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MEMORANDUM

TO: TACIR Commission Members

FROM: Harry A. Green Harry
Executive Director

DATE: July 1, 2009

SUBJECT: *Tennessee Business and Economic Outlook*

Dr. Matt Murray, Professor of Economics and Associate Director of the University of Tennessee's Center for Business and Economic Research (CBER), will discuss the contents of the spring 2009 publication *Tennessee Business and Economic Outlook.*

Published in the spring and fall, this report provides interim updates to the annual *Economic Report to the Governor of the State of Tennessee* (ERG) forecast.

Attached are the United States and Tennessee forecasts from the report, as well as a brief introduction. The full report can be viewed at http://cber.bus.utk.edu/tefs/spr09.pdf.

TENNESSEE BUSINESS AND ECONOMIC OUTLOOK

The State's Economic Outlook

Spring 2009

TENNESSEE BUSINESS AND ECONOMIC OUTLOOK

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Prepared by the
Center for Business and Economic Research
College of Business Administration
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The State's Economic Outlook

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Introduction

As recently as fall, most of us probably didn't know anyone who had been directly affected by the recession. Today, most of us know several people who have lost a job or are on a reduced workweek, and virtually everyone has seen their stock portfolio shrink.

The nation's recession, which began in December 2007, is now the longest of the post World War II era. The collateral damage has been extensive, with the global economy expected to see its first contraction since 1945.

For months economic conditions across the country were deteriorating at an ever-increasing rate. Some mixed signals are now emerging from the economy, perhaps preliminary evidence that the economy is approaching its trough. Consumer sentiment has improved slightly from very depressed levels, mortgage applications are up, the stock market has seen significant gains in recent weeks, and the housing market situation appears to be stabilizing. However, pervasive weaknesses are present elsewhere in the economy, and data for the first quarter of the year are nothing less than miserable. At least there are tidbits of good news coming from the economy.

The housing market continues to be a drag on economic performance, but there is some evidence that the worst may now be over, at least for the national economy. The Case-Shiller® 20-city home price index was down in February, but for the first time in 16 months the setback was not a record breaker. Home sales were down for the first quarter, but at a slower pace than in the fourth quarter of last year. Building permit data for Tennessee remain discouraging. For example, in the first quarter of 2009 permits were down 62.8 percent in Knox County and down 27.8 percent in Bradley County relative to the first quarter of 2008 (www.themarketedge.com).

Job losses continue to mount for both the state and the nation. Nonfarm jobs in Tennessee plummeted 6.7 percent while the U.S saw employment losses totaling 5.7 percent in the first quarter of 2009. These are the worst quarterly setbacks in the current cycle. The decline in manufacturing was worse still with losses approaching 20 percent for both the U.S. and Tennessee economies. The state unemployment rate jumped to 9.1 percent in the first quarter of 2009, compared to an 8.1 percent unemployment rate for the nation.

A rebound in economic activity is anticipated in the third and fourth quarters of the year. Quarterly rates of decline in economic activity will generally decelerate in the next several quarters. Inflation-adjusted GDP will return to the black in the fourth quarter of the year, as will nominal personal income for both the state and the nation. Growth will then be reestablished over the course of 2010. Low interest rates and falling housing prices are expected to revive the housing sector, while fiscal stimulus will help prop up the spending side of the economy, together promoting the economic recovery.

While a turnaround in economic fortunes is expected in the second half of the year, the depth of the recession means that many measures of economic activity will not return to their pre-recession levels until 2012 or 2013. A good example is employment: by the third quarter of 2011 (the end of this short-term outlook horizon), nonfarm jobs in Tennessee will remain below the level that prevailed in 2004. The unemployment rate will continue to rise well into 2010 and remain at stubbornly high levels for several years to come. Tennessee will see its unemployment rate peak at 10.5 percent by the fourth quarter of 2009, while the nation's unemployment rate is expected to reach 10.2 percent in the same quarter.

U.S. Forecast

Current Economic Conditions

U.S inflation-adjusted gross domestic product (GDP) was down 6.1 percent in the first quarter of 2009, slightly better than the 6.3 percent setback in the fourth quarter of 2008 (seasonally-adjusted annual rates). Together these are worst consecutive declines in GDP since the late 1950s. The first quarter GDP report was widely anticipated so the figures did not jolt financial markets. In light of the problems coming from national labor markets, it is surprising that consumer spending—which advanced 2.2 percent—was the sole source of growth for the quarter. Aside from government spending (which was down slightly) and consumer spending, all other broad components of GDP suffered double-digit losses. Business fixed investment fell 37.9 percent while exports were down 30 percent. The good news in the GDP report was the sharp fall in inventories, setting the stage for increased factory orders.

Annualized housing starts slipped to 546,000 in the first quarter, the lowest level since the recession began; starts for 2008 totaled only 903,000. Quarterly existing home sales also fell, but at a slower pace than recent quarters. Residential fixed investment was down 38.0 percent for the quarter, but relief is anticipated in the quarters ahead. Despite the bad news for the quarter as a whole, there are finally some signs of possible stabilization on the horizon. In particular, the number of unsold new homes declined and the inventory of unsold homes fell in March. These positive figures are far from overwhelming, and the negatives continue to outweigh them, but at least there is finally something good to say about the nation's housing sector.

The motor vehicle sector, along with the entire manufacturing sector, remains in dire straights. Reduced motor vehicle activity alone shaved nearly 1.4 percentage points off of GDP growth in the first quarter of 2009. More generally, U.S. industrial production fell 2.2 percent in 2008, but the first quarter loss in the current year was 19.1 percent. Manufacturing jobs were down 3.3 percent in 2008, accelerating to a 17.4 percent loss in the first quarter of 2009. Surprisingly, job losses in the nation's transportation equipment sector (15.4 percent) were marginally better than the losses for the manufacturing sector as a whole.

