SL Sightlines Bulletin
Tracking the American Economy

December 2013

ENDING 2013 ON A PRETTY GOOD NOTE

Most economic indicators are looking pretty good, even if we're a long way from boom territory. Employment growth is decent, state tax collections are flowing respectably. Things are strong enough for the Fed to begin the long-dreaded taper, but not so good that they're going to raise interest rates any time soon. Household balance sheet repair continues, and 2014 is likely to begin on a firm note.

- Healthy employment growth in November—though what's up with health care? Strengh was broadly distributed across industrial sectors and geographic regions—and it looks like the housing bust states are coming back. The household survey largely reversed the weirdness of its October edition.

- State tax collections—both withheld income and sales—looking strong, though we and our contacts are not yet ready to call it a trend change. But it's still encouraging.

- Turn of year note: though things are looking better, remember that the recovery from the Great Recession has produced many surprises.

- Flow of funds accounts: most sectors still deleveraging—even Uncle Sam!—but it looks like households are getting back to borrowing. Still, household balance sheets continued to improve, and even the international accounts are looking better.

- Diesel fuel sales strengthened in the most recent month, which is a good portent for future employment growth (though the Plains are lagging).

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HOPE FOR 2014, WITH A CAVEAT FROM THE GRINCH

NOVEMBER EMPLOYMENT

The November report on employment released by the Bureau of Labor statistics was solid, though its still below-average by long-term historical standards. We're likely to see some firm intentions to taper coming from the FOMC, but any risk of higher interest rates has not been significantly changed by the November numbers, given the signals coming out of the Fed research departments.

The headline gain of 203,000 in the Establishment Survey was widely distributed, with even government participating. The goods sector was unusually strong, with construction up 17,000 (though much of that came from specialty trades, the people who finish, rather than start, buildings) and manufacturing up a hefty 27,000 (more than four times its average over the last year, confirming the strength reported in our withholding survey by some crucial manufacturing states).

Private services overall added 152,000, which is actually weaker than both October's gain and the sector's average over the last year. Retail trade added 22,000, two-thirds of it from general merchandise; wholesale trade, 7,000; and transportation and warehousing, 31,000 (15% of the month's total gain, five times the subsector's share of employment). Professional and business services added 35,000, a third below its recent average, with nearly half the gain coming from temps (up 16,000). Education and health added 40,000, with health care up an above-average 28,000, a contrast with October's weakness. (Still, the health sector's growth has really slowed; the gain for the year ending in November was 1.7%, below the 2012 average of 2.0% and even further below the 1991-2010 average of 2.6%.) Leisure and hospitality added 17,000, half its average. Government rose 7,000, with state and local gain more than compensating for losses at the federal level. It was nice to see the making and moving things sectors (construction, manufacturing, and transportation) leading the way, contributing more than twice their share of employment to the monthly gain, rather than bar and restaurants, which, as pleasant as they are, don't seem like the firmest of foundations for long-term growth.

Diffusion indexes, the share of sectors adding jobs, confirmed the breadth of the gains, with all four measures up, and to rather high levels by recent standards.

Much of the story of the household survey was reversing all of October's anomalies. The two-month gain is an unimpressive 83,000. The participation rate and employment/population ratio both rose in November, which brought the employment/population ratio back to September's level, while the participation rate remains 0.2 below where it was then. Recall that the FOMC is probably mentally adjusting the unemployment rate using these ratios, which has been artificially lowered by labor-force withdrawal.

The number of unemployed fell by 365,000, with all subcategories down except voluntary job leavers (suggesting a higher quit rate, and growing confidence in the labor market—though the confidence measures have a long way to go yet). Most of the decline in unemployment came from those jobless 5 weeks or less; there was little change in longer durations, though the reduction at the short end did have the effect of pushing up the average duration of unemployment. The unemployment rate fell by 0.3 point to 7.0%—which is what one might have expected over the next several months—to its lowest level in five years. And the broad U-6 rate was down 0.6 point to 13.2%, also its lowest level in five years. The number classed as not in labor

force but wanting a job fell by 408,000, also to its lowest level in five years.

Average hourly earnings were up 0.2%, but the three-month moving average fell to 0.1%. Aggregate payrolls rose a strong 0.8%, its best showing in a year.

STATE-LEVEL DETAIL

Please note that we have a lot of detail we are not including in these reports, and get in touch if you would like more information.

State level detail for November looked quite strong as well. For the first time in years all statistically significant changes were positive: jobs up, unemployment down. Fourteen states reported statistically significant changes in their employment levels, all of which were increases, and overall 43 states reported increases, while 7 states + DC reported decreases. Largest percent gains occurred in Indiana (+0.9%) and Nevada (+0.8%), and Vermont (+0.7%); the largest declines, -0.2%, in DC, Nebraska, North Carolina, Ohio, and Washington.

In the Great Lakes region, manufacturing employment rose in Indiana, Michigan, Minnesota, Ohio, and Wisconsin, but declined in Illinois. Largest manufacturing gains occurred in noisy Alaska (+6%), and Hawaii (+2%)l; largest losses were in Connecticut, Delaware, Maryland, North Dakota, Nebraska, and Wyoming.

