ECRI
ECONOMIC CYCLE RESEARCH INSTITUTE

May 2004
Vol. IX, No. 5
Founded by Geoffrey H. Moore

U.S. CYCLICAL OUTLOOK

BROAD MODERATION IN U.S. GROWTH LIKELY

Deceleration Ahead
U.S. economic growth has accelerated significantly since the end of the Iraq war last spring, although payroll job growth languished for months even as GDP growth soared, as anticipated by an array of leading indexes (Vol. VIII, No. 6, June 2003). Lately, in line with our subsequent prediction (Vol. IX, No. 1, January 2004), job growth has clearly picked up.

We are now on the cusp of a transition from this acceleration phase of the economic recovery to the deceleration phase, during which the economy's rate of growth will ease while remaining healthy for the time being. That is the clear message from the growth rates of the U.S. Long Leading Index (USLLI), which peaked last June; the Weekly Leading Index, the U.S. Short Leading Index, as well as the leading services, manufacturing and construction indexes, all of which peaked between November and January; and the Leading Employment Index, which peaked in February.

Economic growth is set to ease, as is the pace of job growth.

Judging by the evidence cited above, economic growth is set to ease not just in the aggregate, but broadly across sectors, in services, manufacturing and construction. In the wake of that downswing in the economy's rate of growth, job growth is also likely to ease.

This does not imply that the economy is about to downshift below its long-term average pace of growth, marking a serious slowdown. What it does suggest is some moderation in the pace of the recovery. While it is still a little early to arrive at a firm conclusion, it also appears that job growth may soon slacken somewhat from its recent pace.

Paul Samuelson's quip that the stock market has predicted nine out of the last five recessions may contain some truth, but it does scant justice to the tight relationship between cycles in economic growth and stock price cycles. As we have pointed out before, there is virtually a one-to-one relationship between stock price cycles and growth rate cycles in the U.S. economy, which are alternating periods of rising and falling rates of growth. Virtually every cyclical downswing in stock prices has been followed by a downturn in the economy's rate of growth.

We know that stock prices are a short leading indicator of the economy, while the USLLI, which excludes stock prices, is a long leading indicator. In other words, the USLLI tends to move ahead of stock prices, and ahead of other leading indexes, in anticipating the economy's growth rate downturns. In that context, the past year has seen a classic pattern in the movements of these indicators, with USLLI growth peaking first, back in June, the other ECRI leading index growth rates peaking about six months later, and stock prices peaking in February.

This leaves little doubt that U.S. economic growth will also peak in the near term, and that the latest downturn in stock prices is underpinned by the economic fundamentals. By the same token, until USLLI growth turns up, it is unlikely that stock prices will begin to reverse the pullback they have seen over the last few months.

The Impact of Rising Oil Prices
Crude oil prices recently surpassed the highs set in 2000, as well as their 1990 highs. We pointed out back in 2000 (*International Cyclical Outlook*, Vol. V, No. 9, September

Continued...

IN THIS ISSUE

***Future Inflation Gauge**: Dipped in April, but inflation pressures have still risen significantly so far this year.*
***Leading Home Price Index:** Rose in April, suggesting that home prices will keep rising for now.*
***Leading Employment Index**: Growth fell further, suggesting that job growth will moderate in the foreseeable future.*
***Long Leading Index**: Growth rate edged up while staying well below last June's high, indicating that economic growth will moderate.*
***Short Leading Index**: Growth fell further, pointing to a near-term moderation in growth.*
***Leading Services Index**: Growth edged up while staying below January's 20-year high, suggesting that service sector growth will moderate while remaining healthy.*
***Leading Financial Services Index**: Growth dipped slightly while staying robust, pointing to healthy growth ahead for the financial sector.*
***Leading Manufacturing Index**: Growth fell well below February's 20-year high while remaining strong, pointing to the possibility of slowing manufacturing growth on the horizon.*
***Leading Construction Index**: Growth fell further, suggesting that construction sector growth will ease further in the months ahead.*

Focus:
Oil, Gold and Inflation
pages 3 to 4

GROWTH WILL MODERATE, BUT RECOVERY REMAINS RESILIENT

...Continued from Page 1

2000) that the oil price shock at the time was capable of tipping the economy into a new recession – just as it had in 1990 – unless short rates were quickly lowered. Unfortunately, it took four months for the Fed to start cutting interest rates.

Many analysts eager to dismiss the danger to the economy from high oil prices have noted that while oil prices may be at record highs in nominal terms, they are far below the levels reached in the early 1980s in real, or inflation-adjusted, terms. Another argument advanced by such observers is that the U.S. economy is now far more energy-efficient than it was two or three decades ago, and is thus not as vulnerable to high oil prices. The problem with these arguments is that while they may be true, they were also valid in 2000, when they helped trigger a recession.

The real issue is different, and has to do mostly with its impact on consumer spending. This is captured by the so-called Katona effect (*International Cyclical Outlook*, Vol. III, No. 9, September 1998), named after the late George Katona of the University of Michigan, who postulated that the timing of consumer spending was linked to price level volatility. This view was based on what he had heard in his consumer surveys: when consumers encountered an unexpected jump in prices, consumption fell and savings increased.

Also, a rapid pickup in the CPI – especially if it arises from higher food or energy prices, like now – causes diminished discretionary spending. That is because a bigger part of the consumer's budget is going to nondiscretionary expenses. As a result, deferrable discretionary spending suffers, ultimately depressing overall spending.

If we proxy the component of inflation that surprises consumers by a 12-month moving standard deviation of the CPI (price level), there is a close fit (Chart 1) between the pace of consumer spending and the volatility in the price level (inverted). In fact, this measure of price volatility tends to anticipate cyclical turns in consumer spending growth, with an average lead of two months.

As the chart shows, price volatility rose to a nine-year high in 2000, plunged in 2001, spiked up again in 2002-03, but came down subsequently before starting to rise very recently. It is a matter of concern that the latest rise in price level volatility is driven by higher food and energy prices. Even so, the rise in prices has so far been relatively modest, as has the dip in the pace of consumer spending. Thus, unless there is a much larger rise in CPI inflation driven by rising oil prices, they do not pose much of a threat to consumer spending.

Inflation Concerns

The question, then, is whether inflation is likely to spike up in the near term. While an oil price spike driven by a supply disruption cannot be ruled out, the upturn in ECRI's Future Inflation Gauge (USFIG) since late 2003 does not, thus far, point to a major upsurge in inflation. As we discuss later (pages 3 to 4), it is more likely that oil price inflation will ease in the near future if there are no unexpected supply shocks.

In fact, the USFIG actually dropped in April. It is too soon to tell whether this is the beginning of a new downturn in inflation pressures after a brief upturn, but that is possible, given the downturns in ECRI's leading indexes of economic growth and employment already mentioned. If so, there would be a lower risk of a sharp rise in inflation or in price level volatility in the near future.

The more important point is that even if there were to be an unexpected shock, the clear uptrends in ECRI's leading indexes of economic growth and employment suggest that the economy is not currently susceptible to such shocks. This is because the U.S. economy is now in a phase of the recovery when the window of vulnerability that had opened up early last year has slammed shut. Until it opens up again due to significant cyclical declines in the leading indexes, external shocks, including oil shocks, are unlikely to derail the expansion.

In sum, the economy is likely to see a broad moderation in economic growth and employment in the coming months. However, it is unlikely to be tipped over into a recession, except by the most massive of shocks.

Chart 1: The Katona Effect and U.S. Consumer Spending