

# Business Cycle Recovery on the Horizon

**The recession will end this year, probably by summer.**

**Green Shoots or Mirage?** At the beginning of the year in this publication ([↗Vol. XIV, No. 1, January 2009](#)), we reported "scattered hints of stabilization" in our leading indexes, but no reliable indication of a business cycle upturn ahead. Rather, we wrote that the outlook for the U.S. economy was "increasingly dire."

In February ([↗U.S. Cyclical Outlook, Vol. XIV, No. 2](#)), we found "tentative signs of stabilization in these leading indexes, which dropped off a cliff last fall." We mentioned the possibility that they may have landed on "the canyon floor – in which case a business cycle recovery may soon be at hand."

In March ([↗U.S. Cyclical Outlook, Vol. XIV, No. 3](#)), we observed that the growth rates of every one of ECRI's leading indexes of economic activity had ticked up, and that "upticks of the sizes already seen ... have always been followed by a growth rate cycle upturn." We also noted that "every (postwar) growth rate cycle upturn that began in a recession has been followed by a business cycle upturn." In the weeks that followed, the sustained advance in the growth rate of the Weekly Leading Index (WLI) made it quite clear that a U.S. growth rate cycle upturn was imminent.

This week, vindicating our view, the Fed's Beige Book reported that "five of the twelve Districts noted a moderation in the pace of decline, and several saw signs that activity in some sectors was stabilizing at a low level," suggesting that a growth rate cycle upturn is in the immediate vicinity. But does that mean that an end to the recession is also in sight? As we shall discuss, there are now genuine grounds for hope that this is indeed the case.

**Persuasive Patterns** Growth in the U.S. Long Leading Index (USLLI) turned up in November, followed in early December by a cyclical upturn in WLI growth. What does this tell us about the likely timing of the U.S. growth rate cycle upturn?

As we discuss later ([↗pages 4 to 9](#)), the historical leads of USLLI growth and WLI growth prior to U.S. growth rate cycle upturns that began during recessions are quite informative. In fact, in the case of USLLI growth, we can examine the leads and lags all the way back to 1920, thus covering not only the postwar era but also the prewar period when depressions and crises were far more common. The preponderance of the evidence, based on those historical lead times, suggests that the growth rate cycle upturn will begin this spring or by early summer, at the latest.

## In This Issue

- [↗Future Inflation Gauge:](#) Fell to a new 50-year low, indicating that inflation is still a non-issue.
- [↗Leading Home Price Index:](#) Slipped a little, while remaining above its November low.
- [↗Leading Employment Index:](#) Growth ticked up, but U.S. employment conditions are set to worsen further.
- [↗Long Leading Index:](#) Rose for the third straight month, pointing to the end of recession later this year.
- [↗Short Leading Index:](#) Growth dipped while staying above its December low, suggesting that a growth rate cycle upturn is imminent.
- [↗Leading Services Index:](#) Growth edged up, as the service sector growth outlook turned a little less gloomy.
- [↗Leading Financial Services Index:](#) Growth inched up, as the outlook for growth in the financial services sector improved slightly.
- [↗Leading Nonfinancial Services Index:](#) Growth ticked up, pointing to near-term slowing in the pace of contraction.
- [↗Leading Manufacturing Index:](#) Growth inched up for the third straight month, indicating a near-term upturn in industrial growth.
- [↗Leading Construction Index:](#) Growth slipped but stayed above November's record low, suggesting a slight improvement in construction sector growth prospects.

**FOCUS:** Equities and Economic Recoveries

This has major implications for the likely course of stock prices, because there is a virtual one-to-one correspondence between stock price cycles and growth rate cycles in the U.S. economy. Since a growth rate cycle upturn is at hand, stock prices are likely to experience a cyclical upswing, which may have already begun in early March. Given the imminence of the growth rate cycle upturn, the cyclical low for stock prices was probably reached in March; if not, its cyclical low is unlikely to be many months away.

**Cyclical upswings in leading indexes and equities. Home prices may begin to stabilize this year.**

Cyclical upswings in stock prices tend to last at least five months or so, if not longer. While stock prices never go up in a straight line, the implication is that once stock prices reach a cyclical low, they will not break that low for at least several months. Rather, they should advance significantly in the months that follow this cyclical trough.