All four regions had statistically significant declines in their unemployment rates in November, the Northeast's rate falling 0.3pp and the Midwest, South and West's -0.2pp. All 26 statistically significant over-the-month changes in unemployment rates were declines, with unemployment falling by 0.6pp in Idaho, New Jersey, and North Carolina, by 0.5pp in Kansas, and by 0.4 in Arizona, Georgia, Missouri, South Carolina, and Tennessee.

Although there was some labor force withdrawal, many of thee declines were accomplished with stable participation, and so are clean. However, the large declines in labor forces of California, Georgia, New Jersey, Pennsylvania, and Tennessee we noted last month not only did not reverse, they snowballed.

Manufacturing employment is holding up, and remains a crucial support in the recovery, which is seeming a bit more durable these days. Although still up 6% over the year, November tax collections, however, were a bit uneven in the manufacturing Midwest. Receipts came in well above forecast in Wisconsin, Nebraska and Iowa, but were disappointing in Ohio and Michigan , the latter possibly calendar related. Sales came in well above forecast in all Midwestern states but Michigan.

BLS data show that Arizona lost construction jobs in November, but California, Florida, and Nevada all added jobs in the sector. This is nicely corroborated by state tax collections: California continues to show improvement in withheld tax receipts, but Arizona has been a bit hit or miss these days, although sales receipts continue to come in above the mark. Florida does not collect withheld taxes, but sales continue to come in above forecast, and home sales are encouraging, although there is some concern that too many purchases are investments.

Our monthly diffusion index, the share of states adding jobs, rose to a strong 43--it has been languishing in the high 20s low 30s for

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

months, with education & health at 37, and construction at 30. Over-the-month growth was negative (if such a thing is possible) in finance alone, ed/health grew the fastest at 0.3%, and other sectors, except government, all rounding up at +0.1%. This supports the improvement in the official BLS diffusion indexes reported at the national level earlier in the month.

STATE TAX RECEIPTS CONFIRM STRENGTH

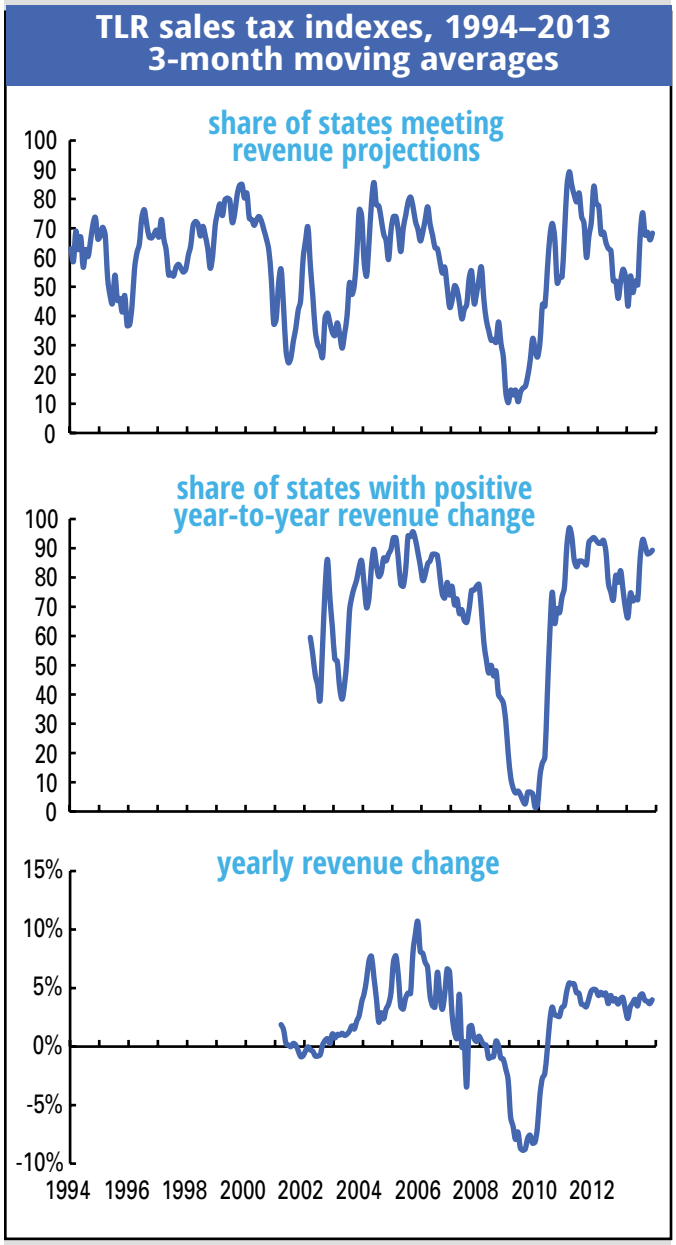
Something has changed in the tenor of our surveys, and although it has not yet been enough to draw confident statements of strength, or upward revisions to current forecasts, it is encouraging that a handful of the officials looking at revenue flows are wondering if the improvement may be becoming sustainable.

In November, 67% of the states in our survey met or exceeded their forecasts for withheld tax collections, up a bit from October's 63%. The number of states reporting growth over the year slipped to 64% from October's 78%, but there were calendar issues, so these declines were anticipated in many forecasts.

Seventy-one percent of the states in our survey met or exceeded their forecasted sales tax collections, up from 60% in October, and 90% reported growth over the year, pretty much even with October's 93%. The average over-the-year rate of change regained the ground it lost in October, rising to 4.7% from October's 3.2%, and the margin from forecast moved back into the positive column, +1%, after falling below, -0.5%, in October.

