TLR
on the economy

April 13, 2018

Five uneasy pieces: history may not tell us what it once did

Challenges ahead include interpreting familiar data in an undoubtedly new context: corporate profits (& tax breaks); signals from LIBOR v. OIS; catching the drivers of coming FOMC moves; a new trend (?) in domestic consumption; & new data on trade.

- March sales tax collections came in below expectations in aggregate, but that was driven by a number of small misses. Percent increases in states benefitting from the upswing in energy extraction were about twice the increases in states that didn't.

- A new American exceptionalism? The decline in the percentage of prime-age workers in the US labor force, by definition not driven by retiring baby boomers, runs against the trend in most of the world. This is our special problem.

- The spike in the gap between the US$ LIBOR rate and Overnight Interest Swap rate perhaps should spur worry about the rise in US corporate debt levels, something we've long detailed, not an impending recession, although of course they are linked.

- In this long slow cycle it's hard to determine where we hit "late," but if we're anywhere near there, here's something else for the history books: after tax profits rising into an aging cycle.

- No matter how you break them out, retail sales have been slowing. Here too, there are explanations beyond cycles: more income going to those less likely to spend, low inflation, and an hurricane inspired surge in late summer and early fall.

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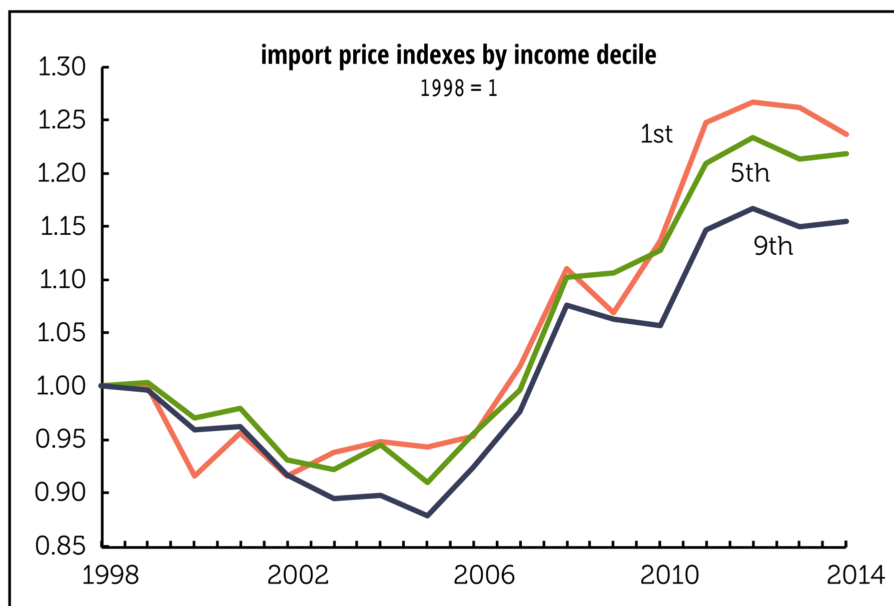
Five uneasy pieces: history may not tell us what it once did

In March 60% of the states in our survey met or exceeded their sales tax forecasts, down from 85% in February, and 84% reported growth over the year, about even with February's 86%. The average over-the-year percent change slipped to 4.3% from February's 5.2%, and the margin from forecast fell below zero, to -0.5%, from 1.9% in February. This metric also was negative in January.



Although the index of expectations weakened from February, many of the misses were quite small, and not worrisome to state contacts. And, in some states the calendar indicated that receipts would be weak over the year, another offset. Gains in states with heavy natural gas extraction were close to twice those in states without. Take the rig states out and the growth rate falls to 3.2%. Growth in Florida is also running strong, and our contact there notes that both the growth and the forecast depend on one-off factors related to recovery efforts, but categories less likely to be included in such efforts were also healthy.

imports and income

With trade much in the news, Colin J. Hoffman & Ryan Monarch, both in the International Finance Division of the Fed's Board of Governors, just released the paper "Distributional Consequences of Trade for U.S. Consumers: Estimating Group-Specific Import Price Inflation."

