SL Sightlines Bulletin

Tracking the American Economy

March 2014

NOT A BAD MONTH, BUT WE COULD USE MORE OF THEM

Withholding receipts, the job market, and retail sales brightened in February. But household incomes are only just crawling out of a deep funk, and we just don't see how some analysts are describing the labor market as tighter than it looks.

- Both our survey of state withheld tax receipts and the official Bureau of Labor Statistics detail on jobs came back to life in February; state sales tax collections slipped, and although the Census report showed that Retail Sales picked up in January, the trend is slowing.

- Real median household income, as computed by Sentier Research, is in a sorry state: up a mere 2.4% from its 2011 trough, leaving it 8.2% below where it was at the peak in 2007.

- A new study from the International Monetary Fund finds that, "lower net [after taxes and transfers] inequality is robustly correlated with faster and more durable growth." Some have found fault witht he report, but they used a massive database.

- The Federal Reserve's Financial Accounts show household balance sheets continuing to improve—but corporate debt is rising.

- Meanwhile, the ratio of stock market capitalization to GDP is well past its 2007 high and is closing in on its dot.com peaks.

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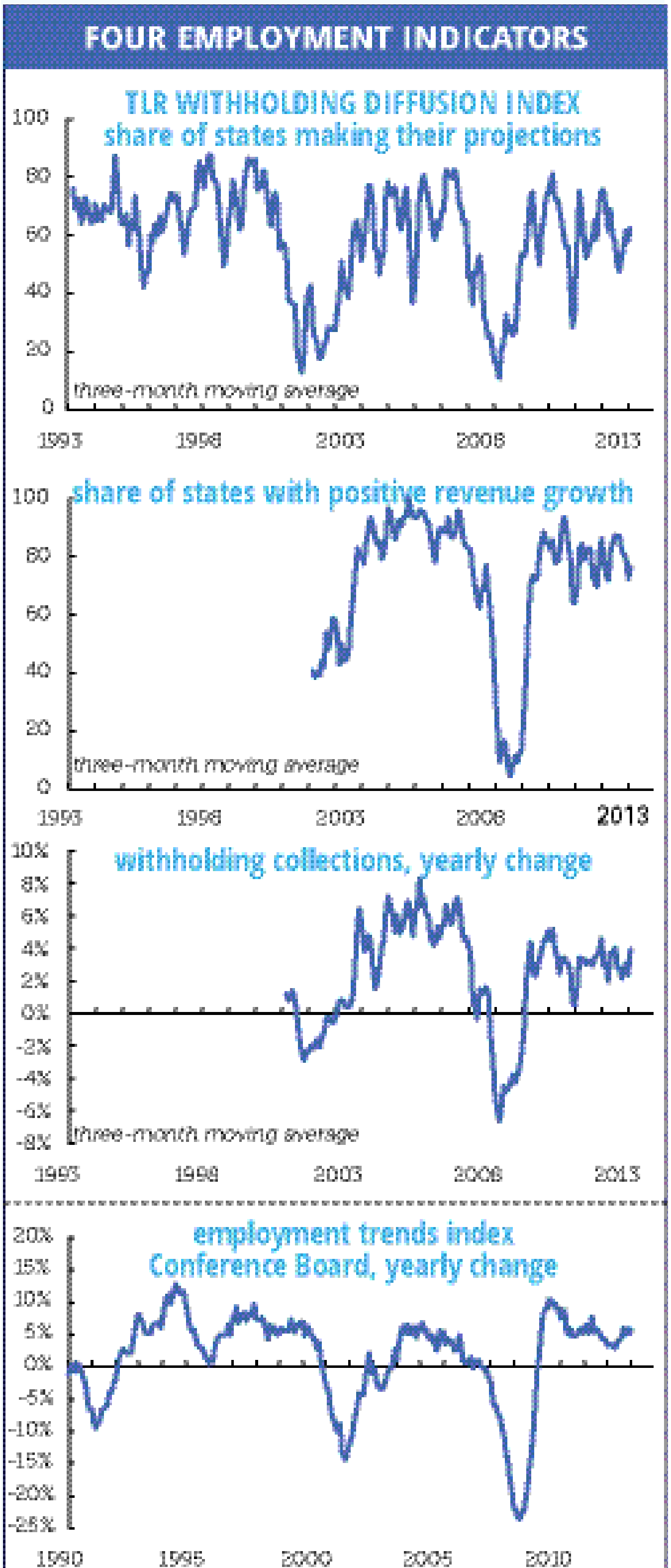
WITHHOLDING & JOBS UP, RETAIL SALES TOO