In fact, the timing of stock price cycles fits into a highly informative sequential pattern followed by the growth rates of ECRI's U.S. leading and coincident indexes. To investigate this pattern in depth, we examine the timing of cyclical swings in USLLI growth, WLI growth and growth in the U.S. Coincident Index (USCI) starting in 1950. While data on WLI growth is not available before 1950, historical data on USLLI growth extends back to 1920, enabling us to examine the sequential patterns in earlier cycles, excluding only the WLI.

**Is this Time Different?** There are some who contend, however, that the current contraction is not like postwar recessions – in fact, some believe that the best analogy may be to the recession associated with the panic of 1907. Therefore, in order to reach back more than a century to that depression, we decided to share with our members for the first time the Index of Original Leading Indicators (IOLI), which we have never before shown to anyone outside ECRI. The IOLI, which is comprised of the original list of leading indicators of recession and recovery ([↗U.S. Cyclical Outlook, Vol. XIII, No. 7, July 2008](#)), not only has an

unrivaled 105-year history, but has been proven to work under an unmatched variety of structural conditions at different times in history and in different countries.

What we know is that over the course of more than a century of business cycles, including depressions, crises and panics stemming from a variety of root causes, cycles in ECRI's composite indexes have clearly corresponded to stock price cycles. In the prewar period, USLLI growth and IOLI growth were typically the first to turn up during recessions, followed by stock price upswings and finally by U.S. growth rate cycle upturns.

In the postwar period, USLLI growth continued to be the first to turn up in most cases, typically followed by upturns in WLI growth and then by stock price upturns. Slightly more often than not in the postwar period, upturns in IOLI growth have followed stock price upswings. As expected, growth rate cycle upturns have followed these cyclical upturns.

We find in the current cycle that the upturn in USLLI growth was followed immediately by an upturn in WLI growth, and then by a likely upturn in IOLI growth. In that sequence of events, the rally in equities that began in early March looks very much like a cyclical upturn that will soon be followed by a U.S. growth rate cycle upturn.

What is notable in this context is that the next step in the sequence is almost always a business cycle upturn. Very importantly, the level of the USLLI has now risen for three straight months, in a manner that is reasonably pronounced, pervasive and persistent compared with the average at this stage of USLLI upturns during past recessions ([↗page 21](#)).

As we show later ([↗pages 4 to 9](#)), the timing of the USLLI upturn, along with a nascent upturn in the WLI, suggests that the current recession will end in the second half of the year, probably by this summer. Might the recent behavior of the stock prices allow us any further insights into the timing of the business cycle recovery?

It should be understood that, especially in the postwar years, the timing of stock price upturns has been one of the best indicators of the timing of business cycle upturns. Specifically, over the past six decades, the median lead of stock prices over business

cycle troughs has been four months, compared with 5.5 months in the prior three decades and seven months in the 1906-19 period. In fact, in the past half century, the lead has varied between two and five months. Thus, if March marked the cyclical low in stock prices, the recession could end by late spring, but more likely by late summer.

Of course, the upswing in the USLLI has thus far lasted only three months. Stock prices have been rising for almost six weeks, and the WLI for five weeks. No doubt, we would prefer to have a couple more months of data to confirm that a business cycle upturn is indeed on the way.

But greater certitude requires more time, which decision makers can usually ill afford. Instead, we have scrutinized a variety of leading indexes, including one with a record stretching back more than a century, to confirm our conclusions.

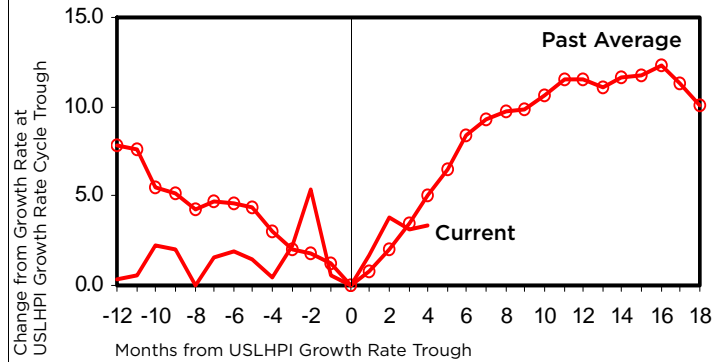
More important than this data is the institutional memory of ECRI, which embodies a continuous tradition of business cycle research reaching back over three generations and a hundred years. This is the body of knowledge that permits us to anticipate an end to the recession this year.

**Home Price Portents** A central element of the current recession is the home price downturn, starting in late 2005, that was anticipated by the U.S. Leading Home Price Index (USLHPI). What we find is that USLHPI growth has lately begun to firm.

