

October 6, 2005

The Liscio Report

On the Economy

For John Liscio 1949-2000

Storm may mask slowing employment

In September 73% of the states in our survey made or exceeded their withholding tax collection targets, largely in line with August's reading of 77%. Although our state contacts are generally pleased with their collections, an increasing number note they are currently seeing a slight slowing trend; some stronger states report withholding growth has slowed by 1%, although still at or even well above estimate, but one large coastal and several of the weaker Midwestern states report they are now falling below estimate and into the 4% growth range, which is uncomfortably close to the margin that could be generated by wage increases alone.

Reports of quarterly collections are mostly in, and they are very strong indeed. Corporate tax collections around the country are making double digit year-over-year gains and estimated tax payments, which include mainly non-wage earnings like capital gains, are up 15%, 20%, and even 30% at states in our survey. (More on corporate profits later.)

In states with the hottest real estate markets and the largest financial sectors the difference between total dollars collected as estimated taxes and total dollars collected as withholding taxes (in the months when the estimated quarterly payments come due) is slimmer than in the states without such concentrations of wealth.

This September, two states in the first category reported estimated tax collections totaled just under 90% of the money that was collected in the separate withholding category, whereas estimated taxes amounted to just 50% of to-

tal withheld levels in states of the latter type. A large state with a top real estate market saw estimated taxes move from the equivalent of 61% of withheld taxes in 2003, to 70% in 2004, and 88% in 2005, pushed up by coincident strength in the capital and real estate markets. Several contacts are looking into these relationships and we'll let you know when we have more information.

Our contact at a state with many high-wealth individuals wondered if income growth in the upper wage brackets is cur-

- ***upper brackets pulling survey up?***
- ***where's the corporate cash going?***
- ***parsing the storm***

fidarsi é bene; non fidarsi é meglio

The Liscio Report - 2

rently accelerating at a rate that is leaving their models "in the dust." That would be in line with the news from the IRS about 2003 tax returns (they take their time releasing the data, sadly): 25% of the total gain in income went to the top 0.1% of taxpayers, and 51% to the top 5%. (These high-wealth individuals likely pay mainly estimated, not withheld, taxes.) The government tables in the NIPAs indicate that social insurance payments, a good proxy for employment trends, weakened in the second quarter. They were still strong, but this goes hand in hand with our contacts' concern that an increasing share of withholding growth is coming from wages, a trend that is apparently continuing into the current quarter.

Diesel fuel consumption at a Midwestern crossroads slipped in August, the most recent month for which information is available, gaining 5% year over year after

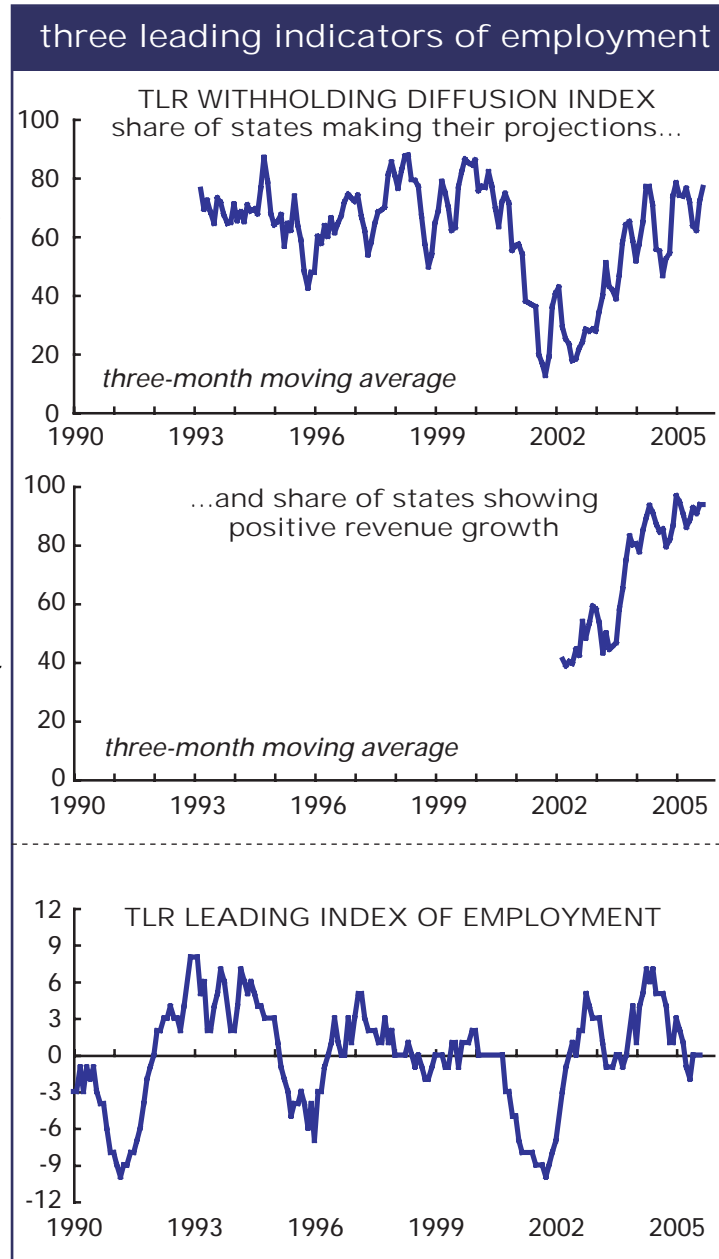
growing by 9% and 10% in the prior two months. And our contact at a large Midatlantic state reported that outside the

