

U.S. CYCLICAL OUTLOOK

NEAR-TERM JOB GROWTH OUTLOOK IMPROVES

Surprise

The latest data for all major coincident economic indicators surprised most economists, handily beating consensus estimates. Specifically, data on nonfarm payroll jobs, the jobless rate, retail sales and industrial production were all better than expected, making it obvious that the U.S. economic recovery is more robust than commonly believed. Even the downward revision to third quarter GDP was driven by an upward revision to U.S. imports data, reflecting higher domestic demand.

These upside surprises are consistent with ECRI's nonconformist stance since last spring. In October, we reaffirmed in this publication ([Vol. XIV, No. 10](#)) that "the early stage of the current recovery will be stronger than any since the early 1980s, and will certainly prove to be less fragile than many expect." The recent data vindicate that view.

Job growth will soon turn positive, but a U.S. growth rate cycle downturn could begin in the first half of 2010.

In fact, the current revival in industrial production is already stronger than in the last two business cycle recoveries in 1991 and 2001-02. That is also true of GDP, which, according to the latest upwardly revised consensus, will prove to have grown at more than a 3% annual rate in the second half of 2009. Most importantly, employment growth, hitherto considered the "missing piece" of the expansion, is on the cusp of positive readings.

Six months ago in this publication ([Vol. XIV, No. 6, June 2009](#)), we wrote that "we should begin to see job gains in non-manufacturing employment" this year. That has already come to pass, with non-manufacturing job growth turning positive in November for the first time since the recession began. The household survey also shows net job gains for the first time since 2007. Of course, there will be some backing and filling in the data, as is typical at turning points, but there is little doubt that overall job growth will turn positive in short order, and the jobless rate will turn down in the first half of 2010, if it has not peaked already.

That outlook is consistent with the latest improvement in the Leading Employment Index, whose growth rate

has surged to a 25-year high (Chart 8, [page 10](#)). If there is a near-term peak in the jobless rate, as we expect, it would occur less than a year after the end of the 2007-09 recession. In contrast, the jobless rate peaked 15 and 19 months, respectively, after the 1990-91 and 2001 recessions ended. Once again, the current economic recovery is on track to be the strongest since the early 1980s.

The broader point is that ECRI's leading indexes are designed to systematically anticipate these cyclical "surprises." As we discuss later ([pages 5 to 6](#)),

Continued...

IN THIS ISSUE

Future Inflation Gauge: Rose to a 14-month high, indicating that inflation pressures have begun to simmer.

Leading Home Price Index: Increased in November, pointing to a positive home price outlook.

Leading Employment Index: Growth surged to a 25-year high, suggesting that job growth prospects have turned quite optimistic.

Long Leading Index: Climbed to a new record high, confirming the sustainability of the recovery.

Short Leading Index: Growth remained close to October's 59-year high. Thus, near-term economic growth prospects remain favorable.

Leading Services Index: Growth remained in a cyclical upswing, suggesting that growth in service sector activity will continue to improve.

Leading Financial Services Index: Advanced to a 17-month high, pointing to a continued recovery in the financial services sector.

Leading Nonfinancial Services Index: Continued to rise, suggesting that a revival in nonfinancial services activity is at hand.

Leading Manufacturing Index: Growth stayed close to October's six-decade high. Thus, industrial growth prospects remain upbeat.

Leading Construction Index: Rose in November, suggesting that a recovery in construction sector activity is about to get underway.

Focus:

Surprise Indexes
[pages 5 to 6](#)

RISING RISK OF GROWTH RATE DOWNTURN

[...Continued from Page 1](#)

"surprise indexes" that provide summary measures of economic and earnings surprises "offer little guidance about upcoming directional changes in the economy and stock prices." But ECRI's leading indexes – and, in particular, the U.S. Long Leading Index (USLLI) – consistently anticipate cyclical turns in these surprise indexes, drastically reducing the risk of being caught flat-footed by directional shifts.

Of course, even hard facts cannot change entrenched opinions. They merely give birth to new rationalizations of existing views. Accordingly, any future deceleration in economic growth, no matter when it occurs, is apt to be interpreted as a precursor of a "double dip" or the down leg of a "W-shaped" recovery, or as evidence of an end to a stimulus-driven "sugar high."