A NEW "CONCERN"

We often note that revenue estimators can't just forecast weak collections and wait for



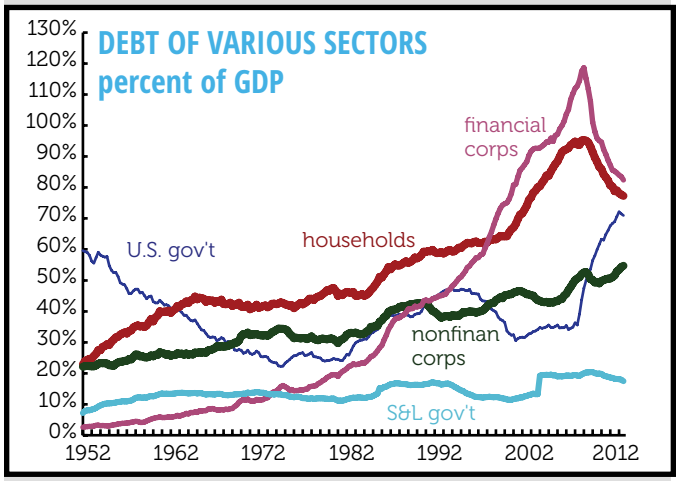
pleasant surprises. Money that comes in over-forecast often cannot be spent, and although the public probably prefers such surprises, legislators—AKA the boss—are annoyed by misses in either direction.

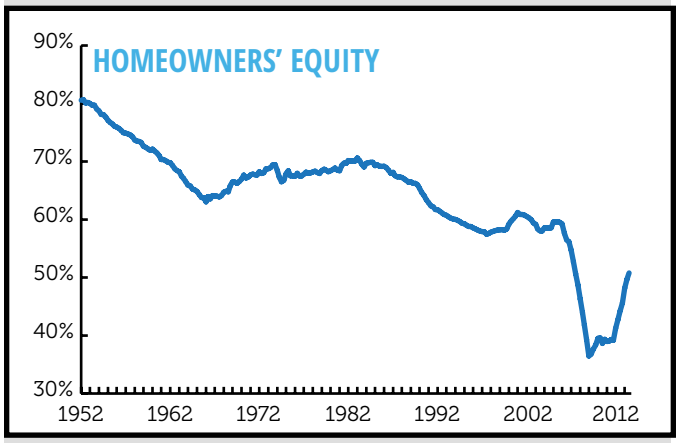
We got a thoughtful note on this topic from one of our contacts, who is a bit "concerned" that there is growing upside risk to his forecast, and perhaps to forecasts in other regions as well. He has found that the areas hardest hit by the housing bubble are now outpacing other regions in employment growth. Although the West and the South are not yet adding jobs at the same clip they were before the bubble burst, they are now outpacing the Midwest, which has now exceeded the annual gains of 2005-6, and the Northeast, which has now matched its admittedly tepid rate of 2005-6. He is not willing to raise his forecast just yet, but we believe his logic is sound, and wanted to pass it along. And that was echoed by a contact in a large eastern state, who believes that a few more months of receipts in the current range will drive their forecasts up significantly. But since we've been here before, and many times at that, his department is holding off on making that official until they see a few more "strongish" months.

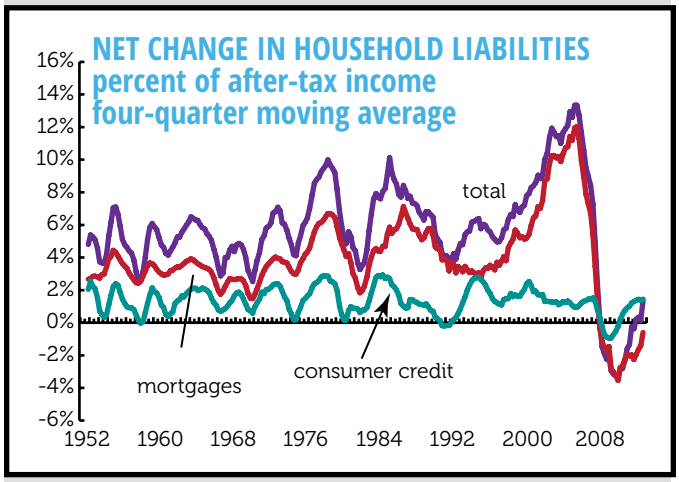
A WORD FROM JANUS

With the taper in place, and accepted by the markets, modest underlying improvement in labor force details (although initial claims have returned to unfortunate levels), and an upward revision to GDP (now in line with what one would expect given strength in auto sales), we are in decent shape heading into the new year, even if the Grinch pushes us to reiterate the forever caveat: we have been here before.

FLOW OF FUNDS: HOUSEHOLDS BORROWING AGAIN







Old habits die hard: we're still calling the Fed's quarterly release the flow of funds, even though it's been officially renamed the Financial Accounts of the U.S. "Flow of funds" is snappier and nicely descriptive. Here's an overview of what happened in the third quarter of 2013.