They work to shift the focus from the effects of international trade on different groups of workers to different groups of consumers, and want to know if changes in prices driven by increased international integration exacerbate or ameliorate real income inequality, driven by nominal income changes.

The authors reference a 2016 paper, "Measuring the Unequal Gains from Trade," in which Pablo D. Fajgelbaum & Amit K. Khandelwal (of UCLA and Columbia) review the effects of import price disparity on high- and low-income consumers. Their scenario involves closing down trade, which is extreme and we don't expect, but their work is still worth

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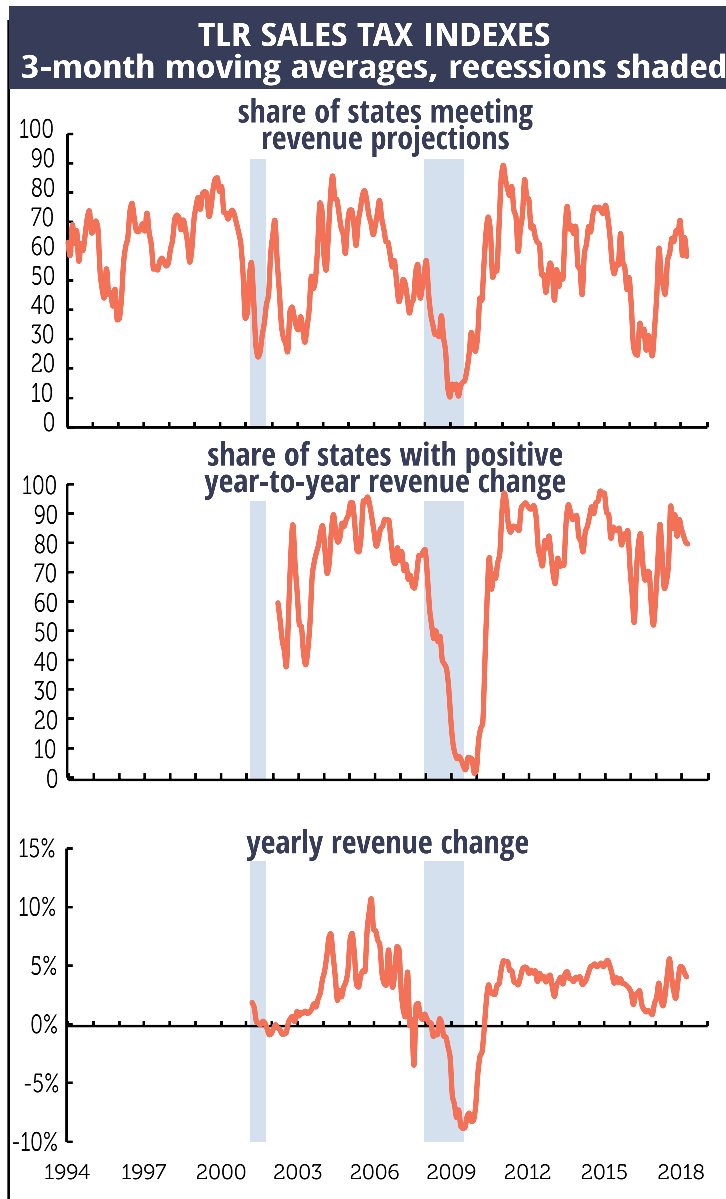
a look. Using the elasticity of imports, incorporating both trade costs and income, they find that such a closing off of trade would be about twice as hard on lower income groups than on the top decile: lower-income consumers spend more on traded goods, with lower elasticities, whereas higher income groups spend more on services. This bias extends around the world, but in countries with lower elasticity of exports, fewer gains would accrue to the poor from opening trade.