Overall nonfarm employment dipped 0.4 percent last year. But like numerous other measures of economic activity, conditions worsened in the first quarter of 2009, with jobs falling 5.7 percent. Weekly initial claims for unemployment insurance remain well above 600,000 draining state unemployment insurance trust funds across the country. The national unemployment rate continues to drift upward, yielding an 8.1 percent rate for the first quarter of 2009, compared to 5.8 percent for 2008. The March unemployment rate was 8.5 percent, four percentage points above the rate that prevailed in February. Significant numbers of American workers are on short-term furlough and reduced hours. The broader measure of underemployment plus unemployment was 15.8 percent in March.

Figure 1 shows the situation for the labor market across the states. For the year-over-year period March 2008 to March 2009, the nation lost jobs at a 3.5 percent pace. The corridor from Florida to the upper Midwest—which includes a large concentration of employment in the transportation equipment sector—has performed worse than the nation as a whole. The same is true of many western states that saw the housing bubble grow and then pop. Only four states in the country were able to engineer gains in employment over the period shown.

Interest rates have fallen significantly in the face of aggressive action by the Federal Reserve and Treasury. Thirty-year fixed mortgage rates are now under 5 percent encouraging refinancings and ultimately offering the impetus for additional home sales. The 3-month London Interbank Offer Rate (LIBOR) is now under 2 percent. Together these pose growing evidence of an appreciable thaw in lending markets.

Inflation has eased in light of falling energy and food prices, but other prices have remained sticky. Consumer prices actually fell 8.3 percent in the fourth quarter of 2008 and fell an additional 2.3 percent in the first quarter of 2009 (seasonally-adjusted rates). But so far the economy has been spared widespread deflation.

American Recovery and Reinvestment Act of 2009

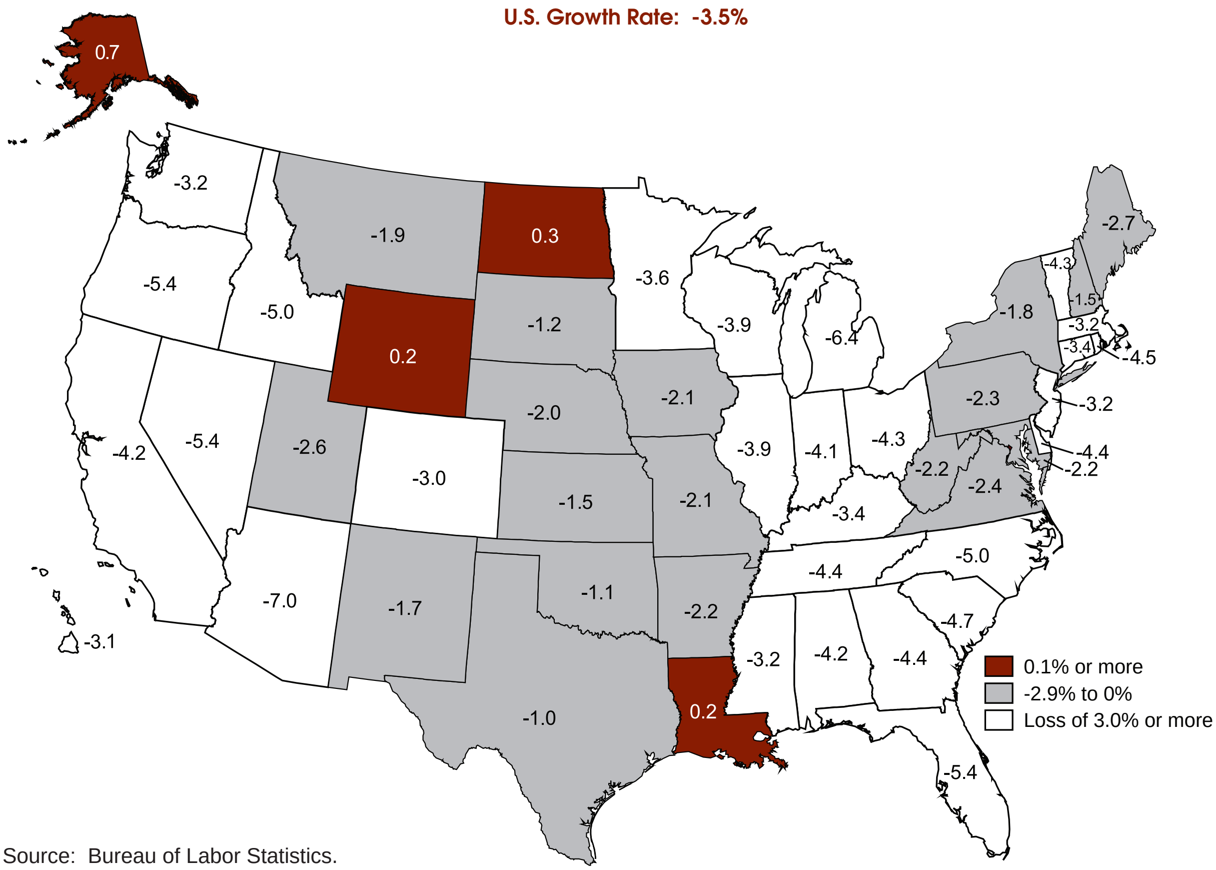
The financial market crisis and economic downturn have challenged policymakers to devise and implement policies that can stem the loss of GDP and employment in the short run, while at the same time laying a good foundation for long-term economic growth. There is little modern precedent for the magnitude and scope of problems confronting the economy today, so it should be no surprise that the policy proposals and actions have received sharp criticism from the public, press and politicians. The Treasury, Federal Reserve, former and current Congress, and former and current President have all taken aggressive steps to lessen the severity of the recession. The Federal Reserve has continued its unprecedented efforts by keeping the discount window open to banks and non-bank financial institutions and maintaining a federal funds target rate of 0-0.25 percent.[1] The Treasury continues to work to unfreeze the credit markets using the much-discussed Troubled Asset Relief Program (TARP), along with other less-publicized actions like the Term Asset-Backed Securities Loan Facility (TALF) targeted to consumers and small businesses.

