

January 14, 2008

The Liscio Report

On the Economy

For John Liscio 1949-2000

Dimmed lights and a giant Grinch

In December 60% of the states in our survey met or exceeded their sales tax collection targets, down from 72% in November. The months of November, December, and now January and perhaps even February are coalescing into one long holiday shopping season, and our

contacts won't have a bead on the season as a whole until January receipts, at least, are final. Many of our contacts suggested that easy comparisons make December receipts appear stronger than they in fact are: in December 2006 our

index sagged to 32%, with many states 10 and 12% below December 2005 levels, which is a pretty low bar. (A few states are just back to where they were in 2005.) We would also point out that any strength reported for Black Friday seems to have dissipated as the season wore on.

For the past few years we have been among those most concerned about the underlying strength of the economy, largely because the majority of our tax

contacts never felt comfortable with the make-up of their receipts. Now that many of these experienced estimators suspect the turn that concerned them is upon us, we thought it would be helpful to review the trend in our surveys over the current cycle. Our sales tax index collapsed in

November of 2000, and withholding followed suit in February 2001. Withholding receipts bottomed in August 2001, and began to recover in spring 2003. Aggressive auto incentives caused sales tax receipts to spike in late

2001, but they fell back in mid-2002 before beginning their giddy climb in 2004. Our tax contacts generally don't argue with money, but they worried that the growth they were seeing was not sustainable. For one, they suspected the present was robbing the future. Additionally, anecdotal evidence, employment numbers, and reviews of tax data suggested that a disproportionate percentage of growth in withholding was coming from upper-incomes, and that about 33% of the growth in sales

- ***is the long-anticipated turn here?***
- ***Recession Index update: it's looking more like the real thing***
- ***what federal tax receipts mean***
- ***MEW, spending, credit cards***
- ***GAFO deflation***

fidarsi é bene; non fidarsi é meglio

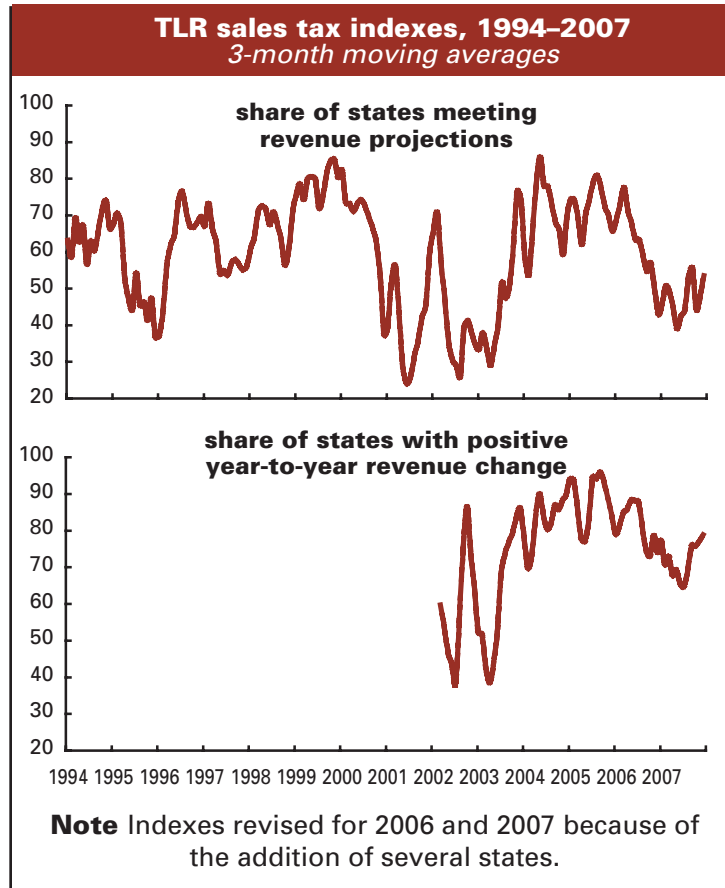
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tax was coming directly from housing related purchases, and this is not even considering the effects of MEW. Sales tax receipts were running well ahead of withheld receipts beginning in 2004, an unusual and unsettling relationship. During that stretch, as the press reported on state budget surpluses, we repeatedly cautioned that states were recovering from a real slump, and that our contacts were dismayed to see excess cash going everywhere but into rainy day funds. In 2006 sales tax receipts weakened, and weakened, and weakened, falling to “recessionary levels” in over half the states in our survey, where they remain. Withholding receipts have been sliding since last spring, a growing cause of concern, and in many states corporate payments are now negative y/y. And the press is littered with reports on state deficits. Our position has been that we would sound the all clear when our contacts were comfortable with the make-up of their revenue streams. So far that hasn't happened.

