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U.S. CYCLICAL OUTLOOK

NON-INDUSTRIAL GROWTH PROSPECTS IMPROVE

Yield Curve Signals

With U.S. economic growth easing, the treasury yield spread first tightened, and then inverted this summer. The inversion of the 10-year 3-month spread, often thought to be a harbinger of a recession, has deepened of late. In fact, that spread is about the most negative it has been since early 2001, when the economy was on the cusp of a recession.

In recent years, some have argued that the decline in long-term interest rates relative to short rates was due in part to the surge in global demand for long-dated paper, and thus no longer a good recession predictor. Be that as it may, the yield spread has not historically been as good a recession predictor as billed (*Internation Cyclical Outlook*, Vol. X, No. 8, August 2005). Thus, it did not properly invert before the 1990-91 recession, and gave a false alarm of a recession in the mid-1960s. It also failed to signal the three prior recessions.

Still, even when it gave a false alarm of a recession, an inverted yield curve correctly predicted at least a slowdown in growth. Accordingly, the deepening inversion of the yield curve today appears to assume, at the minimum, a slowdown that will induce the Federal Reserve to cut interest rates in the coming months.

While the industrial slowdown will deepen, service sector growth will pick up.

Indeed, U.S. economic growth has slowed, perhaps more than commonly acknowledged. It is possible that the dawning realization of that slowdown is contributing to the increased inversion of the yield curve. But the outlook for growth, as suggested by ECRI's forward-looking indicators, is already shifting.

A Stealth Slowdown

In earlier issues of this publication (e.g., Vol. XI, No. 2, February 2006), we had repeatedly warned of an industrial slowdown. That slowdown is now a reality, although not as obvious as it could be.

To some, it may seem that our pessimism about U.S. industrial growth was premature, at best. After all, the year-over-year, or 12-month, percent change in U.S. industrial production hit a six-year high in September. However, a closer look at the data shows a very different picture.

Most analysts routinely base their analyses on the 12-month percent change in industrial production (pale blue line, top panel, Chart 1a), which makes it look as if industrial growth is still in an accelerating trend, despite a dip in October. But, while simple, this measure is seriously flawed, as it compares the latest month's data with the reading exactly a year earlier that may be unduly distorted. In this case, such a comparison produced a highly favorable comparison with the drop in industrial production in the immediate aftermath of Hurricane Katrina, and the appearance of a continued acceleration in growth.

Because of the potential for such distortions, ECRI stopped using this measure decades ago. Rather, we use a smoothed growth rate, comparing the latest month's data with the *average* reading over the prior 12 months – a much more stable base for comparison. This smoothed growth rate (dark blue line, top panel, Chart 1a) shows that industrial production growth peaked last June, has clearly turned down in recent months, and is now at an 11-month low.

As the top panel of Chart 1a shows, the smoothed growth rate (dark blue line) reaches a peak or trough either before, or at the same time as, the corresponding peak or trough in the 12-month percent change measure. It is therefore a better indicator to track the economy's cyclical swings.

Since industrial production is a coincident indicator, and its smoothed growth rate has already turned down, the U.S. is well into an industrial slowdown, just as we had predicted early this year. The slowdown is now a fact, not a forecast, and is showing up in the 12-month change measure, as well.

The economic slowdown is also evident in other coincident indicators of the economy. But the distortions created by the 12-month change measure are particularly clear in its portrayal of personal income growth (Chart 1a, second panel, pale blue line).

