008-2010, released with the October 31 minutes, suggests that we don't have to go to the flawed model hypothesis: the Fed appears willing to accept a

much weaker rate of the growth than the markets appreciate.

We were surprised that these forecasts did not receive more attention in market commentary. They're essentially projecting three years of very slow growth: 2.2% next year, 2.5% in 2009, and 2.6% in 2010. (These are the midpoints of their ranges.) This is a full point below the long-term average for U.S. GDP growth,

about two points below the expansion average, and pretty close to recessionary territory.

This projection may well be the fruit of the work that the Fed has done, suggesting a sharp slowdown in the rate of labor force growth. We've filed dissents against that view, but the Fed seems to believe otherwise. (Reinforcing that perception is their projection that unemployment won't rise much despite that slow growth.) So if we get the Fed-projected labor force growth of 0.7% over the next few years



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plus productivity growth of 1.8%—both below their long-term averages—we'll get something like 2.5% growth.

If this is what the Fed wants, then it makes sense that they're not rushing to open the taps. It's quite possible they'd like to see several years of subpar growth

to restore household balance sheets and get the international accounts closer to balance. Such an environment will not generate profit growth of the sort the markets got

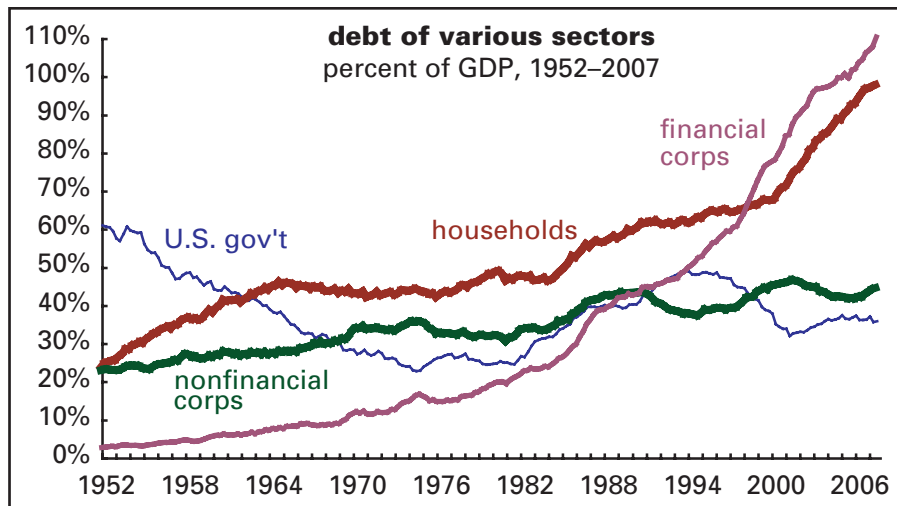
used to over most of the last 25 years. It's also a growth rate slow enough to generate consumer, fiscal, and quite possibly, political strains.

A final point about the projections: the FOMC projects only four economic variables, GDP growth, PCE headline and core inflation, and the unemployment rate. This reinforces something we've argued over the years: the Fed pays more attention to the jobless rate than the markets do. Our guess is that they feel more comfortable with the unemployment rate closer to 5% than 4%. We could be facing some tough years.

### flow of funds review

Several major themes emerge from a study of the third quarter flow of funds accounts, which were released last week:

- The housing bust is *starting*, but only starting, to show up in the figures, but the broader credit crisis has not. Household borrowing has slowed, but remains high by historical standards, and both nonfinancial and especially financial corporations accelerated their pace of borrowing from earlier in the year.



- Corporate profitability has now clearly peaked for the cycle, and is heading down. This is a long leading indicator, but the peak was in 2005, so the clock is tick-

ing.

- Investors, both domestic and foreign, don't seem too excited by prospects for the U.S. economy, judging by equity and direct investment flows.

Every major sector increased its debt load (relative to GDP; see graph above). For the U.S. economy as a whole, total credit market debt outstanding rose from 339% of GDP to 343%; that 4 point increase was more than twice as big as the second quarter's, and was the biggest increase since the fourth quarter of 2006. The financial sector was responsible for more than half the gain, though households put in a respectable performance. Nonfinancial corps, which had been very restrained in their borrowing through most of this cycle—actually reducing their debt load from 2001–2005—have increased their

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borrowing steadily ever since early 2006.

### households

Household net worth declined from 574.1% of disposable personal income (DPI) in the second quarter to 571.7%—a modest decline, but it's been basically flat for close to a year. The decline was all the result of a 3-point drop in residential net worth, from 106% of DPI to 103%; at the 2005 peak, the figure was 112%. Nonresidential net worth rose by 0.5 point, extending a five-year streak. Given the distribution of assets and liabilities, that means that upper-income households, especially very upper-income ones, have been shielded from the housing bust, but the broad middle class is starting to feel it. But it could fall a lot more; the 1952–99 average for residential net worth is 89%.