The tenor of our discussions took a significant turn for the worse this month, concern continues to mount in the stronger states, no one was shy about using the R word, and several contacts compared

the current trend to what they were seeing in 2000-2001. The level of discomfort is amplified by the fact that we have no reference period for the recent housing bubble and its concomitant run-up in construction. Oh, and the only two times

in the last century that mortgage debt was running so far ahead of production were the 1950s, which one would expect after years of depression and war, and the 1920s. Let's definitely not go there.



Recession Index: rise accelerates

Speaking of the R word, we've been looking in on our Recession Index—a monthly count of the number of stories including the word “recession” published in the *New York*

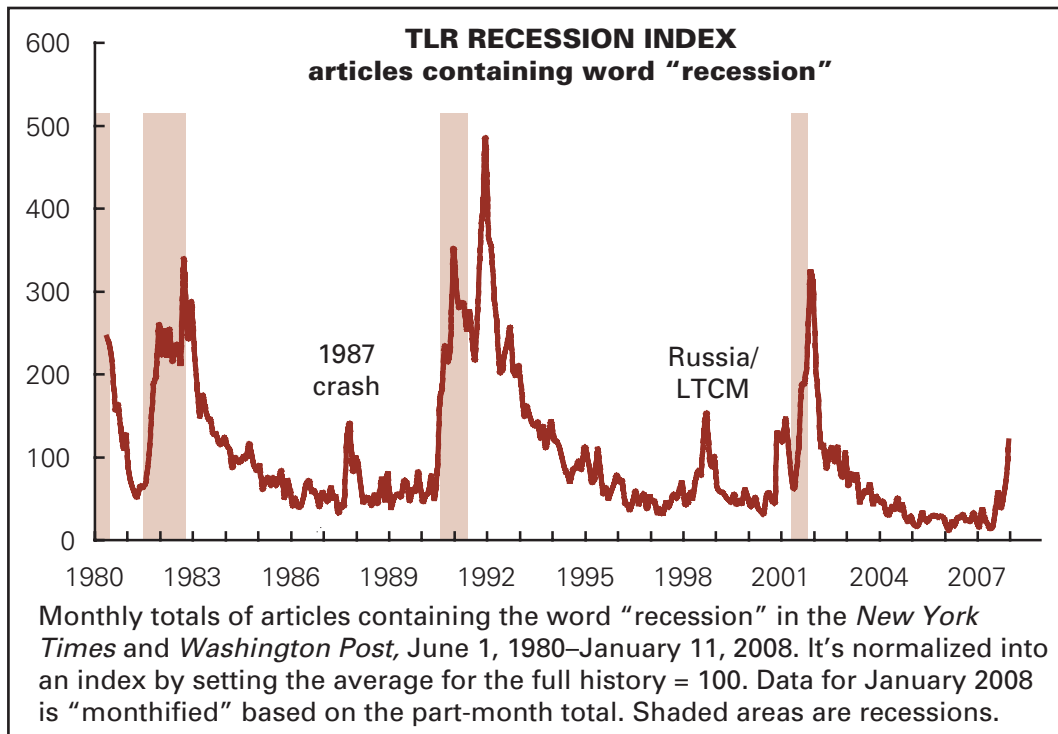
Times and *Washington Post* that has proved a very timely indicator of downturns over the last three decades—and it's been making uglier sounds with each passing week. When we last graphed the Index, in our December 6 issue, it was rising, but not yet to dangerous levels. It's now a lot closer to sounding a full-blown recession alarm (see graph, p. 3).

Last month's version extrapolated the frequency count for the first five days of the December into a full month. But the number of articles containing the word rose as

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the month went on, and has continued to rise in January. The right end of the graph is now looking very much like the onset of the last three recessions. It also bears some resemblance to the spikes around the 1987 stock market crash and the 1998 Russia/Long Term Capital Management crises. But those panic spikes rose very quickly and decayed just as quickly. The

don't believe a word the BLS says, but more often it's the Panglossian types who want to prove that everything's OK. Most recently, we've seen a (minimally labeled, minimally sourced) chart of federal withholding receipts press-ganged into supporting the argument that there's plenty of labor income around to keep recession at bay.



recession rises were more drawn out, and didn't decay quickly. The Index did start rising with the outbreak of the subprime panic last August—but it's continued to rise five months later. In the 1987 and 1998 panics, the Recession Index started fading within a couple of months.

