

January 13, 2009

The Liscio Report

On the Economy

For John Liscio 1949-2000

Sales tax receipts miss lowered forecasts, again

Only 7% of the states in our survey hit their sales tax collections forecasts in December, down from 14% in November. States reporting growth in tax collections over the year slumped to 13%, from an upwardly revised 17% in November. December collections reflect activity in the prior month as well as early in the current month, so we have seen some of this weakness already in last month's Retail Sales print, but the speed with which the SDI is deteriorating from already depressed levels is alarming.

As we have reported, the behavior of sales tax receipts has been a major concern to our state tax contacts since late 2000, first because they were falling fast and then, with the advent of the first round of auto incentives, because they were climbing far ahead of withheld receipts, an unsustainable situation. Next, as the housing bubble inflated, our contacts added the concern that one-third of the growth in sales receipts was com-

ing directly from purchases related to the home, even before wealth effects and home-equity extraction were factored in. In late 2005 collections began to slip, and by the summer of 2006 many of our contacts noted that sales tax collections were growing at a recessionary rate, in some cases below the rate of inflation. Cur-

rently many states are reporting double-digit over the year declines and, with a few outliers, even the best-positioned states are reporting year-over-year growth hovering around the zero line. At the beginning of the year the SDI's three-month moving

average was 50%; currently it is 10%.

A Midwestern tax contact directed us to a presentation Richard Curtin, who heads up the Reuters/University of Michigan Consumer Confidence series, gave at a mid-November regional forecasting conference. We are passing along the outline, will circulate a link to the paper when it's on the web, and ask everyone to remem-

- ***sales tax collections deteriorate some more***
- ***the five degrees of discontent: can we just keep it at the fourth?***
 - ***MEW goes negative***
- ***flow of funds report: deleveraging starts...but oh so far to go***

fidarsi é bene; non fidarsi é meglio

The Liscio Report - 2

ber the conference took place two distressing months ago.

Professor Curtin names the “five degrees of economic discontent.” First, Inflation, and the struggle to maintain living standards. Second, rising Unemployment, and postponement of purchasing which can in itself spur on recession. Third, Wealth contracts, deepening declines in spending. Here he notes that drops in stock

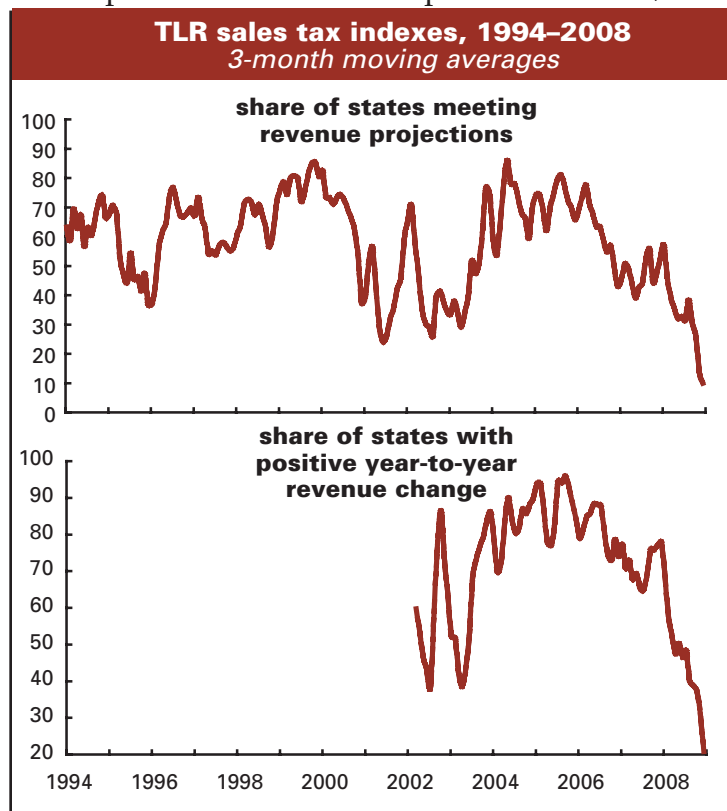
prices are common, but falling home prices are more troublesome for the consumer. (The home ownership rate is in the low 60s, whereas only about half the population owns stocks—and only a third have a portfolio larger than \$5,000. The bottom 60% of the income distribution has only enough savings to cover a few months of expenses.) Fourth, Economic Policies designed to ameliorate the recession

kick in. If they work and confidence rises, great. If not, political discontent is ratcheted up while confidence is dragged down. These first four stages are generally part of every recession. Stage five, Despair, is not. Here economic survival becomes the overwhelming concern, and consumers are willing to make “enduring structural changes” as systemic failures foment the sense that something is terribly wrong.