major metropolitan areas his industry contacts are detailing slowing demand and lower backlogs likely owing, they believe, to the pressures of elevated fuel prices.

Diverging sectors?

The two ISM surveys surprised in opposite directions, with manufacturing coming in above expectations, and its service counterpart coming in below. That contrast might be a symbol of the broad economy right now, with Katrina-inspired rebuilding stimulating the factory sector, and high energy prices taking their toll on services. Comments in the ISM

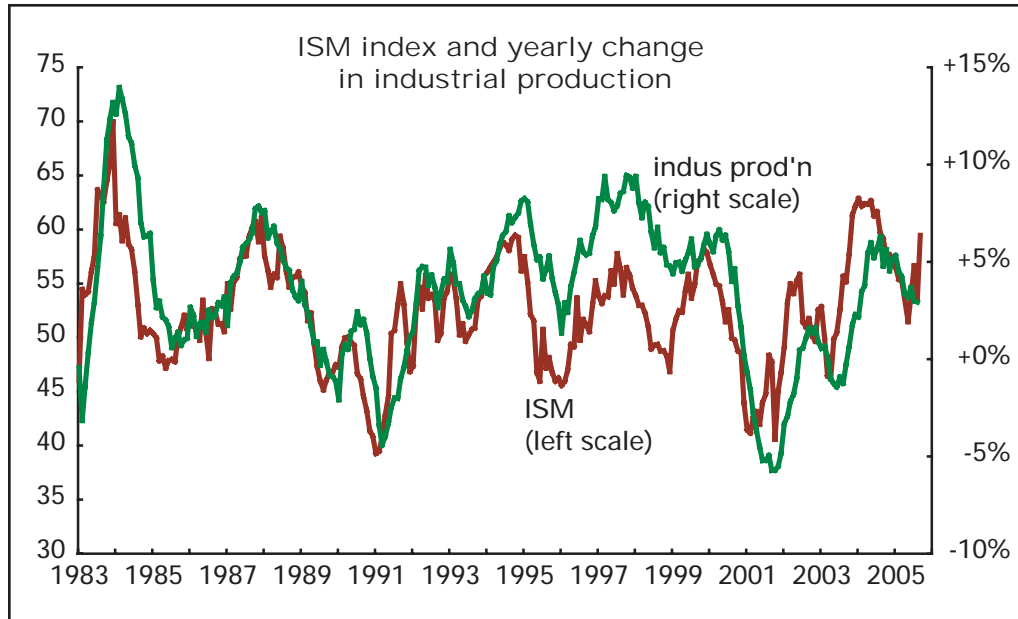
manufacturing press release offered vivid testimony of the hurricane's influence. An electronics and an instruments firm reported bulging order books from rebuilding. A chemical company complained about the challenge of getting raw materials, like petrochemicals. Tight supplies



The Liscio Report - 3

were visible in sharp increases in the price and delivery components. But the service side lacked the consolation of fat order books, with new orders slipping markedly, and customers expressing worries that their inventories were too high. And the employment components in both sur-

December, we'll begin a comprehensive analysis of these important and often overlooked series. For now, we'll take a look at the corporate side in this issue, and the household side in next week's retail issue.



veys turned in disappointing performances.

But, as the nearby chart shows, the sharp increase in the ISM manufacturing survey should be taken seriously. It tracks very well with industrial production, and unlike the employment components of both surveys, the relationship hasn't broken down in recent years. Whether this has a broader or more sustained stimulative effect remains to be seen, but the combination of rising prices, materials shortages, and rising production can only encourage the hawkish forces at the Fed.