Federal tax flows and employment

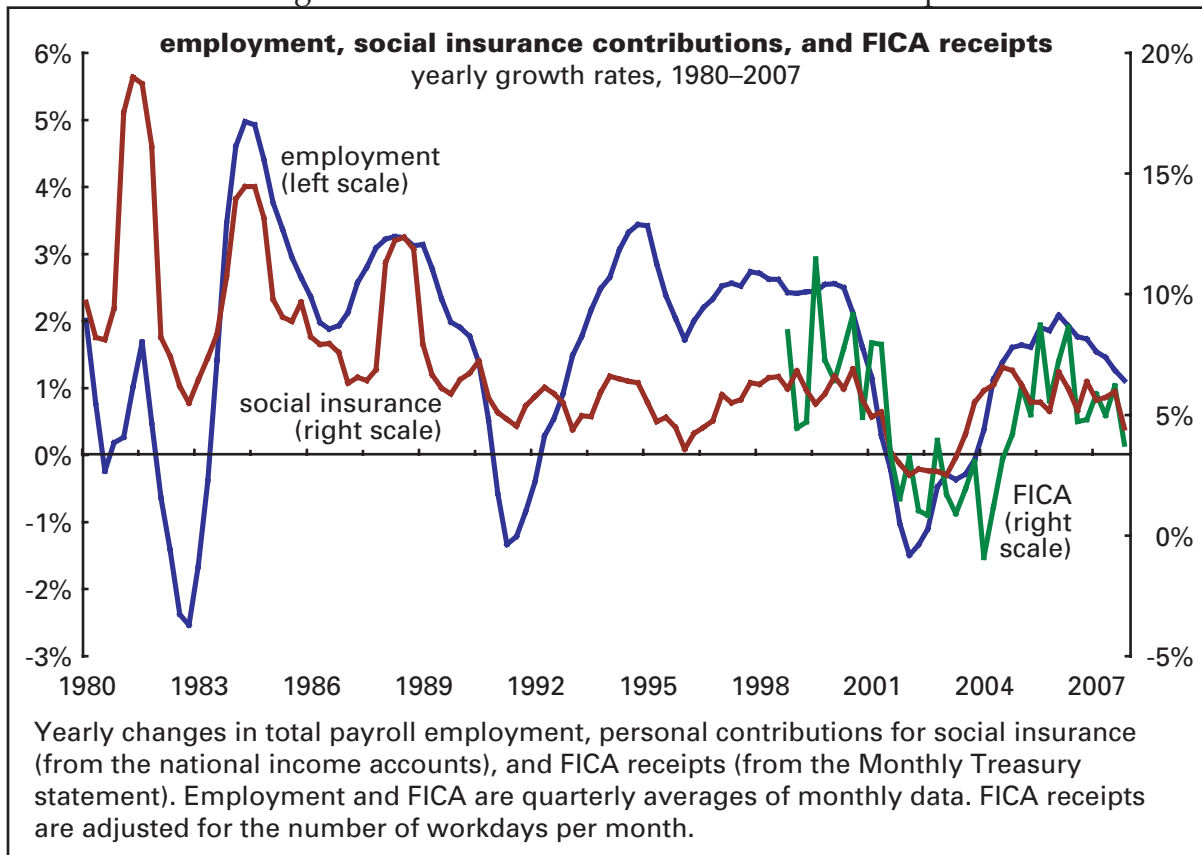
From time to time, we see analysts pointing to the strength or weakness of federal income tax withholding receipts as evidence of the strength or weakness of the labor market. Sometimes it's bears who

We're always very skeptical of these efforts. We've spent a fair amount of time trying to tease meaning out of the withholding data in the Monthly Treasury Statement, and the data haven't cooperated. The series is extremely volatile, and requires such extensive smoothing through moving averages and the like that the series loses a lot of its timeliness. To take a recent example, December's haul of \$107 billion was an all-time record, up 12% from last year, and eclipsing the previous record, set in January 2007, by almost \$10 billion. Last month's bulge, like those of

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December 2006 and January 2007, were almost certainly the result of bonuses, and tell you nothing about the state of the job market. In fact, the correlation coefficient between yearly changes in employment and Federal withholding since 1975 is a

seamless, correlation between the yearly change in social insurance contributions series in the national income accounts and payroll employment. Those two series, along with the FICA receipts, are graphed below. The fit isn't perfect—note the



minuscule 0.196. A much better fit with employment can be found using FICA receipts, which reflect employment changes at all but the highest level of the wage distribution. The correlation between the monthly measures of yearly changes is a much more respectable 0.537 (though we have the data only going back to 1999). Adjust FICA receipts for the number of workdays per month and take a six-month moving average, and the correlation with employment rises to 0.650.

