

U.S. CYCLICAL OUTLOOK

INFLATION PRESSURES EASE

Growth to Moderate

After many months on virtual autopilot, the Federal Reserve has signaled that its actions will now be more data-driven. Since the Fed's actions are known to influence the economy with long lags, the data that drive the Fed's upcoming moves should presumably be forward-looking. Thus, ECRI's leading indexes of economic growth and inflation are especially relevant at this juncture.

After recovering from the lows of last fall until early this year, the growth rates of ECRI's U.S. Long Leading Index, Weekly Leading Index and U.S. Short Leading Index of the overall economy have all come off their recent highs. This is also true of the sectoral leading indexes for services, manufacturing and construction, even though the growth rates of the coincident indexes for those sectors have all improved since last fall. In fact, the growth rate of the coincident index for services is at its highest level in seven months, while growth in the coincident index for manufacturing remains around its best reading in more than a year.

While paying lip service to forward-looking indicators, in practice many financial market economists make little distinction among leading and coincident indicators. This may be because their econometric models are generally trend-following in nature, and possibly due to insufficient knowledge about whether specific indicators are actually leading, lagging or coincident at cyclical turning points.

*U.S. inflation pressures
have begun to recede.*

Thus, the recent improvements in coincident indicators of economic growth, containing little information about upcoming cyclical turns, nevertheless buoyed market confidence in economic growth prospects, and even stoked some inflation fears. Yet the message from ECRI's array of leading indexes of economic growth is clear and consistent. U.S. growth will remain healthy for now, but should begin to moderate in the coming months.

Part of the reason for the expected moderation in growth, as we discuss later ([pages 3 to 4](#)), is that growth in existing home prices has already turned down, and a cyclical downturn in those prices is now a distinct possibility. This is likely to be followed by a slowdown in consumer spending growth due to a reduction in the wealth effect of rising home prices on homeowners, who account for five out of six consumer spending dollars.

Meanwhile, rental inflation has turned up, hurting the spending power of home renters, who are generally at the lower end of the income scale. Lacking the financial resources of homeowners, this group suffers disproportionately from the recent surge in energy prices. Thus, consumer spending growth is also likely to be hurt by a pullback in spending by this group.

Separately, ECRI's array of international leading indexes still sees a fresh global industrial slowdown on the horizon. Thus, the fall in the growth rate of ECRI's Leading Manufacturing Index to half of its October high is a notable sign, suggesting that U.S. manufacturing growth will begin to ease in the next few months. Overall, growth prospects are no longer as bright as the popular view would suggest.

Misleading Indicators of Inflation

The so-called market moving numbers play a key role in determining expectations for growth and inflation. Notwithstanding the experience of the late 1990s, when strong growth clearly did not lead to high inflation despite the absence of Fed rate hikes, the markets often infer their inflation expectations from coincident indicators of growth.

Of course, payroll job growth is widely considered to be the "granddaddy" of market moving numbers, partly because it is the first set of hard government data to be released. Judging by its immediate impact on interest rates, one would expect it to be an excellent predictor of inflation cycles. Yet, as we showed in this publication over eight years ago ([Vol. II, No. 12, December 1997](#)) and verified recently, payroll job growth is the very worst of all the

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Future Inflation Gauge: Dipped to an eight-month low in March, indicating that underlying inflation pressures have begun to recede.

Leading Home Price Index: Remained unchanged in March at a level suggesting that home prices will stay under pressure.

Leading Employment Index: Growth slipped in March, while still pointing to positive near-term job growth prospects.

Long Leading Index: Growth ticked up but stayed below January's 21-month high, hinting at some moderation in economic growth in the longer term.

Short Leading Index: Growth slipped a little, but the near-term outlook remains healthy.

Leading Services Index: Growth edged up while staying below its recent high, suggesting that service sector growth prospects have dulled slightly.

Leading Financial Services Index: Growth slipped, indicating slightly dimmer prospects for financial sector growth.

Leading Nonfinancial Services Index: Growth inched up in March while staying below earlier highs, suggesting that nonfinancial services growth will not pick up much further.

Leading Manufacturing Index: Growth dipped further below its October high, as manufacturing sector growth prospects faded a little.

Leading Construction Index: Growth remained unchanged below January's high, underscoring the lackluster prospects for construction sector growth.

Focus:

Housing Under Pressure
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INTERNATIONAL PRESSURES RAISING INTEREST RATES

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market moving numbers in terms of its tendency to cry wolf about inflation cycle turns, which happens almost a third of the time when there is a cyclical turn in job growth. In addition, about one out of every seven inflation cycle turns is missed by this indicator.

The U.S. Future Inflation Gauge (USFIG), while not perfect, is far better as a leading indicator of inflation cycles. Historically, it has never missed an inflation cycle turn, and only one-eighth of its turns amount to false alarms. In fact, it comes out quite favorably in a head-to-head comparison with a fairly demanding benchmark.

Chart 1a (top line) shows the TIPS (Treasury Inflation Protected Securities) spread, or the spread between the yields on ten-year treasury notes and ten-year TIPS. This spread is perhaps the purest available measure of the market's inflation expectations, representing insights gleaned by the markets from all available indicators. But it is available only since 1997.