Hoffman and Monarch find that low- and high-income groups have about the same share of expenditures on imports, and both have increased to about 10% as of 2014 from around 7% in 1998. However, the 1st decile's share of imports excluding food and fuel is about 70%. That share falls to about 66% for the second decile, and then rises through the deciles to 77% for the top. But all goods are not equal. Those much disparaged washing machines are about 1.8% of expenditures for the lowest decile, steadily falling to just 0.8% for the highest, whereas spending on imported sporting goods rises from about 0.5% for the lowest to 2.2% for the highest decile.

We can see where this is going. Although inflation in imported goods has risen for all groups, the lower income groups have faced higher inflation in import prices. Using prices for 228 Harmonized Commodity Description and Coding System sectors—let's stick with HS—the authors find statistically significant differences in price changes across income groups. As the graph on p. 2 shows, import inflation was up 24% for the first decile, and 15% for the ninth.

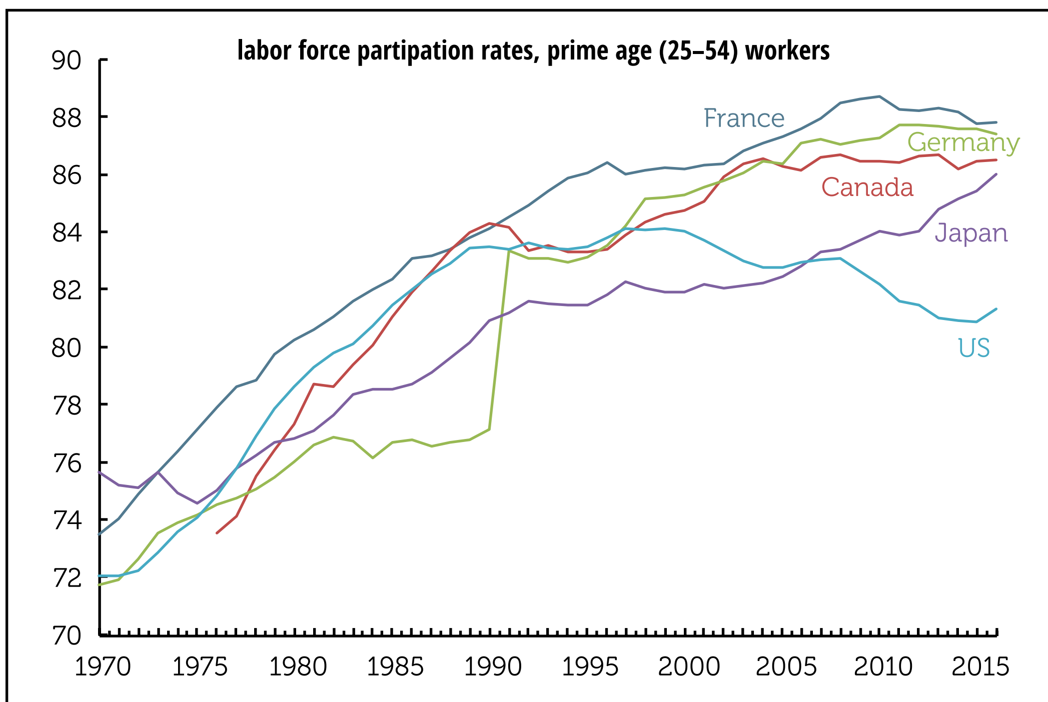
And China held yearly changes in import inflation down for all deciles. Without China, yearly import inflation would have been up an additional 0.5–0.6 percentage points.

Since the method used to produce the results allows the authors to see different expenditure shares of the deciles within the same sector, and different expenditure shares across product varieties, the authors were able to demonstrate that taking out cross-sector differences aligns yearly increases for all deciles at 1%. That indicates to the authors that high-income consumers

gravitated to sectors with lower inflation, and leads them to conclude that nominal income inequality that has risen owing to trade in the last decades, was not mitigated by changes in import prices across income groups. This is pretty specific information, but it underscores how much more complicated the debate should be.

we're alone here

Weak labor force participation is one of the most striking and written about features of the current expansion. As we've noted in the past, some of that is the result of an aging population, but far from all of it. In international context, it's even more striking.