We've also found a decent, but hardly

misses on the employment decline and subsequent recovery of the early 1990s—but it's still pretty good. And both social insurance contributions and FICA receipts at the end of 2007 are considerably below their levels of a year earlier—just like employment.

MEW

The weakening in labor income, except at the very high end, is coming at the same time as the weakening in mortgage equity withdrawal (MEW), producing a double whammy for consumption.

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The graph on the top of p. 7 shows MEW as a percentage of disposable personal income (DPI). It fell from 7.0% of DPI (at a seasonally adjusted annual rate) in the second quarter to 5.7% in the third; the peak was 13.2% in the first quarter of 2006. The

constriction in this juicy flow has made itself felt in debt repayment, home improvement, and personal consumption, as the second graph on the page shows.

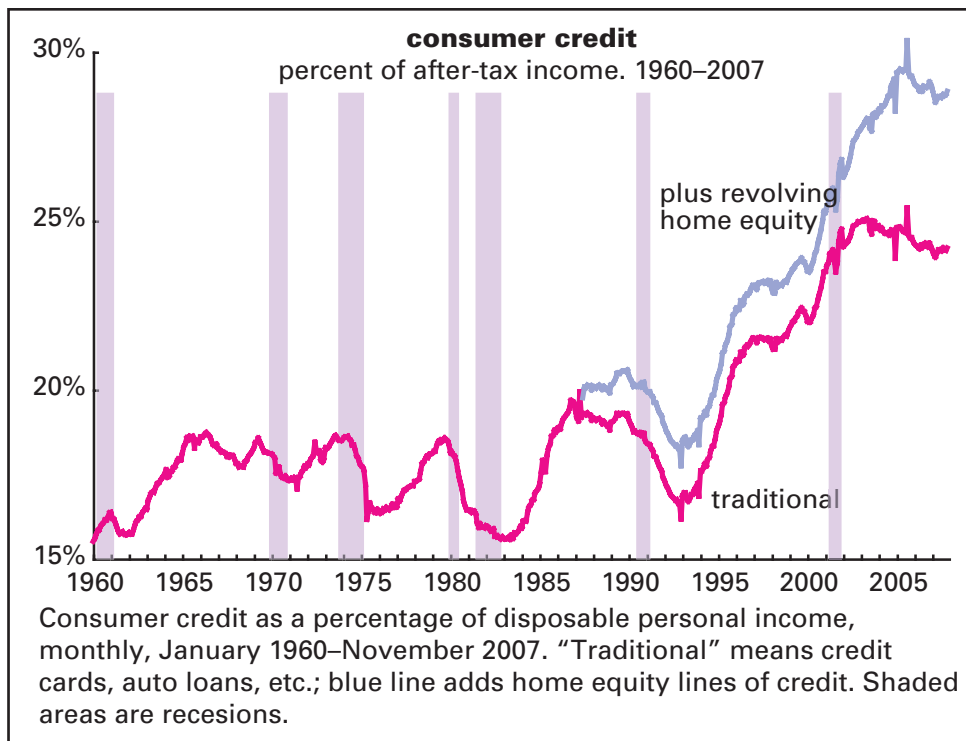
(A note on the source of the MEW data: they're unofficial estimates from Federal Reserve economist James Kennedy, based on the paper he did with Alan Greenspan, "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences," FEDS working paper no. 2005-41.)

It is probably true that some of the decline in MEW has been offset with increased use of credit cards. That was probably the cause of the November uptick in revolving consumer credit. But when measured against DPI, consumer credit outstanding is off its 2005–2006 peak, and looking not unlike its behavior before the 1990 recession. (See graph above) And it's quite

possible that the recent uptick in credit card debt isn't so much the result of new spending but the evaporation of MEW proceeds applied to debt paydown.

Alarming anecdote department: #1 A

credit card company is running TV ads promising a month without interest for customers who pay their bills on time for six consecutive months. Are solvent debtors that hard to come by?



GAFO deflation

Some price indexes have spiked recently, with the November headline CPI coming in at 4.3%. That spike is visible in the retail ex-auto price index, graphed along with the CPI on p. 6. But not in a major chunk of the retail sector—the so-called

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GAFO segment, what the Census Bureau defines as “firms which specialize in department store types of merchandise.” (GAFO stands for general merchandise, appliances, furniture, and office equipment, though the sector is larger than those four.)