In reality, because deep recessions tend to be followed by stronger revivals, the initial pace of acceleration cannot be long sustained, and gives way to a period of decelerating but still positive economic growth. This was the case after the 1973-75 and 1981-82 recessions, when the economy entered growth rate cycle downturns 11 and 14 months, respectively, after the recessions ended – but those slowdowns did not turn into economic contractions.

After mild recessions, the pattern has been more mixed. Thus, following the end of the 1969-70, 1980, 1990-91 and 2001 recessions, growth rate cycle downturns began after 26 months, six months, 38 months and eight months, respectively. In only one of those four cases – in 1981 – did the growth rate downturn turn into a new recession, which was duly anticipated by ECRI's leading indexes.

In its latest reading, the USLLI has climbed to a new record high, underscoring the sustainability of this recovery, but its growth rate has eased for the second straight month from September's six-decade high. Meanwhile, the growth rate of the Weekly Leading Index (WLI) has also been easing for eight weeks since its October 9 record high. As we show later ([page 18](#)), this downturn in WLI growth is a bit more pronounced, almost as pervasive, but clearly less persistent, than it has been, on average, after past recessions. In other words, while we prefer to await further confirmation from these leading indexes for evidence of persistent easing, a growth rate cycle downturn could begin in the first half of 2010.

Exit Angst

With the economic recovery seen in the coincident indexes clearly gaining momentum, the Fed has now signaled that quantitative easing measures – in particular, the crisis-fighting liquidity facilities – will be

largely withdrawn by early 2010. The question is when the Fed will begin actual rate increases.

While many believe that rate hikes will start around mid-2010, it is worth recalling that the Fed waited two and a half to three years after the last two recessions to begin rate hikes. The Fed clearly expects inflation to recede in 2010, given the extent of slack in the economy and their focus on output gap models to predict inflation. Because the Fed's biggest fear is a new recession that would pitch the economy into a deflationary spiral, it is not surprising that they would prefer to keep rates low for an extended period.

The Fed would face a serious dilemma if there were to be a more serious surge in underlying inflationary pressures, as measured by the U.S. Future Inflation Gauge, than we see today. However, given the possibility of a growth rate cycle downturn next year, that is not a given at this time.

The key question is the Fed's ability to judge the appropriate timing of rate hikes. After all, it has been well over a decade since they last demonstrated the requisite ability to time preemptive rate hikes. In the lead-up to the Great Recession – and even in early September 2008, nine months into that contraction – they proved to be clueless about the reality of recession, worrying needlessly about inflation, with the associated policy flip-flops ([U.S. Cyclical Outlook, Vol. XIII, No. 10, October 2008](#)). In fact, the week after the Lehman failure in September 2008, Chairman Bernanke warned that if the Troubled Assets Relief Program (TARP) was not enacted, "jobs will be lost, the unemployment rate will rise, more houses will be foreclosed upon, GDP will contract." What he did not seem to realize is that all of that was happening anyway, as the economy had already been in the grip of recession all year. Yet, the subsequent success in averting a depression may have reinforced the Fed's habitual hubris.

This overconfidence is, in part, associated with the "scientific" approach to econometric forecasting popularized largely by Paul Samuelson, a giant of economics who died just this week. It is worth recalling that in the late stages of the long expansion of the 1960s, it became a consensus among economists – many of them Samuelson's followers – that they could fine-tune the economy to the extent that the business cycle, as the title of a 1969 volume proclaimed, would become "obsolete."

