

June 12, 2006

The Liscio Report

On the Economy

For John Liscio 1949-2000

Will corporations step up to the plate?

Our index of states at or above their projected monthly collections of sales taxes rebounded to 66% in May after April's lackluster 49%. There were, however, a number of tricky calendar adjustments and our contacts suggest we look at the two months together, and, since one month's sales tax collections include activity from the end of the prior month, we are taking their advice. Our SDI remains strong, but our contacts in many regions report a slowing trend, welcome news to many of them because they generally consider sales taxes running so far ahead of income and employment growth, as has been the case, an unsustainable situation.

Gas prices are back up again and all but one of the states in our survey that missed their May sales tax estimates do not collect sales tax on gasoline. Some of the biggest margins fell to states that impose sales taxes at the pump. Remarked one, "This is the biggest month of growth compared with the same month last year we have ever experienced, and it's coming from general sales as well as gas sales."

- ***RE related taxes slow***
- ***what consumer credit spike?***
- ***flow of funds: housing still up, corps flush***

As we have been reporting, the landscape is changing. Revenue flows in regions that have had the strongest growth in recent years are currently moderating, and some Midwestern states are now holding their own. Our contact at one Midatlantic state said that they are currently exceeding targets by slim margins after years of robust growth, and another reported currently meeting revised more modest expectations. And we were a bit surprised by this remark from a contact at one of the states that has been a top performers in recent years: "We're doing really well and will continue to be doing so for... at least a few months."

There are renewed signs of trouble at some Midwestern states. One large state hit especially hard by woes in the auto industry has missed their sales tax targets for two months running, falling 6% below estimate in May, a cause of concern to our contact there. And the Midwestern Diesel Fuel index is flashing yellow, logging two outright declines in the last four months, and a growth rate for those four months of just 3%, which compares to the 8% rate

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established in September through December.

Comments from our state contacts confirm the slowing in the housing market apparent in other data. In one large Southern state the “real estate markets continue to downshift, with prices stable but number of transactions showing double digit declines from a year ago.” Our contact in a large Midatlantic state listed the housing market among his major concerns, noting that the number of actual transactions fell 16% in April, and that transfer taxes are currently falling after climbing 20-30% in the last five years. “From a revenue standpoint it doesn’t seem to be hurting yet, but in the transfer side it’s really slowing down.” He also suggested that he’d be finding out “sooner rather than later” the broad effects of all this on his state’s economy. Several contacts noted aggressive advertising by homebuilders highlighting discounted prices and increased allowances for material upgrades. This hasn’t happened in years and suggests a significant increase in new home inventory. We’ve even seen some red tags noting “price improvement” on apartments for sale here in NYC, a euphemism for “discount” that was new to us.

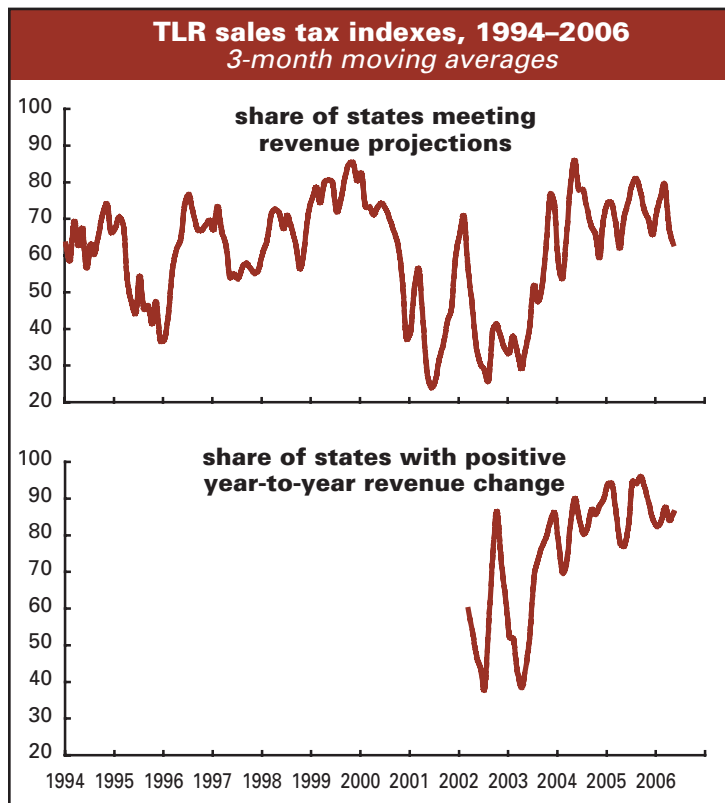
Consumer credit spike?