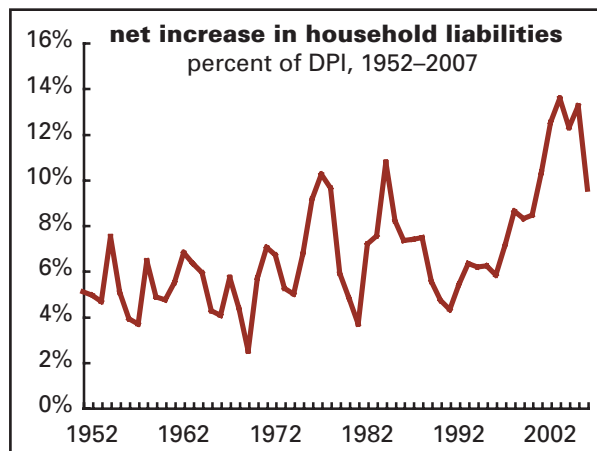
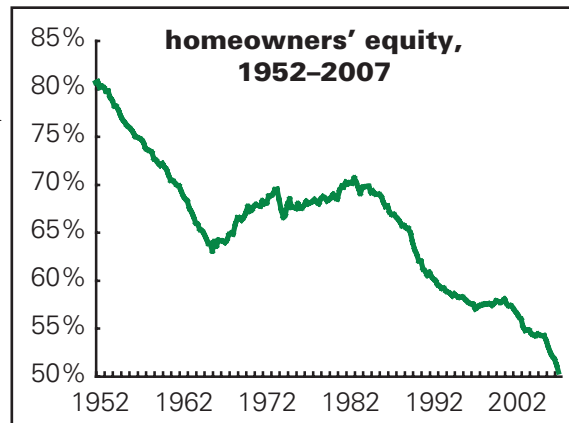
Homeowner's equity fell again, to an all-time low of just above 50% (see graph, above right).

As the bottom graph at right shows, households have slowed their pace of borrowing, but it still remains at the high end of the historical range. The graph shows yearly averages, to filter out some of the noise from the quarterly series. A quarterly graph would show somewhat more of a

decline in the third quarter, but not by all that much. At 9.0% of DPI, fresh borrowing is still at the high end of its historical range, and a full standard deviation above its 55-year average.

Three-quarters of the new borrowing was in the mortgage market, a somewhat lower share than at the peak of the housing boom, but still above the long-term average.

On the asset side, mutual fund holdings rose slightly (again relative to DPI), though at a considerably slower pace than what prevailed from 2003–6. There's also some evidence that households are flying to quality. Money market funds and bank deposits were up for the quarter, extending a three-year pattern. Direct stockholdings have been drifting lower for a year. Residential real estate fell from 207.3% of DPI to 204.8%, down from the early 2006 peak of 209.6%. But it's got a long way to fall before it hits the pre-2000 maximum of 158.0%—much less its average of 132.7%.



### nonfinancial corporations

Corporate profitability—which we define as NIPA profits for nonfinancial corporations divided by the flow of funds estimate of the value of the tangible capital stock—has now clearly rolled over. There were a few head-fakes in the last couple

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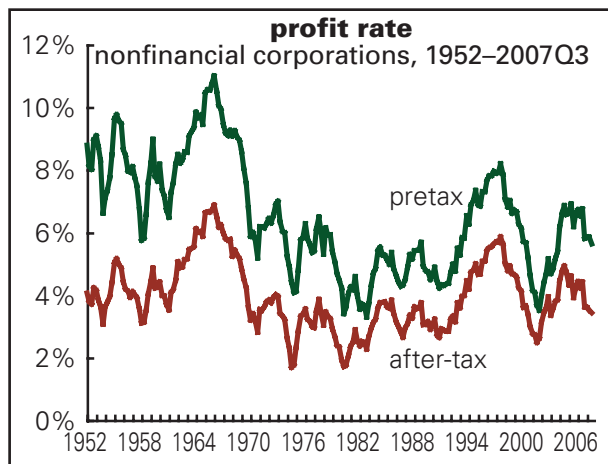
of years, but as the graph on p. 5 shows, it now looks real. Pretax profitability has now given back about a third of its 2001-5 gain, and after-tax has given back about half.

As noted above, nonfinancial corporations are doing more borrowing lately than they did a few years ago. Part of the reason for this is no doubt the expansion of the so-called financing gap, the difference between internal funds (profits plus depreciation) and capital expenditures. For the early years of the expansion, internal funds were close to or even more than enough to cover investment. But with profits eroding and investment edging upwards, the financing gap has opened wide, to around 25% of capex. (Capex rose a bit, in the third quarter, from 7.5% to 7.7% of GDP; it averaged 7.4% in 2006.) Borrowing has risen from almost nothing in 2002 to 4.4% of GDP so far this year.