Congress and President Obama worked to pass the American Recovery and Reinvestment Act of 2009, which was designed to spend government dollars quickly in an effort to forestall an outright collapse of the domestic economy. Of the nearly $800 billion in spending outlined in the stimulus package, a little more than $200 billion has been allocated to state governments. In many ways, states are better suited to spend money quickly and efficiently than the federal government.

[1] For additional discussion, see *An Economic Report to the Governor of the State of Tennessee, 2009*, Center for Business and Economic Research, The University of Tennessee.

Figure 1: Nonfarm Employment Growth, March 2008 to March 2009

U.S. Growth Rate: -3.5%



Source: Bureau of Labor Statistics.

They administer the large social service programs such as Medicaid and operate transportation infrastructure improvement programs.

Particularly in the face of immediate budget cuts, states are able to respond quickly and spend sizeable amounts of money that have been received from the federal government. Because states cannot run deficits to fund ongoing spending, the alternative to federal stimulus would have been additional spending cuts and tax increases, actions that would have aggravated the severity of the recession, much in the same way state and local fiscal policy aggravated the depth of the Great Depression. Stimulus money is critical in helping states bridge budget gaps to avoid this perverse outcome, but at the cost of significantly higher federal deficits.

The size of fiscal stimulus grants to the states varies widely, between 4.3 and 24.4 percent of general fund spending.[2] Although the money comes with restrictive requirements for expenditures, in the short run it will undoubtedly help states mitigate layoffs and the reduction or elimination of critical social services. For instance, a significant portion of the funds is directed at increasing every state's Medicaid matching rate. While this will directly increase the dollars available to maintain Medicaid programs, it will also free up general fund dollars to maintain expenditures in non-Medicaid programs that would otherwise face deep cuts. In addition, states have received funds that are specifically designated to restore K-12 and higher education funding to FY 2008 levels.

The stimulus does present some problems for the states, as it will simply delay tough budget choices that must be made. The funds last for two years, at which time states will again be on their own despite significant pessimism among economists that growth will take state economies and budgets back to their pre-recession levels. Even under an optimistic scenario of recovery, revenue may not increase sharply enough to replace stimulus funds once they are exhausted. According to a report by the Rockefeller Institute of Government, if the current fiscal crisis is longer but milder than the recession of 2001, states would still face budget gaps of $70 billion or more.[3] Furthermore, as the federal government looks for ways to deal with the enormous deficits precipitated by this recession, states will likely be saddled with more mandates and less federal aid to fund them. For many states, current tax portfolios will be insufficient to meet post-recession budget demands. This will in turn place additional pressure on local government finances as one might expect increased mandates and lower grants from the states.

Tennessee will receive more than $4 billion in stimulus funds, most of which will be used to prevent or delay cuts in key programs such as K-12 education and TennCare. In addition, the stimulus provides $644 million for transportation infrastructure, almost $500 million for food stamp benefits and other nutrition programs, $180 million for energy efficiency programs, $90 million for environmental programs, $200 million for housing programs, and $55 million for law enforcement and community services.[4] Governor Bredesen has said that while the money will allow time for agencies to adapt to smaller budgets, it will not prevent deep cuts over the next four years.[5] CBER economic and revenue projections indicate tax revenues in Tennessee will rise above their pre-recession levels by the time stimulus funds are exhausted. However, the additional tax revenue will be modest.

U.S. Forecast Summary

The rate of decline in GDP will ease in the second and third quarters, and by the fourth quarter the economy will once again be expanding. But for the year as a whole GDP will be down 3.4 percent. Annual growth in GDP should tally 1.4 percent in 2010. As shown in Figure 2, it will be 2011 before the level of output for the national economy matches its pre-recession peak.

[2] Grants as a percentage of estimated general funding spending, fiscal years 2009–2011. From *State Policy Reports* Volume 27, Issue 3. Federal Funds Information for States.

[3] Boyd, Donald J., *What Will Happen to State Budgets When the Money Runs Out?* February 19, 2009. The Nelson A. Rockefeller Institute of Government.

[4] American Recovery and Reinvestment Act (ARRA): TN.gov; http://www.tnrecovery.gov.

[5] Governor's Budget Address, March 23, 2009.