Curtin’s accompanying charts, all through October and going back to the fifties and sixties, are ghastly. Consumer sentiment, as of October, was at least two standard deviations below the mean, as were consumers’ assessments of their finances, which were at their worst level ever. Reported income declines went negative in Q2 2008 and remained there for the first time since 1960, and postponement of purchases hit 45% in October; the previ-

ous annual low was about 28%. Going forward, Curtin suggests that consumption could contract -0.9% in 2009, with credit sensitive purchases hardest hit. He stresses the importance of getting a floor below the “freefall in employment,” (written when job losses were still in the -250K range, and the unemployment rate was 6.5%), restoring credit, of course, and the importance of public confidence in gov-

ernment policies. In October, confidence in government policies was about two standard deviations below the mean, and well below the annual lows in 1973, 1981, and 1993. When President-elect Obama is sworn in next week, he needs to have all his ducks, their shovels at the ready, in a row as we work together to keep the fifth stage at bay.

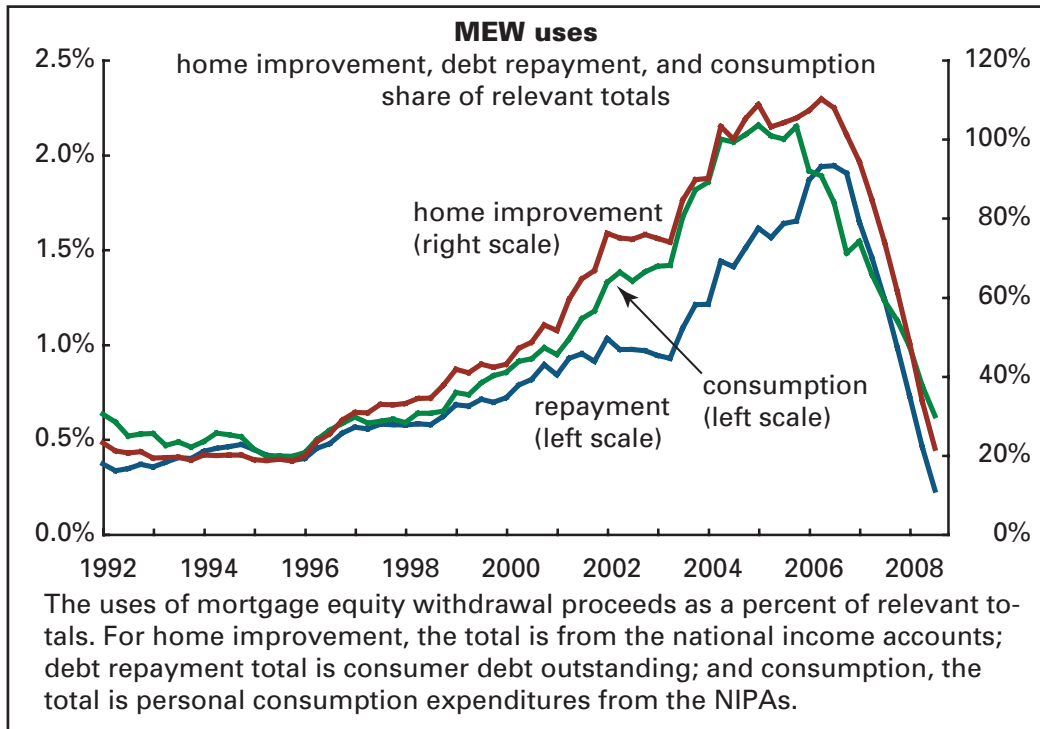


The Liscio Report - 3

MEW: way down

Fed economist James Kennedy is winding down his production of mortgage equity withdrawal statistics; alas no more after the fourth quarter estimates are released in March. And, another alas, the

As the graph below shows, that means a lot less cash available for consumption, debt paydown, or home improvements. At the peak of the boom, MEW financed about 2% of consumption; in the third quarter of 2008, it was down to 0.4%. This seems to be the major path for the trans-



third quarter release—which, it should be pointed out, are informal estimates and not official Federal Reserve data—is missing the seasonal adjustments.