Last Wednesday’s release of the consumer credit numbers was reported with superlatives — “soared!,” “hefty gains!,” “biggest rise in ten months!” This seems a little overdone. We’ve been emphasizing

the importance of adding in revolving home equity lines of credit to traditional consumer credit, to get a fuller view of the borrowing-to-spend picture, and the home equity series has been logging a lot of negative signs lately (seven out of the last eight months, to be exact). April home equity credit was down by 0.9%, the most since January 2001. When added to traditional consumer credit, the

combined gain was just 0.3% in April, less than half as much as the June 2005 figure that April’s increase was the “biggest since.” Over the last year, the yearly growth in the combined measure has fallen from 8.5% to 2.3%.

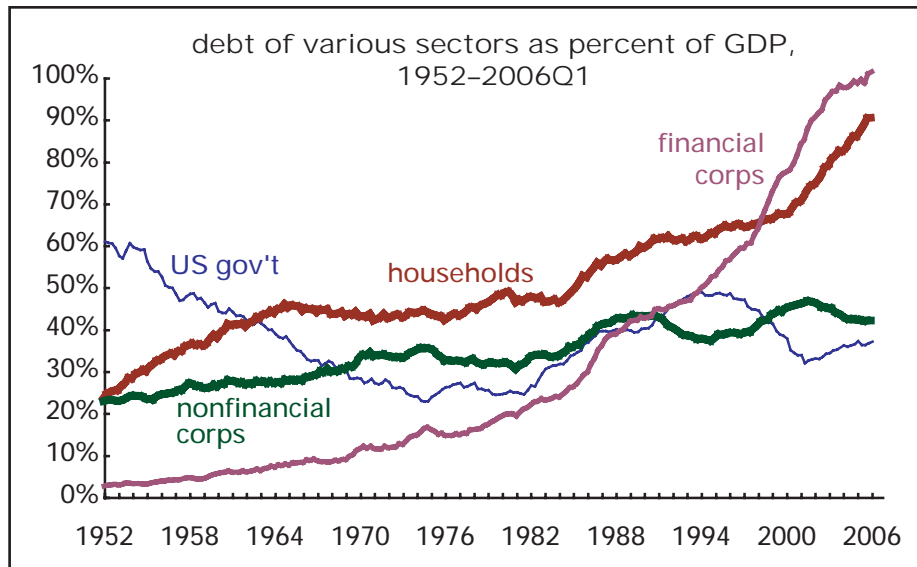
Looking beyond the April credit numbers, Gallup’s late-May update of its Experian Personal Credit Index shows consumers just as cautious about taking on new debt as they were early in the month (which we wrote up in our May retail issue). And with the MBA mortgage application index off 7% since April—and over 11% on the



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refi component—the home equity series is likely to continue leading the way down after five years of leading the way up.

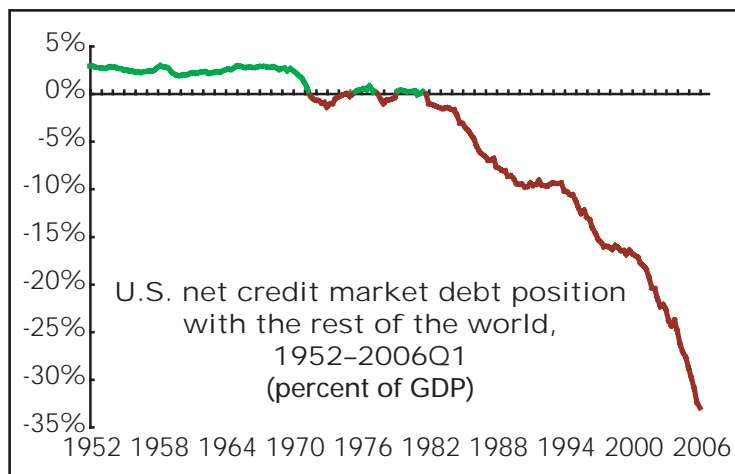
The chart immediately below summarizes the debt picture for the major sectors. Note that nonfinancial corporations remain quite prudent. The standouts, of



Flow of funds review

After saying that, it feels a little like re-viewing ancient history to take our regular look at the flow of funds accounts, which were re-released last Thursday. The first quarter of 2006 mostly saw extensions of the financial trends of the last few years: households, the federal government, and the financial sector continued to take on new debt (as did the nation as a whole to foreign creditors), and the nonfinancial sector continued to enjoy a gusher of profits.

course, are the household sector and the financial corporations that mediate household debts. But the rate of debt growth in both sectors slowed last quarter after several years of ripping growth. Federal debt,



however, expanded at a rapid clip in the quarter after several quarters of expanding "only" in line with GDP. With domestic savings still in insufficient supply to fund domestic borrowing, U.S. foreign debts, as the chart at left shows, continued

to expand, reaching a record 33% of GDP in the first quarter. No slowing is visible there, though if the mortgage market is on the verge of rolling over, then that may happen soon.

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The charts on p. 6 take a close-up look at some of the major components of household balance sheets.