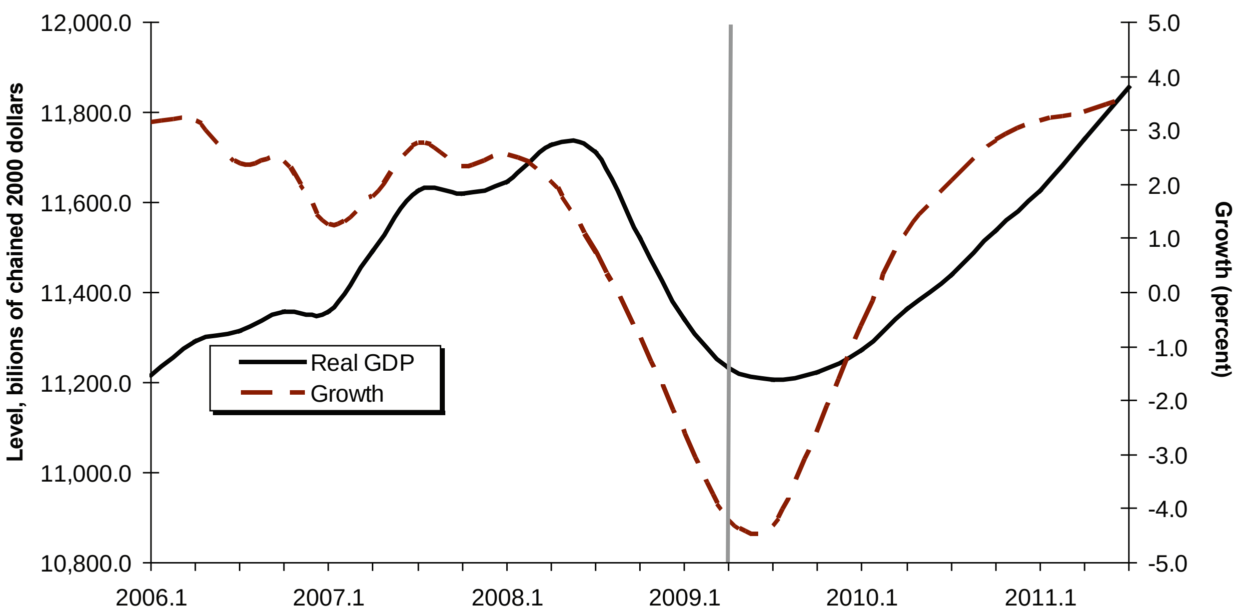
The rebound will be buoyed by the fiscal stimulus package, direct federal government spending, consumer spending and a return to growth in the housing sector. Exports will offer additional help as 2010 unfolds, as will nonresidential fixed investment. But exports will be down 15.3 percent in 2009 while nonresidential investment will fall 18.8 percent for the year. Housing starts will trend upward in the years ahead, after bottoming out in the second quarter of 2009. But it will be many years before the level of starts returns to its pre-recession peak. By 2011, housing starts will have broken the 1 million mark. For perspective, housing starts totaled 2.1 million in 2005.

Employment growth will lag behind the expansion in output as the economy will find itself with significant excess capacity in the commercial and manufacturing sectors. (Investment in manufacturing capacity will be negative through 2011 while commercial investment will remain in the red through 2010.) And businesses will be reluctant to bring large numbers of workers back on to the payroll given the uncertainty that characterizes the economy's outlook. The result will be weak employment growth, a rising unemployment rate and sharp growth in labor productivity once output begins to expand again.

Figure 3 shows the outlook for employment into 2011. On an annual basis, nonfarm jobs for the national economy will fall 3.6 percent this year and fall an additional 0.8 percent next year. On a quarterly basis, employment growth will not turn positive until the second quarter of 2010. The number of jobs in the national economy in 2011 will fall short of the level that prevailed in 2008. The anemic job market will translate into a rising unemployment rate through the third quarter of 2010. The unemployment rate should average 9.1 percent in 2009 and 10.2 percent in 2010.

The inflation outlook hinges on the speed of the recovery and the policy actions taken by the Federal Reserve. Trillions of dollars will have been injected into the economy as part of the monetary and fiscal stimulus initiatives, including the Federal Reserve's monetization of debt, i.e., the purchase of federal government bonds. Given the gap between actual and potential GDP, this has not proven to be a problem to date. Expect the Federal Reserve to act quickly to drain liquidity from the financial system when growth re-emerges.