Before seasonal adjustment, mortgage equity withdrawal went negative in the third quarter: $-\$39$ billion gross, or $-\$64$ billion net of fees and other costs. That's the first negative reading since 1991, when the net figure was $-\$5$ billion (and the gross was a positive $\$6$ billion). Needless to say, this is a major shift; a year earlier, net MEW was $\$96$ billion. Relative to disposable personal income (DPI), net MEW was -2.4% in the third quarter; at the 2006 peak, it was $+9.5\%$.

mission of the housing bust to consumption. Most of the deceleration in consumption over the last year can be explained by the slowdown in income growth and the implosion of the job market. But it's clear that the extra juice that MEW lent to consumption in the mid-2000s has now gone rapidly into reverse.

flow of funds: a quick look

A quick look at the third quarter flow of funds data, which came out last month. Of course, the third quarter was when things in both the markets and the real economy took a decided turn for the worse. Even so, it's clear from the data that while deleveraging has begun, it's

The Liscio Report - 4

only just begun.

macro

As the upper graph below right shows, the pace of nonfederal borrowing has

slowed dramatically, to a very low rate by historical standards, and probably slowed some more in the fourth quarter. Still, as the lower graph shows, the growth in overall debt outpaced

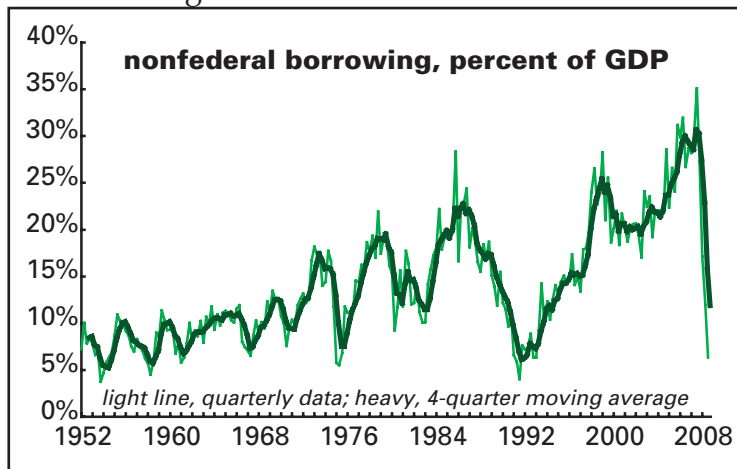
GDP growth, as it has for almost 30 years. It would mark quite a structural shift even if debt growth were just to match GDP growth, as it did from the early 1950s through the early 1980s. We're closer, but still no cigar.

Those are flows, or rates of change. Debt stocks, however, remain at extremely high levels, and are only beginning to edge

downward for some sectors. As the graph on p. 5 shows, among major sectors, only households and nonfinancial corporations are showing signs of reducing debt levels, and they're pretty modest signs. Debt of financial corporations continued to rise

relative to GDP in the third quarter, as did debt of the federal government, which is almost certainly only in the early stages of a dramatic rise.