Time was when Americans used to deride the European job market as a torpid thing. But now the derision can come from the other direction, as the graph above shows. (The data source is the OECD.) U.S. participation fell below Germany's in 1997; below Canada's in 1998; and below Japan's in 2007. (It's lagged France for the entire history of the graph.) And aging populations can't be blamed here: the U.S. has the lowest median age of the countries graphed, and the population is restricted to prime-age workers.

Of course, the participation rate includes the officially unemployed (that is, those looking actively for work) along with the employed, and the U.S. has a lower unemployment rate than Canada and France (though not Germany and Japan). But the weak standing of the U.S. holds up, as the top graph on p. 5 shows, if you look at employment/population ratios for 2017. (We didn't graph these over time because the data coverage is much spottier.) The U.S. rate is almost 8 points behind Sweden; 6 behind Germany and Japan; and 4 behind Canada. It's a point below the EU average (the full 28 countries, not the 19 in the eurozone).

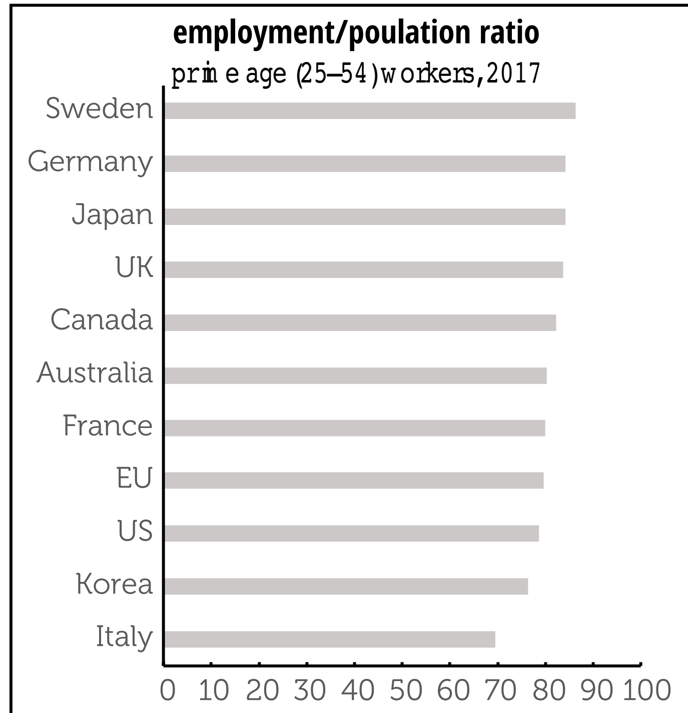
We'll be publishing a short piece on participation rates and wage measures next week.

out for the long haul?

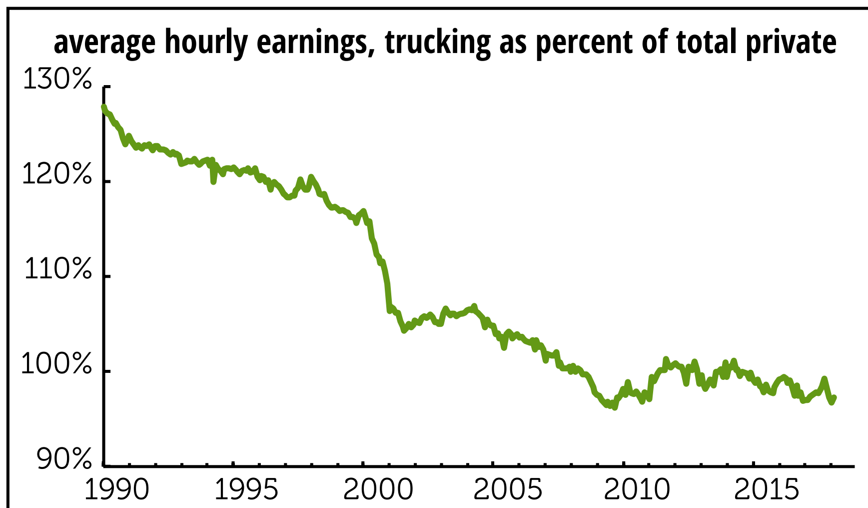
Truck drivers are supposed to disappear someday soon, to be replaced by robots, but right now they're in short supply, as Gillian Tett reported in a recent column in the *Financial Times*. Capacity utilization is said to