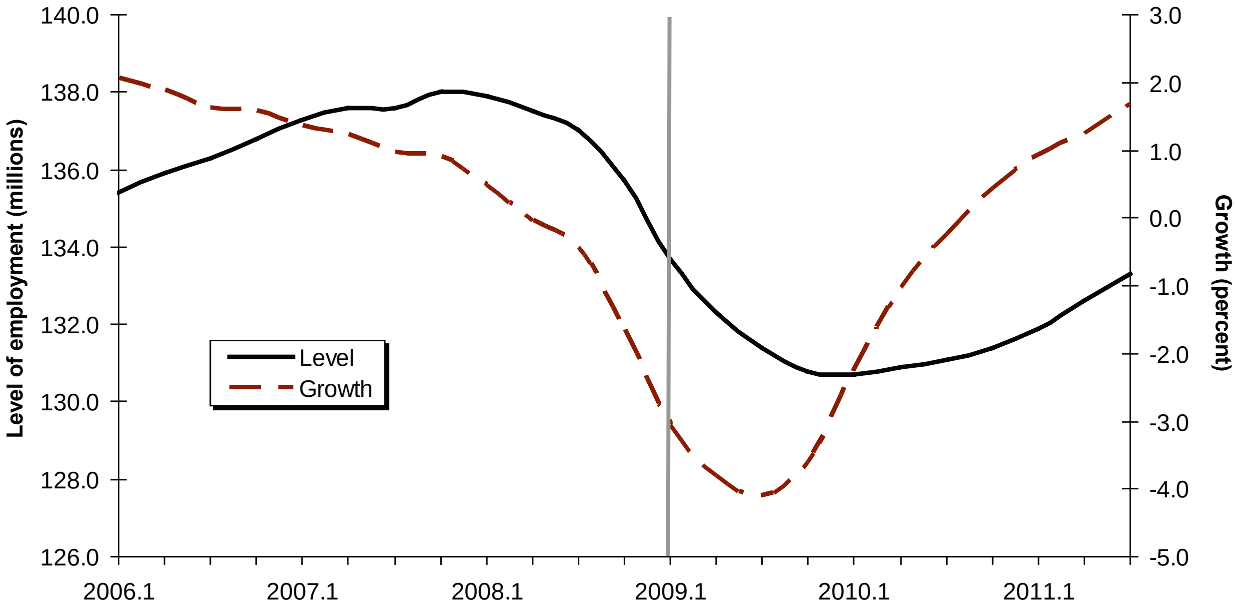
Figure 2: Real GDP



Source: Bureau of Economic Analysis and IHS Global Insight, Inc.

Inflation, as measured by the consumer price index, will actually slip 1.4 percent this year before rebounding with a 1.6 percent gain next year. The GPD deflator will show greater stability with a 1.5 percent gain in 2009 and a 1.0 percent gain in 2010. Oil prices are expected to drift upward in the quarters ahead putting pressure on wholesale and consumer prices. But oil prices will remain well below $100 per barrel over the short-term forecast horizon.

Figure 3: United States Nonfarm Employment



Source: Bureau of Labor Statistics and IHS Global Insight, Inc.

Tennessee Forecast

Current Economic Conditions

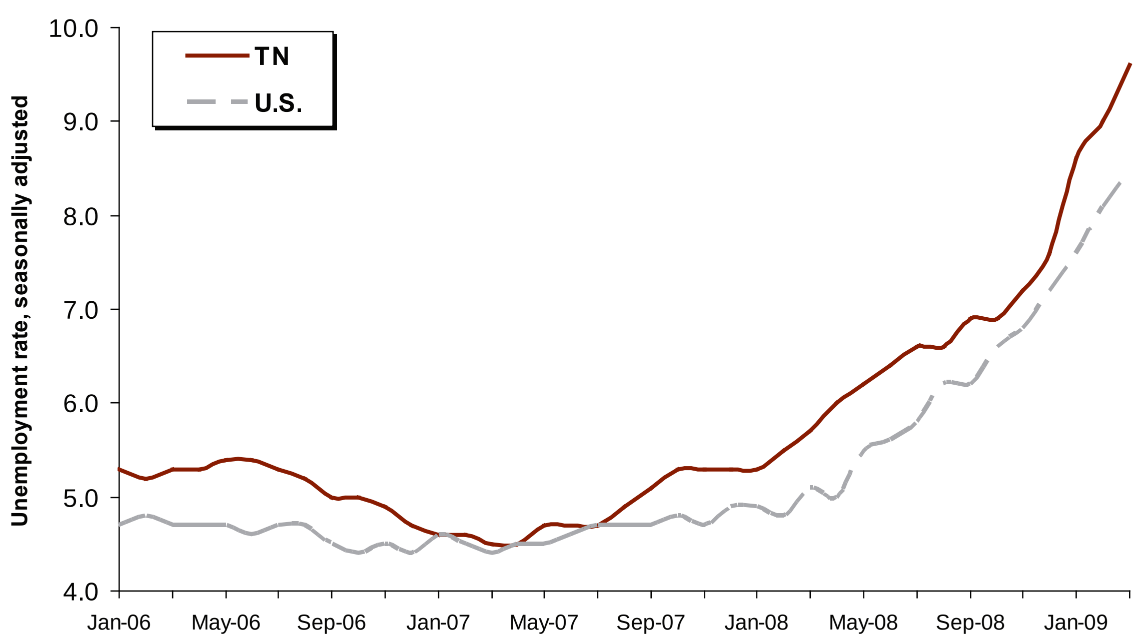
Economic conditions in Tennessee have deteriorated sharply since the first of the year. Following nonfarm job losses of 3.8 percent in the fourth quarter of 2008, jobs plummeted 6.7 percent in the first quarter of 2009. The job losses have been broadly based, affecting most sectors of the state economy. The only exceptions in 2008 were information services, education and health services and government. In the first quarter of 2009, only education and health services and local government were able to engineer job gains.

Manufacturing has fared worse than other sectors of the state economy as industrial production has contracted. For the year as a whole, manufacturing jobs fell 4.8 percent in 2008. Unfortunately that was the good news: job losses in the first quarter of 2009 came in at 18.3 percent. The only subsector of manufacturing to see job gains last year was chemicals where jobs were up 1.9 percent. The overall nondurable goods sector suffered a 2.1 percent loss while durable goods saw jobs fade at a 6.4 percent pace in 2008. The biggest losers in 2008 were wood products (down 10.8 percent), furniture (down 9.7 percent) and transportation equipment (down 8.3 percent).

The state and national unemployment rates began drifting upward in the spring of 2007 as shown in Figure 4. Rate increases accelerated in the spring of last year, and another surge can be seen in late 2008. By March of 2009, the state rate had reached 9.6 percent, well ahead of the 8.5 percent national unemployment rate. The "insured unemployment rate"—that is, the share of the total labor force that is unemployed but covered by the unemployment insurance system—was about 4.3 percent in March, indicating that significant numbers of unemployed Tennesseans have not seen their incomes partially replenished by unemployment insurance compensation.