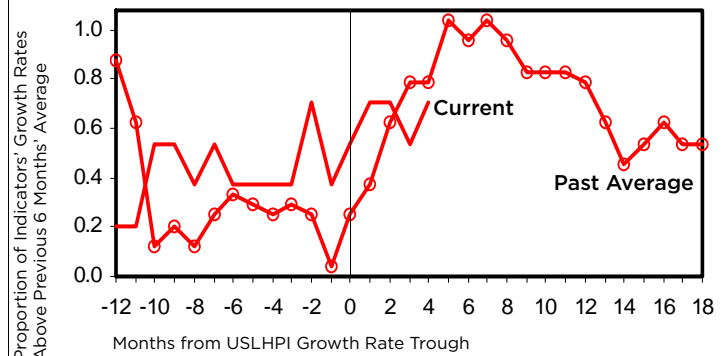
Chart 1a shows that the recent upturn in USLHPI growth is almost as pronounced as the median at this stage of comparable past cycles; Chart 1b shows that it is about as pervasive; and Chart 1c shows that it is as persistent. In other words, while USLHPI growth has been rising for only four months, there are early indications of a potential growth rate cycle upturn in home prices.

If this upturn continues, the pace of decline in home prices is likely to stabilize in the months ahead. If that happens, it could potentially trigger a sea change in market sentiment about the housing-related securities that are central to the current credit crisis. The potential implications are obviously enormous.

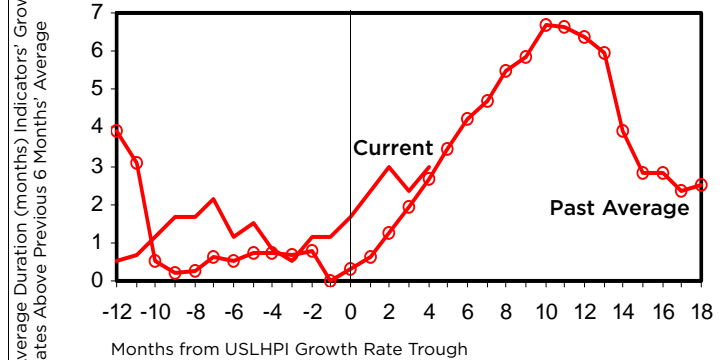
**Chart 1a: How Pronounced an Increase in USLHPI Growth?**



**Chart 1b: How Pervasive an Increase in USLHPI Growth?**



**Chart 1c: How Persistent an Increase in USLHPI Growth?**



For now, it will be increasingly critical to monitor the USLHPI. Especially if an upturn in USLHPI growth occurs in the context of a business cycle recovery, the prospects for the U.S. economy may become significantly brighter than most believe today.

**The Giant Error of Pessimism** The long history of business cycles is peppered with periods of excessive optimism and pessimism. The persistence of prosperity tends to inflame the animal spirits, giving rise to what Wesley C. Mitchell, who mentored ECRI's late founder, Geoffrey H. Moore, called the "error of optimism." As Mitchell wrote in 1927, "...the optimistic error once born grows in scope and magnitude.... But since the prosperity has been built largely upon error, a day of reckoning must come... Then the past miscalculation becomes patent – patent to creditors as well as to debtors, and the creditors apply pressure for repayment. Thus prosperity ends in a crisis."

Once the cycle turns down, unquestioning faith is broken and pessimism runs rampant. Or, as Mitchell quotes A. C. Pigou writing in 1920, "The error of optimism dies in the crisis but in dying it 'gives birth to an error of pessimism. This new error is born, not an infant, but a giant; for (the) boom has necessarily been a period of strong emotional excitement, and an excited man passes from one form of excitement to another more rapidly than he passes to quiescence.'"

Following the latest crisis, the "giant error of pessimism" is now rampant. This is why today many are skeptical that we have the first clear signs that the recession will end in the coming months.

It is important to understand that our recovery forecast is simply our best reading of an array of objective leading indexes that have stood the test of time better than any others in existence. It is rooted in a rigorous quantitative approach that, unlike most predictions, is not based on hopes or fears, hunches or assumptions, or even data fitting.

We are not long-term bulls or bears, and we do not rule out the danger that the well-established long-term buy-and-hold approach to stock market investment will remain a poor strategy in years to come. Yet, it is precisely in such an environment that our cyclical approach is likely to shine. Quite simply, while we are optimistic about the direction of the cycle today, we will change our view when our leading indexes turn down. Until then, we believe a sunnier view of the economic outlook is in order. ■