

October 11, 2007

The Liscio Report

On the Economy

For John Liscio 1949-2000

Could it be a recession?

Just 45% of the states in our survey met or exceeded their sales tax collections in September, down from 57% in August. The percentage of states reporting positive results year-over-year held steady at 77%. As we often mention, sales tax due dates are lagged, so one month's collections include activity from the second part of the prior, and the first half of the current, month. Some of the weakness in September receipts reflects the slump in August sales we already know about.

Last month we reported that, "sales taxes are a problem." The problem continues: the majority of states in our survey are forecasting year-over-year growth rates associated with recessions, and the majority of the states missed those forecasts in September.

Looking around the country, the most consistent stability was again in the Midwest. A few of the smaller states made their modest forecasts, with all but one reporting a narrowing margin, and one

of the big manufacturing states in the region has been doing well in sales taxes for several months. Our contact believes the modest improvement in auto manufacturing is behind the more positive y/y comparisons. . The Southwest and West fared poorly. Sales tax receipts in several states

barely budged, and in two they were in outright decline, with the housing market the culprit. One large state in the region reported healthy growth in sales tax receipts, albeit at a slightly slower pace. Some states with deflating

housing markets in the South reported year-over-year declines in tax receipts, while states along the Midatlantic seaboard did relatively well. In the Northeast, two states with concentrations of local wealth and wealthy tourists reported double-digit growth, while the others skirted the lower edge of their forecasts.

Sometimes we're all so focused on the monthly numbers that we forget about longer-term trends. As an antidote to that,

- ***sales taxes: the problem continues***
- ***stunning drop in port traffic: bad holiday season ahead?***
- ***job market? strong??***
- ***are we at the edge of recession?***

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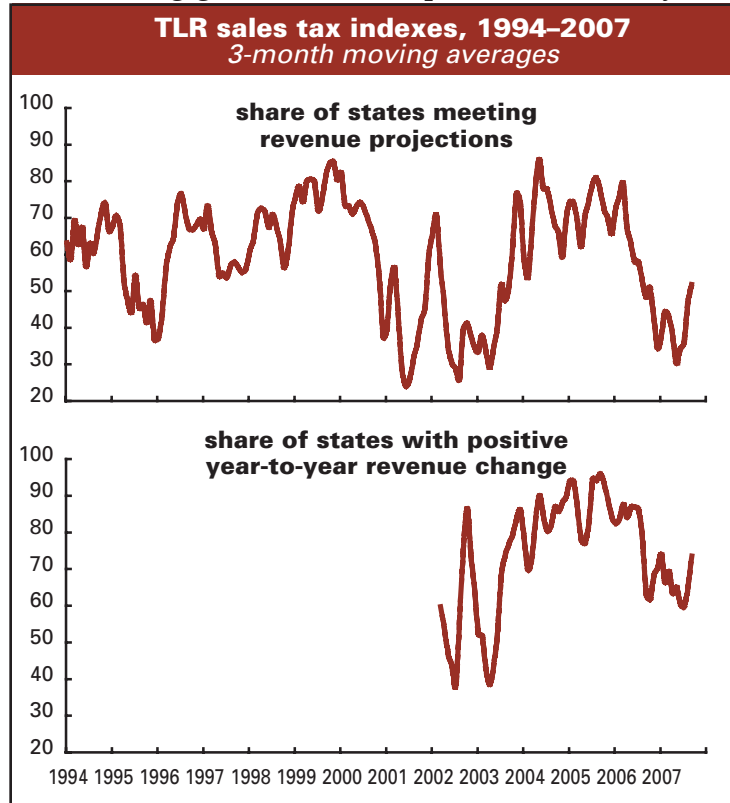
we've graphed the yearly change in total retail sales on p. 3. The pace has slowed considerably since the expansion peak of 2005–2006—down by roughly half, in fact.

Several contacts voiced concern about the effect of weakening withholding growth

coupled with recessionary sales tax receipts on the holiday season. It may be that some the slump reported in container traffic into U.S. ports in a recent *Los Angeles Times* article is an early warning of a weak holiday season. In August, the number of containers coming into the ten top U.S. ports actually fell 1.4% year-over-year, the first decline since Global Insight began tracking traffic in 2005.

Readers of the report apparently fell into two categories: those who, expecting an increase to an all-time high, were so surprised by the fall that they went on typo patrol, and those in struggling sectors like the building materials supply chain who, having recently cut their orders by up to 16%, were not surprised at all. Sung Won Sohn, CEO of Hanmi Bank in Los Angeles, believes retailers must be expecting a weak holiday season, and mentioned he is hearing from his own customers that those catering to the Hispanic population are having an especially tough time. Although the drop in incoming traffic was

modest for key U.S. ports as a whole, containers coming into Los Angeles and Long Beach Harbors, which handle close to 50% of all traffic, fell 6.7% between August 2006 and 2007. In the years between 1997 and 2006 containers handled in the twin ports rose 10% a year.