Unemployment rates for Tennessee counties are illustrated in Figure 5 for March of 2009. Every county in the state had a higher unemployment rate in March of this year relative to the prior year. The biggest change was in Perry County where the unemployment rate spiked 12.4 percentage points to reach 24.1 percent. Only 22 counties have unemployment rates below the 10 percent threshold.

Figure 4: Tennessee and U.S. Monthly Unemployment Rate, January 2006 to March 2009



Source: Bureau of Labor Statistics.

The obvious culprit behind the rising unemployment rate is the pervasive wave of job losses. Figure 6 shows that initial claims for unemployment insurance did not become a clear and consistent problem until fall of last year. The largest jump in weekly claims did not occur until the weeks of January 10 and January 17 of 2009, with claims up 30,753 and 22,515. These are the largest increases of the current business cycle. Continued claims did not surpass 100,000 until the week of January 10, 2009 (112,174 claims); claims have been sustained above 100,000 since early January. One implication of rising claims is shown in Figure 6, with benefit payouts skyrocketing. This is the pattern that is putting the state's unemployment trust fund at risk.

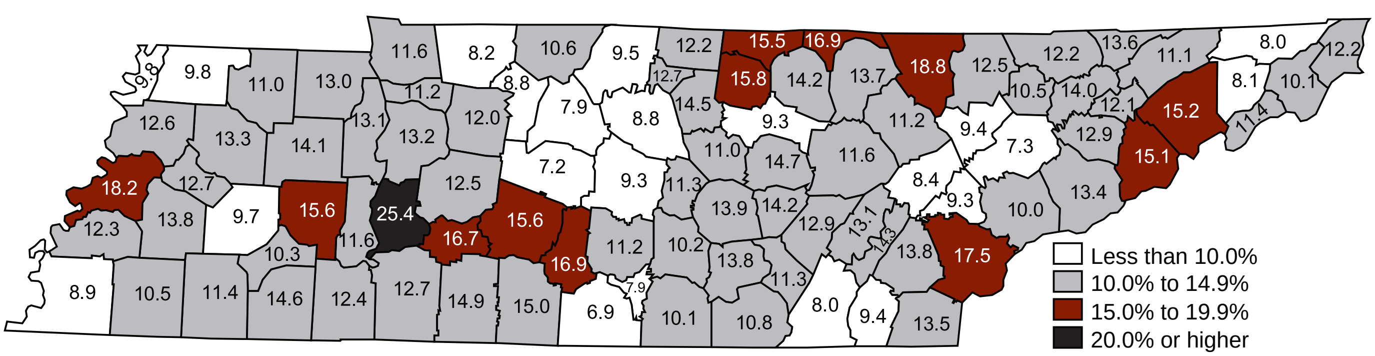
Personal income growth slowed over the course of 2008, culminating in nominal income growth of only 3.9 percent, slightly ahead of the 3.8 percent rate of growth for the national economy. (Tennessee personal income advanced 5.2 percent in 2007 versus a 6.1 percent rate of growth for the nation.) Income growth in 2008 was the slowest since 2003 when income also grew at a 3.9 percent pace. The first quarter of 2009 is likely to show a 1.6 percent decline in personal income. Wage and salary income has been hurt by the erosion of the state's job base as well as lower growth in the average wage. Proprietors' income was able to eke out a 0.5 percent gain last year, while rent, interest and dividend income grew 3. 6 percent, well below the 9.4 percent growth rate registered in 2007. Transfer payments, on the other hand, were up sharply at a 9.1 percent rate.

Taxable sales have been battered by the recession. Following growth of 4.1 percent in 2007, taxable sales contracted at a 2.2 percent clip in 2008. Especially discouraging is the trend established in the last two quarters of the year, with seasonally-adjusted sales falling 10.3 percent in the third quarter and 18.1 percent in the fourth quarter. The 11.9 percent collapse in sales in the first quarter of 2009 certainly offered no relief. The first quarter saw automobile dealer sales plummet 30.2 percent—improvement over the 45.9 percent setback in the previous quarter. Purchases from manufacturers fell 24.8 percent, miscellaneous durable goods were off 24.8 percent and miscellaneous nondurable goods dropped 19.9 percent.

The falloff in taxable sales has had a dramatic effect on the budget of the state and the budgets of local governments across the state. Figure 7 shows year-over-year growth in total tax collections and sales tax collections through March of 2009. The most recent 5 months have year-over-year sales tax collections falling 7.6 percent, 10.3 percent, 6.9 percent, 7.9 percent and 8.9 percent. For March alone, year-over-year sales tax collections were off by nearly $46 million.