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

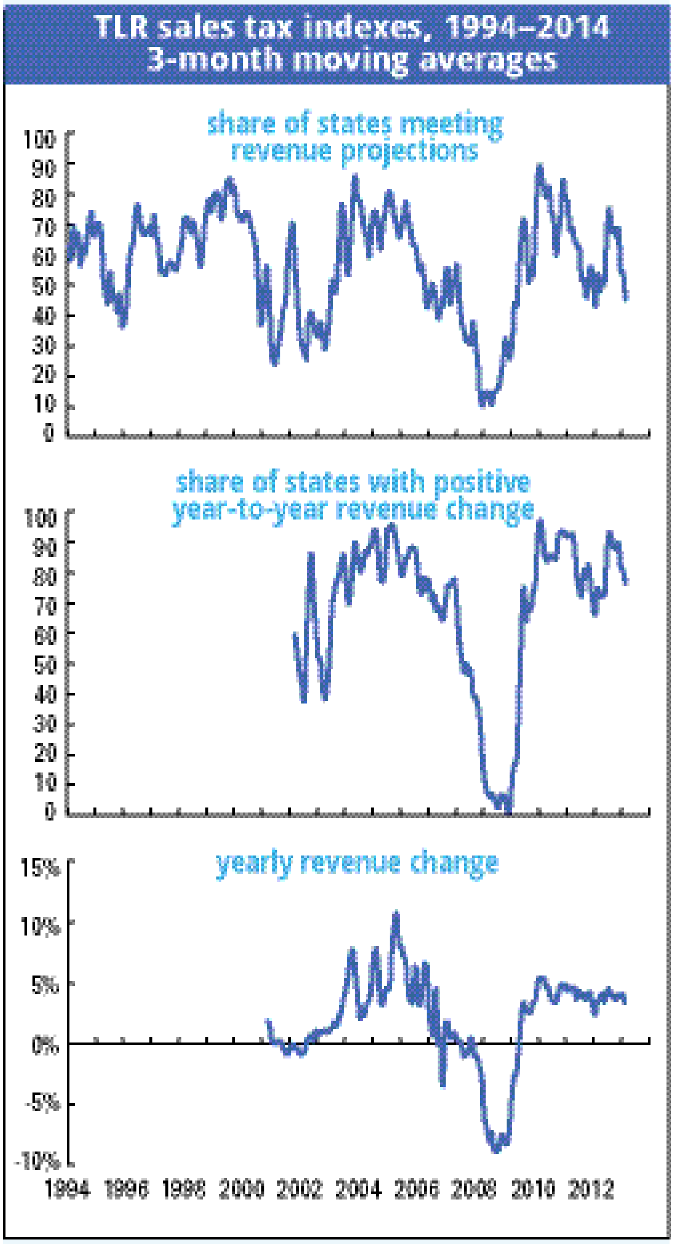
In February 73% of the states in our survey of withheld tax receipts met or exceeded their forecasted collections, up from 54% in January, and 82% reported growth over-the-year, up from January's 57%. The year-over-year percent change rose to 6.5% from January's 1.1%, and the margin from forecast to 1.9% from January's 1.2%. (All averages weighted by state population.)

The modest increase in the margin by which forecasts were exceeded in February tells the story. As we noted last month, revenue officials fully expected a weak January followed by an improved February because of tax-driven behavior last year. As the bonus payment schedule has moved back toward normal, tax receipts shifted into February. January was a bit weaker than expected, February a bit stronger, but the anticipated pattern held. Our contacts expect March to be buoyed by bonuses as well, especially because they are hearing that rank and file workers have done quite well this season.

Since bonuses seem to be such a big part of February's improvement, we're not going to put too much stock in regional breakdowns. Housing bubble states continued to improve in February, and Arizona, which has been stumbling, regained its footing. The Midwest was mixed. Some states hardest hit by winter had the weakest receipts, but hourly workers, those most likely to lose income in foul weather, are less likely to have taxes withheld, so our contacts were concerned about a genuine slowdown more than a weather effect. We'll see.

GOOD JOBS NUMBERS

The improvement in our survey tracked nicely with the Bureau of Labor Statistics' employment report. February's headline gain of 175,000 was the strongest initial print



since November's 203,000, and slightly below the average of the six months before that. The private sector gain, 162,000, is considerably below the average of the previous five months. Goods production had a good month, adding 22,000 jobs, 15,000 in construction and 6,000 in manufacturing. Private services added a below-average 140,000. Education and health added 33,000 jobs, but health care itself was up just 10,000, a third below its recent average. Leisure and hospitality, another engine of job growth, continues to power along, adding 26,000 jobs, most of it bars & restaurants. State and local government employment rose by 19,000, and Federal employment fell 6,000. Some important sectors were in the red, with both retail and transportation & warehousing off 4,000, and information, 16,000.

The average workweek fell 0.1 hour to 34.2, its lowest level in three years. The yearly gain was the weakest since July 2010. If that was caused by the weather, as we suspect, then no big deal, but it bears watching.

Average hourly earnings were up a strong 0.4%, a rate not seen since last June. We don't think that's the start of a new trend though: over the last forty years, when an unusually large number of workers have missed work because of weather, wages generally increase sharply, and then fall back in line with trend or below the next month. That's probably because the workers least likely to be paid when not at work are hourly workers, who generally get lower wages. In February, 601,000 workers were unable to get to work because of weather, half again

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as high as the February average over the last five years, and easily meeting the bar. We expect March wages to be soft.

The household survey was considerably weaker. This is a very volatile series, so monthly moves don't say much, but yearly change in the household survey, when adjusted to correspond to the establishment survey, is now half that of the establishment count (0.8% for the adjusted household vs. 1.6% for the payroll). The participation rate and employment/population ratio were both unchanged. But the number of full-time jobs was up and part-time down—not a bad thing.

So, we have a return to trend employment growth on the payroll side, somewhat offset by weakness on the household side.

State level employment bounced back nicely in February after a weak January. The best news in the report included declines in unemployment rates not flattered by labor-force withdrawal, and improved conditions in California, Florida, and Utah, if not Arizona. Employment in the Midwestern manufacturing states held up well. It does appear that January weather was a problem – 7 of the 10 states we flagged for weather related weakness in January bounced back in February.

CONSUMPTION NEWS

In February 45% of the states in our survey met or exceeded their forecasted sales tax collections, down from January's 57%, and the percentage reporting growth over the year slipped to 77% from January's 89%. The average rate of change also fell, to 2.7% from January's 3.7%, and the margin below forecast widened to -3% from January's -0.9% (all averages weighted by state population).

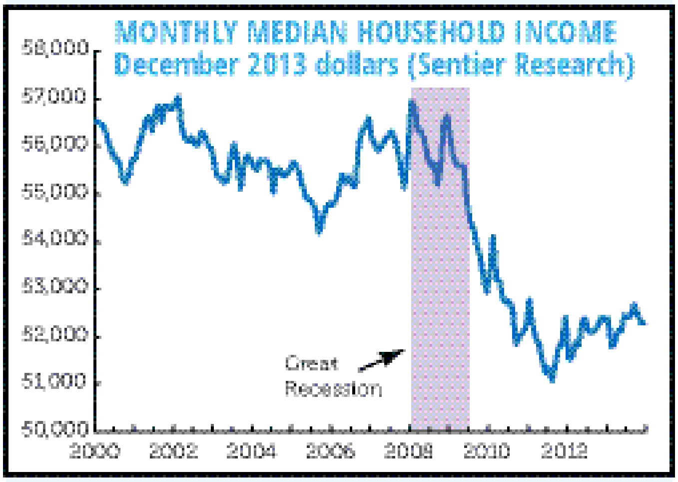
We heard repeatedly that the winter weather depressed sales, and business contacts suggested to state revenue officials that the weather really did have an impact. State sales tax collections are lagged, and it's likely that quite a bit of the weakness in our survey was already reflected in January's official and negative Retail Sales report.