We'll have more to say about the R word in a moment, but we do want to mention that our state contacts are bringing up the "recession scenario" more often these days. Although a few contacts are hopeful, based on recent stability in withheld and sales taxes, that things may not be as bad as they had feared they as of yet see no trends indicating this is so, and are in a stark

minority. The primary risk of recession is, of course, the housing market: not one contact thinks the worst of the housing market correction is behind us, although some suggest it may have stabilized momentarily.

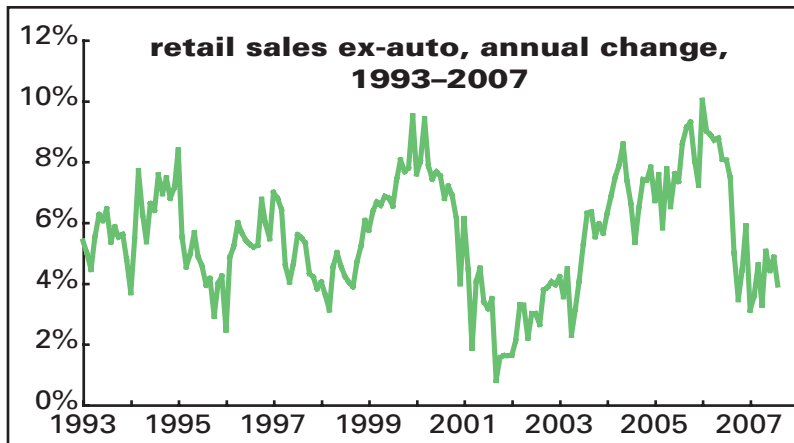
But it's important to note that contacts in some states where there was no housing bubble suspect that the real economy may be shaky enough to drag their states into a extended periods of sluggish growth and perhaps stagnation, if not recession. And several contacts who had anticipated real slowing in a number of tax components,

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including corporate profits, are surprised by the magnitude.

JOLTS!

We were surprised to read and hear over the last several days repeated references to last Friday's employment report as strong. By what measure? September's percentage gain was well under half the long-term average, and came in at the 31st percentile of monthly changes since 1950. What were people expecting that made that look strong?



But that's not the only sign of torpor in the job market. Wednesday morning's release of the August Job Openings and Labor Turnover Survey (JOLTS) from the BLS confirmed the picture of a U.S. labor market that has been losing dynamism. The rate of new hires was 3.4% of employment, down from a 3.5% average for the first half, and a 3.6% average in 2006. The deceleration in the private sector was more marked: from 4.0% in 2006 to 3.9% in the first half of 2007 to 3.7% in August. Curiously, construction was not the weakest of the major sectors; it actually showed a pickup from the first half. Retail and professional and business services all weakened more than the private sector average from 2006 through August 2007.

Separations (quits plus terminations) displayed a similar weakening trend, falling from 3.4% in 2006 to 3.3% in the first half of 2007 to 3.2% in August. The private

sector's decline was similar. Separations in construction rose from their first half average, but are still below their 2006 average; this sector just won't roll over. As with hires, separation rates in retail and professional and business services also were below their first half averages.

The net result—hires less separations—

shows a flat-to-declining trend: 0.2% total, exactly the same as the 2006 and first half of 2007 averages; the private sector was 0.1%, the same as the first half, and down from 0.2% in 2006. Turn-

over—hires plus separations—was 6.6% of employment, the lowest in four years. While these numbers aren't as dramatic as the Business Employment Dynamics series, which are near all-time lows in turnover, they're still quite low. Is the U.S. labor market in a period of structural senescence? Rapid movements in and out of jobs used to be seen as a sign of the national economy's excellence at "creative destruction," to use once more Schumpeter's overused phrase. Are we losing our edge?

recession watch

Are we in or near recession? Though it's not a done deal by any means, we may well be. Here's some evidence.

First, our recession index, which counts the number of articles containing the word "recession" in the *New York Times*

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and *Washington Post*. (We stole the idea from *The Economist*, which first applied it to the UK.) Over the years—at least since Nexis coverage begins in 1980—it's proven a timely indicator of downturns. We sent a note around about this a few weeks ago, pointing to a sharp spike in the index, though its absolute level remained low.

