

May 2, 2002

The Liscio Report

On the Economy

For John Liscio 1949-2000

Muddy Waters

Our preliminary index for state withholding tax collections fell to 17 in April, down from 32 in March. The three-month moving average, charted on p. 2, fell to 25, a drop of almost 20 points in two months. Year-over-year negativity remains the norm, and only a few states were encouraged by weakly positive collections. Tax officials at states of every stripe are singing the blues.

We're calling our index preliminary because it is early in the month; several states do not have their numbers, and others are giving us rough figures. Generally, however, our early surveys do not differ substantially from the final ones.

A number of states missed their projections by wide margins. Our contact at a large western state was especially concerned because he and his colleagues had worked hard to get all the bonus and stock option income out of the 2002 projections, and then cut some more off to be on the safe side. They still missed by a staggering 14%. Several big midwestern states reported double-digit declines year-over-year, some missing their marks by a bigger margin than they did in March.

By now, all the bonus and stock option froth should no longer cloud the year-over-year comparisons. And all calendar quirks this year should serve to boost collections. In fact, a few states had pencilled in some growth based on how collection days fell. It didn't happen.

Several states call their year-to-year drops unprecedented. Some have looked back over thirty years of data and not found anything to match them. This is caused by the double whammy of tax breaks put into place during the giddy mid-to-late 1990s, and current economic weakness — though our contacts stressed that even without the tax cuts they'd be looking at big deficits. Some noted that in the early 1990s when collections were bad it was against a constant drumbeat of how weak the economy was, but now it is against talk of how things are improving. And almost all mentioned the 5.8% GDP number as likely to be revised down.

There is also concern at the states that BEA's recent downward revisions to wage and salary data for 4Q 2001 are not big enough. For example, one state calculated that wages there were down close to 5% for a specific period, while BEA says they

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were off only 1%. And since the states are looking at the data sources the BEA will use for their final estimates down the road, the lower numbers are probably closer to the mark.

There were, however, some bright spots in our conversations. A number of estimators who projected a longer and deeper recession than was generally accepted believe that things are where they should be if we're beginning to recover — but we're taking a long time to get off the mat.

We've remarked many times on how this has been a very unusual business cycle. One of the more unusual, and disturbing, features has been the poor performance by the stock market (despite

Wednesday's strong close). As the chart on p. 3 shows, the market made a bottom in line with the average business cycle trough, and rallied nicely for a few months into the apparent trough in the real economy (which we're assuming to have been in December). But it lost its step sometime in January, and began May some 6% below the level at the presumed December trough, instead of 11% above, where it would be five months into a

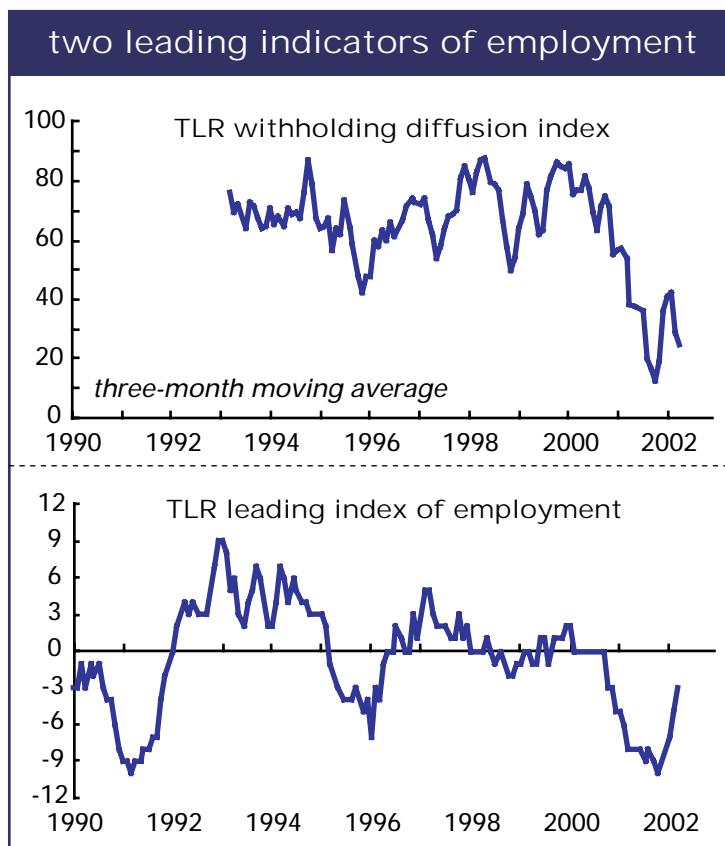
"normal" recovery.

And this has happened despite one of the greatest easing programs in the history of the Federal Reserve. The table on p. 4 shows the stock market response to extended bouts of Fed easing (updating one we did last fall). Usually the response is

quick and strong, with the S&P typically up 9% in the six months after the first easing move, and 17% a year after. Not this time — the market's down on every interval shown. In only two other cases was the market down a year later: in 1981, during the deep, double-barreled recession of the early 1980s; and in 1930, a time only the obsessive like to think about. Fifteen months have passed since this easing cycle be-

gan, and the market is still down — 17% (and that's using the monthly average for April — it'd be down almost 20% if we used the April 30 close). The only precedent for the market remaining weak for fifteen months after the Fed turned generous was in 1930–31.

We doubt this is a portent of breadlines in the near future, but what does it mean?



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Several answers suggest themselves. One is that there's no sustained profits recovery in sight — and if there's no profits recovery, capital spending is likely to stay depressed. Another is the inflows of capital from abroad, which helped power both the real economy and the financial markets during the boom, have slowed to a trickle. And another is that it's taking a very long time to unwind a long boom.