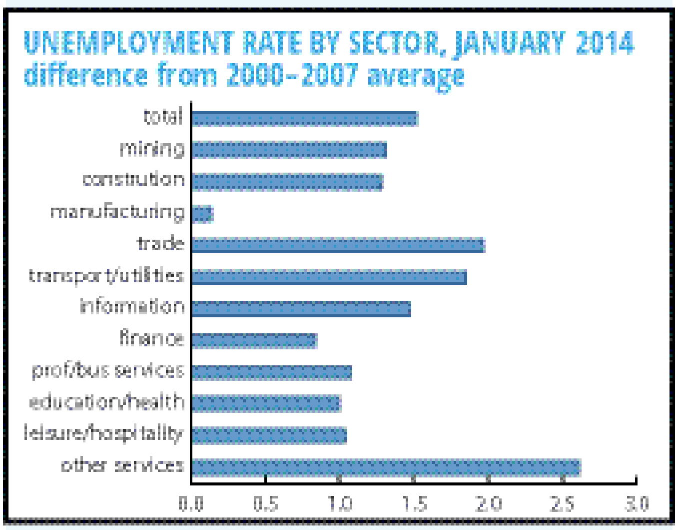
Despite the bad weather in February, the Census' official print on Retail Sales came in at 0.3% for all sales, sales excluding automobiles, and sales excluding autos, gasoline, and building materials, which is the subhead that goes into GDP. The three-month trend is, however, 0.3% below the three-months ended in November. And year over-year sales grew at just 1.9% in the three months ended February: the growth rate for the prior for months averaged 3.9%, so that's something to watch as well. Especially with income growth as weak as it is these days.

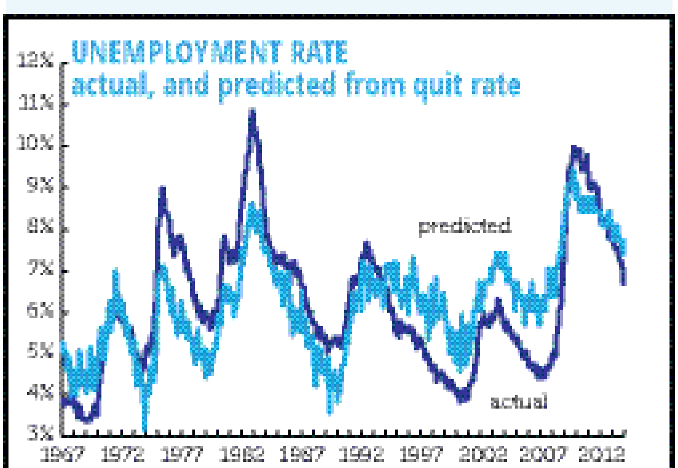
HOUSEHOLD INCOMES

We follow a monthly series on median household income from Sentier Research. Sentier, formed by two Census Bureau alums, aims to come up with timely estimates of the annual household income figures that Census publishes every September for the previous year.

The series is graphed top left, p. 5. (The most recent month available is December 2013; the January figures have been delayed by revisions to source data at the BLS.) Note that real income went essentially nowhere during the 2002–2007 expansion—but actually held up for a while during the Great Recession. But as the recession ended and recovery kicked in, incomes fell, and fell hard. From the peak in January 2008 through the trough in August 2011, real household income fell by 10.3%. It's since risen by a mere 2.4% (total, not annual rate), leaving it 8.2% below where it was at the peak.







Really, when you look at this graph, you wonder how retail sales have managed to recover from their recessionary depths.

LABOR MARKET TIGHTNESS?

Lately we've been seeing the argument that because many of the unemployed may never work again, it's wrong to adjust the official jobless rate, either statistically or mentally, to compensate for depressed participation rates, and the job market is tighter than it looks.

We don't agree. A 6.6% rate is two-thirds of a standard deviation above the 1948–2007 average of 5.6%, and it's even further above, in absolute terms, its 2002–2007 average of 5.3%, an expansion that was far from robust. It may be close to the Congressional Budget Office's estimate of the "natural" rate of 6.0%, but there's nothing scientific about these estimates; six years ago, the CBO projected that the natural rate would be 4.8% now.

A more subtle version of the argument looks at sectoral unemployment rates and finds some getting awfully low. We don't see that eitehr. Graphed at middle left are unemployment rates by sector compared to their 2000–2007 averages. In only one sector—manufacturing—is January's rate close to its average, though it's 0.1 point above. Next closest is finance, 0.8 point above. The others are 1–2 percentage points above.

DATA POINT: QUIT RATE

Chair Yellen has made it clear she follows the quit rate, as should we all: it's an excellent place to look for signs of labor market tightness. If workers perceive jobs as easy to get, they're more likely to quit. And, short of that, they're more likely to demand raises from employers eager to keep them. Yet the quit rate is low by historical standards.

The BLS started publishing the quit rate in 2000. Since the quit rate tracks the number of those unemployed 5 weeks or less very closely, we used that series to estimate the quit rate going back to 1967. (Where the two series overlap, the fit is very tight—an r^2 of 0.93.) December's 1.7% rate is well below the full series' 2.1% average. It's also well below levels seen close to previous business cycle peaks, like 1979, 1989, 1999, and 2007.

The quit rate moves with the unemployment rate. You can "predict" the unemployment rate with decent accuracy with the quit rate, in fact. But as the graph on the bottom of p. 5 shows, the unemployment rate associated with the December 2013 quit rate is a point above its actual level. Putting it more bluntly, workers are acting as if December's unemployment rate were 7.7%, not the 6.7% it was.