Because personal income spiked up in December 2004 due to a one-time Microsoft dividend payout, the 12-month change

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Future Inflation Gauge: *Declined further, suggesting that inflation pressures are tailing off.*

Leading Home Price Index: *Rose again, but it is still too early to predict a bottom in home prices.*

Leading Employment Index: *Growth ticked up from a one-year low, but job growth prospects remained subdued.*

Long Leading Index: *Growth slipped while staying above last spring's low, suggesting that overall economic growth will remain lackluster.*

Short Leading Index: *Growth edged up from a 14-month low, but the near-term economic growth outlook is still pessimistic.*

Leading Services Index: *Growth jumped to an 18-month high in October, brightening service sector growth prospects.*

Leading Financial Services Index: *Growth improved further, revitalizing the financial services sector's growth outlook.*

Leading Nonfinancial Services Index: *Growth climbed to an 18-month high, reviving nonfinancial services growth prospects somewhat.*

Leading Manufacturing Index: *With growth dropping further to a 15-month low, manufacturing sector growth prospects turned gloomier still.*

Leading Construction Index: *Growth snapped back from a 43-month low, but it is too soon to predict an upturn in construction sector growth.*

Focus:

Can Business Investment Hold Up?
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SERVICE SECTOR GROWTH TO PICK UP

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(pale blue line) spiked down in December 2005 – a distortion not shown in the smoothed growth rate (dark blue line). Also, because personal income plunged in August 2005 due to Katrina, the favorable comparison made the 12-month change spike up in August 2006, unduly flattering personal income growth. Once again, this is a distortion not shown in the smoothed growth rate (dark blue line), which shows that personal income growth has actually been in an easing trend since last February.

The divergences are not as glaring in the case of payroll job growth (Chart 1a, third panel) but are significant, nonetheless. Specifically, while the 12-month change (pale blue line) shows job growth rising to its best reading since last March, the smoothed growth rate (dark blue line) has been moderating since its March high.

The bottom panel of Chart 1a shows the growth rate of retail sales, with nominal values being used because they are available through October. In this case, the 12-month change (pale blue line) does show a slowdown in growth, but the smoothed growth rate (dark blue line) has now plunged to a three-year low. Excluding automobiles, growth in "core" retail sales (not shown) displays an even starker divergence, with the smoothed growth rate plunging to its worst reading since the 2001 recession.

The coincident indicators shown in Chart 1a are key measures of output, income, employment and sales, which are used to determine the state of the business cycle and determine official business cycle dates. It is clear from the chart that, while the 12-month change measure may still be obscuring the reality, growth has been trending down in all four measures this year – the hallmark of an economic slowdown. It remains to be seen when it is more widely recognized.

However, growth has not slowed equally across the major sectors. Chart 1b shows the smoothed growth rates of ECRI's coincident indexes for services (top line), manufacturing (middle line) and construction (bottom line). It is obvious from the chart that the slowdown in the construction sector has been the sharpest, though not quite as brutal as in the 2001 recession. The manufacturing slowdown has been less severe, but comparable to past non-recessionary slowdowns. However, growth in the service sector has eased only slightly, less than in recent post-recessionary slowdowns.

With the service sector accounting for 83% of jobs, it is not surprising that job growth, while well below pre-recession highs, has not eased much (Chart 1a, third panel). Therefore, regardless of the growing inversion in the yield curve, the slowdown patterns seen in the service sector and employment are very far from those seen in the lead-up to the 2001 recession.

However, the indicators shown in Charts 1a and 1b are all coincident. While they display the differences among the sectors and among the key coincident indicators of the overall economy, they are not forward-looking. For insights into the future, it is necessary to examine ECRI's leading indexes.

Split Decisions

The industrial slowdown we had predicted earlier is now a reality, but it is not over. In fact, growth in the Leading Manufacturing Index continues to decline, falling to a 15-month low in October (Chart 20, page 14). Thus, the U.S. industrial slowdown is set to deepen.

Separately, growth in the Leading Services Index has turned up quite decisively, and has soared to a 21-month high (Chart 14, page 11), based on a pronounced, pervasive and persistent upturn in the index and its components. Evidently, the end of the mild service sector slowdown is already in sight.

There are also improving signs from the construction sector, where the leading index growth rate jumped in October to a six-month high (Chart 22, page 15), based on a fairly pervasive improvement in its components. While it is too early, based on a one-month uptick, to suggest that the leading index is already in an uptrend, it is certainly encouraging.

