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The Liscio Report

On the Economy

For John Liscio 1949-2000

And Now a Structural Profit Warning?

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Since today is the first of the month, we have not been able to do our withholding tax survey (the majority of our contacts don't get their figures until tomorrow at the earliest). There's a glimmer of hope among some tax officials who believe their states are regaining their footings after foundering at the end of the year, but any projections would be irresponsibly premature. Look for our full report on state withholding and sales tax collections on Wednesday, February 7.

It's now become the conventional wisdom that (as this newsletter suggested several weeks ago) the U.S. economy stabilized in January after a scary slide at year-end, thanks to the aggressive Fed easing at the beginning of the month. Let's hope that yesterday's move had a further salutary effect: a number of indicators have been deteriorating with stunning speed and severity. The University of Michigan's consumer sentiment numbers took deep plunges in December and early January, plunges of a magnitude last seen at the onset of the 1990-91 recession. Ditto the Conference Board's consumer confidence survey, whose January fall is even worse than the one seen at the onset of the last recession — and that's the overall index, which is

an average of consumer evaluations of present conditions and their expectations for the future. The fall in the expectations component is far worse than the early-1990s recession, and even the early-1980s recession; the only precedent is the drop in late 1973 and early 1974, at the onset of a nasty slump.

Other stats coming from the Conference Board are also a bit alarming. Their measure of CEO confidence "plummeted," as the Board put it, in the fourth quarter of last year, reaching its lowest level since the early-1980s recession.

And the Board's index of leading economic indicators has declined for three consecutive months, a classic sign that a recession will soon be upon us, though many analysts are discounting this news.

While our withholding tax survey figures aren't available yet, other leading measures of employment we follow are still flashing warning signals. While initial claims have come off their year-end

peaks, layoffs, according to ISI's count, have "exploded to a record of almost 35,000 a week." That's way above levels that prevailed at 1993's peak, when downsizing was in the headlines and job-killing CEOs were portrayed in "Wanted" posters on magazine covers. December's growth in temp employment growth lagged overall job growth, usually a

*It seems the economy
found a foothold in
January after that scary
year-end slide--may the
consumer take heart,
and have a drink on
Chairman Greenspan!*

fidarsi e' bene; non fidarsi e' meglio

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sign of weakening. And the consumer confidence figures, which have historically led the payroll numbers by a few months, are certainly not pointing to any pickup anytime soon.

Nor is the news from abroad terribly cheering. A business climate index compiled by the Ifo Institute of Munich, based on a survey of corporate managers, has slipped for seven consecutive months, after rising strongly for most of 1999 and into early 2000. December's erosion was attributed to anxieties about the U.S. slowdown cutting into German exports. Business confidence measures in Belgium and the Netherlands are also slipping, and retail sales in several European countries are either rolling over or heading down.

Meanwhile, bad news is coming out of Japan in droves. Preliminary signs are that the country's latest attempt at a recovery is faltering, with GDP growth for the fourth quarter likely to come in close to 0. For all of 2000, consumer prices posted their largest annual decline in the 30 years the present series has been published, the second consecutive annual decline, a first. Retail sales have declined for four years steadily. Any serious weakening of the U.S. economy couldn't help Japan very much.

So, instead of providing a counterweight to the U.S. slowdown, the rest of the world seems to be catching the disease.

Wall Street is getting used to profit warnings,

but so far, like the economic news, these have been read in more a cyclical than a long-term, structural vein. But there may well be an important big-picture story behind all the news — the end of a 15-year profit run.