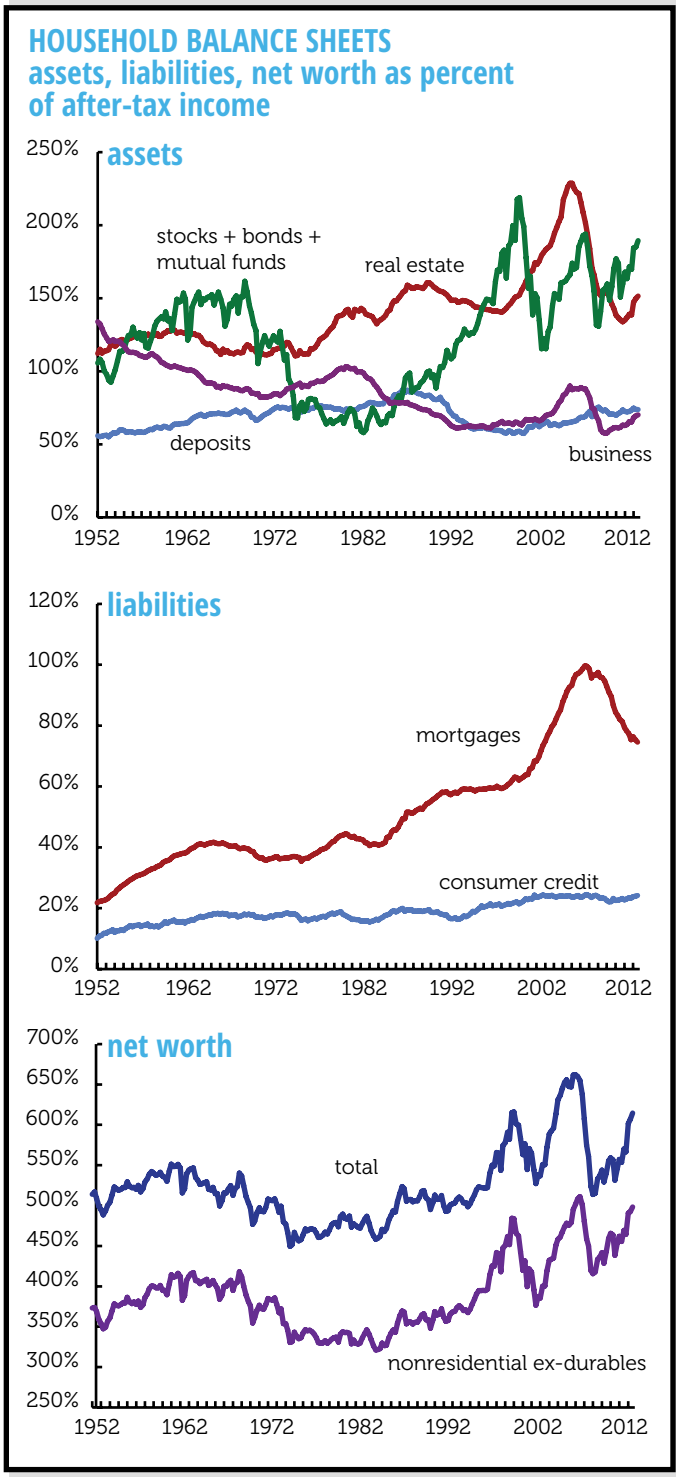
DEBT BY SECTOR

Although there was some pickup in household borrowing, it was modest, and most sectors continued deleveraging. Total credit market debt fell from 346% of GDP to 344%. As the top graph to the left shows, all major sectors except nonfinancial corporations showed a decline in their debt/GDP ratios—even Uncle Sam, whose ratio was down for the second consecutive quarter. (Of course, the ratio has doubled over the last five years, but that's getting to be old news. The sequester and other budget deals have kept a lid on spending, and recovery has brought in higher revenues.) The household debt ratio is back to 2003 levels, something it would have been impossible to imagine in 2007. Financial corporations' debt is back to 2001's ratio.

An exception is nonfinancial corporations, whose debts continue in a long uptrend—it's almost 10 points above where it was on the cusp of the Great Recession. It seems odd to worry about overleveraging while deleveraging continues, but you have to wonder if corporations are getting carried away. Although interest rates are likely to stay low for some time, they won't stay this low forever, and rolling over that much debt in a rising rate environment could get interesting.

HOUSEHOLDS

Household balance sheets improved nicely in the third quarter. (See graphs, p. 7.) Assets rose to 724% of after-tax income, their high-