be around 100%, 15 points above where it was at the start of the decade and 7 above its long-term average. The producer price index for the industry is up 6% over the last year.

Curiously, though, this tightness is not showing up in wages. As the graph below shows, average hourly wages for production workers in trucking fell from 128% of the private sector average in 1990 to 96% in 2009. It rose to 101% in 2011, but has been drifting lower ever since. It was 97% of the average in February 2018—barely above what it was coming out of the recession.



And not only are wages not rising to alleviate the driver shortage—as Tett points out, new drivers have to pay $5,000–10,000 for training. All the talk of robots may make the field seem unattractive to the young and/or career-changing, but that fee is a pretty stiff barrier to entry. Trucks.com reports that it's a "churn and burn" situation for both the male drivers, and the tiny & decreasing minority of female drivers, both of whom often fall through the crack in those first months of training. It all makes you wonder if the fees aren't the true prize, with AI in the wings.

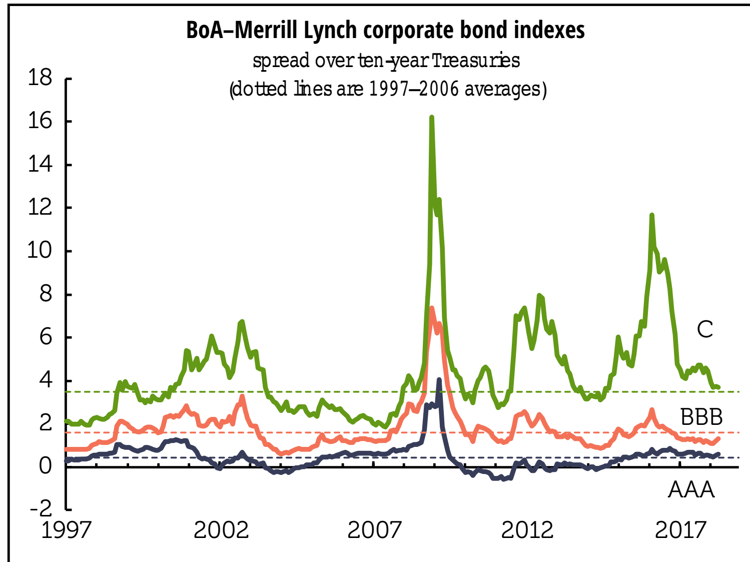


risk spreads: balanced news

A spike in the gap between the three-month U.S. dollar LIBOR rate and the Overnight Indexed Swap, to a level not seen since the crisis days of 2009, caused worry to spread about declining credit quality, though that alarm was countered with claims that the culprit was structural changes in bank funding and not something dire. Part of the reason for a rise in LIBOR may be that after the recent tax reform, corporations are no longer sheltering profits abroad in bank bonds—unpleasant for banks but not necessarily a sign of deteriorating health in the credit system.