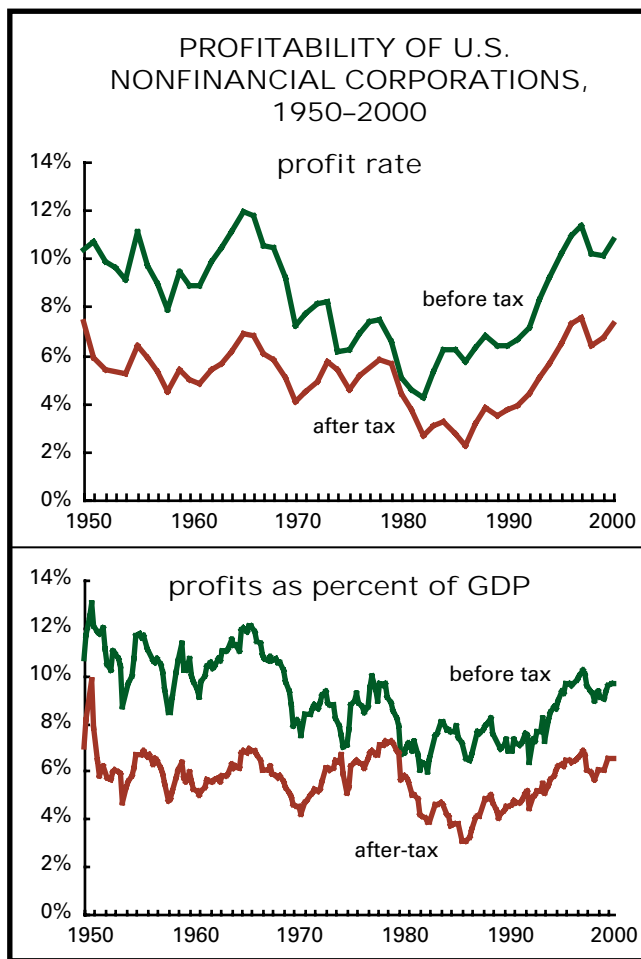
Shown in the graphs to the left are two measures of the profitability of U.S. corporations,

before and after taxes. The first is an estimate of the profit rate, computed by dividing profits (from the national income accounts) by the value of the capital stock (from the Fed's flow of funds accounts). Conceptually, the first is a measure of the return on capital; the second, capital's share of the national income.

Both versions tell pretty much the same story. During the "Golden Age" of the 1950s and early 1960s, profits were high. They varied with the business cycle, but they always recovered. That changed in the mid-1960s. Profitability, by both measures, peaked in late 1965/early 1966 — just before the first financial crisis of the post-

World War II era, the credit crunch of 1966. Profits then slid steadily for the next 16 years, finally bottoming out in late 1982, at the end of a deep recession.

From that trough, profitability rose pretty steadily, with barely a pause even for the 1990–91 recession — to a peak in mid-1997. To do that, profits obviously had to outgrow the general economy. From the low in the fourth quarter of 1982 to the peak in the third quarter of 1997, nominal GDP grew by 153%, while



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profits grew more than twice as fast, 332%. Compensation of labor — wages, salaries, and fringe benefits — lagged GDP, growing just 140%. Since the 1997 peak, however, profits have lagged GDP growth (13% vs. 20%), while labor income slightly outpaced general growth (21%).

We don't have the profit numbers for the fourth quarter of 2000 — they won't be released until revised GDP figures come out at the end of February — but they're probably not going to sparkle. So we can say that for the last three years, profits have been languishing, compared to the performance of the previous 15 years. What does this all mean? The growth in profitability is probably the most important fundamental underpinning for the bull market in stocks. The pickup in growth and the decline in inflation couldn't have happened without the profit upswing. But now profits appear to have stumbled, even if they haven't gone into reverse. So it's not much of a surprise that the financial markets have been sputtering, growth has been sagging, and corporate investment is weakening.

The big question is whether this is just a cyclical pause or something of more long-term importance. Profitability levels are at or near the peaks they reached in the mid-1960s; a chart reader might interpret this as some kind of resistance level. Maybe, as in the earlier Golden Age, profitability will recover with the economy in six or twelve months. But it may also be that the profit gusher is running dry, and all the pleasing trends of the last two decades could soon be the subject of nostalgic reverie.

At this point, we can't tell which it is. But there's a lot to be on the lookout for.

Friday's Employment Report: A discussion of weather details seems pretty anticlimactic in the wake of the Fed's move, but it is worth noting that 2000 was characterized by an extreme fluctuation: the January-October period was the warmest since 1895, but November and December were the coldest on record,

dragging the entire year down to a shabby 13th warmest since NOAA started keeping tabs. We know that the economy as a whole certainly felt the chill of those two months. Specific to employment, after two years of prime weather conditions (prime for everyone but manufacturers of winter wear that is) the winter's onslaught on construction jobs began in November, with a drop of 7,000 in outside construction jobs. In December construction fell another 13,000. After these two months of bitter cold, January's temperature and precipitation were right where they should be, contributing to the case for some rebound in the month, especially as the seasonal adjustment factors anticipate construction fall-off to begin in December, not November as it did in 2000.

There's plenty of evidence for an increase in the unemployment rate, and wages may surprise a bit to the upside.