The cyclical swings in the USFIG, the middle line in Chart 1a, can be clearly related to the cyclical moves in CPI inflation (bottom line), which the USFIG leads at turning points. It is notable that the USFIG has dropped in four of the last five months, and the latest data point, released on the morning of this month's jobs report, showed it falling to an eight-month low, even as the markets interpreted the employment data to be largely inflationary.

But, as the chart shows, the correspondence between the market's inflation expectations represented by the TIPS spread and actual inflation cycles is relatively tenuous. In other words, the markets have some difficulty in predicting inflation cycles.

Separately, the belated rise in rental inflation (pages 3 to 4), affecting almost 30% of the CPI and nearly 40% of the core CPI, helped boost the latest monthly reading of core CPI. Of course, the CPI and core CPI are coincident indicators of inflation, in any case. Ironically, as we pointed out in this publication (Vol. IX, No. 3, March 2004), it was the distortionary effect of the same component

that led to needless alarm about deflation in 2003 – a conclusion that was echoed by a subsequent Atlanta Fed study. Thus, inflation worries based on stronger core CPI readings are likely to be misplaced.

International Influences

Traditionally, U.S. analysts have looked to U.S. indicators in order to divine the future direction of economic growth and inflation, which are presumed to be the major determinants of U.S. interest rates. However, in an increasingly global economy, this is a questionable proposition.

Chart 1b presents some evidence of the influence of international inflation indicators on the U.S. economy in the past decade. The top line in this chart is the G6 Future Inflation Gauge (G6FIG), which in this case represents a weighted average of ECRI's future inflation gauges for the G7 economies *excluding* the U.S. – namely, Japan, Germany, France, the U.K., Italy and Canada. The bottom line shows U.S. ten-year treasury yields.

What is interesting is that, especially in recent years, the G6FIG has led ten-year yields. In particular, the recent surge in ten-year yields has much to do with the belated realization that inflation pressures are rising abroad, especially in the Eurozone and Japan, as shown by the earlier upswing in the G6FIG.

The deflationary impact of the integration of China and India into the global economy represents a structural shift that is now widely recognized. So is their contribution to the soaring prices of precious metals and industrial commodities, including crude oil. Of course, the recent increases in the prices of oil and gold are partly due to geopolitical factors. Notably, purchases of gold coins by individuals in Iran have lifted their prices by 32% in the last two months.

While the prices of many commodities are soaring, in many cases due to supply-related issues, an upcoming global industrial slowdown could check the enthusiasm for such commodities. But, more importantly, a key lesson from our economic cycle research is that such narrow categories of indicators cannot serve as reliable predictors of inflation cycles. Rather, it is essential to cast a wide net to capture the key cyclical leading indicators of international inflation, as the G6FIG does.

In sum, U.S. growth is now poised to moderate, and underlying inflation pressures appear to be in a cyclical downswing. However, the financial markets react to far more than domestic economic indicators, making it increasingly important for observers to keep a keen eye on international economic indicators.

Chart 1a: U.S. Inflation and its Predictors

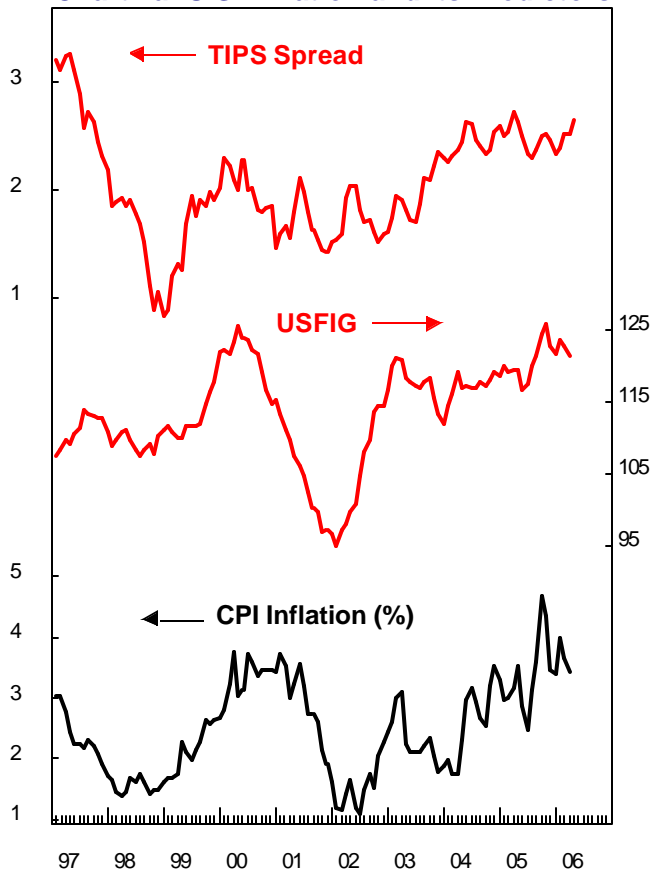


Chart 1b: International Inflation Pressures and U.S. Interest Rates