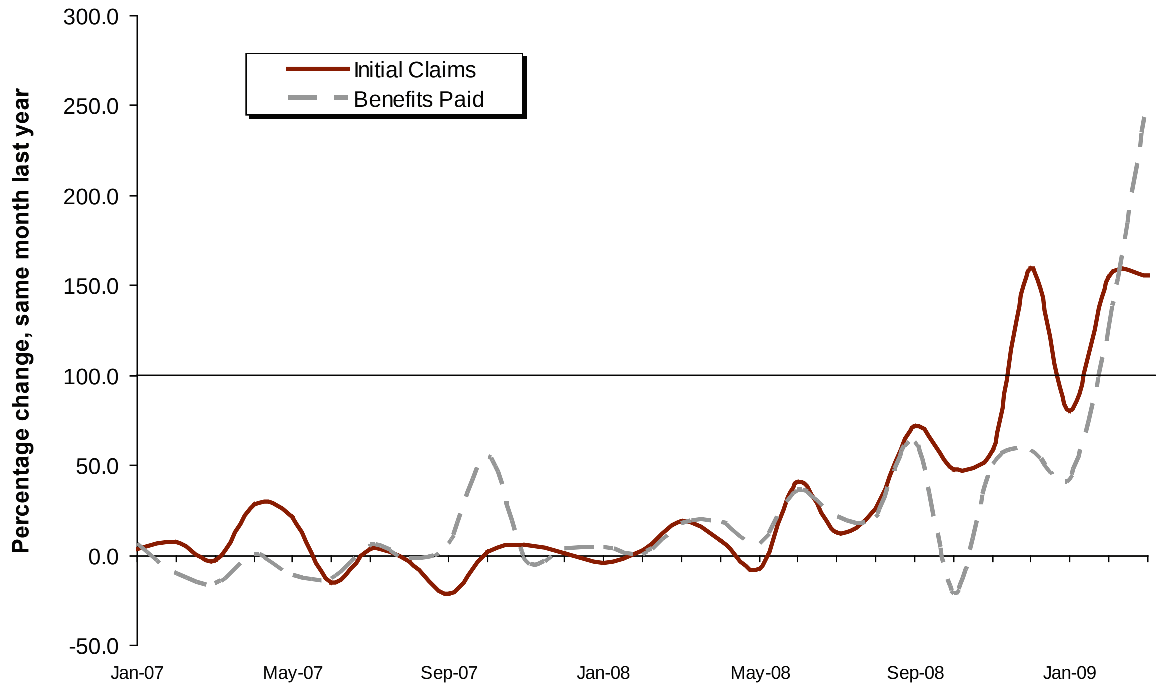
continued on page 10

Figure 5: County Unemployment Rate, March 2009



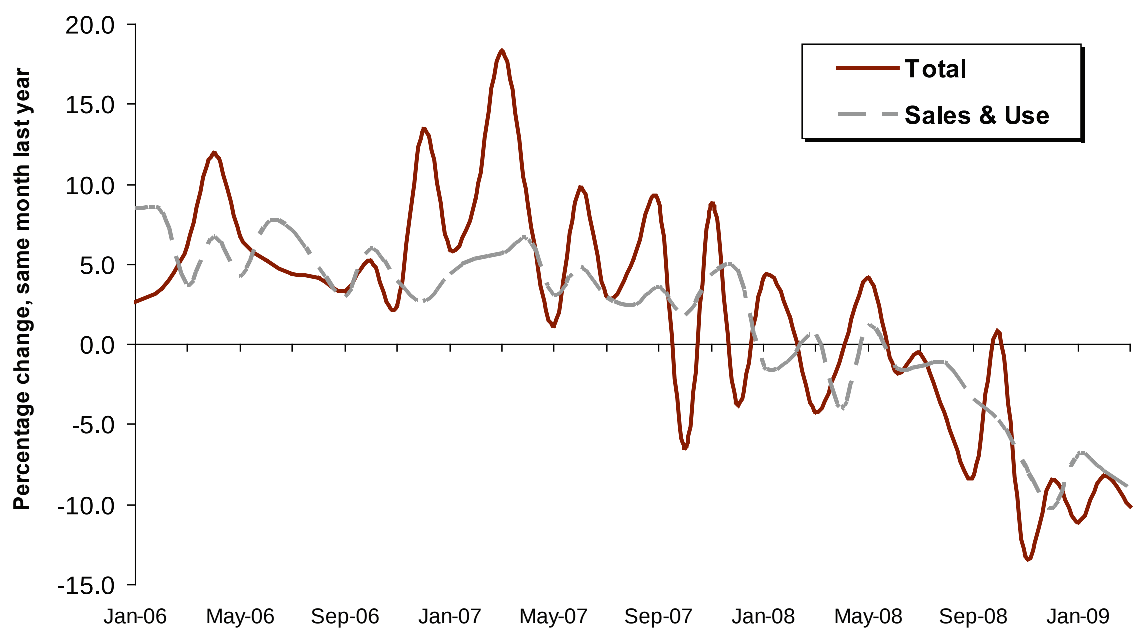
Source: Bureau of Labor Statistics.

Figure 6: Tennessee Initial Unemployment Insurance Claims and Benefits Paid



Source: Bureau of Labor Statistics.

Figure 7: Tennessee Tax Collections, Total and Sales & Use, January 2006 to March 2009



Source: Tennessee Department of Revenue, *Revenue Collections*, monthly.