INEQUALITY AND GROWTH: CODA

As we noted last month, income inequality is increasingly seen as a macroeconomic problem, political philosophies aside. And there's new evidence of this in a new paper by IMF economists Jonathan D. Ostry, Andrew Berg, and Charalambos G. Tsangarides.

Using a relatively new extensive international database, Ostry et al. find that "lower net [after taxes and transfers] inequality is robustly correlated with faster and more durable growth." That is, lower inequality is associated not only with higher average growth rates, but also more longer-lasting growth spurts. They also find that, excepting extreme cases, redistribution does not harm growth. As they say, "Thus the combined direct and indirect effects of redistribution—including the growth effects of the resulting lower inequality—are on average pro-growth."

That conclusion, of course, could be the beginning of a long political argument. But it does suggest that doing anything to worsen inequality—like bringing forward the date of Fed tightening—could damage the economy's growth prospects over the longer term.

CHECK IT OUT

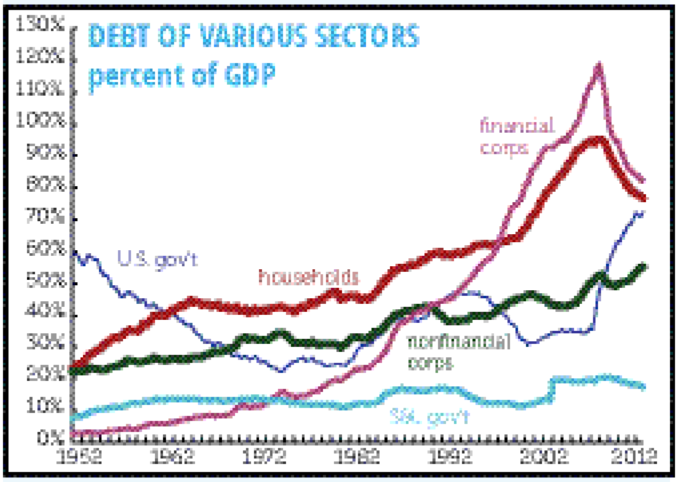
In an effort to capture some of the complexities of the labor market beyond the scope of the headlines, the New York Fed has just introduced a new feature on its website: "Eight Different Faces of the Labor Market," in which they group several indicators under eight categories. If you visit, you'll see that the job loss and unemployment indicators are the strongest, many of the others are either in decline, flat or moving up at a snail's pace.

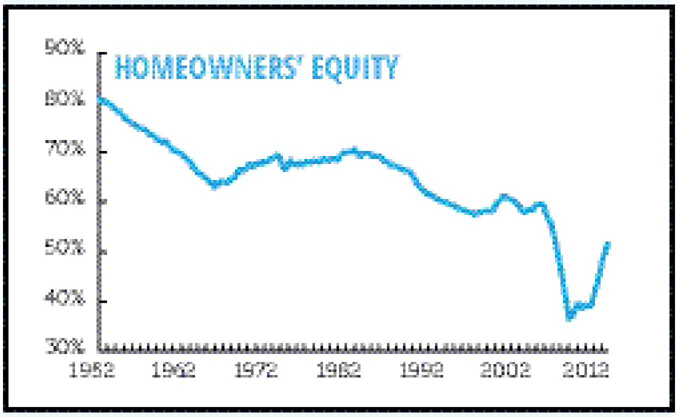
The most interesting feature is their own measure of "mismatch"—the degree to which available workers are a poor match for available jobs. Although this theory seems to be enjoying new life lately, as a way of arguing that the labor market is tighter than it looks, it's not supported by the New York Fed indexes: both their occupational and sectoral measures are below their 2006 levels.

Also not supporting the tight labor market thesis: the recently released Job Openings and Labor Turnover Survey (JOLTS) data for January shows the Beveridge Curve, central to the theory, continuing its crawl left toward a more normal range. But the quit rate, a measure of worker confidence, fell by 0.1 point in January. While well up from its recession lows, it's still at the low end of its historical range. Were the labor market seriously tightening, we'd expect to see the quit rate rising.

Elsewhere on the web, State Street has just released a new inflation index generated by scanning online prices. It tracks the monthly CPI quite closely. The "robust" March reading, excluding food and transport, suggests to them that weakness in recent U.S. data is weather-related.

FINANCIAL REPORT: HOUSEHOLDS PRUDENT, FIRMS NOT, STOCKS PRICEY





It's time for our quarterly review of the Federal Reserve data series formerly known as the flow of funds—a name we just can't shake—and now called the financial accounts of the U.S.