As the graph shows, GAFO prices have been declining almost without interruption for more than a decade, and despite a

recent uptick, they remain well below the zero line. Since retail data are reported and consumed in nominal terms, it’s worth remembering that gains in that kind of pricing environment are really hard to come by. Sure enough, retailers reported that holiday shoppers were unusually focused on bargains; even champion discounter Wal-Mart reports the going to be “difficult.”

Tuesday’s retail numbers

Alarming anecdotes #2, #3, and #4: AT&T’s CEO announced that disconnections owing to unpaid bills are up (an internal report shows that the FBI has missed some incoming intelligence transmissions owing to unpaid bills—tsk tsk), RE research firm Reis Inc. reported that mall vacancies rose to an 11-year

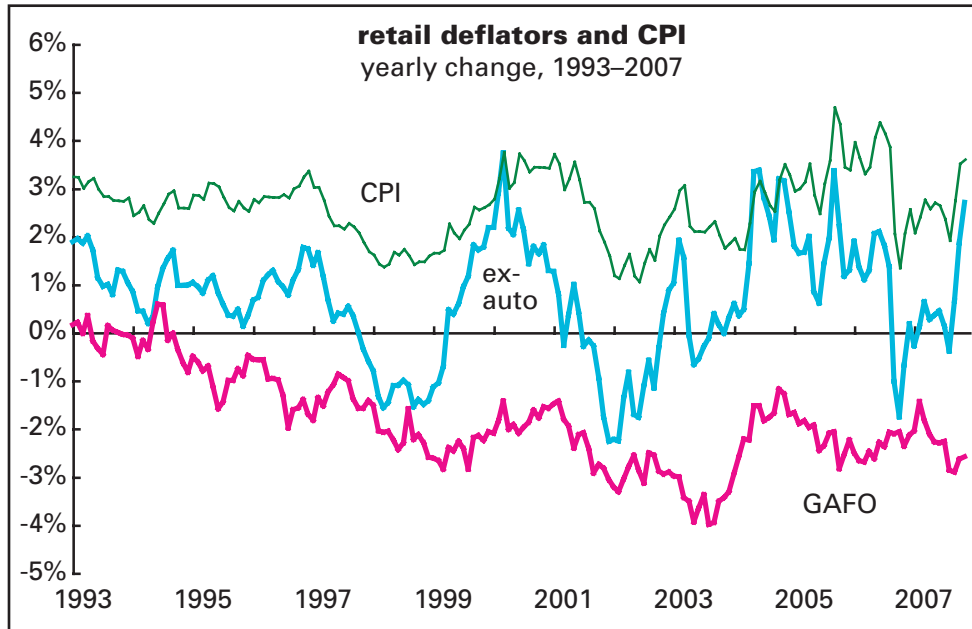
high, and a retired school teacher, a solid member of the middle class, told us that after reviewing his electric bill he decided against Christmas lights this year. It did seem rather dark this Christmas, and it was hard to ignore the giant inflatable

Grinch that replaced the usual riot of lights in a neighbor’s yard in rural upstate New York.

It’s pretty clear that the early Thanksgiving boosted November

retail sales at the expense of December, so we expect December’s headline number to come in at +0.1, with both ex-auto and ex-gas components flat. We suspect the risk is to the downside, but a weaker number may not mean much to the markets since most eyes are cast downward these days.