Tennessee Forecast Summary

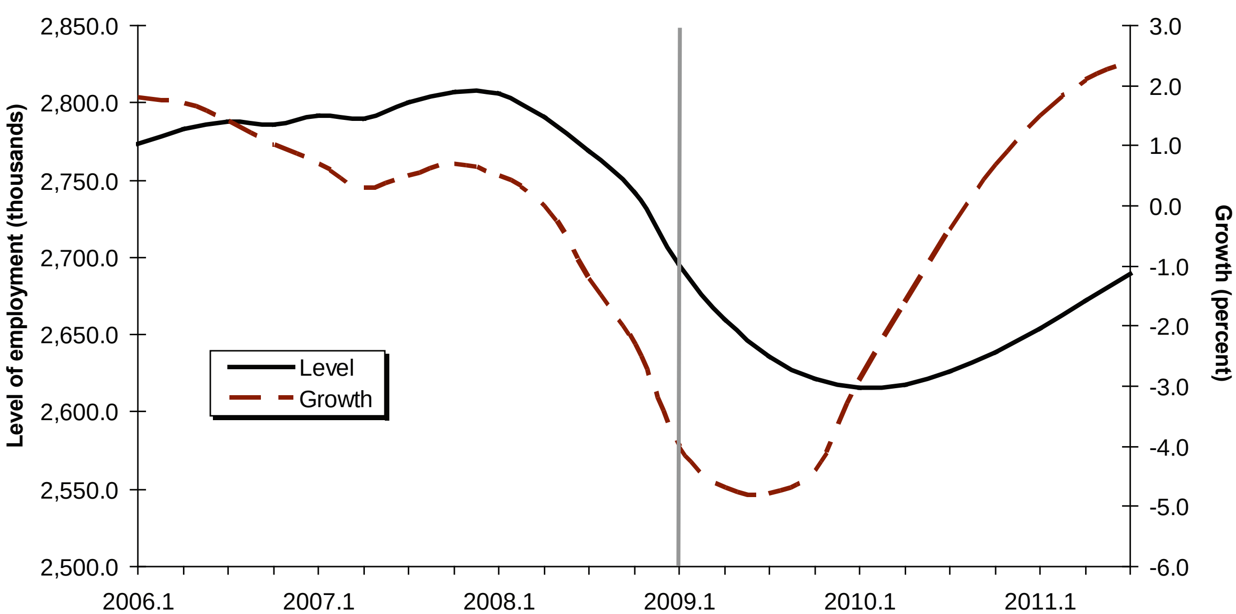
Tennessee's economic fate is in hands of the national economy. With U.S. economic growth expected to re-emerge in the second half of the year, Tennessee should find itself on a path of recovery before year's end. The fundamental caution is that while there are some signs that the recession is starting to ease, there are still no broad-based signals of an outright turnaround in economic activity. This is likely to be the pattern in the weeks and months ahead. But slowly and surely, the positives will begin to outweigh the negatives, the economy will find its trough, and the economy will begin to grow again.

The employment trough for Tennessee will be delayed into 2010, as will be the case for the national economy. As shown in Figure 8, the rate of job decay will slow through the first quarter of 2010. The second quarter of 2010 is expected to be the first quarter of positive job growth since the fourth quarter of 2007. Nonfarm jobs are projected to decline by 4.5 percent this year, and decline a further 1.1 percent next year. Figure 8 indicates that by the close of the short-term forecast window (the third quarter of 2011), nonfarm jobs still will be well below their pre-recession peak. This is 16,500 fewer jobs than prevailed as far back as 2004.

The only sectors of the state economy that will not suffer job losses in 2009 are education and health services and government. Manufacturing will be down 12.5 percent, with employment in durable goods falling 14.6 percent and employment in nondurable goods falling 9.2 percent. Within the durable goods sector, setbacks in excess of 20 percent will take place in wood products, transportation equipment and furniture. The only subsectors within durable goods manufacturing that will avoid double-digit jobs losses are machinery and miscellaneous durable goods. The situation in nondurable goods manufacturing is only marginally less painful. Textile mills, printing and related products, plastics and rubber, and miscellaneous nondurable goods will all suffer double-digit job losses.

Durable goods manufacturing is expected to engineer only a slight turnaround in the employment outlook by the third quarter of 2010, while jobs in nondurable goods manufacturing are expected to continue to contract throughout the forecast horizon.

Figure 8: Tennessee Nonfarm Employment



Source: Bureau of Labor Statistics and UT-CBER.

All of this is especially discouraging for rural communities in Tennessee which rely disproportionately on manufacturing jobs relative to the more diversified metropolitan counties of the state.

Employment in trade, transportation and utilities is expected to decline 4.9 percent this year. Jobs in information will fall 6.7 percent, financial activities will be down 6.1 percent, professional and business services will be off 5.0 percent and leisure and hospitality services will slip 2.5 percent. The only good news on the job front is the 2.8 percent gain anticipated for education and health services and the 0.5 percent gain expected in the government sector.

The number of unemployed people should continue to grow well into 2010 while the labor force will contract in the face of bleak job prospects. Expect the state unemployment rate to average at least 10 percent this year, compared to a 9.1 percent rate for the nation. The state unemployment rate will peak at 10.5 percent in the fourth quarter of 2009 and remain at this level through the second quarter of next year. The unemployment rate for 2010 will likely average 10.4 percent. The last time the state unemployment rate rose above 10 percent was 1983.

Nominal personal income should advance only 0.2 percent this year, improving to 1.7 percent growth in 2010. The U.S. will also see income growth of 0.2 percent this year, with slightly stronger growth of 1.8 percent surfacing next year. On a fiscal year basis, expect Tennessee's nominal personal income to be up 1.8 percent in 2008/09 and to grow 0.4 percent in 2009/10.

Wage and salary income will slip 2.5 percent in 2009 under the weight of jobs losses and weaker growth in the average wage. Proprietors' income will contract by 2.7 percent, while rent, interest and dividend income will decline by 5.6 percent. Transfer payments will surge by 12.6 percent, up from the 9.1 percent rate of growth recorded last year.

Taxable sales should show improvement over the quarters ahead, but year-over-year losses will be sustained throughout 2009. For the year as a whole, sales will be down 8.1 percent, while growth in 2010 will tally 3.5 percent. On a fiscal year basis, taxable sales will fall 7.7 percent in 2008/09 and fall 1.9 percent in 2009/10.

Other than slow improvement in the trajectory of taxable sales, there is little good news in the detail of the short-term forecast. The only sectors expected to see growth this calendar year are liquor stores and food stores. Automobile dealer sales will be off 23.4 percent in 2009, but by the first quarter of 2010 year-over-year sales will return to the black. Purchases from manufacturers and miscellaneous durable goods sales will tumble 16.6 percent and 16.9 percent for the year.