Flush but not spending

Starting with the next release of the quarterly flow of funds data from the Fed in

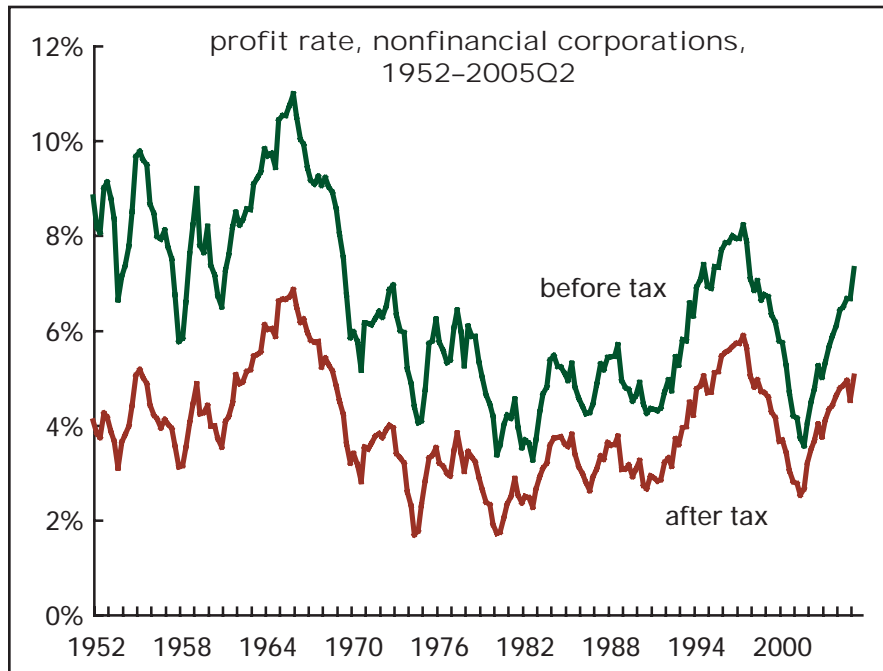
The nonfinancial corporate sector is doing very well. Profitability, which we measure by dividing before- and after-tax profits by the value of the tangible capital stock, was up sharply in the quarter, and is at some of the highest levels we've seen in the last 30 years, bested only by the peaks of the 1990s. (See chart on p. 4.) But this is not inspiring any serious increase in capital spending.

As the top chart on p. 7 shows, corporate cash flow—profits plus depreciation, a/k/a internal funds—is normally a determinant of capital expenditures; correlation coefficients between the two series are in the .45–.50 range (depending on exactly how you specify them). But lately capital expenditures have lagged internal funds. The difference between the two,

The Liscio Report - 4

sometimes called free cash flow (depicted in the middle chart), is high by historical standards, and has been for the last four years. So where's the spare cash flow going? Much of it is being delivered to shareholders. The bottom chart on that page shows what we might call "transfers to shareholders"—dividends plus net eq-

tions were investing and hiring rather than distributing cash to shareholders. With profit rates high, the only rational explanation we can see for this behavior is that managers haven't yet gotten over the anxieties induced by the bursting of the 1990s bubble.



uity offerings—as a percentage of corporate cash flow. Note the long uptrend in this series, and its currently high reading. The major reason here is a persistently elevated level of negative equity issuance: that is, instead of offering new stock to the public, firms are buying up their own stock and buying the stock of their merger targets. That persistent buying, coming from a sector that is usually thought of as a net seller of stock (through IPOs and other offerings), has been a tremendous support to the stock market.

It's hard to imagine where the stock market might be if it had to depend more on outside buyers. But there's little doubt the real economy would be zippier if corpora-

Job gloom

Most of the surveys covering the job market that we follow are flashing yellow these days. According to Gallup, 56% of Americans say this is not a good time to find a "quality" job, while 38% say it is—roughly the neighborhood this indicator has been for almost all of 2005. The labor market components of the Conference Board's confidence survey took a pretty rough hit in September, with the share of respondents reporting jobs to be plentiful falling to 20.1% from August's 23.6%, and the share of those reporting jobs hard to get rising from 23.1% to 25.4%. This is the worst mix since last December.

The Liscio Report - 5

And while the headline numbers in the Michigan survey were distressing enough to read, the press release made for even gloomier reading: the two-month decline in the index was the worst on record, and “such steep and widespread declines in confidence have typically triggered recessions.” The release qualified this anxiety some by noting that reconstruction spending might offset the drag. But expectations for inflation, the general economy, and respondents’ personal finances in the coming months were the worst in more than a decade. High gas prices are dragging down car-buying intentions more intensely than they have since the 1979 price surge, and high prices produced the lowest level of house-buying intentions in nearly 25 years.