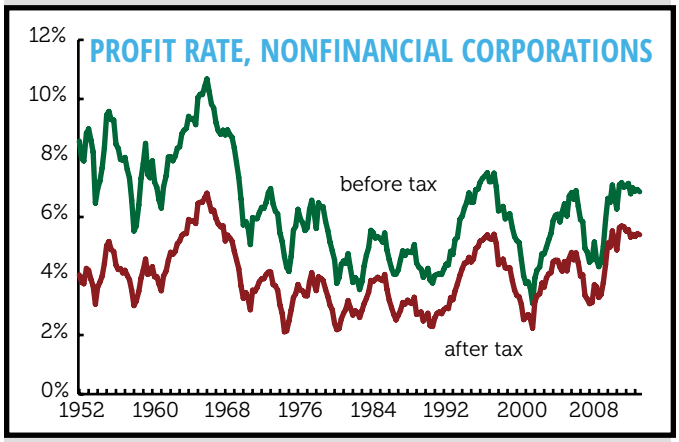


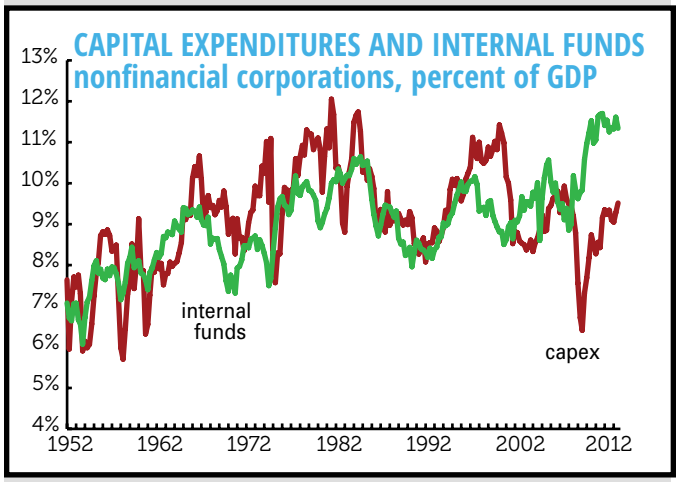
est level in five years, with both housing and financial assets contributing to the rise. And liabilities fell to 109% of after-tax income. The rise in assets and decline in liabilities pushed up net worth from 607% of after-tax income in the second quarter to 615% in the third.

The bottom graph to the left shows two definitions of net worth—total and nonresidential excluding durables. (The Fed counts durable goods as household assets, but since they're usually nonliquid, depreciate rapidly, and produce no income, we prefer to subtract them from the net worth calculations.) The "total" line actually corresponds roughly to the 95th percentile of the wealth distribution, since the ownership of financial assets is so upwardly skewed. The nonres ex-durables concept offers a much better picture of the "average" household—and it looks to have largely recovered from the recession-induced collapse.

And, as the graph on the bottom of p. 5 shows, homeowners' equity has recovered markedly, after having fallen through most of the housing boom and subsequent bust. It broke above 50% for the first time since late 2007. (It's rather amazing that it fell by about 10 points during the bubble, as debt increased far more rapidly than house prices.)

And as the graph at the bottom of p. 5 shows, households are borrowing again, though gingerly. Mortgage debt increased by 0.7% of after-tax income, its first increase since early 2009 (though that's a tenth the rate it was rising in 2007). Consumer credit increased by 1.4% of after-tax income, the same as the third quarter, and about the rate of increase we've seen over the last couple of years. That coincidentally is the average rate of increase in consumer credit since the quarterly flow of funds numbers began in 1952—so while we're not yet at the boomy over-2% rate of increase, we're seeing decent credit growth. Not in mortgages, yet, though, which are





only just crossing the zero line.

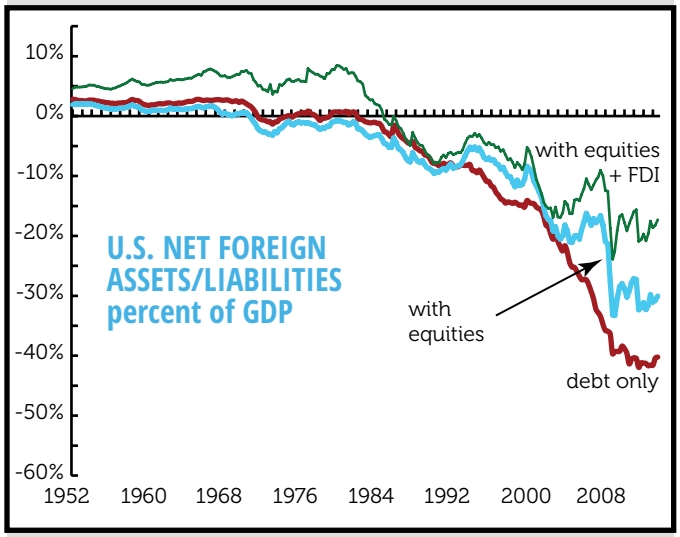
NONFINANCIAL BUSINESS

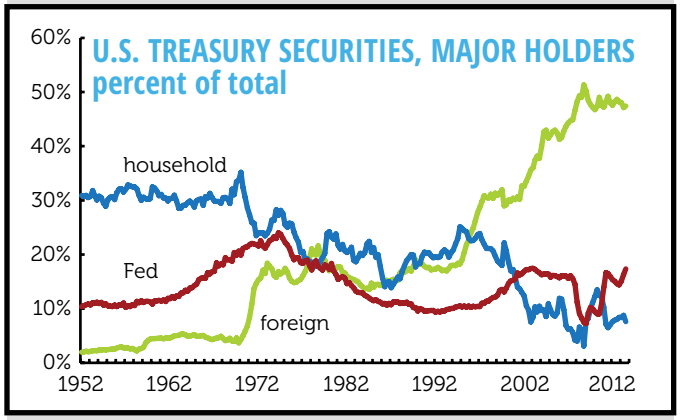
Corporate America remains in fine fettle (aside from that debt blemish maybe). Profitability (defined as profits from the national income accounts divided by the Fed's estimate of the tangible capital stock—see graph, top left) has been flat at a fairly high level for the last year or so. It's off its 2011 peak, but not by much. We've found this measure of profitability to be a long leading indicator; it suggests a maturing expansion, but one which still has a year or two to run.

