The Changing Cyclical Contours of the U.S. Economy

March 2010

ECRI

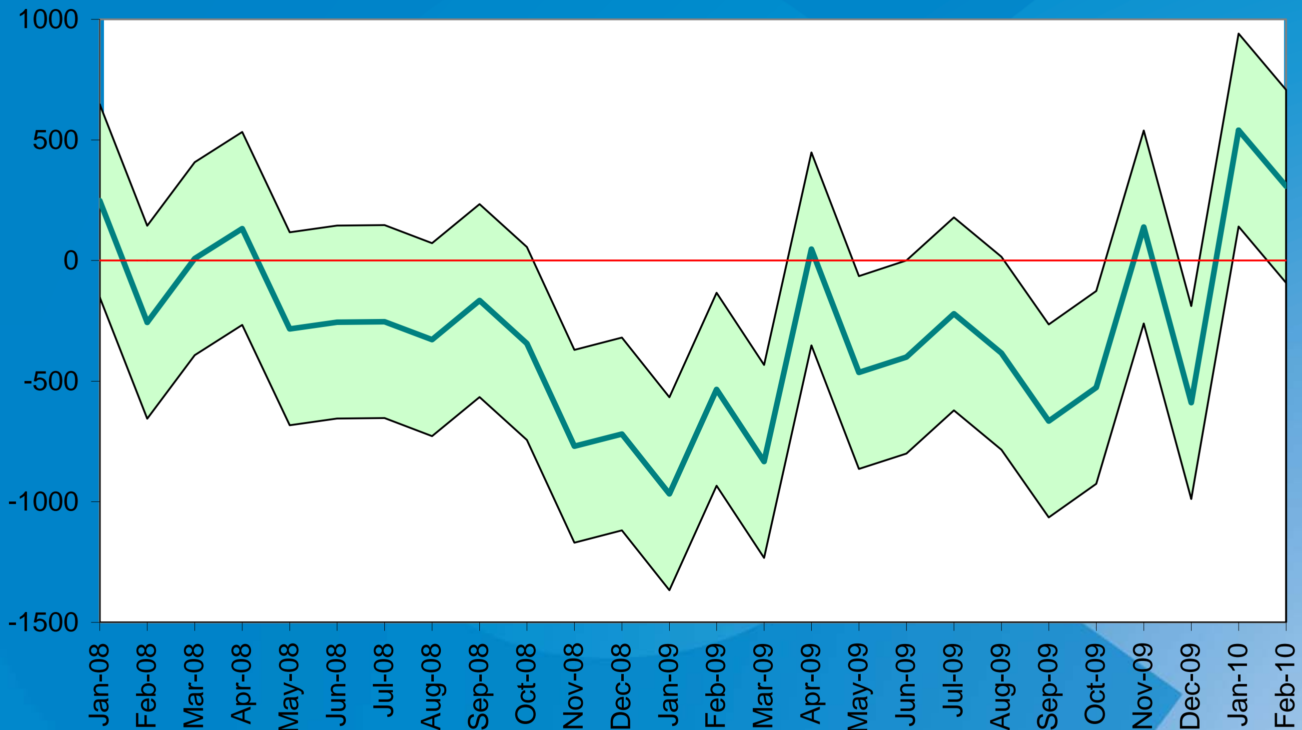
It was over nine months ago that I last presented to you and I think it's fair to say that at the time ECRI was far more optimistic than the consensus – we had already been predicting an end to recession for a couple months.
It now looks as though the recession may have ended in June, around the time we were meeting.

Let me say upfront, **we're not economists. Rather, we are students of the business cycle and we do not use econometric forecasting models**.
The reason why has become more evident in the wake of the Great Recession.

Instead ECRI uses leading indexes which correctly anticipate both recessions and the recovery.

Let's begin with where we stand in this business cycle with regard to perhaps the most important dimension, and that is jobs…