These gloomy attitudes may be influenced by all the bad news of the last month, and actual behavior often differs from expressed attitudes and intentions, but this is not good news—and suggests that the fundamentals of the labor market and household finances were not improving before bad weather made conventional economic indicators so hard to read. Confirming this is the continued flatness in our leading index of employment, which is stuck at 0 for the third consecutive month.

Friday’s numbers

The BLS has announced that they have changed their estimation methods for the month in order to capture the effects of Hurricane Katrina. For now, if an establishment in the disaster zone does not respond to their survey they are taking that to mean the establishment is in fact not operating, instead of imputing like behavior reckoned from similar businesses that

did respond. The BLS suggests this may cause them to overestimate job losses owing to the hurricane. On the other hand, they are assigning added weight to establishments that do respond so that the region will not be under-weighted at the national level. This could go either way.

It is impossible to guess how Katrina in tandem with the changes the BLS has made to keep their data collection techniques from wiping away the effects of the storm will play out on Friday morning. We don’t need to point out that here is the possibility of a major surprise to either side. But we see an asymmetrical risk to how the market will react to either one.

We have heard from a number of traders that although consensus is more tame, they are currently prepared for the possibility that Katrina will produce a stunning fall, even down to -400,000 in Friday’s BLS report, thus increasing the possibility that a weak number will be taken in (perhaps faltering) stride. It is likely, though, the markets will be sensitive to any kind of upside surprise, especially since FOMC members have been aggressively speaking out about inflation this week. (We’ve even wondered if they have done so in part to keep the bond market from rallying hard if Katrina’s reported damage is greater than anticipated.)

And we are concerned that whatever the

Copyright warning and notice: It is a violation of federal copyright law to reproduce all or any part of this publication or its contents by facsimile, xerography, scanning or any other means. The Copyright Act imposes liability of up to \$100,000 per issue for such infringement. *The Liscio Report* does not authorize reproduction by subscribers or anyone else. However, multiple copy discounts and limited (one-time) reprint arrangements are available. Copyright 2005, TLR II. All rights reserved.

The Liscio Report - 6

reality there is a possibility that Katrina's effect on the reported numbers may well be on the low side of the scale. The CBO has suggested that job losses owing to the hurricane are between 280,000 and 400,000, and the BLS has provided data broken out by level of effect and FEMA damage designations. Total employment in the areas affected by Katrina stood at 5.8 million in 2004, at 2.8 million for the "most affected" areas, and at 370,000+ within Katrina-damaged areas as defined by FEMA, the last number probably most in line with actual job losses. The Labor Department estimates that 279,000 Katrina-related unemployment claims were filed, but this doesn't include those who couldn't get to register, or who hadn't yet lost jobs they were yet to lose.

Oil rig and port workers throughout the region were back on the job as soon as it was considered safe, and we have been told they were working around the clock, just as you'd expect. There are anecdotal reports of large casinos and private employers keeping their employees on the payroll even if they were unable to work, and the city of New Orleans is only now announcing layoffs of thousands of their employees. The BLS reports that about 1/3 of the establishments they survey to obtain information for the region report from centers outside the affected areas. It seems logical that many for these would be the same establishments that were able to keep their employees on payrolls, something the smaller local businesses could not do. If these establishments are given extra weight that could make things look a lot better. Finally, many of those who were able to drive away from the region over the weekend before the storm hit may well have found alternative employment in the two weeks between the

onset of the floods and survey week.

We think we'd be seeing employment growth of about 150,000 without Katrina. But we're factoring in a somewhat modest, under the circumstances, hit to the federally reported numbers, and looking for a drop of around -150,000 in the total payrolls reported on Friday. It may be that the devastation we watched unfold will not leave a mark of similar magnitude on the national numbers.

The irony is that our discussions with our state contacts lead us to believe that there may be hiring weakness brewing, but we won't get more information on how that may show up in the Federal reports until October 21 when the BLS releases state and local employment data.