And, as the graph on the bottom of p. 6 shows, cash flow greatly exceeds capital spending. The gap narrowed some in the quarter, as internal funds fell from 11.6% of GDP to 11.3%, and capex rose from 9.3% of GDP to 9.5%. But the gap, aka free cash flow, remained at 1.8% of GDP. Its 1952–2007 average was -0.3%. Corporations are generating plenty of cash, but they're not spending it lavishly on investment or employees. They are, however, continuing to shovel vast pots of it out to their shareholders, via takeovers, buybacks, and traditional dividends. Such transfers to shareholders took up just under half of internal funds, or 5.6% of GDP Those figures are about twice their long-term averages. They're good news for the stock market, but probably not for long-term prosperity.

REST OF WORLD

The U.S.'s balance with the outside world continued its improving trend, as the graph on the bottom left shows. After about a year of flatness, late 2011 through early 2012, the ratio of credit market debt owed to foreigners to GDP has improved for two consecutive quarters, and three of the last four. The pattern looks even better if you include net eq-



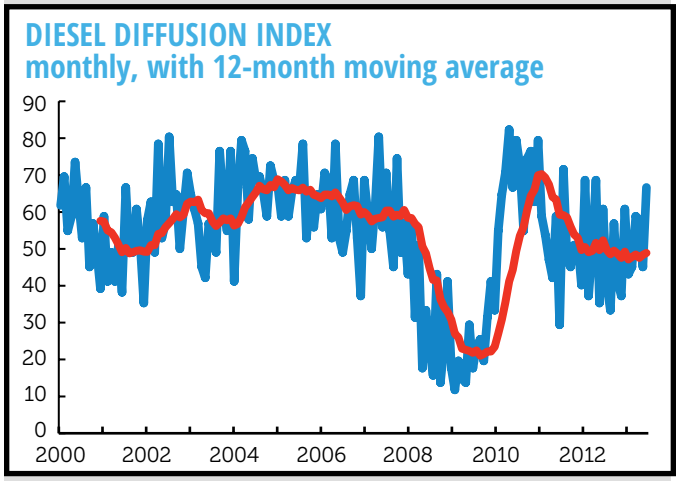


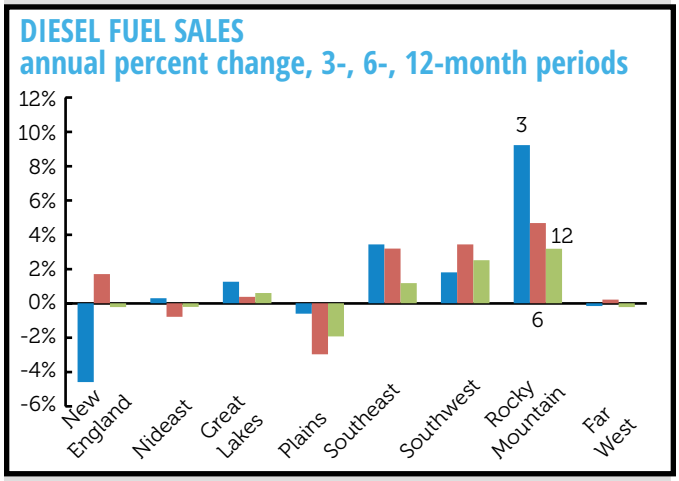
uity and foreign direct investment holdings. After years of deterioration in the foreign accounts, this stability-cum-improvement is a refreshing change.

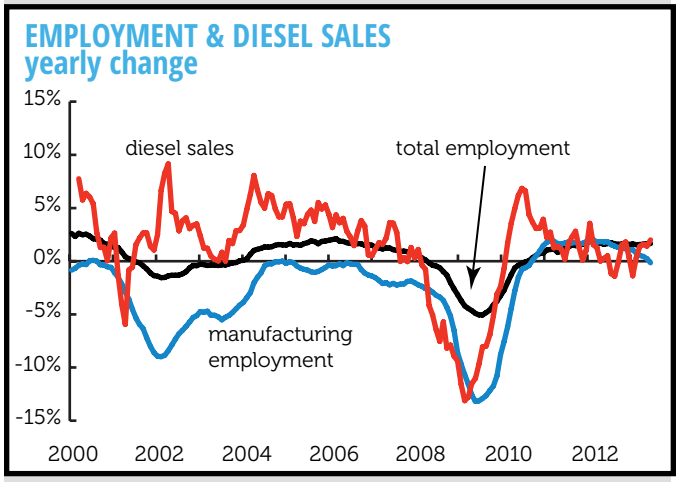
A major reason for the improvement, as the graph to the bottom left shows, is that the foreign share of Treasury debt holdings has been stable for the last four years. And while QE might lead one to thing that the Fed has just taken the place of foreigners, the graph shows that that's not really true; the central bank's share is about where it was ten years ago, and is actually lower than it was in the early 1970s. Households, though, which had stepped up their Treasury purchasing from 2009 through 2011, have stepped back.

So, deleveraging goes on, with Washington even joining in to some degree. At this point, it'd be nice to see the mortgage borrowing line break firmly above zero; a continuation of the housing recovery would feel a lot better now than extended prudence.