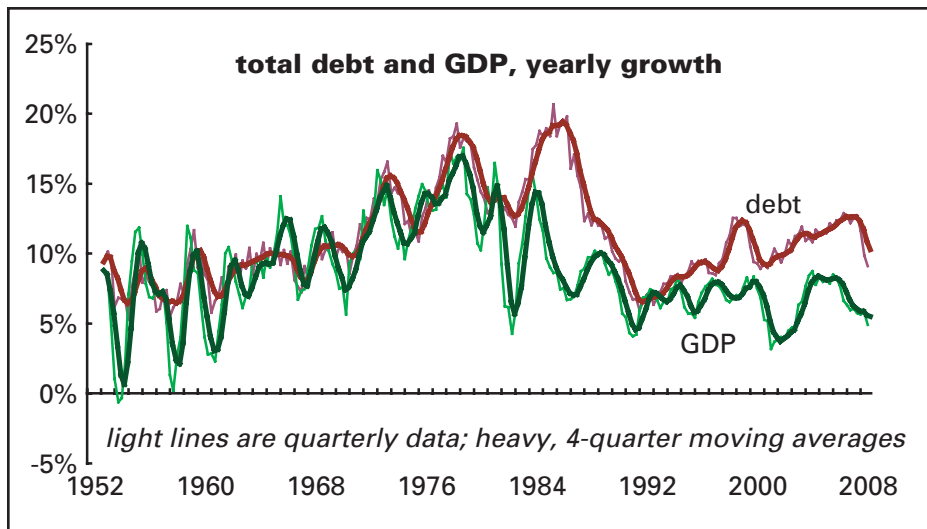
households



Total household assets fell from 683% of after-tax income in the second quarter to 666% in the third, with almost all major asset classes except bonds falling. The third quarter reading is almost 100

points off its 2007 peak (769%)—but it's still quite elevated by historical standards (e.g., the 1952–1990 average of 555%). And although household real estate—mainly

owner-occupied housing—is well off its peak (179% of DPI in the third quarter, vs. a high of 230% in 2005), it's still about 50 points above its long-term average.



As the upper graph on p. 6 shows, there's still a lot of daylight below even the latest, severely reduced levels. But as the lower graph on p. 6 shows, the decline in household real estate is the biggest in flow of funds history.

The Liscio Report - 5

And while mortgages are starting to roll over (graph on top of p. 6), consumer credit isn't—nor are total liabilities. In other words, if mean reversion still has any explanatory power, this could run a long time.

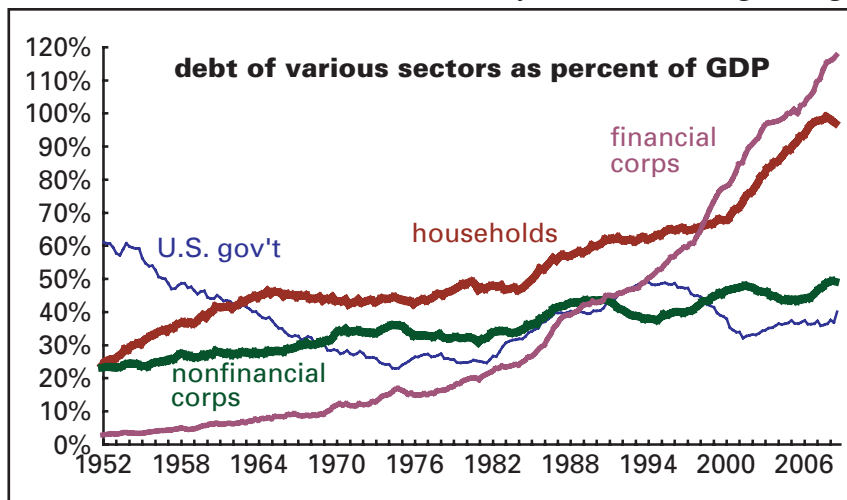
nonfinancial corps

Surprisingly, the profitability of nonfinancial corporations (by the standard TLR definition: NIPA profits divided by the value of the tangible capital stock from the flow

of funds) ticked up in the third quarter. This tends to be a long leading indicator: it peaked in 1997, three years ahead of the stock market and four years ahead of the broad economy, and again in 2006, again well ahead of the stock market and economy. And while the series does bounce around (as the upper graph on p. 7 shows), this does offer some encouragement, at least for now, that we're not facing the immediate prospect of a total rout.

As we've been pointing out almost every quarter since we started doing these flow of funds reviews, Corporate America spent the fat years shoveling cash into its shareholders pockets. Instead of being net issuers of stock, nonfinancial corporations turned into net buyers, thanks to takeovers and buybacks. While that trend hasn't fully reversed, it's slowed considerably. In the fourth quarter of 2007, net equity retired equaled 7.8% of GDP at an an-

nualized rate; two quarters later, that had slowed to 1.9%. Net retirements picked up in the third quarter, to 2.9% of GDP, but that's the lowest number since 2005. Still, this is probably another of those trends, like deleveraging, that's in its early stages and could carry on for more time than anyone could imagine right now. As the



lower graph on p. 7 shows, once upon a time (like the 1950s through the early 1980s), corporations were net issuers of stock, not net buyers.

outside world

And the U.S. position with the rest of the world shows no sign at all of stabilization. (See graph on p. 8.) Net foreign debt now exceeds 40% of GDP, double what it was in early 2002. Even adding on foreign direct investment and holdings of foreign equities doesn't help out the way it used to. This dependence on foreign capital remains a major point of vulnerability for the U.S. economy.