In fact, the U.S. Leading Home Price Index (Chart 5, page 7) has risen for two months, based on a reasonably pervasive improvement in its components. If the advance persists, it would point to a bottom in home prices, perhaps by late spring or early summer.

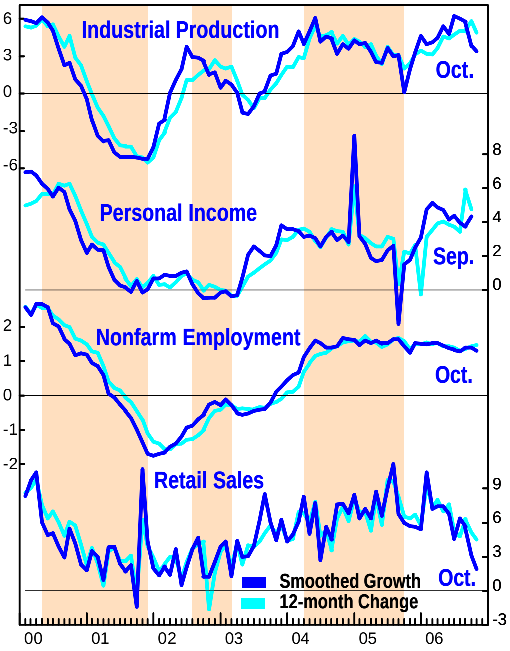
The result of these developments is likely to be a two-speed economy, with industrial growth slowing further, and the rest of the economy picking up speed. It is worth noting that we correctly foresaw a similar pattern of two-speed growth in 1998, in the wake of the Asian crisis.

Last August in this publication (Vol. XI, No. 8), we suggested that by late fall, we would be in a position to decide whether the trajectory of the slowdown was recessionary or otherwise. It now appears that a recession will be avoided next year, especially due to the probable revival in non-industrial growth.

While actual inflation has dropped, there remains some concern about lingering inflation pressures. But there is also good news on the inflation front. The decline in the U.S. Future Inflation Gauge (Chart 3, page 6), designed to measure inflation pressures, had already been pervasive and persistent, but it is finally becoming pronounced. Thus, inflation concerns should begin to fade in the coming months, clearing the way, in principle, for rate cuts.

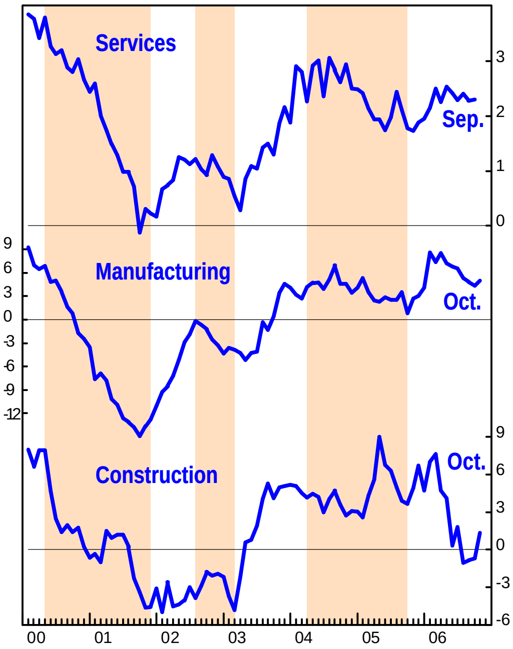
Still, a question worth pondering is whether such rate cuts will materialize if any recessionary threat fades further, as is probable. Thus, it seems we are faced with split decisions on two fronts – on divergent growth trajectories between the industrial sector and the rest of the economy, and between the near-term directions of growth and inflation.

Chart 1a: U.S. Coincident Indicators, Growth Rates (%)



Shaded areas represent U.S. growth rate cycle downturns.

Chart 1b: U.S. Coincident Indexes, Growth Rates (%)



Shaded areas represent U.S. growth rate cycle downturns.