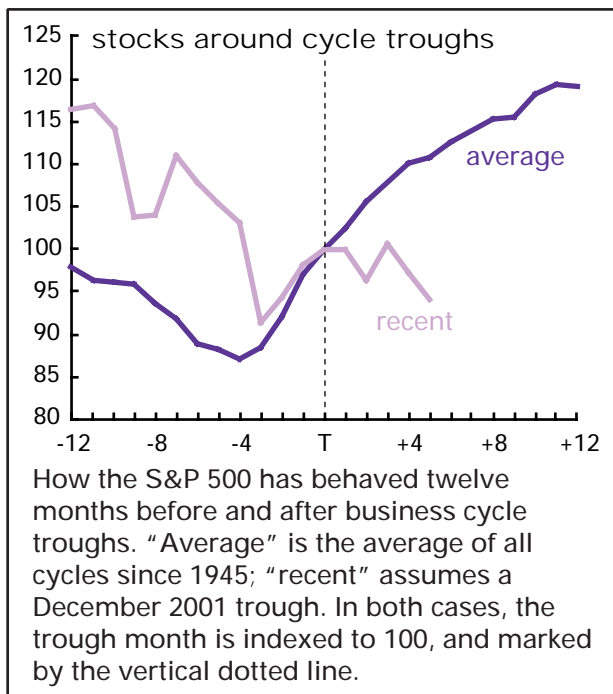
Regardless of the cause, a weak stock market is likely to be a drag on consumption going forward. Some numbers from the Investment Company Institute (ICI) make this point dramatically. Between 1996 and 2000, mutual funds distributed an average of \$202 billion a year in capital gains. Last year, distributions fell to just \$72 billion. And there's not much more where that came from; unrealized gains in mutual funds stood at \$1.5 trillion at the end of 1999 — but by late last year, those unrealized gains had turned to unrealized losses of \$200 billion. Unless the market picks up steam, consumption will be more dependent on wage and salary growth, which has been rather weak lately.

Our leading index of employment has

continued its steady rise from last October's bottom, and has been behaving much like it did in earlier recoveries. But it's still in negative territory and not signalling any strong burst of hiring in the near future. Several of its components have merely shifted from negative to neutral, and none are yet firmly positive. We'll be watching the claims numbers carefully over the next several weeks, hoping the distortions from the extended benefit program will work themselves out of the system — but, as we pointed out in last week's special edition, the continuing claims numbers, which are largely uncontaminated by the special program, are also drifting higher. In a textbook recovery, this wouldn't be happening. Our unemployment model forecasts a rise in

the unemployment rate from 5.7% to 5.8% (with 5.9% not out of the question, though rounding anomalies work against this possibility).

The employment components of the Conference Board's consumer confidence survey were curiously mixed, with the share of respondents reporting jobs to be "plentiful" rising from 20.6% in March to 20.9% in April — and the share of those reporting jobs "hard to get" rising even more, from 21.1 to 22.5%. Expectations also diverged, with those imagining a better job market six months hence rising from 20.7% to 22.4%, and those imagining a worse market also rising, from 13.5% to 14.7%. Respondents to the weekly ABC / Money Magazine consumer comfort poll have been sounding gloomier about their personal finances — almost certainly a re-



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flection of the stock market and the job market — over the last several weeks. These numbers are still better than where they were late last year, but much of the optimistic turn in February and March were reversed in April.

Seasonal factors expect strong hiring in April — it will take over 700,000 new jobs before adjustment to produce a flat number after. Even though the overall factor this April is not as aggressive as the factor for last April, it may well be too optimistic in expecting close to 250,000 construction hires. Winter 2001–2002 saw job losses in construction before seasonal adjustment of around 150,000, roughly half the drop of the previous year. Fewer winter losses should mean weaker spring gains. So, Friday’s payroll numbers should surprise on the downside, possibly falling back into negative territory. Wage growth should continue to decelerate and the work week show a slight uptick. But we don’t think that the report will provide a clear read of the economy’s overall direction; the employment picture could remain muddy for some time yet.

by Philippa Dunne and Doug Henwood

	STOCK MARKET REACTION TO FED EASING STREAKS			
	change in S&P, months after first easing			
	6	9	12	15
5/21	-0.8%	+4.8	+19.8	+24.0
5/24	+13.8	+26.0	+25.3	+32.8
2/30	-10.8	-29.5	-27.6	-40.8
5/33	+9.9	+28.0	+14.2	+7.8
11/57	+8.3	+18.2	+30.1	+35.7
6/60	-0.8	+12.0	+14.6	+17.5
6/70	+19.1	+31.8	+31.9	+31.5
9/74	+23.0	+35.6	+24.3	+30.2
6/80	+16.5	+16.3	+15.5	+3.2
8/81	-11.7	-10.2	-15.4	+6.5
6/82	+27.0	+38.5	+51.7	+52.4
10/84	+9.6	+16.8	+13.0	+26.3
3/86	+2.6	+7.0	+25.9	+29.7
11/90	+19.9	+23.5	+22.4	+30.9
9/91	+5.2	+5.4	+8.1	+12.5
1/01	-9.8	-19.3	-14.4	-16.7
average	+8.7	+14.9	+16.9	+20.0

How the stock market, as measured by the S&P 500, reacted to extended bouts of Fed easing. Dates in first column mark the first easing move; successive columns show percentage change (unadjusted for inflation) six, nine, twelve, and fifteen months following first easing move. Average is mean, excluding the most recent period; medians (not shown) are a bit higher than the means, mainly because of the extreme negative values for 1930.

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