Job Growth, Household Survey, Showing Margin of Error



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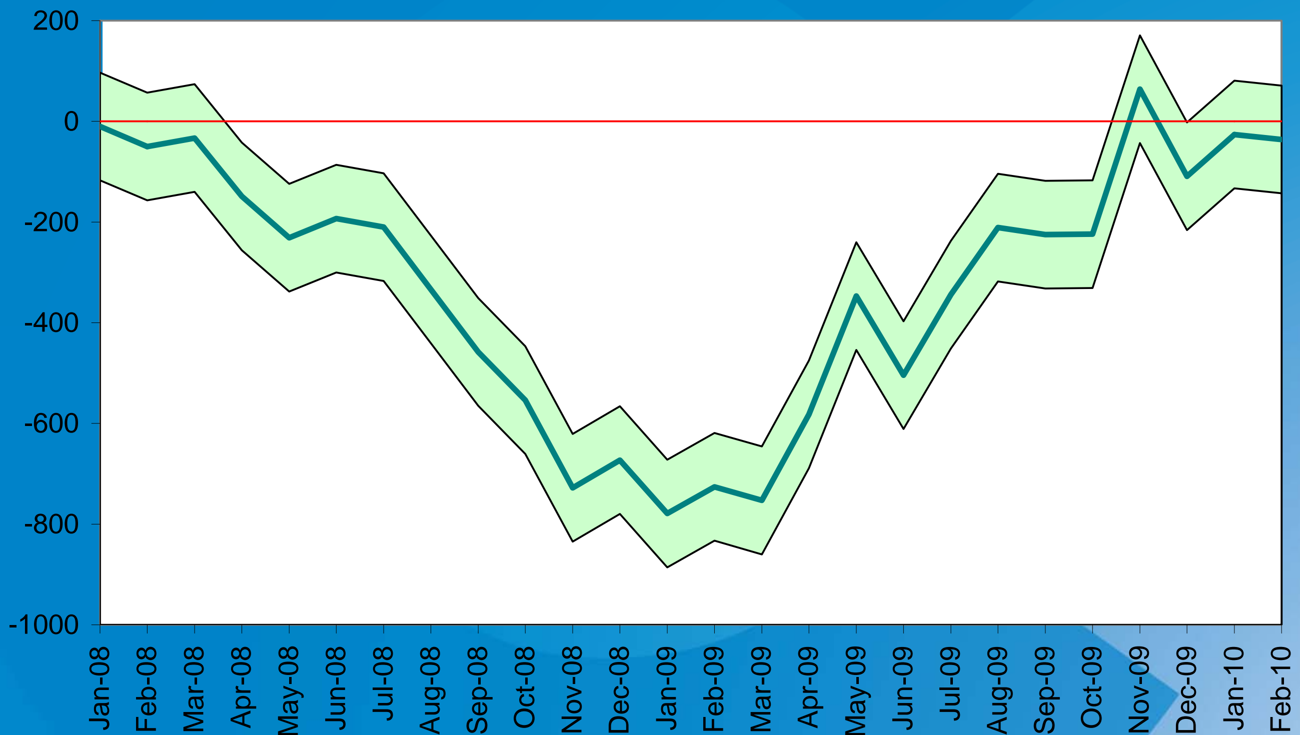
For the first time since the recession began, job growth, as measured by the household survey, turned positive in January – even taking the margin of error of 400,000 jobs into account.

This jobs number has now been positive for two months, which is a key reason the jobless rate has been trending down.

The job growth uptrend in the chart is quite clear.
By the way, the household survey leads the establishment survey 78% of the time at business cycle troughs, with a short lead of a month or two.

In that context, let's look at the payroll survey data…



Showing payroll job growth, where the uptrend is even clearer.

Unless there's a reversal in the trend, payroll job growth will almost certainly turn positive in short order.
ECRI's Leading Employment Index (not shown) is quite clear that this uptrend is not about to change.

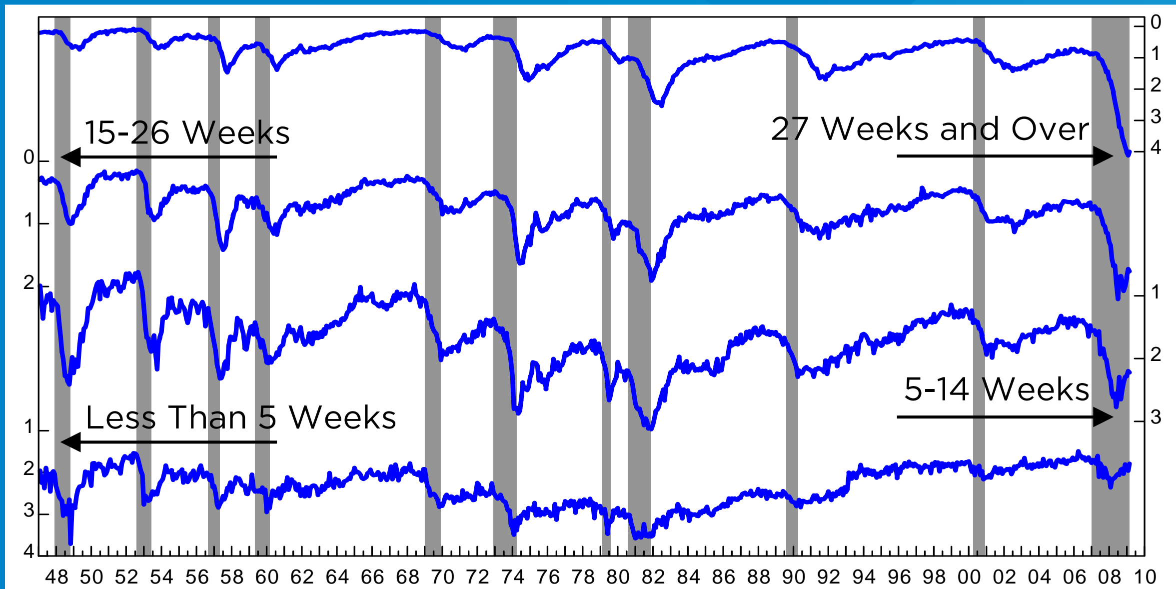
The overall message from these two charts is unambiguous: we are on the threshold of positive job growth.

Having lost well over 8 million jobs during the recession it will take many, many years to recover, and as we will see in a few moments, the length of the expansion is unlikely to be long enough to do so.

Recovery and recovering, does not mean "recovered."

Still, the jobless rate, and especially the long-term jobless rate, remains very high, which demands that we dig deeper into that data…

Unemployment Rates (%, Inverted) by Duration of Unemployment



Shaded areas represent U.S. business cycle recessions.

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Chart of jobless rate by duration, all shown inverted, *so an upward move is an improvement*.

Certainly, the long-term (27+ weeks) jobless rate is around record highs, which is a major problem for the economy, but at long last we've seen at least a one-month downtick.

In contrast to soaring long-term unemployment, the jobless rates for 26 weeks and under (lower 3 lines) have all peaked, and have been falling faster than in the last 2 recoveries (show on chart).

This is main reason why overall jobless rate has been falling from Oct 2009 high.