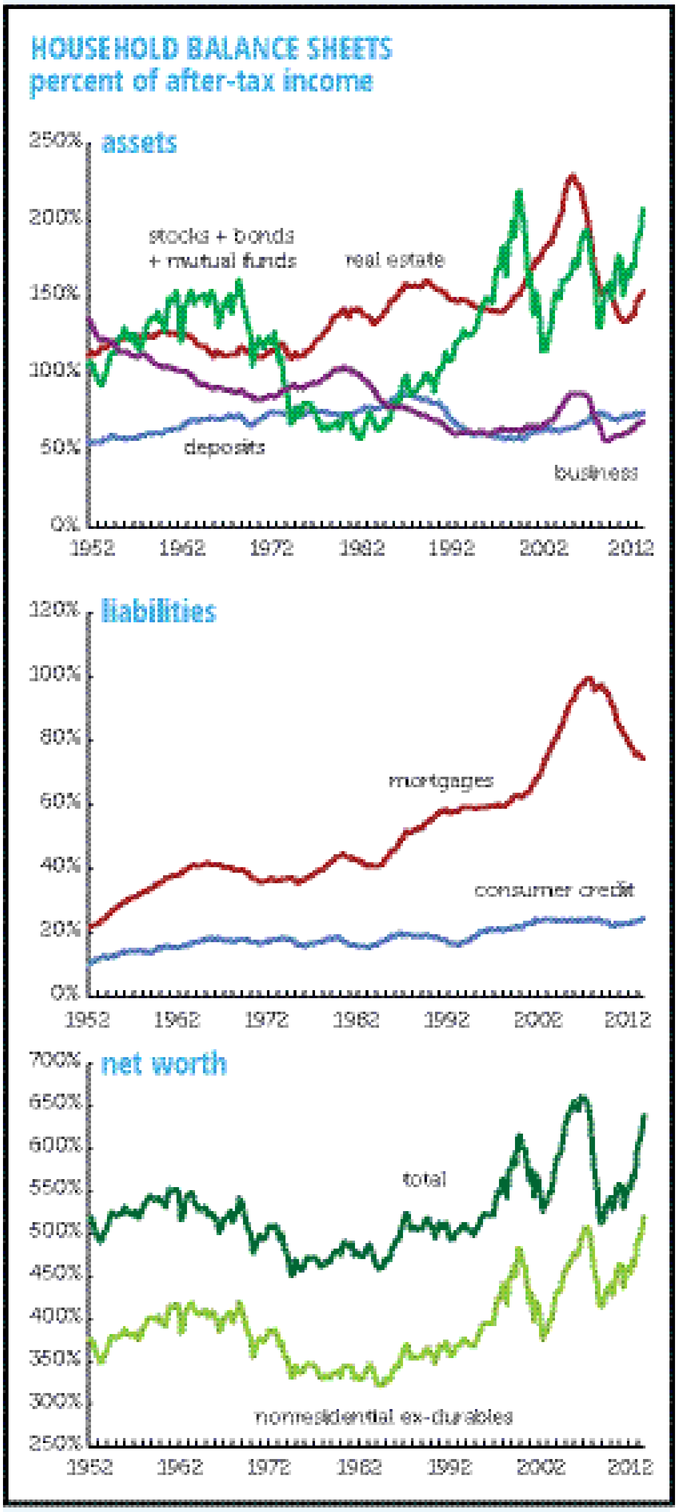
Highlights:

- households balance sheets continue to improve
- corporations are borrowing to buy back their stock but not invest so much
- the stock market is looking very rich
- and the U.S. international accounts continue to look rather stable after a long slide into the red.

CREDIT MARKETS

As the top graph on the left shows, while households continued their long reduction in debt levels relative to GDP—from 95% at the beginning of 2009 to just under 77% at the end of last year—nonfinancial corporations have been increasing their debt ratio at a fairly steady pace. This is a little odd, given that (as we'll see in a bit) they're flush with cash and not really investing it; the most likely explanation is that they're borrowing for takeovers and buybacks. Financial corporations—who borrow to lend mostly—were flat for the quarter, but are way down from their bubble peak.

The public sector turned in a mixed performance, with state and local governments continuing to reduce their debt/GDP ratios, while Uncle Sam reversed two quarters of decline with a small increase. The pace of federal borrowing has slowed dramatically; the debt/GDP ratio doubled in the recession and its aftermath, but has been flattish over the last year. While it's reasonable to be



concerned about the state of federal finances over the longer term—assuming the population doesn't stop aging and health care doesn't stop getting more expensive—there looks to be little cause for worry in the short- to medium-term.

HOUSEHOLDS

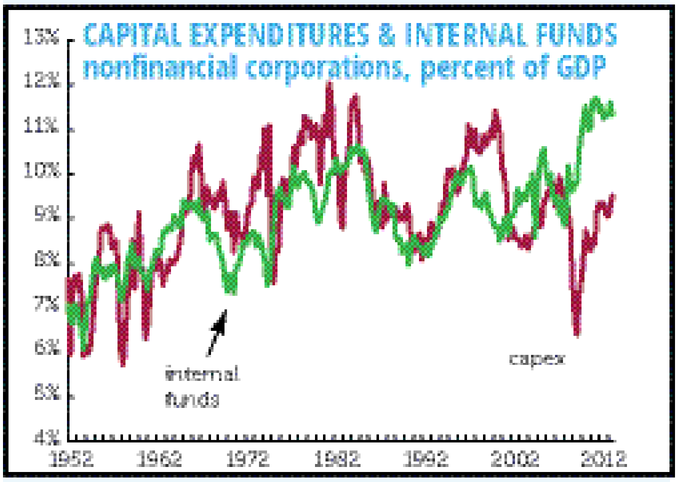
Household balance sheets extended their recovery, with net worth rising to 639% of after-tax income, the highest it's been since early 2007. (See graph to left.) The Fed includes consumer durables as assets in their computation of net worth; stripping those out (since they depreciate rapidly, are illiquid, and return no income), and household real estate as well (the light green line on the bottom graph in the trio to the left, makes the net worth picture look even better.

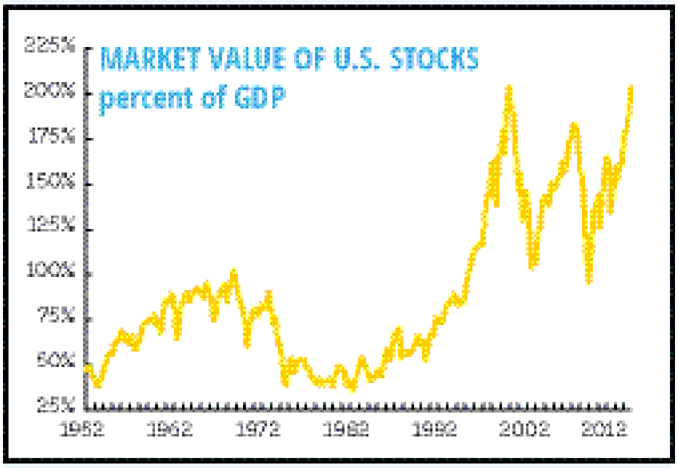
Several things caused the improvement in overall net worth: the value of household real estate rose 2.4% in the quarter while mortgage debt rose a mere 0.2%, and the value of stocks and mutual funds rose by 6.6%. Of course, since the ownership of stocks and mutual funds is heavily skewed towards the upper brackets, the more modest improvement in residential net worth (see graph, bottom left, p. 7) is a better picture of what the average household experience at the end of 2013—but that is highly welcome, for sure.