But it's not just capital spending amidst declining profits that have put a pinch on corporate finances. Firms continue to retire stock, through takeovers and buybacks, at a furious pace. Net equity issuance was -6.1% of GDP in the third quarter, an all-time record (see graph, p. 6). It would be difficult to exaggerate the importance of such stock retirements to the rise in stock prices since the bull market took off in 1982. According to the financial orthodoxy, firms should have taken advantage of high stock prices by issuing equity; they've done exactly the opposite.

*outside world*

For once, the level of net U.S. debt to the outside world did not set a record; at 37.0% of GDP, it was down 0.1 point from the second quarter. But as the graph on p. 8 shows, it is a remarkably larger number than it was just a few years ago.



Note, however, the other lines on that graph, which add in net holdings of foreign direct investment and equities. As the two graphs below that show, there's been a sustained net outflow of such assets for most of the last 15-20 years. (Annual averages are used for the flow charts

because they're so volatile from quarter to quarter.) The equity outflow has eased somewhat this year, but the FDI outflow is close to a record.

Debts impose strict and well-defined servicing characteristics on debtors, so paying interest and principal on the U.S. balance of foreign debt could be a considerable burden in the coming years. But the outflows of FDI and equity, while imposing no fixed or onerous terms, do suggest that private investors, both domestic and

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foreign, see better prospects abroad. For those of us who live here, that's rather anxiety-provoking.

### credit crisis footnote

Maybe we'll have to wait until the fourth quarter numbers are released in March

2008 to see some sign of what has the markets so panicked. But you sure don't see a crisis in the Fed's weekly H.8 bank asset and liability release. As we noted in the last issue, commercial and industrial loan growth is strong, and offsetting a lot of the collapse

in the commercial paper market. But the yearly growth rate in consumer lending has picked up considerably—from 5.2% for the year ending in May to 8.6% for the year ending in November. Real estate lending is off, which is hardly a surprise—and as we've pointed out before, the commercial real estate market may be following the residential into a bust—but despite that, growth in so-called core loans (C&I, consumer, real estate) has actually picked up speed since the spring, with the other segments more than compensating for the slowdown in real estate.

The contrast with the credit crunch of the early 1990s is stark. C&I loans were falling by more than 4% a year for most of 1992, and the other segments failed to compensate, so core loans contracted in nominal terms from mid-1991 to the end of 1992. Loan growth didn't turn strongly positive until 1994 was morphing into 1995.

Of course, bank lending could start contracting if the credit environment gets nastier, but it hasn't happened yet. We'll keep an eye on it.

### Thursday's retail numbers

We expect both the headline and the ex-

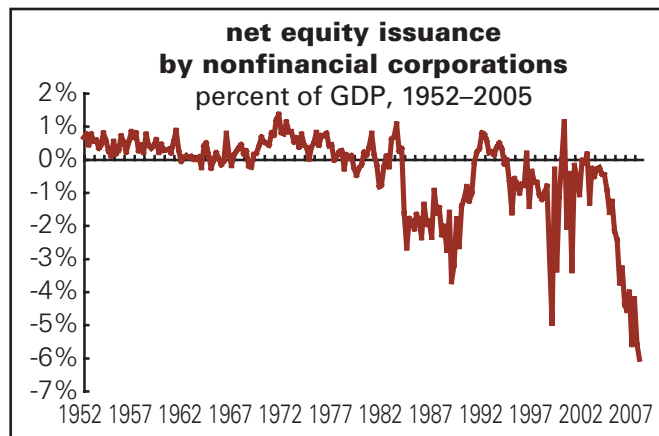
auto component of November's retail sales report to print above consensus at +1.1%, with a big assist from gas prices. We are confident the market will discount such a strong number as a calendar anomaly and, like our state contacts, wait for December figures to

reach a conclusion on the consumer.

### Attention readers

Marni Atherton recently joined us as Director of Marketing and Circulation, and we are very happy to have her with us. We are not so happy about the number of readers she has unearthed who have been receiving forwarded copies of our research for so long that they actually think they are *bona fide* subscribers.

We'll spare you the hectoring about taking food out of the mouths of Doug's toddler, Philippa's son, and John Liscio's wife and children. And we will work with all our legitimate subscribers to make sure everything goes smoothly as we move to standard industry practice of locking down research in the new year. In the meantime, though, please check to see where you got this report. If it did not come directly from Philippa or Marni please call Marni, who



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will ask no questions, at 877-324-1893 to set up a subscription.

Two incentives: we will be increasing our rates for new subscribers in the new year, and are considering some form of lagniappe for those on the roster at the turn of the year. Note to all professional traders who “can’t afford” our rates: don’t quit your night job!

By the way, John’s family is thriving. Laura is a freshman at University of Indiana, and Greg has two more years of high school. Fran is back behind the lens and doing fine work. She joins us in sending thanks to those of you who contributed to the fund for the Liscio children’s education in 2000. And we all join together to wish you all a very happy holiday season.

—Philippa Dunne & Doug Henwood

***the outside world***

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