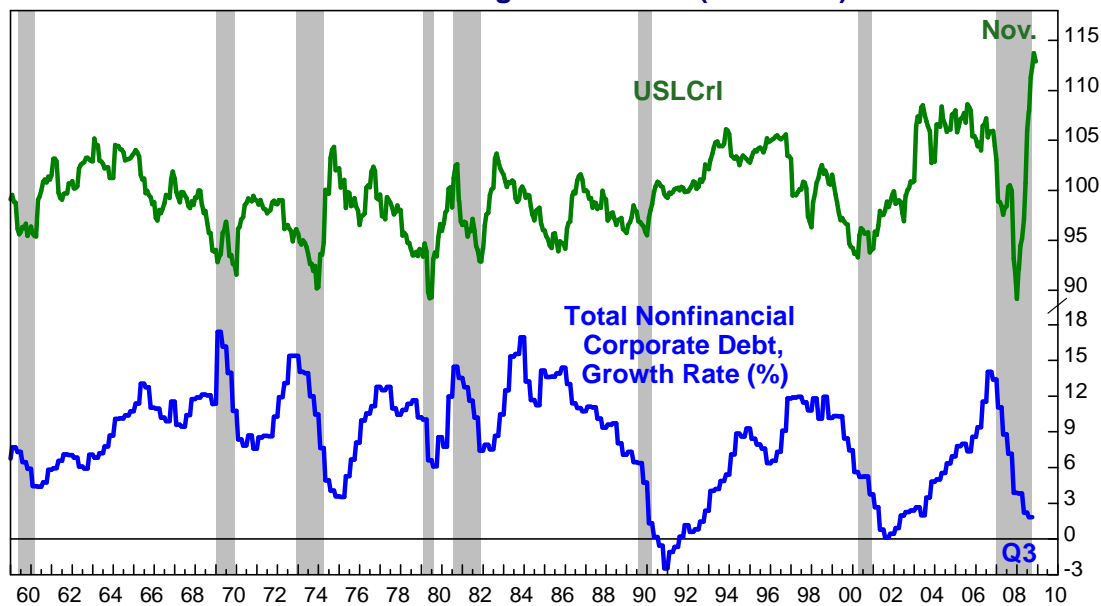
In that context, it is telling that the monthly government publication compiling leading economic indicators, named "Business Cycle Developments (BCD)" when introduced in 1961, was revamped to incorporate

[Continued...](#)

CREDIT GROWTH TO TURN UP IN 2010

[...Continued from Page 2](#)

Chart 1: U.S. Leading Credit Index (1992=100)



Shaded areas represent U.S. business cycle recessions.

"additional data reflecting" the econometric modeling approach and renamed "Business Conditions Digest" at the end of 1968. Of course, it retained the familiar acronym, BCD.

A year later, the 1969-70 recession arrived. Yet, in September 1970, nine months into that recession, Samuelson was still proclaiming that business cycle researchers had "worked their way out of a job!" It would seem that belated recession recognition is nothing new.

History was to repeat itself near the end of the long 1982-90 expansion. In March 1990, the U.S. government phased out the BCD. Four months later, the next recession arrived. Eventually, in the late 1990s, with "new era" talk buoyed by another long expansion, academics began to publish articles about the "end of the business cycle." It did not take very long for the next recession to arrive.

Yet, because the 1990-91 and 2001 recessions had been relatively mild, researchers in the late 1990s discovered "the great moderation," which Ben Bernanke, in a 2004 speech, attributed mostly to improved monetary policy, even while acting as a cheerleader for a prolonged period of low interest rates that would set the stage for a huge boom-bust cycle. Through all these ups and downs, the faith in the "scientific" approach to economics, i.e., standard econometric models, has never wavered. The critical question today is whether such an approach is up to the task of correctly signaling the right time to hike rates. As we shall show, the stakes this time are much higher.

Next in Line

The 2009 economic recovery has evolved in a textbook pattern, repeatedly confounding consensus expectations. Less negative growth has given way to comfortably positive economic growth, and employment, at least in the non-manufacturing sector that accounts for 91% of jobs, has begun to increase. Overall job growth should soon turn positive, as well.

A common worry today is the lack of credit growth. Yet, as Chart 1 shows, credit growth (bottom line) is a lagging indicator of business cycle upturns. In fact, as the sharp upturn in the U.S. Leading Credit Index (USLCrI, Chart 1, top line) strongly suggests, credit growth will also turn up in 2010. After all, it is nothing new for banks to wait for the economic recovery to take hold before beginning to step up loan activity.

At that time, an increase in inflation concerns would be understandable, even though, as we have noted, the Fed expects to see lower inflation next year. From our cyclical vantage point, it is too soon to know whether surging inflation, a deflationary spiral, or neither, will eventually turn out to be the real problem. That depends on the Fed's timing skills, which will, in large measure, determine the extent of cyclical volatility we see in the years ahead.