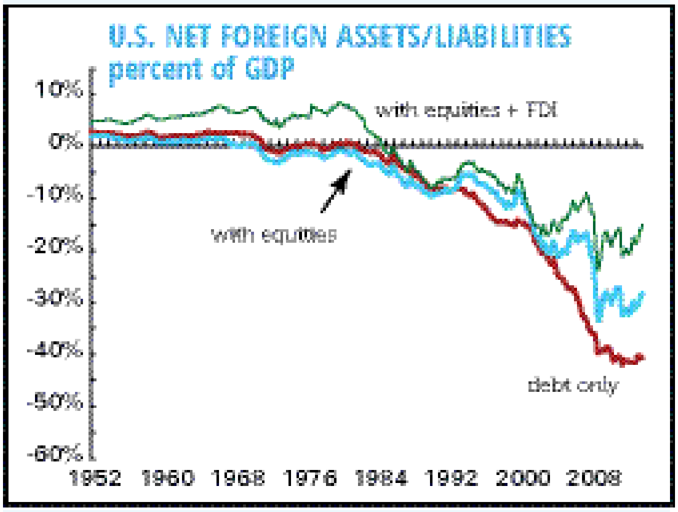
The consumer credit ratio has been impressively flat since 2000; we're going to take a look at what's going on under the aggregate (i.e., education debt up, credit card use not) in the near future.

NONFINANCIAL CORPORATIONS

We don't have the NIPA profit data for the fourth quarter yet, so we can't present the usual profitability graph; we'll report on that as soon as we can.







But as the graph to the left shows, nonfinancial corporations are still rolling in cash, with internal funds as a percent of GDP near an all-time high. And although capital expenditures have recovered substantially from their recession depths, they're still far below the green internal funds line. Much of the difference, known as free cash flow, has been devoted to buying stock, either through takeovers or buybacks. In the fourth quarter, nonfinancial firms retired stock equal to 6.1% of GDP—no match for the 10.1% record set in 2007's fourth quarter, but four times the 1952–82 average, and nearly twice the 1983–2007 average.

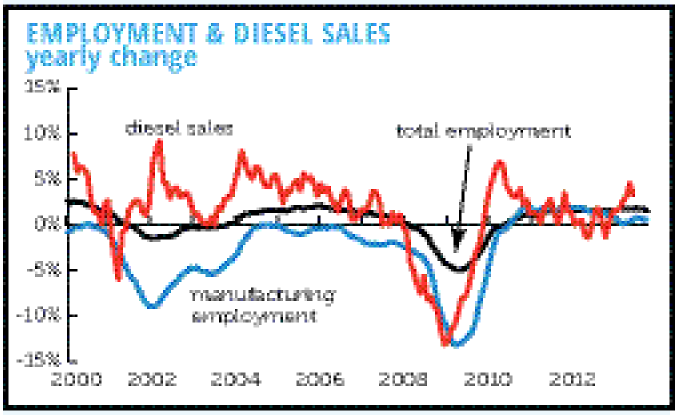
This vigorous retirement of stock has been a major support to the market. We've been quiet about sounding valuation alarms, but things are starting to look seriously frothy these days. As the middle graph to the left shows, the ratio of stock market capitalization (both financial and nonfinancial firms are included in this measure) to GDP is well past its 2007 high and closing in on the dot.com level. This is getting worrisome, and we'll be returning to this topic very soon.

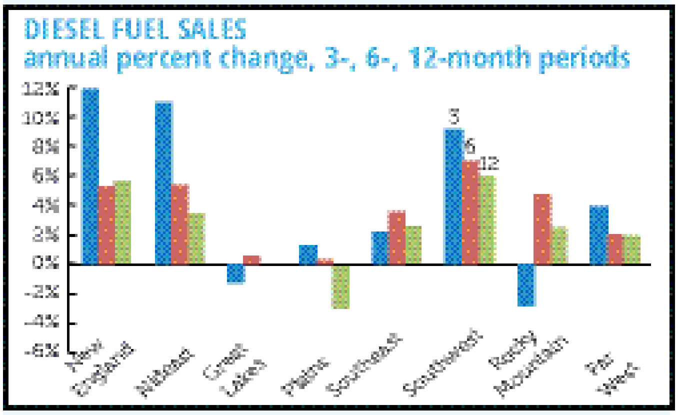
REST OF WORLD

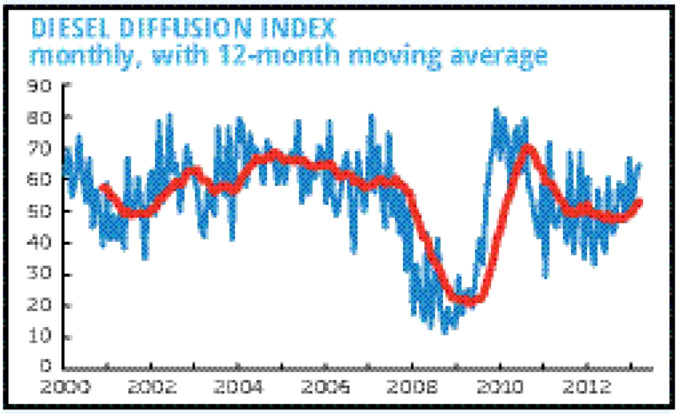
As the graph to the bottom left shows, the long slide of the U.S. into net foreign debtor status looks to have stabilized. The ratio of net foreign debt to GDP is only slightly higher than what it was five years ago. And if you add in net U.S. holdings of equity and foreign direct investment, the position has improved substantially. Given how much Washington has been borrowing, this is impressive.

So while households are looking to be in better financial health than they've been in some time, the nonfinancial corporate sector is looking less so, and the stock market may be something to start biting nails over.

DIESEL SALES DECELERATE







The Federal Highway Administration's most recent release of sales data for diesel fuel shows sales for the year ending in October up 3.0%, down from September's 6.0%. Thirty-three states reported sales increases. As the graph to the bottom left shows, the one-month diffusion index rose a hair, but with this noisy series it's best to look at the twelve-month moving average, which is in a clear uptrend.