As the bottom chart shows, net worth continued to improve, with the broadest definition now having recovered almost three-quarters of the 2000–2002 decline. But, as the asset detail shows, the major reason for that improvement is the continued increase in residential real estate values. Take that

away—along with the durable goods that the Fed includes in its definition of household assets—and you see that nonresidential wealth excluding durables has made a much less dramatic recovery, more like half than three-quarters of the 2000–2002 decline. (Durable goods typically depreciate rapidly, and are not easily sold except at deep discounts; the logic of counting

them as assets strikes us as less than compelling.) But it should be pointed out that aggregate measures of household net worth are very misleading, since different sets of people hold the assets and owe the debts. Oversimplifying but not

by much: the top 10% of the distribution holds about three-quarters of all assets, and the bottom 90%, three-quarters of all debts.

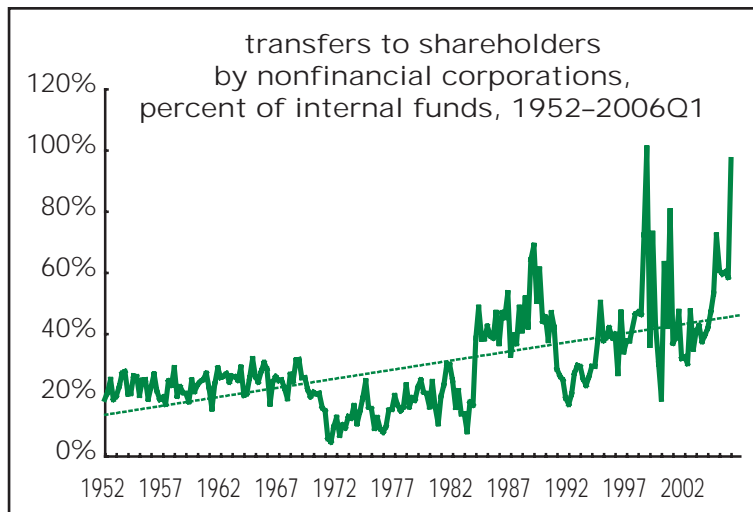
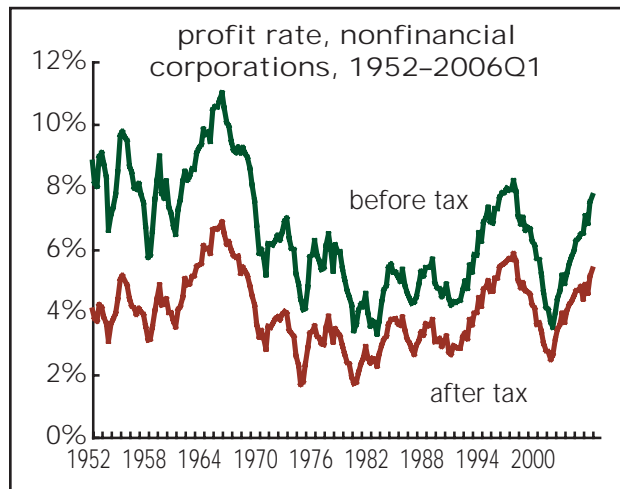
The corporate sector continues to thrive. Profitability—defined as profits from the

national income accounts divided by tangible assets from the flow of funds accounts—is near regaining its 1997 peak, which was itself the best performance in 30 years. But, while profitability is high, capital expenditures remain at the low end of their historical range—under 8% of GDP, compared with near-10%

levels in the late 1990s, and numbers north of 10% in the mid-1980s. This is a little mystifying; if firms are making so much money on existing operations, why are they so reluctant to invest? Instead, they've been shoveling cash out to their shareholders, through buybacks and takeovers (which enter the flow of funds accounts as equity retirements). If you add

net equity offerings/retirements to regular dividends to get a measure of transfers to shareholders, as does the chart at left, you see that it's at a near-record level, exceeded only by one quarter of 1998, and eclipsing previous cyclical peaks in

1989 and 2000. This extreme has a late-cycle feel about it.



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Consumers have carried this recovery, and with their spending now showing signs of a late-cycle slowdown, this would be the ideal and long anticipated time for corporations to up their capital spending and hiring.

Tuesday's retail numbers

According to Mike Niemera over at the International Council of Shopping Centers, one of the warmest Mays on record supported clothing sales, and he sees no signs of consumer pullback except among the "economically sensitive." Although the advance retail sales number came in below consensus last month, there were a lot of plus signs in the details. Of the non-auto related components, only building materials showed a significant drop over the month. With the housing market cooling, and warm weather earlier in the year likely robbing some growth from the current period, it's not likely we'll see a rebound there. Gas prices, though, should provide a boost to the overall numbers, and we're expecting retail sales to be up +0.2% in May, with the ex-auto component at +0.6%. Ex-auto, ex-gas we're looking for +0.4%, which is below the 0.6% average of the previous six months. Like many of our state contacts, we're looking for retail sales to weaken in the coming months, as higher interest rates, increasing debt-shyness, higher gas prices, and a weakening housing market take their toll.

by **Philippa Dunne and Doug Henwood**

household balance sheets



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