But, especially for short-term (under 5 weeks) jobless rate (bottom line), the picture is dramatic.

1, it has been trending lower since the early 1980s.

2, while it spiked during the 2007-09 recession along with the other measures, its peak was lower than in any recession in the 20th century (show on chart).

Let's think about that for a minute: this was a milder recession for this cohort than any recession in the 20th century!!!

3, this short term jobless rate is already (at 1.79%) nearing the record low (1.49%) seen in 2007

Implications: job market for those with skills closely matching market needs is tighter than people think, while structural shifts relating to bubble related jobs and manufacturing help keep long-term unemployment high.

Let's look at the business cycle from another angle

A Solitary Standout

- In April 2009, we predicted that the recession would end by summer.
- In August 2009, we not only ruled out a double dip, but forecast the strongest recovery since the early 1980s.
- That is now a fact, not a forecast, in terms of both GDP growth and joblessness.

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In April 2009 based on our leading indexes we predicted that the recession would end by summer

In August 2009, again based on our leading indexes, we ruled out a double dip, AND went further to forecast that the recovery would be stronger than the last two

Today, this is a fact, not a forecast, both in terms of GDP and the overall jobless rate

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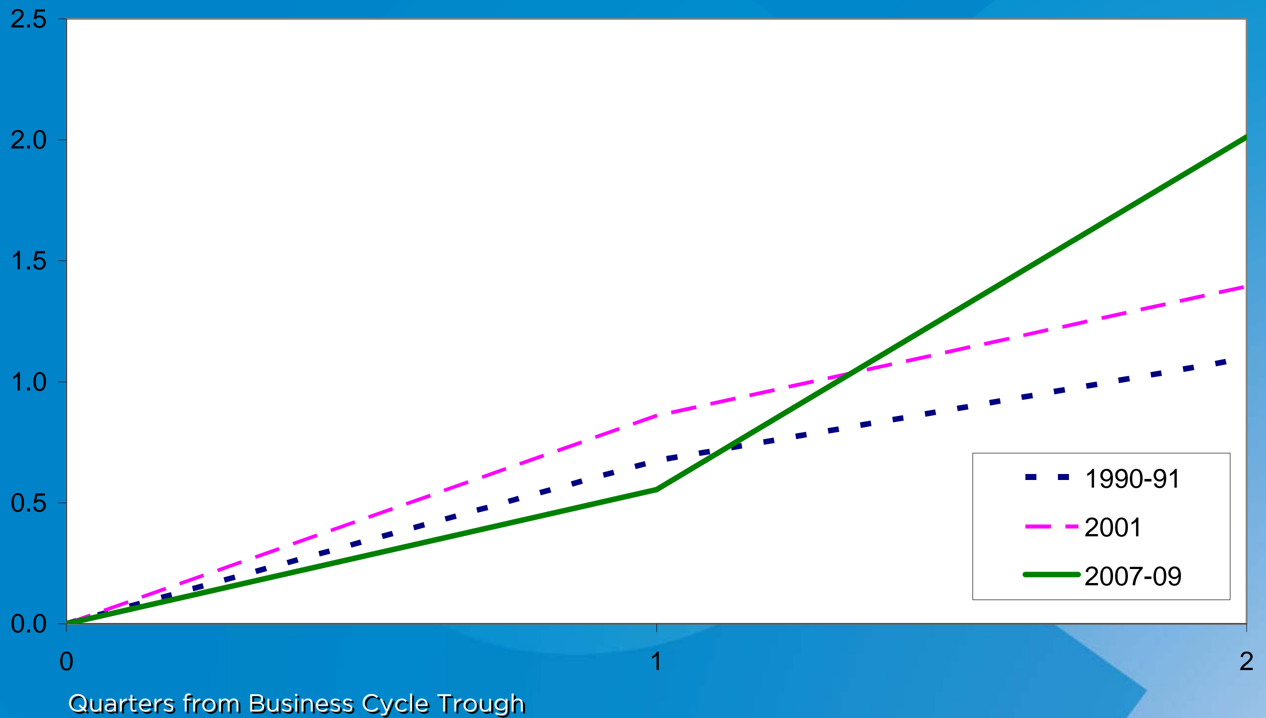