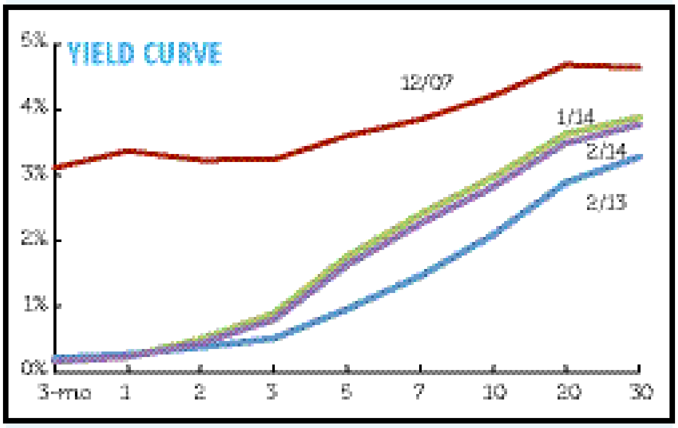
Diesel sales strongest in New England, Mideast, and Southwest. The middle graph shows sales growth by BEA region. The three regions showing the strongest growth were the same as in September. Weakness in the Great Lakes might be thought to reflect a slowdown in auto production, but on closer look, much of the sag comes from Wisconsin. The Plains are the laggard, but they did go positive.

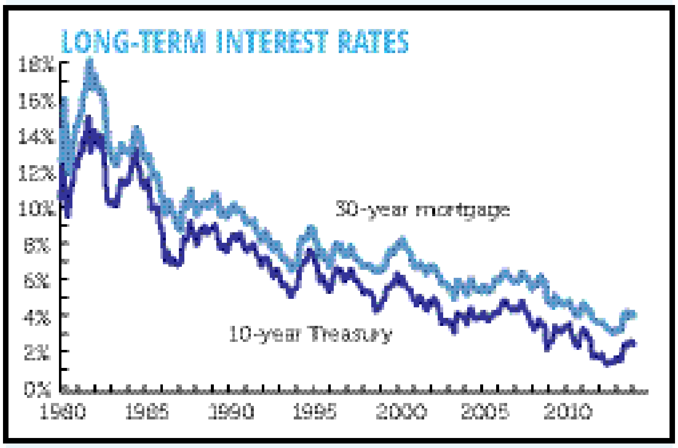
Employment growth slows along with diesel. Nationally, diesel fuel sales perform well as a forward indicator of changes in employment. The third graph presents year-over-year percentage changes in total and manufacutring employment, and a three-month moving average of diesel fuel sales.

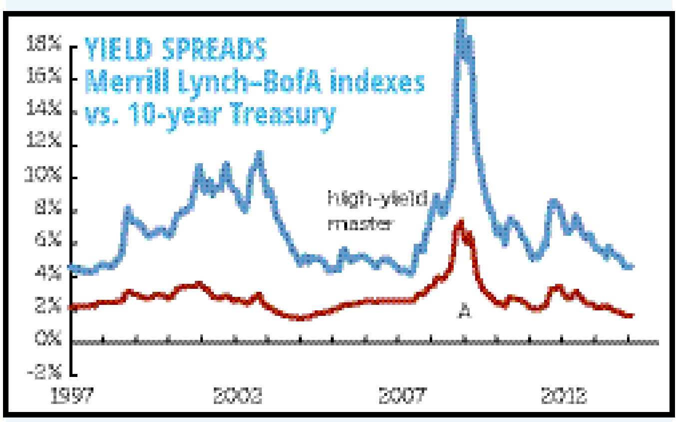
During the most recent 3-months for which data are available (August–October), diesel sales increased by 3.3% compared to 2012. The three month moving average shot up beginning in March and increased every month through September. October marked the first slowdown in eight months.

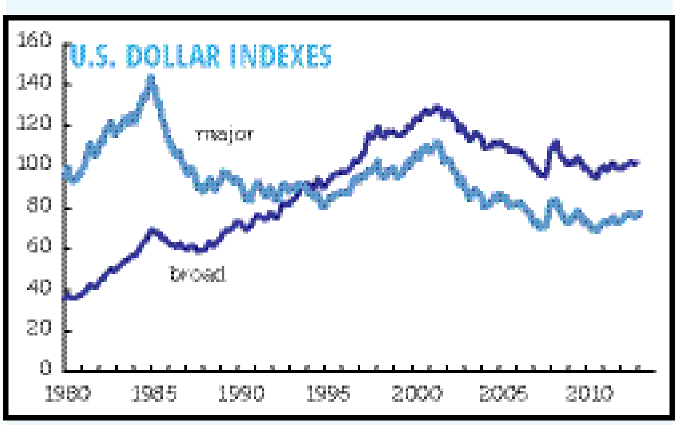
In comparison, the yearly change for total payroll employment continued trending upward through November when the rate reached 1.8%. But from January to February there was a sizable drop in the growth rate, to 1.5%. The pattern in manufacturing was similar. The growth rates for both total and manufacturing employment followed the decrease in the diesel fuel sales growth rate, but with a lag of three to four months.

FINANCIAL INDICATORS









Fed continues asset purchase reductions. At its February meeting, the FOMC continued scaling back on asset purchases. Targets are now $25 billion per month of mortgage-backed securities and $30 billion per month of Treasuries. The schedule for beginning to raise the funds rate remains mid-2015. The new forecasts for real GDP lowered the top of the ranges for the current and following two years by 0.2%. Unemployment rate forecasts were also lowered by 0.2–0.3 points.

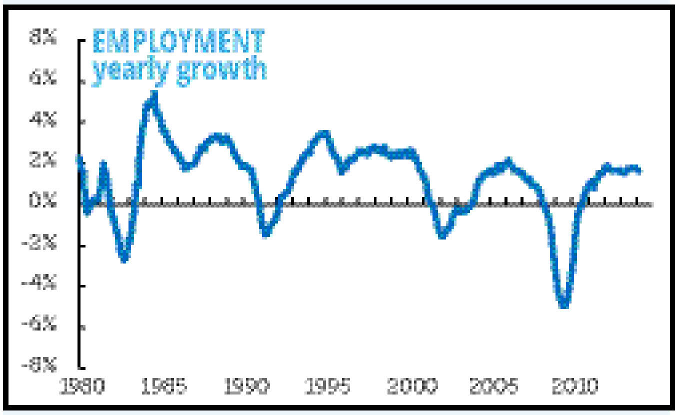
Long yields decline. During February, Treasury yields moved lower for most maturities, more at the long end than the short (surprising given the Fed tapering). Long yields are up only 50–60bps over the last year.