The Long View

The "great moderation" thesis originated in the wake of the singularly successful "soft landing" engineered by the Fed in 1994-95, which effectively prolonged the expansion. One key reason for the mildness of the 2001 recession was aggressive monetary easing –

[Continued...](#)

MORE FREQUENT RECESSIONS LIKELY

[...Continued from Page 3](#)

especially after the September 11 attacks – boosting consumer spending on interest-sensitive items like automobiles and homes. Monetary policy was also complemented by fortuitously timed income tax cuts earlier in 2001, and the sharp post-9/11 increase in federal spending on homeland security.

As is often the case, the psychological phenomenon of "attribution bias" helped central bankers like Mr. Bernanke ascribe the "great moderation" of business cycles to skill rather than luck, leading to his conclusion in his 2004 speech that the "great moderation" would persist. But it is not only because he was proved wrong by the recent cyclical volatility, nor just because we believe luck played a bigger role than acknowledged, that we think that there has now been a lasting step-up in cyclical volatility. The point is that it will take far more skill than the Fed has shown in many years, not to mention luck, to properly time their next rate hike cycle.

As we discussed last month in this publication ([Vol. XIV, No. 11, November 2009](#)), "the combination of weak trend growth during the next expansion and the death of the 'great moderation' is a recipe for frequent recessions." The importance of strong trend growth is underscored by the fact that while China – with a GDP trend growth of 10% a year over the last 20 years – has seen no recessions in that time period, Japan – with a GDP trend growth rate of 1% a year over the same time frame – has seen four recessions, with the intervening expansions lasting less than three years, on average. As we concluded, the implication is that, "unless we are about to experience a long expansion, it will be many years, and possibly decades, before we see the jobless rate drop to the lows seen only a couple of years ago."

In developed countries like the U.S., "safety nets" like unemployment benefits, as well as poverty-oriented cash and non-cash transfers, are meant to be countercyclical in effect, increasing when the economy turns down and boosting fiscal costs from increased unemployment and lower incomes for the poor and long-term unemployed. The presumption is that, if these programs work to maintain human capital and skills during down times, people would find productive jobs when the economy rebounds. If so, the fiscal savings during business cycle upturns, from increased tax revenues from productive work and lower expenditures on the countercyclical programs, would more than offset the accumulated debt from the recession years. But, if the jobless rate – and especially the long-term unemployment rate – stays

high over the course of several tightly grouped business cycles, the fiscal outlook would be far more grim. The resultant fiscal deficits could place increased burdens on monetary policy makers to adopt tighter policies, even though such actions could result in more frequent recessions that ultimately compound the problem.

As we pointed out in January ([U.S. Cyclical Outlook, Vol. XIV, No. 1](#)), more frequent recessions also tend to increase the equity risk premium, thus lowering price-earnings multiples for stocks. Under the circumstances, a buy-and-hold strategy for stocks is unlikely to be rewarding. Just consider Japanese stock prices, which have lost almost three-quarters of their value in 20 years.

We are optimistic about what the New Year will bring in terms of a further improvement in U.S. economic activity, especially with regard to jobs. However, we have a much more cautious view of the risks in the new decade. This is because a long expansion would require the Fed to time rate hike cycles almost perfectly, in order to engineer a "soft landing."

Such a long expansion is imperative for avoiding a long-term problem of stubbornly high unemployment. This is evident not only from the example of Japan over the last two decades, but also of the Great Depression, whose effects lingered as long as they did only because the 1937-38 depression swiftly undid most of the achievements of the 1933-37 revival. The bottom line is that long expansions are needed after severe recessions to undo the damage. After the 1929-33 depression, not even four years of expansion were quite enough, despite 10% annual GNP growth. This time, trend growth is likely to be far lower, and the danger of frequent recessions accordingly higher.

That is why it is so important for the Fed to correctly time the preemptive rate hikes. Else they will risk frequent recessions and thus a deflationary spiral – or surging inflation that would necessitate sharp monetary policy tightening, once again risking recession.

Throughout, ECRI's leading indexes have demonstrated a real-time ability to prevent users from being blindsided by recessions and recoveries – not only during the "great moderation" but also in the "Great Recession." They have worked just as well as for Japan over the last two decades. In sum, with the U.S. economy more likely to dip in and out of recession in the years ahead, it will be increasingly necessary to keep a close watch on ECRI's array of leading indexes.