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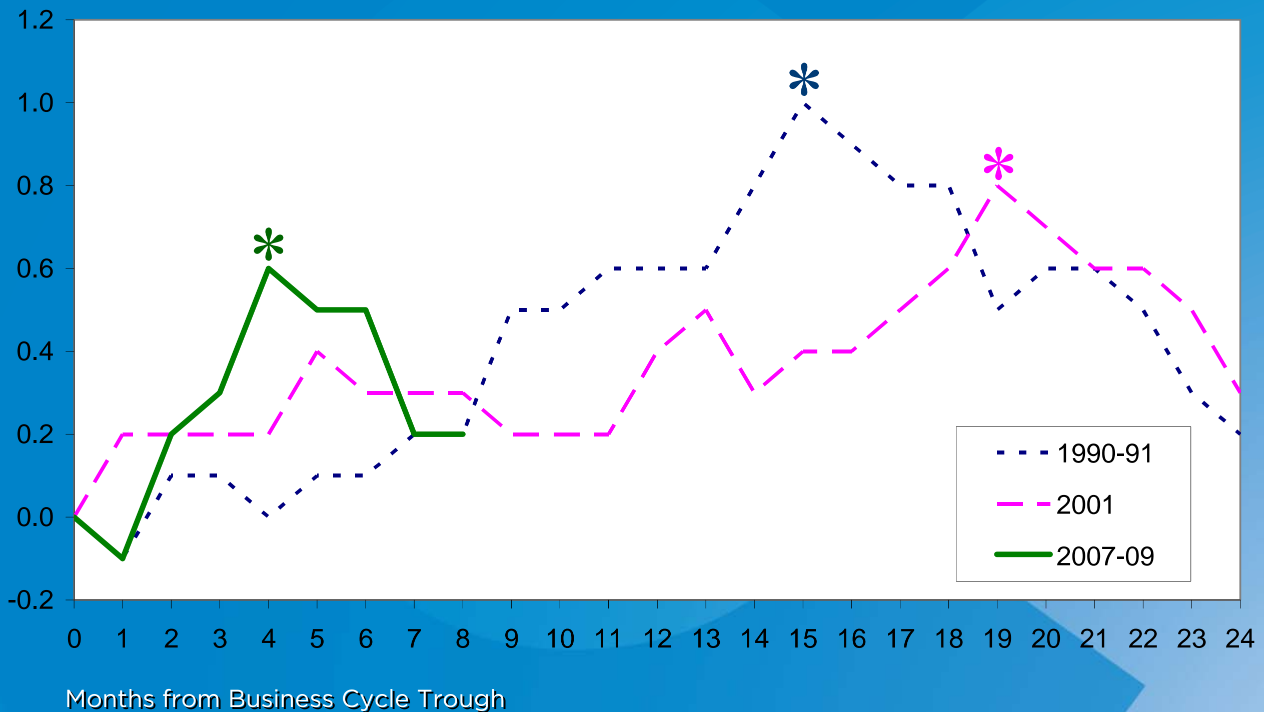
First, let's look at GDP

As you can see, in the first two quarters of recovery, GDP has grown at double its pace following the early 1990s recession, and almost one and a half times the pace following the early 2000s recession.

GDP growth surpassed 4% (actually 4.1%) in the second half of 2009 and that's clearly stronger than the early stage of the last two recoveries

How about the jobless rate?

Unemployment Rate, Change from Business Cycle Trough



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In the last two recoveries, the jobless rate peaked about a year and a half after the recession ended.

But this time, it looks like it's turned down only a couple of months after the recession ended, and, as we've explained, it isn't about to ramp up to new highs, meaning that the consensus is going to be off by more than a year, in terms of the predicted timing of a peak in the jobless rate.

To be clear, jobless rate in this cycle ***<u>has peaked already</u>*** in Oct. at 10.1%

<u>Never</u> seen a .4% decline in jobless rate that was followed by a new cyclical high in joblessness.

Mind you, following previous two recessions, unemployment didn't peak for 1 ½ years, which has led prominent Wall St. houses to forecast that unemployment will keep rising thru 2010 and beyond towards 11%. What we are seeing is that their timing of the peak in joblessness is going to be off by more than a year.

Now let's look at fwd-looking index that was key to ECRI's forecast last summer of a stronger recovery than the last two…

Long Leading Index Growth, Stock Prices and Coincident Index Growth

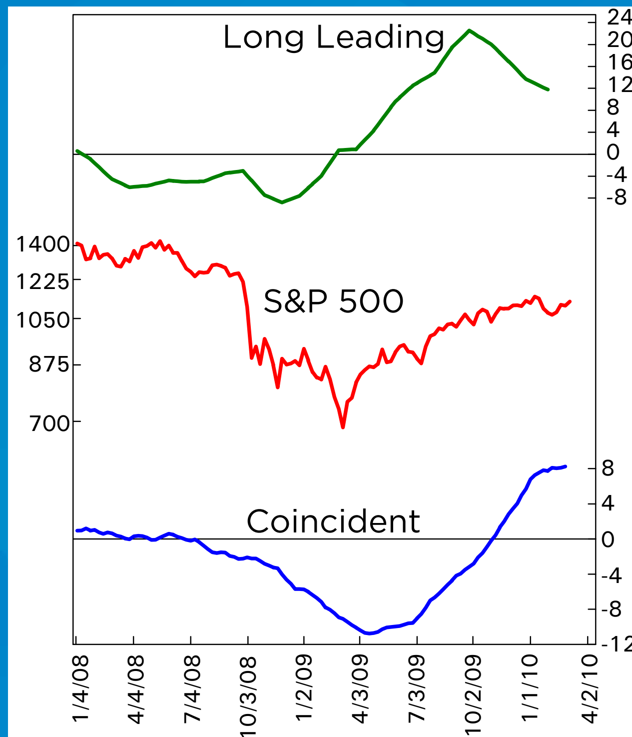

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Chart US Long Leading Index growth rate, S&P 500, Coincident Index growth rate.

Going back to the early 1920s this is the classic sequence coming out of recession (show LLI trough, then others)

At ECRI we don't make market calls but this sequence was so clear back in March 2009 (the week after the market low), that Jim Grant in *Grant's Interest Rate Observer*, called our outlook a "table pounding historical observation."

His take was that, "the implications could not have been clearer that a market rally, when it started, would be no sucker's affair, but the real McCoy."

A month later in April 2009 we predicted that the recession would end by summer.