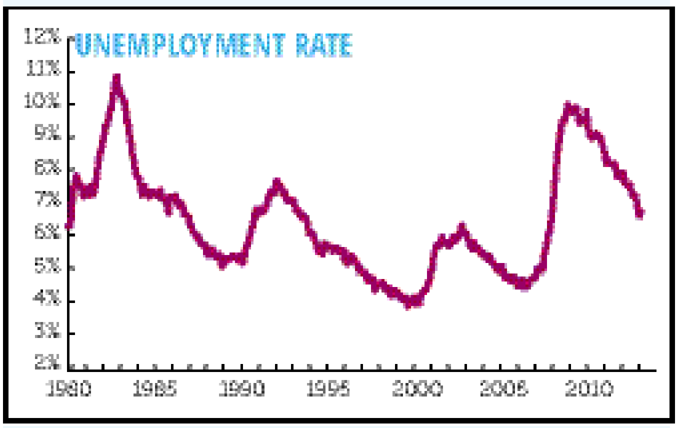
Yield spread signals growth. The spread between 3-month and 10-year Treasury yields declined by 16bps during February, mainly due to a decline at the long end; the spread remains at a level that signals an improving economy. One factor keeping Treasury long-maturity yields down: a large reduction in the budget deficit, down 24% over the last year.

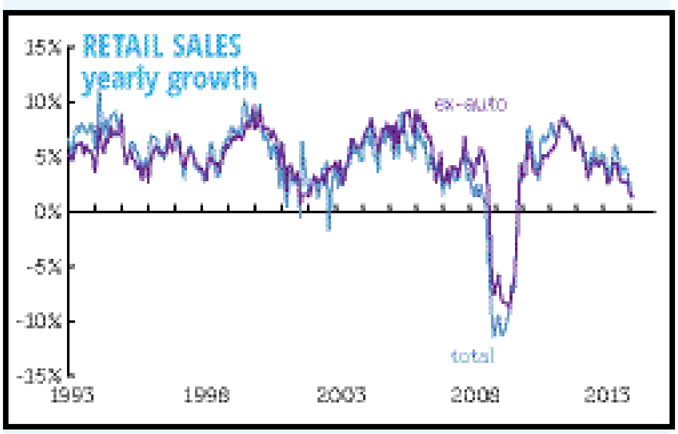
Yields on most corporates down. Yields fell by 10–20bps for most ratings. The only exception was CCC and lower, where yields rose by 2bps. One thing worth noting is that over the full range of corporate debt ratings average yields are from 2 points (AAA) to 5 points (CCC and below) below yields from 2002–2007 During February $99.7 billion in new corporate debt was issued, with $15.1 billion (15.1%) being high yield debt. During February 2013 the amount issued equaled $106.0 billion.

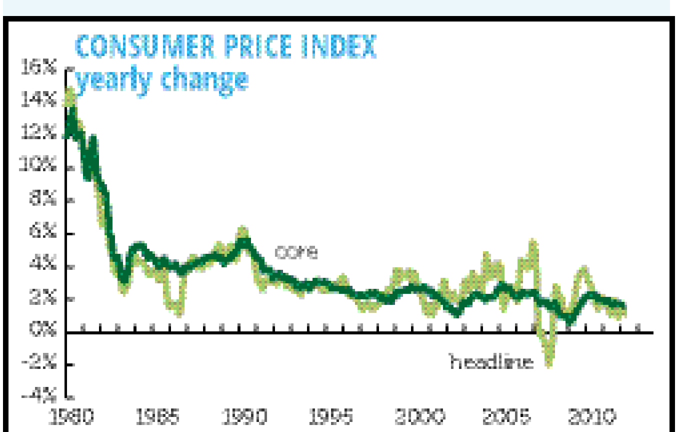
Mortgage rates also down. Average rates on both 15- and 30-year conventional mortgages fell by 13bps in February. February existing home sales decreased 0.4% from January, and 6.7% for the year. Weather is the likely explanation.

REAL INDICATORS









Employment chugs along. While February's monthly job gain felt robust, the annual growth rate fell to 1.6%, from 1.7% in January, and 1.8% last fall. It matches the 1980–2007 average. The headline figure is held down by the weakness in government employment, down 0.2% for the year (led by Uncle Sam, down 3.0%). Private sector job growth was 2.0% for the year ending in February, above its 1.6% long-term average, but still down from late last year.

Unemployment ticks up. The jobless rate ticked up 0.1 point to 6.7% in February, reversing January's decline. While it's way down from its recession peaks, it's still well above its 1980–2007 average of 6.1%.

Retail decelerates. Total retail sales for the year ending in February were up 1.5%, less than half their rate last fall, and a quarter their rate last summer. Take out autos, and the decline is less severe—1.3% for the year ending in February, a third last summer's rate. Take out building materials as well—the core measure, that's an input to GDP—and it's not quite half. Still, wallets are looking less unbuttoned than six or eight months ago. One caveat: prices in many retail sectors are declining, which weakens nominal sales growth.

No inflation. Yearly headline inflation fell to just 1.1% in February, very close to the bottom of its charted range. Core inflation, at 1.6%, is also very close to its modern lows. Both are well below their 1980–2007 average of 3.9%.

Speaking of inflation, an indicator we don't graph but do pay attention to (as does the FOMC) is capacity utilization, a measure of economic tightness that is a clue to future inflationary pressures. It was at 77.1% in February, about where it's been for the last two years, and 1.5 points below its 1980–2007 average. It is very hard to see signs of inflationary pressure anywhere.