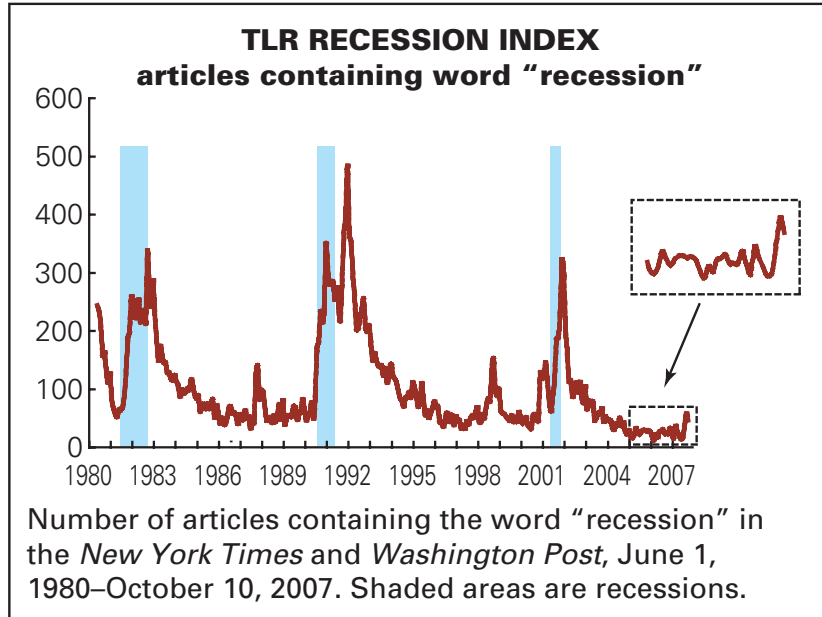
With only a third of October behind us, the index has eased back somewhat (see graph to the right). As we pointed out in the note, the index did give a false alarm after the October 1987 stock market crash, so it was quite possible that the summer's financial turmoil is the cause of a similar head fake. But the index remains elevated, so we'll keep an eye on this in the coming weeks.

On p. 6, we've assembled graphs showing the behavior of some crucial indicators around business cycle peaks. For this experiment, we treated August as the peak month of the recent cycle, mainly because that's the latest month for which all the data series are available. Consumer confidence, retail sales, capital goods, and the unemployment rate trace the cycle averages pretty well, though obviously this is all quite preliminary. The stock market is the strongest exception. Payroll employment has been growing more slowly than in earlier cycles, and continues to grow, so that's not yet recessionary, but it's not

boomy either. If the job market is entering recession, we should see some serious elevation of the initial claims numbers in the coming weeks.

A fascinating, and little-appreciated fact: the Fed normally starts cutting the funds

rate at or near the beginning of a recession. In other words, a decline in fed funds is often a sign of recession, and not an antidote to one. The big recent cut was the Fed trying to administer such an antidote, and really stands out in the table on page 5, where



we've assembled the data behind the graphs.

The table shows the change in the same indicators in the three months leading up to a peak, and the three months before that, and compares that historical experience to the recent averages. It's not a perfect fit, for sure, but it's not a terrible one

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either. The recent behavior in confidence, employment growth, and capital goods orders are pretty close to the recession-onset average—and the rise in unemployment is worse than what is usually seen at or near the beginning of a downturn. Some clear warning signs, though they require confirmation before the yellow light turns to red.

and often does obscure the trend.

Our model expects September's headline number to post at 0.3%, with the ex-auto component up 0.4%, and it has been reliably capturing monthly moves that may seem counter-intuitive. The uptick in the ex-auto number reverses the August drop, but is flat for the two months taken together. By the way, gas prices have been

recession onset: how does the present measure up to the past?

	recent			cycle averages		
	latest 3 months	previous 3 months	change	3 months bef peak	3 months bef that	change
fed funds	-9.7%	+0.2%	-9.9%	-0.8%	+1.4%	-2.2%
confidence	-5.2	-2.7	-2.5	-2.7	-2.0	-0.7
S&P 500	+1.9	+3.9	-2.0	-3.0	-1.9	-1.1
retail	-0.0	+2.3	-2.3	+1.1	+0.6	+0.5
unemployment	+3.7	+3.0	+0.7	-0.3	+0.1	-0.4
employment	+0.2	+0.3	-0.1	+0.3	+0.6	-0.3
capital goods	+0.2	+5.1	-4.9	-1.4	+5.8	-7.2

Table shows the percentage changes in seven major indicators for the three most recent months, the three months before that, and the change from the previous to recent period, as well as the three months before a business cycle peak, the three months before that, and the change between the two periods. Indicators are fed funds (monthly average, latest reading: October 2007), consumer confidence (Conference Board, latest: September), the S&P 500 (monthly averages, latest; October), total retail sales (latest: August), the unemployment rate and the growth in payroll employment (latest for both: September), and new orders for nondefense capital goods ex-aircraft (latest: August). In the case of fed funds and unemployment, the changes are percentage changes, not percentage point changes (e.g., a move from 4% to 5% would be a 20% increase, not a 1% increase).

Friday's numbers

Well, it's back to the wildly fluctuating and heavily revised Advance Retail Sales report. (We know the employment revisions are distressing, but they pale in comparison.) Although over-the-year the monthly retail sales reports show a slowing similar to what we are seeing in state sales tax receipts, the monthly noise can

oddly well-behaved: crude is up over 30% since May, but gasoline is down 10%. You've got to wonder how long that can go on.

—Philippa Dunne & Doug Henwood

recession graphics



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