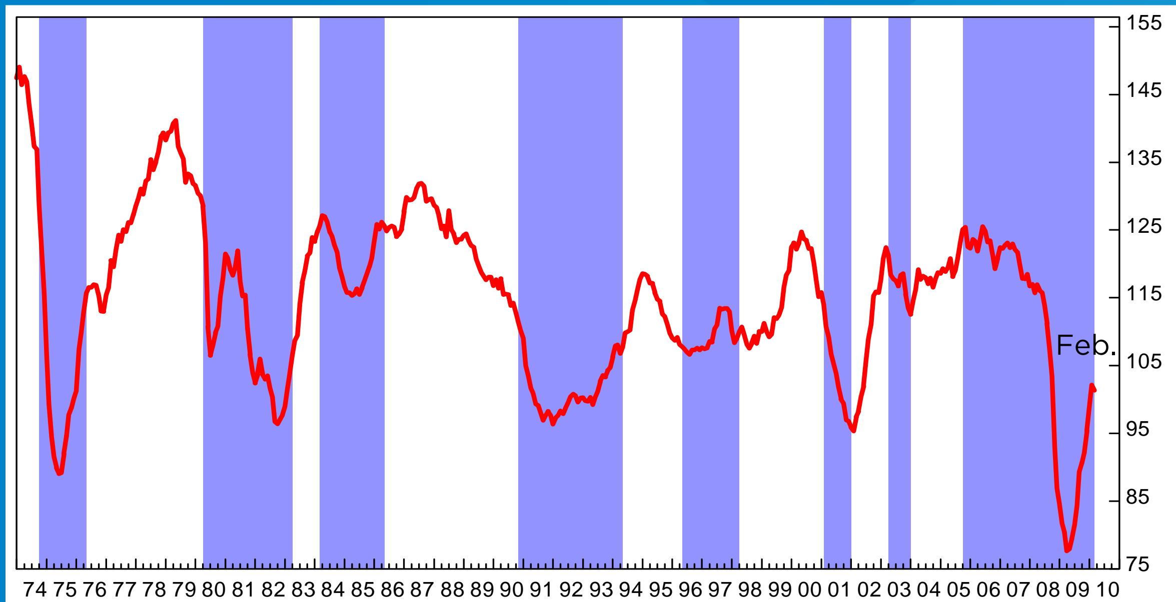
I expect that some of you are thinking that the Long Leading Index is some variation of the Conference Board's LEI. It is nothing of the sort, especially for a decision maker. When in April we were pounding the table on the end of recession by summer, here's what the Conference Board said when its latest LEI release showed a big drop—and without a single monthly uptick since June 2008, "There's no reason to think that this recession is going to end any time this spring or this summer."

For a decision maker, there's a world of difference there.

What's notable is that the LLI ***growth rate*** is now in a clear downturn, pointing to an easing in economic growth starting soon. That's going to make for a much more interesting market in 2010.

But aside from economic growth, there's another factor that's going to make this a trickier ride for the markets.

U.S. Future Inflation Gauge



Shaded areas represent U.S. inflation cycle downturns.

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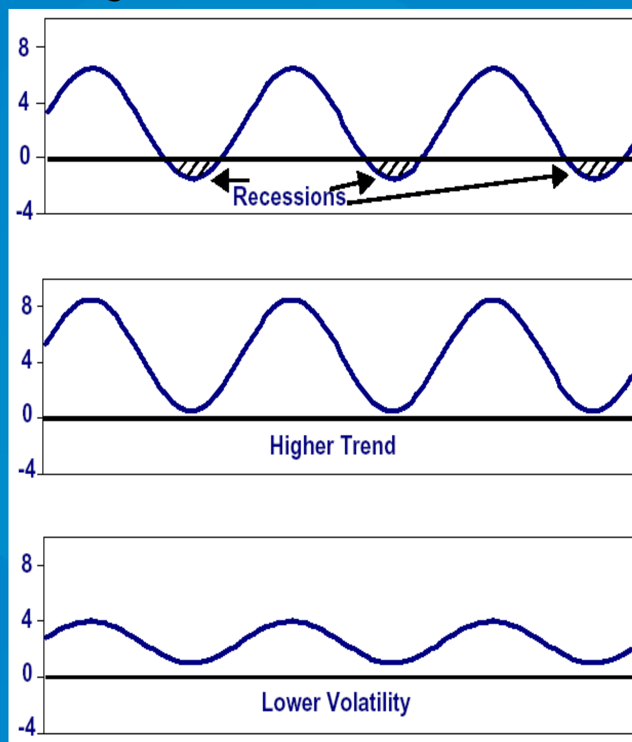
Chart of the USFIG, a ***FORWARD-LOOKING*** composite index to measure underlying inflation pressures.

It's telling us that, not only is deflation off the table for now, but that inflation pressures have started to simmer.

But this is not the only thing that'll make the Fed's job interesting in the coming years.

As we're about to see, we shouldn't expect this expansion to be like the long ones we've become used to over the last three decades…

Effects of Higher Trend and Lower Volatility on Business Cycles



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Here's a stylized chart showing economic growth – when it goes below zero, that's a recession.

Now, how do you get rid of such recession, or at least make them less frequent?