— Philippa Dunne & Doug Henwood

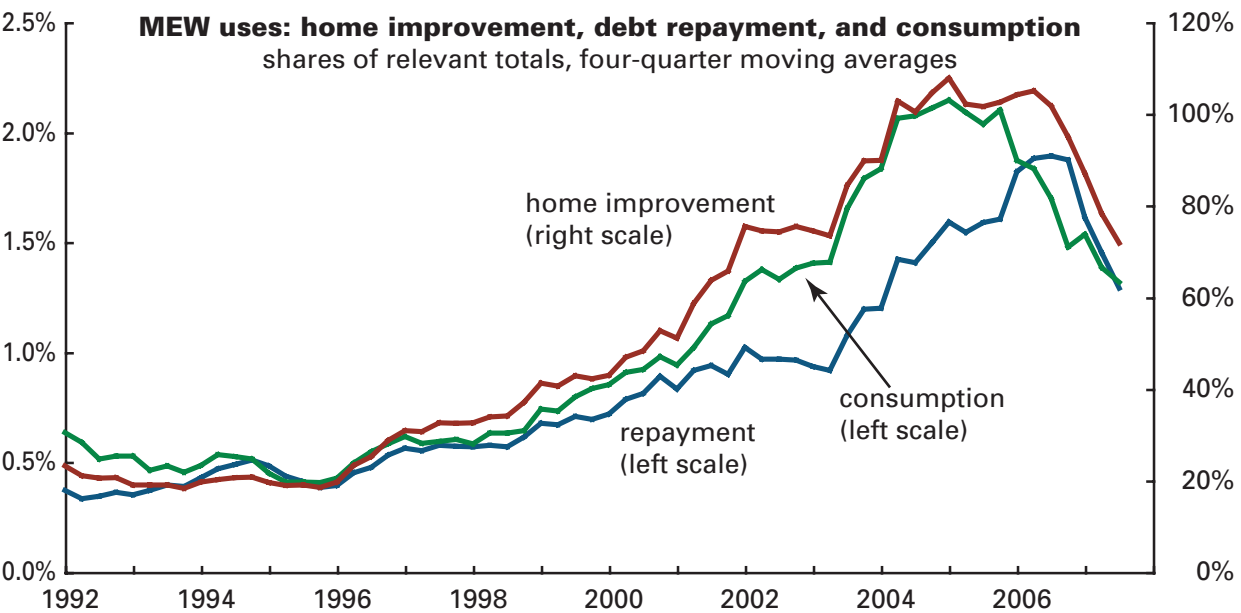
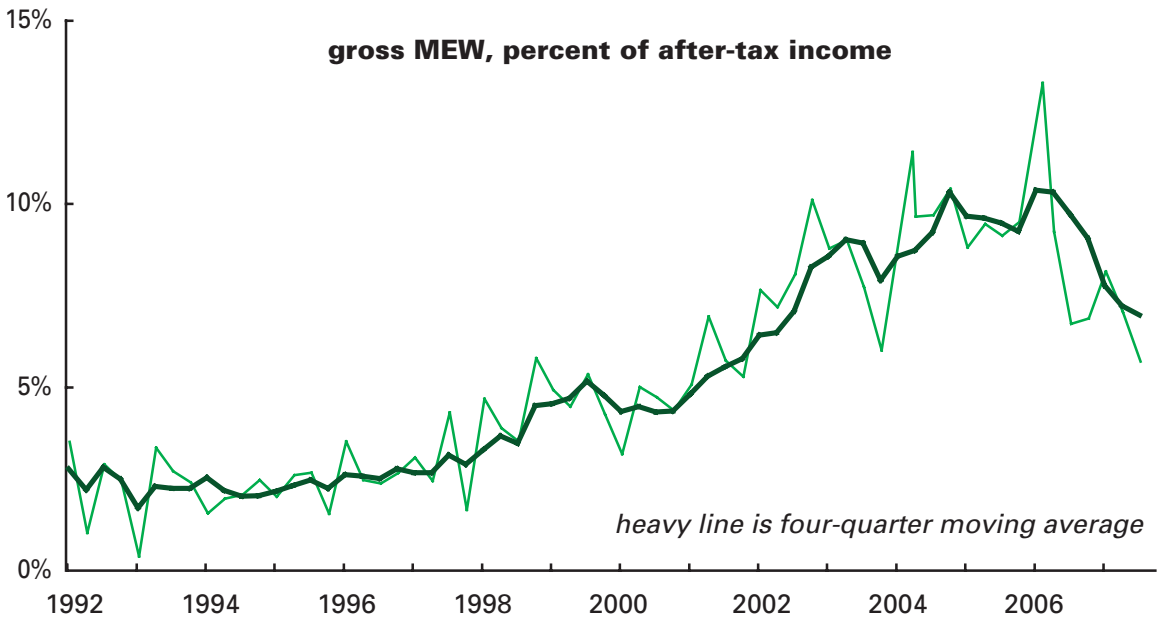


MEW



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MORTGAGE EQUITY WITHDRAWAL how much was taken and where it's gone



Top graph shows gross mortgage equity withdrawal as a percentage of disposable personal income, quarterly data and four-quarter moving average. Bottom graph shows uses of funds acquired from mortgage equity withdrawal expressed as a share of relevant totals. For home improvements, the total in the denominator is outlays for residential improvements from the national income accounts; for debt repayment, the total is consumer credit outstanding; for consumption, it's personal consumption expenditures from the national income accounts.