It looks to us as if the point of economic policy in the coming months and years will have to be to mitigate the shocks of reduced reliance on debt and lower rates of income growth. Restoring the status quo ante would be a bad idea even if it were possible, which it isn't.

Wednesday's numbers

We were surprised by the relative strength of the November retail sales report, and

The Liscio Report - 6

are even more surprised looking at December tax receipts and what they mean about November sales activity. Since last summer, revisions to the past month have been modest, and our forecast is based on only modest revisions to November, although our hunch is that we could see a substantial markdown. We anticipate December overall sales fell by 1%, with the ex-auto component dropping 1.3%. The most depressing news we heard was that gift cards, already under attack from consumer groups who point out that many of them languish in teenagers' rooms until they expire, were off because the smallest denomination one can give without looking like a cheapskate is \$25.00, so many shoppers opted for a \$12.00 book or CD instead.

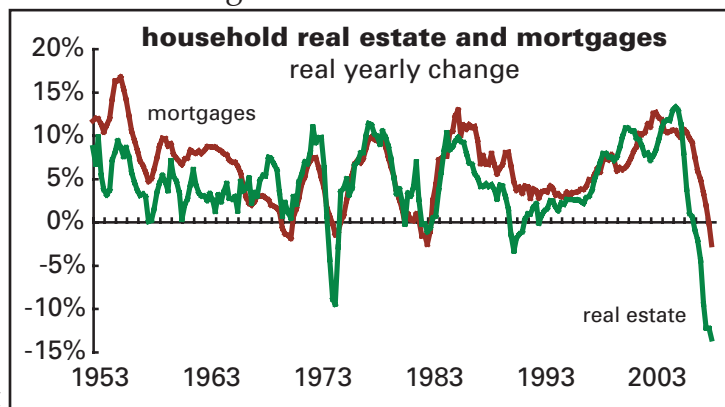
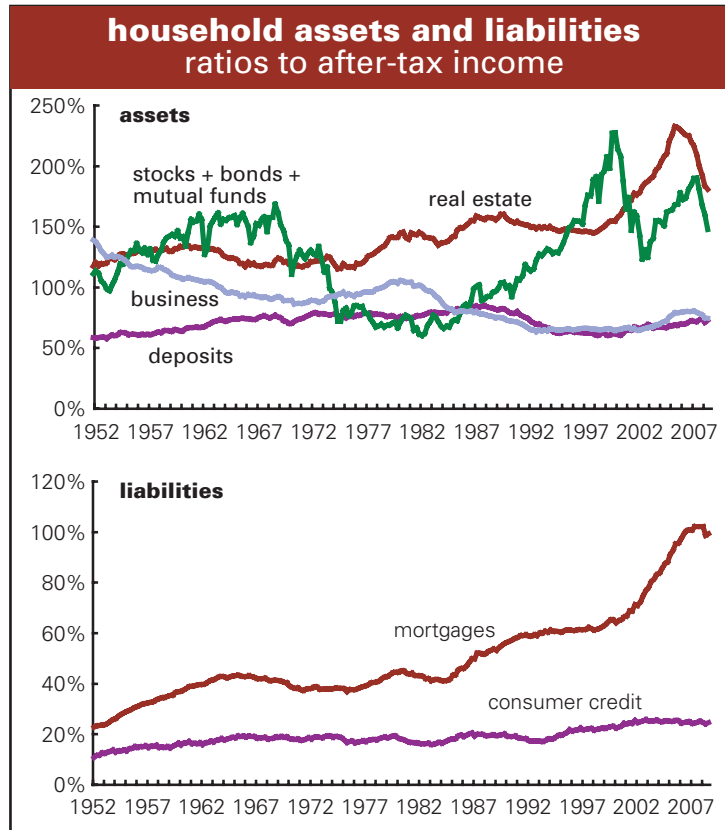
data point

The Quarterly Census of Employment and Wages report for the second quarter of 2008 will be released later this morning. QCEW data are used in the annual benchmarking of the nonfarm payroll numbers, and we got

out first hint about Q2 back in November when the series was incorporated into the revised NIPA wage and salary data.