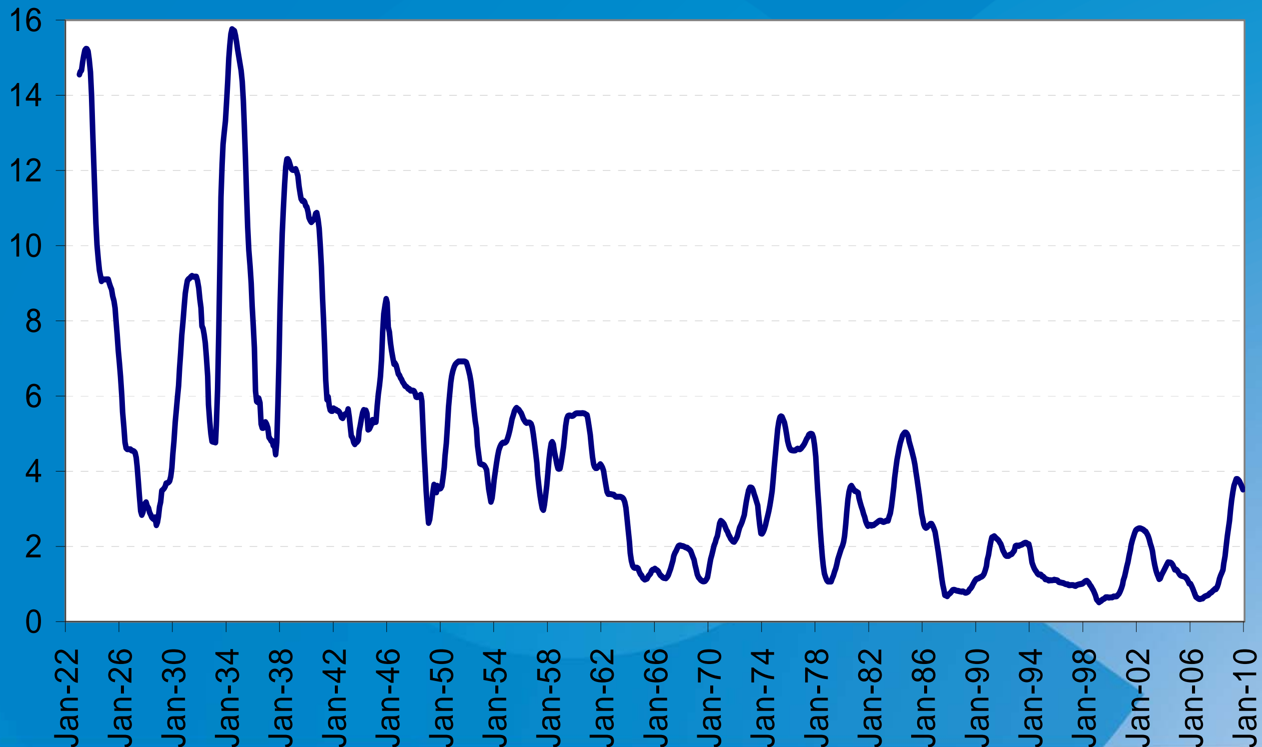
It's simple, in theory. Just lift the trend growth rate enough that this wavy line (middle) no longer dips below zero – voila, no more recessions!

This has been the Chinese model for the last two decades.

Alternatively, you could leave the trend growth rate unchanged, but reduce the volatility (lower line), and you'll get far fewer recessions.

That was not too far from the U.S. model during the period known as the Great Moderation – say, mid-1980s to just before the Great Recession.

But, as we'll see, it looks like the Great Moderation is history…



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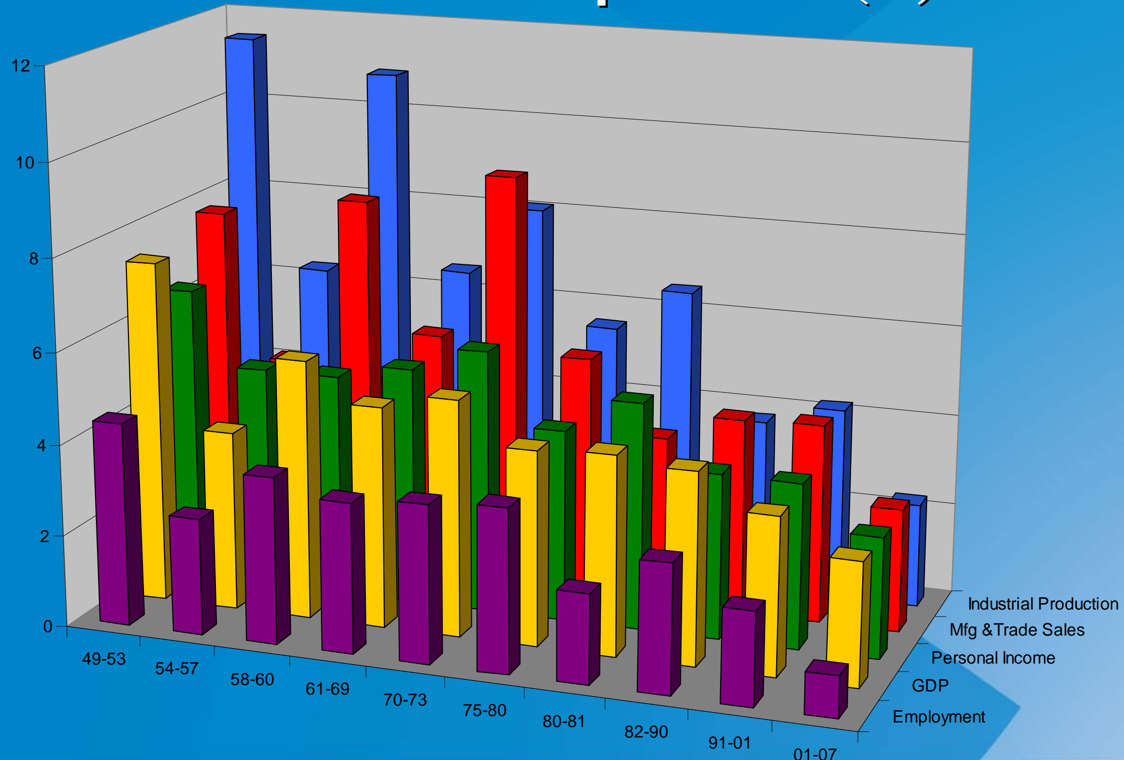
This chart shows the volatility of U.S. economic growth going back to the early 1920s.