DIESEL FUEL SALES







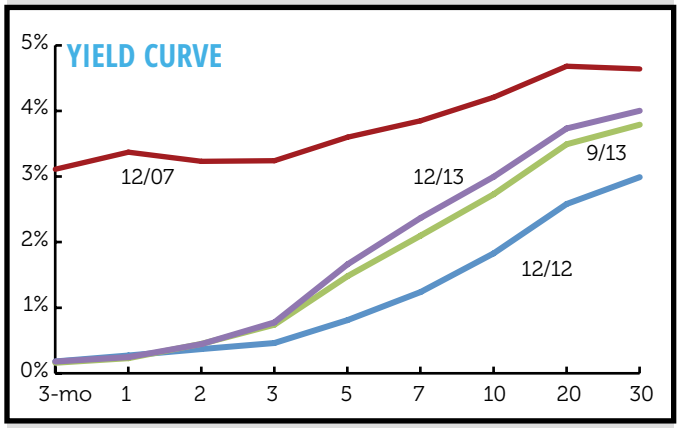
The Federal Highway Administration's most recent release (November) of sales data for diesel fuel—actually special fuel, which is predominantly diesel fuel—shows year-over-year sales during July increased by 6% nationwide. Thirty-four states reported sales increases for the month, bringing the one-month diffusion index up nicely. Since this is a noisy series, it's best to use a moving average to show its trend. (See graph to left.) It shows that after a sharp recovery from the Great Recession, the index has eased over the last couple of years, but it rose slightly in July.

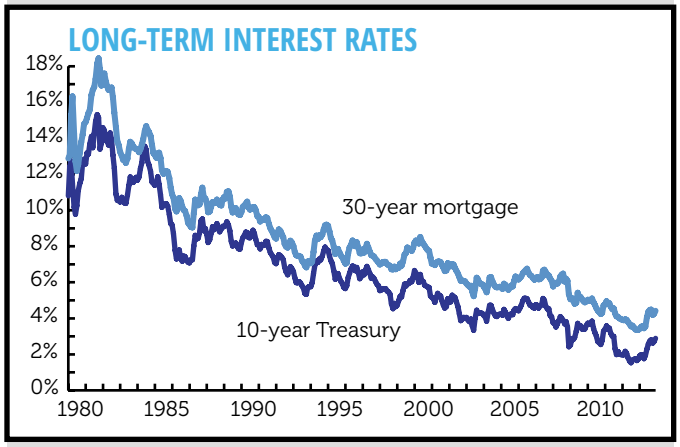
The second chart shows regional sales trends in the yearly rate of change over the most recent 3-month, 6-month, and 12-month periods. Growth has been strongest in the Rocky Mountain, Southeast and Southwest regions. The New England decline may be an anomaly, because of the unsual behavior of one state, but weakness in the Plains states looks well established.

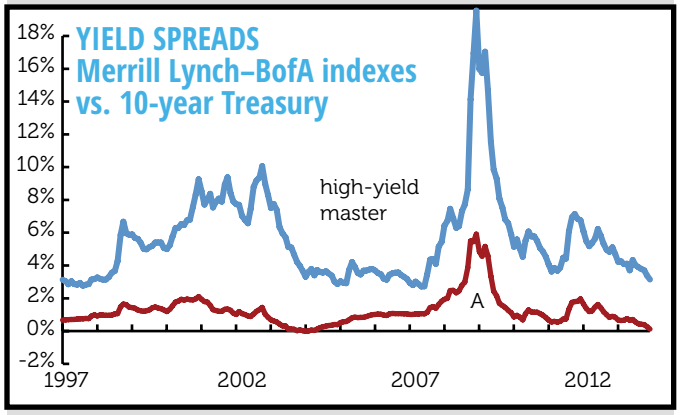
Diesel fuel sales have performed well as a forward indicator of changes in total nonfarm and manufacturing employment, as the graph to the bottom left shows. Over the past two years the growth rate for diesel fuel sales moved up to a post-recession peak during February 2012. Since then the rate of growth has gone negative seven times. But growth accelerated over the summer. Employment shows a similar trend, as job growth slowed for most of 2012 and early 2013, but by summer, employment growth had recovered. These recent trends are amplified in manufacturing employment.

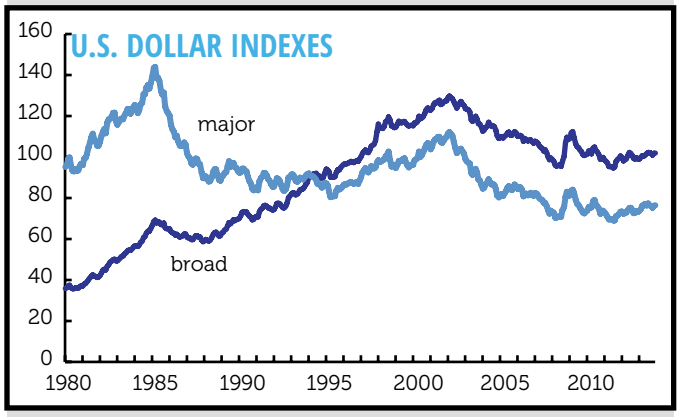
The most recent diesel fuel sales data offers hope that the rates of growth for both total nonfarm employment and manufacturing employment will accelerate in future months, though several regions may well remain laggards for a while.

FINANCIAL INDICATORS









The taper, finally. At the conclusion of its December 17–18 meeting the FOMC announced that beginning January it will reduce monthly purchases of Treasury and mortgage debt by $10 billion. Recent strength in employment growth was cited as a reason for this action. The low rate of inflation continues to concern committee members: it's running below the Fed's 2% target.