Other measures of credit anxiety are not even flashing amber. Graphed on the top of p. 6 are the premia for corporate bonds over 10-year Treasuries. They're lower than they were a year ago and very close to their pre-crisis

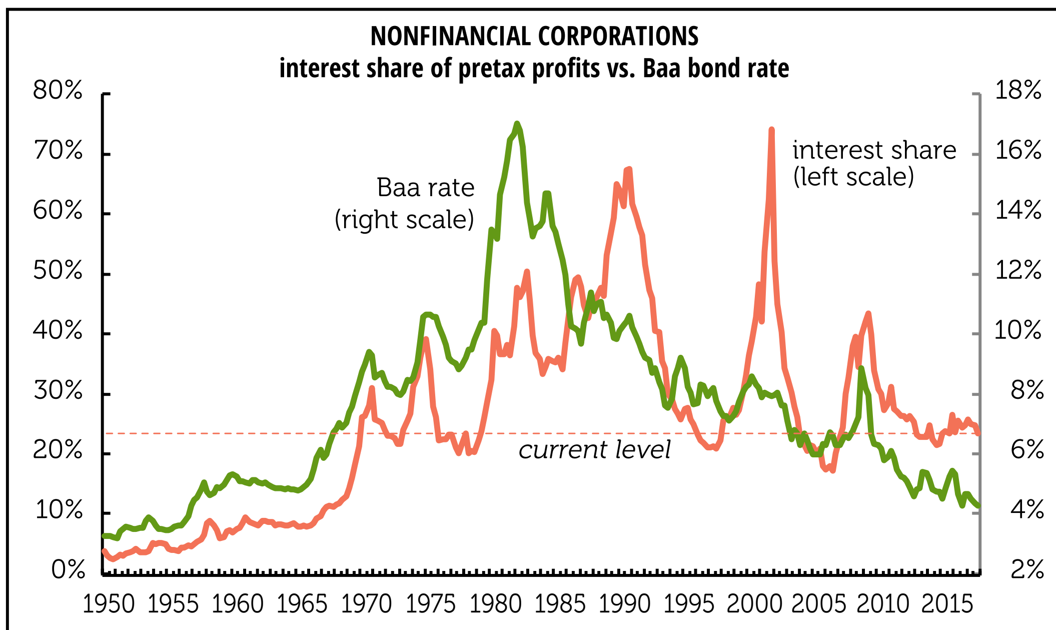
averages. The BoA–Merrill High Yield index, which isn't graphed, is 150bps below its pre-crisis average. We only have two recessions in the history of this series, but note that risk premia, especially on the sub-AAA debt, began rising well ahead of the onset of recession (six months ahead in 2007, and fifteen ahead in 2000); they look like good long leading indicators. That's not happening now—despite the rise in corporate debt over the last few years, a topic to which we now turn.



unfortunate vindication, perhaps

While rising federal debt has certainly gotten a lot of ink, as we used to say, the corporate kind is only beginning to get broader attention (though we've been worrying about it consistently for years).

Interest payments accounted for 23.3% of pretax profits for nonfinancial corporations in 2017Q4. That's not unprecedented. But what is unprecedented, as the graph below shows, is what is happening with interest rates at levels not seen in over sixty years. Baa corporate bonds, a decent proxy for the rates corporations pay overall, yielded 4.3% at the end of last year, which is what they offered in 1956. But back then, interest payments claimed just 4.6% of pretax corporate profits, less than a fifth the current bite. Or, looked at from the other angle, at times in the past when the interest share was in the 23% neighborhood—like 1972, 1976, 1996, and 2007—Baa rates ranged from 6.3% (2007) to 9.2% (1976).