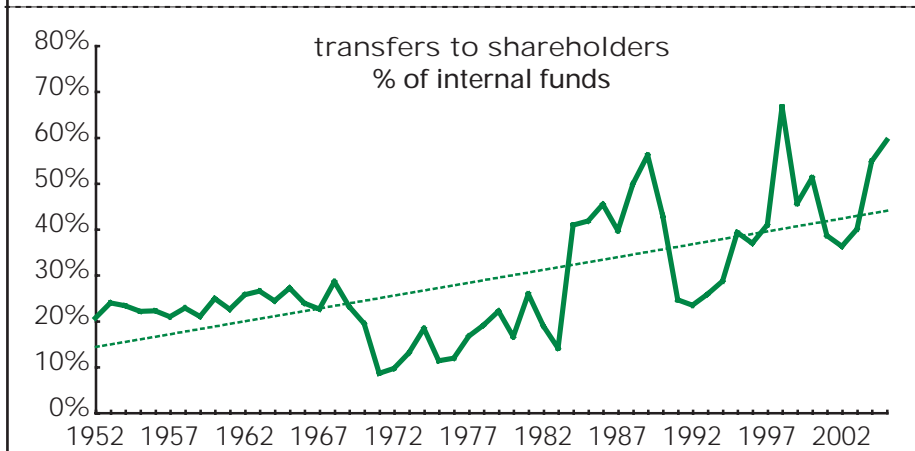
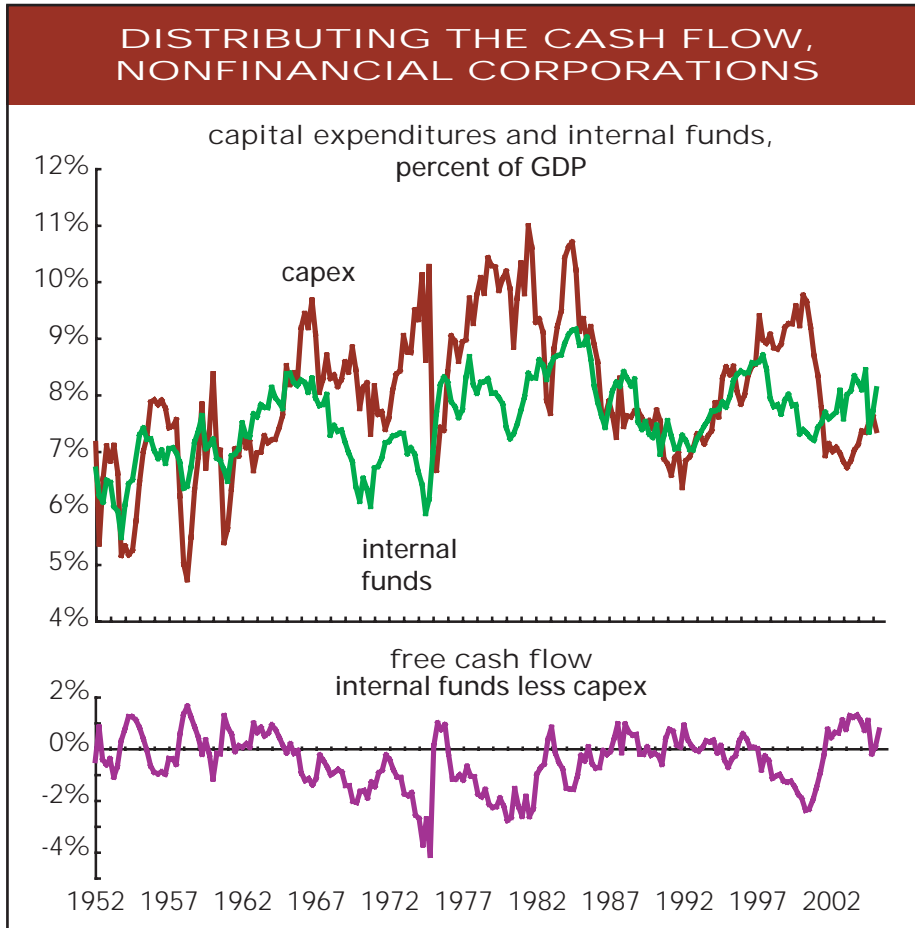
We expect the unemployment rate to climb from 4.9% to 5.0%, earnings to come in at +0.3% (from the weak +0.1% gain last month) and the workweek to remain unchanged.

by Philippa Dunne and Doug Henwood

***corporate
cash flow***



The Liscio Report - 6



Top chart shows capital expenditures and internal funds (after-tax profits plus depreciation) for U.S. nonfinancial corporations as a percent of GDP. The middle chart shows the difference between those two quantities, sometimes called free cash flow. The chart on the bottom shows dividends plus net new equity offerings — what might be called transfers to shareholders — as a percent of internal funds. See pp. 3–4 for discussion. Data from the Federal Reserve flow of funds accounts. Top two charts are quarterly; bottom, annual.