Here's the period of the Great Moderation, which some well-known economists used to attribute in part to the Fed's monetary policy skills. We don't hear much about that anymore.

But if nothing else, it's going to be pretty challenging to smoothly withdraw the huge stimulus provided to the economy. It looks like business cycle volatility is going to be significantly higher than it was during the Great Moderation.

But there's another problem…

Annualized Pace of Growth in U.S. Coincident Indicators in Postwar Expansions (%)



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(ECRI study published in *NYT* Aug, 2008) It is clear that the trend rate of growth during expansions has been falling for decades, with the 2001-07 expansion showing the lowest trend growth of all (see key coincident measures during each expansion shown in chart).

And there's no indication that this pattern is going to change in this expansion.

The convergence of lower and lower trend growth, and higher cyclical volatility leads just to one result:

A greater likelihood of growth dipping below zero, if you recall our stylized chart, i.e., more frequent recessions because we're seeing the opposite of what you would want, higher volatility, lower trend

There's something else to see here; we've had this secular trend of weaker expansions that is now being conflated with the strength of the cyclical recovery by many who don't know any better, and yes I do mean some of the top wall street houses.

It's silly to compare the strength of the initial rebound in this recovery to one from what we saw decades ago when the economy was quite different. That is why last summer ECRI forecast a recovery that would be stronger than the last two, not even trying to compare it to earlier recoveries. And of course at that we were called crazy. Now that our forecast has come to pass, all of those pessimists who were calling us crazy have moved the goalposts and comparing this recovery to those from decades ago.

As I said earlier, we're students of the business cycle, not economists, and from that vantage point are able to pull apart the cyclical from the structural and thereby provide different insights.

Let's sum up the implications...

Conclusions

- Cyclical cheer, structural gloom
- More frequent recessions likely to keep headline jobless rate cycling around high levels
- Death of buy-and-hold for stocks

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Our conclusions are (paraphrase bullets):

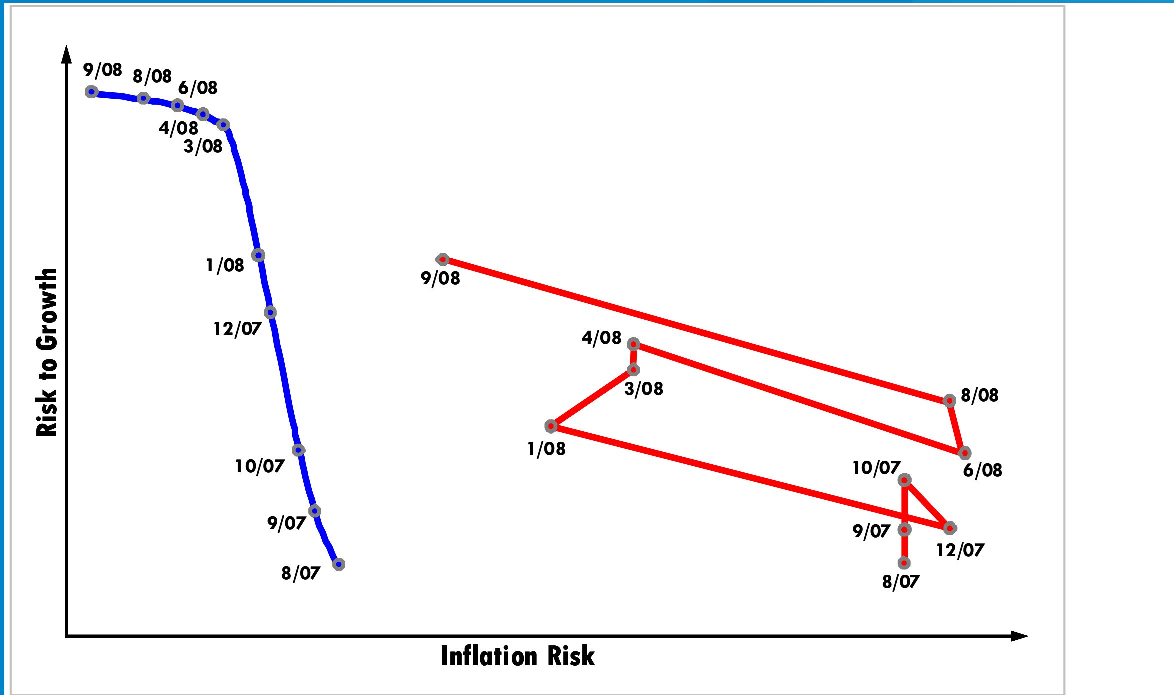
BULLET 1, this is where we stand today

BULLET 2, biggest challenge for policy makers, and yet still not part of the policy debate.

BULLET 3, recessions are associated with major bear markets, so if more frequent as ECRI believes, then big challenge for investors

Next page: Appendix on poor Fed monetary policy timing during Great Recession

Evolution of ECRI's and Fed's Views About Inflation and Growth Risk



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EXCERPT FROM ECRI's *U.S. Cyclical Outlook*, Oct. 2008 REPORT

A Flip-Flopping Fed

The Bernanke Fed has rightly been lauded for the aggressive and creative measures it has taken this year to tackle the credit crisis. In the process, commentators have glossed over its earlier failures, which have proved to be devastating in retrospect.