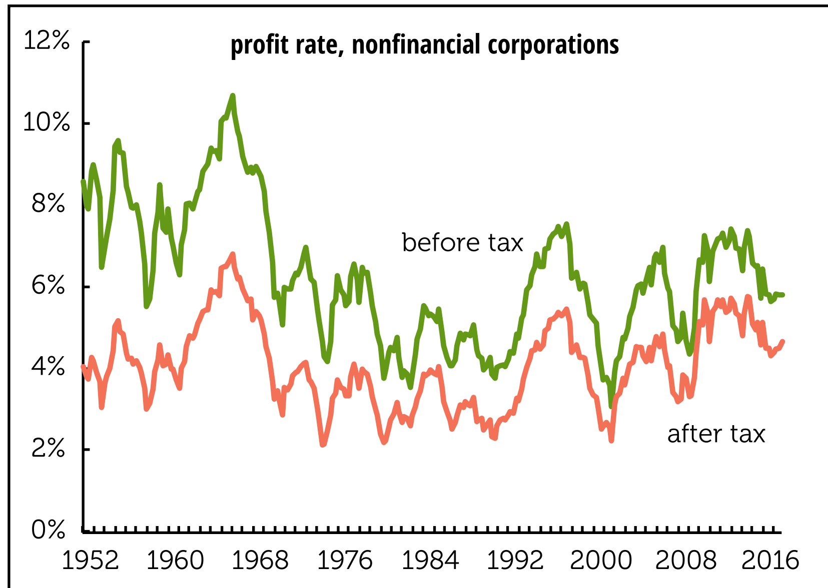


Right now, Baa rates are low because benchmark Treasuries are barely up and risk premia are well below long-term averages. If, as the Congressional Budget Office projects, 10-year Treasuries rise towards 4.0% and over over the next

couple of years, and risk premia merely return to their averages, Baa rates should rise from 4.6% now to around 6.4%. Assuming no increase in debt levels (relative to profits) and a normal recessionary profit decline, the debt service bite on corporate cash flow could rise if not to peaks seen in 1990 and 2001, then to the neighborhood seen in 1982 and 2009. (The reason 2009's figure wasn't higher is that the distress was concentrated in the financial sector, which is excluded from this analysis.) You have to wonder if rates this low are adequate compensation for risks.

profitability up, but

Speaking of corporate profits, we didn't get to run our usual profitability graph in the last financial accounts review because the NIPA figures weren't out yet. They are now, and the results are graphed on p. 7.



Pretax profitability—profits with IVA and CCAdj divided by the value of the tangible capital stock—was unchanged at 5.8% for the third consecutive quarter. It's been around this level for two years. But thanks to a decline in the effective tax rate to 19.7%—a record low, beating previous lows of 20.0% set in 2008 and 2015—the after-tax rate rose from 4.5% to 4.7%. Both are well below their 2010–2014 highs, but the revenue code is only beginning to flatter after-tax profits, even as the economic cycle matures.

Monday's retail numbers

Headline retail sales have been negative for three months in a row (though revisions could change this). Such streaks are quite rare, and rarer still outside recessions. Since the modern retail series began in 1992, there have been nine instances of three-month negative streaks in headline retail (including the current one); just five of them (out of 312 months) have occurred outside recessions (assuming we're not in one). The previous instances, working backwards, were in 2015, 2012, 2002, and 2000. The last was as the 1990s bubble was leaking; the second-to-last was part of a jobless recovery; and the first two are part of this newest economy, where a lot of old rules of thumb have to be sent back to the shop.

As we all know far too well, this is a very noisy series, but any way you look at the trends, they are weakening. Overall, including noisy automobiles and largely price-driven gasoline sales, the most recent three-month ran at -0.1%, down -1.2pps from the prior three month's +1.2%. Taking out only autos the most recent three months were +0.1%, nice to see a positive sign, but that's down 0.9pps from the prior three months. Excluding gasoline as well, over the most recent three months sales were unchanged, which is 1.1pps below the prior three months. The six-month trends look better, with all

tranches up 0.4pp from the prior six months.

Sales tax receipts were strong in February. In fact they were edging toward what would have been considered expansionary mode before the 2001 and 2008 recessions. That makes us suspect something in Monday's report might show an improvement, perhaps a revision. The three-month negative streak we mentioned at the beginning of this section may just be payback for the vigorous spending of late summer and early fall 2017, which may have been driven above trend by storm recovery efforts. And the stronger stream of income flowing to the upper deciles with their lower propensity to spend may be in there too.

We expect March sales to come in at +0.1% overall, -0.1% excluding automobiles, and +0.1% excluding gasoline as well. Recent data, and indeed much economic thinking, outlines an economy that perhaps should be evaluated with more lenient metrics.

—Philippa Dunne & Doug Henwood