Nominal wage and salary growth was revised down from the initially reported +3.1%, annualized, to +0.8%, and within the private sector from +2.8% to 0%. We'll know how much of the downward revisions came from employment and how much from wages at 10:00AM. Our guess is that it will be ugly.

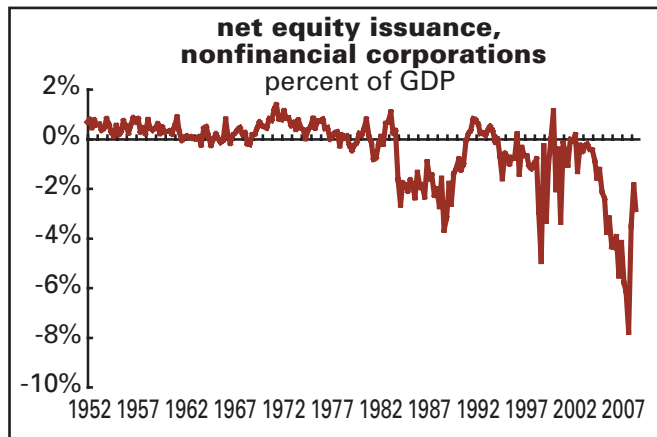
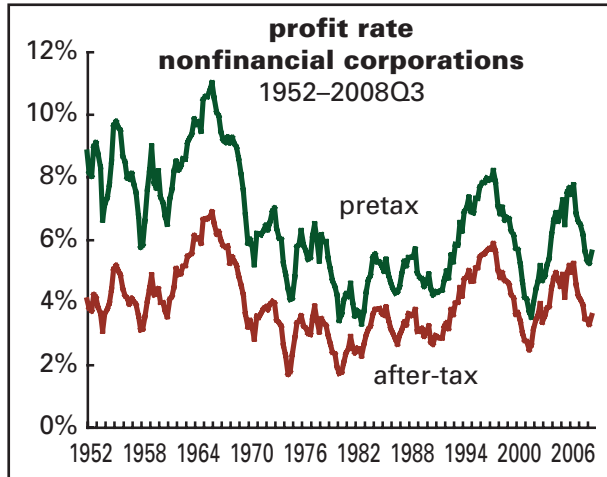
—Philippa Dunne & Doug Henwood



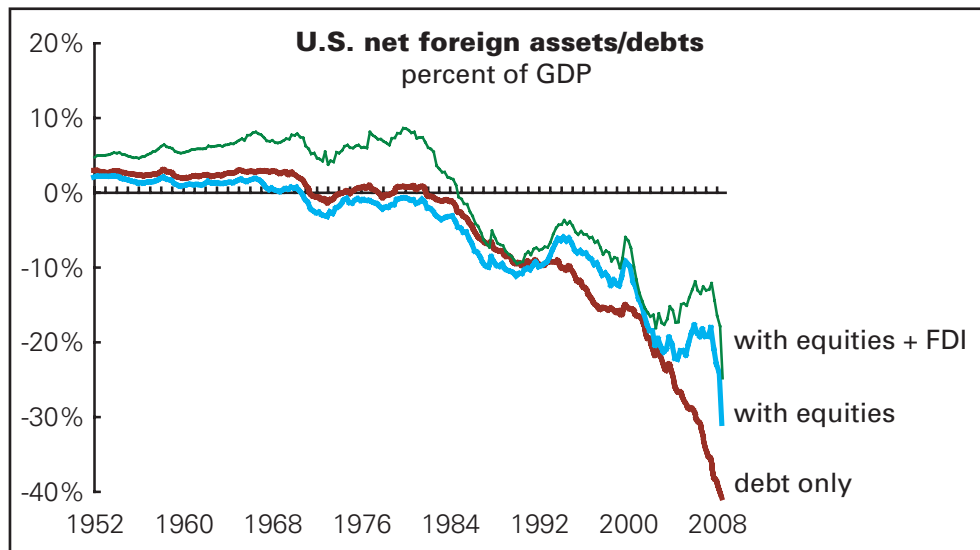
more graphs



The Liscio Report - 7



The Liscio Report - 8



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 2008, TLR II. All rights reserved. **Fax subscribers:** If you would like to be removed from our list, please call 1-866-860-3439 and follow the voice prompts using pin #4365.