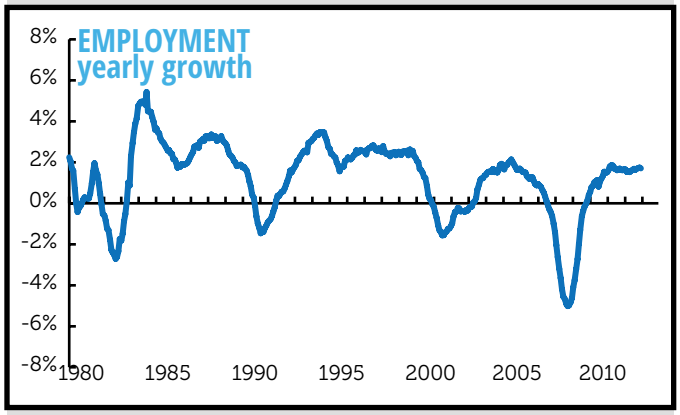
Yield curve steepens. During November, yields on short maturity Treasury notes decreased, while for longer maturities yields increased slightly. This likely reflects to the combined effects of anticipating the taper in early 2014 and the unwinding of the budget melodrama risk premium at the short end.

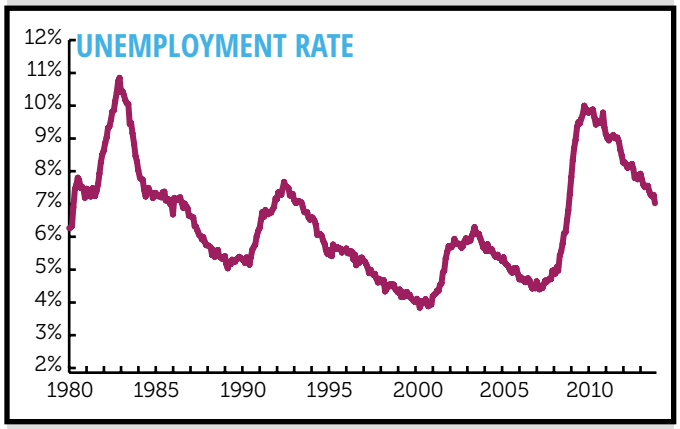
Yield curve points to continued growth. After a slight tick down during October the spread between 3-month and 10-year Treasury yields moved up to 2.65 points during November and to 2.82 in early December. This widening is a positive sign for growth. As the Fed scales back on debt purchases while maintaining the federal funds target near zero the spread will likely increase in 2014.

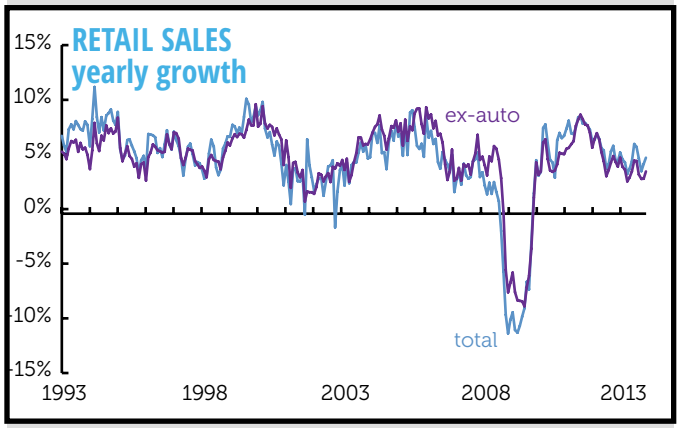
Most corporate rates drop. From October through early December, rates on less risky corporate debt rose slightly, but rates on the riskier stuff fell. But risk premia fell across the board, with the yield on A-rated debt falling below the 10-year Treasury rate. During November, $113 billion in new corporate debt was issued, 20% of it high-yield..

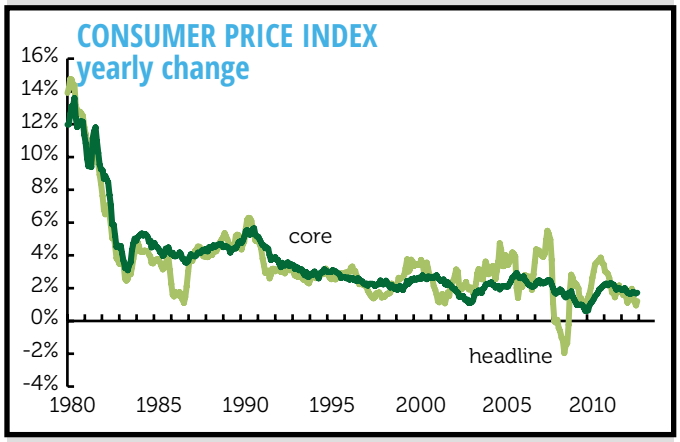
Mortgage rates rise a tad. Mortgage rates rose in November and early December. The somewhat higher rates seem to have had an impact on sales of existing houses, which decreased by a combined 5.1% in October and November. On the other hand, new house sales jumped 17.4% in October, and fell back just 2.1% in November, to a level 16.6% above November 2012.

REAL INDICATORS









Employment growth has settled into a stable growth rate of 1.7% a year overall, and 2.1% for the private sector, where both measures have been for five of the last six months. While there's still a deep employment deficit to make up from the Great Recession, this rate of job growth is not bad by historical standards. Of course, getting out of the jobs hole would require higher-than-average growth, but given the historically sluggish recoveries from post-financial crisis recessions, we could be doing a lot worse.