The Fed has a dual mandate – to promote stable inflation as well as maximum employment – but its monetary policy actions have a lagged effect on the economy. Thus, they need to be forward-looking on both the business cycle and the inflation cycle in order to properly devise their policy. In practice, however, they have failed conspicuously to do so, not realizing the gravity of recession threats before it was too late, and relying on backward-looking indicators of inflation to inform monetary policy.

In this context, it is instructive to examine the evolution of ECRI's and the Fed's views about inflation and recession risks since the credit crisis began in the summer of 2007. For this purpose, we have drawn a stylized chart illustrating the respective perceptions of these risks over the last 14 months (Chart 1a). Here, the horizontal axis represents inflation risk, with a rightward move denoting rising inflation risk. The vertical axis represents the risk to economic growth, with an upward move denoting rising recession risk.

Our assessment of the evolution of the Fed's stance (red lines) is based on the Fed's official statements of the balance of risks, supplemented by the statements of Fed governors. We based our assessment of the evolution of ECRI's stance (blue lines) on the cyclical movements in the USFIG and WLI, supplemented by the views expressed in regularly published ECRI reports.

These judgments were necessarily subjective, though we strove to be impartial. Others examining the same record might very well arrive at a somewhat different depiction of the evolution of the views of ECRI and the Fed, though we strongly believe that the essentials of the diagram would still be the same.

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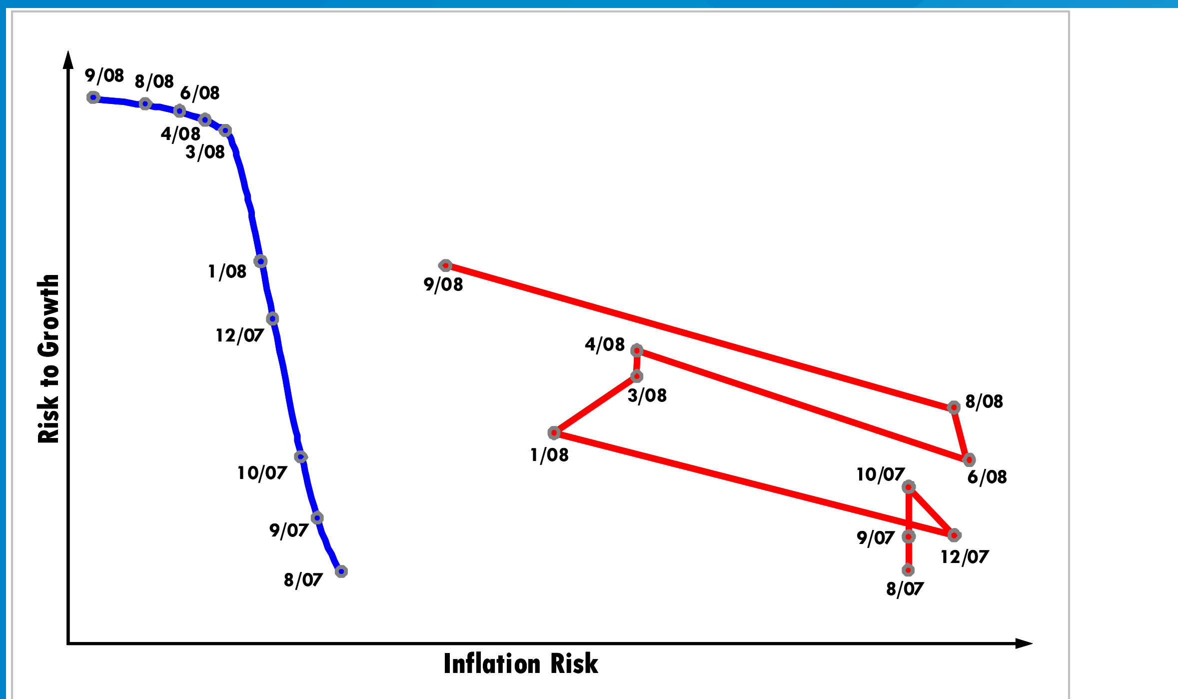
Evolution of ECRI's and Fed's Views About Inflation and Growth Risk



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The chart shows that in August 2007, ECRI and the Fed had similar assessments of recession risk, but sharply different estimates of the inflation threat. In contrast to the Fed's pronouncements, we noted that "inflation pressures are in a clear cyclical downtrend" and "thus, the Fed need not be daunted by inflation concerns if, in its judgment, rate cuts are called for" (*U.S. Cyclical Outlook*, Vol. XII, No. 8, August 2007). At the same time, we warned that "if the market instability continues in the weeks and months ahead, it will be increasingly critical to monitor the WLI, as well as the credit spreads, for early indications of a recessionary shift in the economic outlook."

Readers will recall that as the months wore on the USFIG continued in its cyclical downswing, but with WLI growth falling faster, we became increasingly worried about recession. Last November, in this publication (Vol. XII, No. 11), we wrote that "the magnitude of the latest interest rate shock and oil shock puts them in recessionary territory – in the past, such shocks have triggered economic contractions… The growing weakness in the growth rates of ECRI's leading indexes is a warning that recessionary weakness could develop. One key danger is a sustained credit crunch, because the credit crisis is clearly not over."

By the following month (*ECRI Weekly Update*, December 21, 2007), we were ringing the alarm bells, noting that "growth in the Weekly Leading Index (is) now approaching its worst reading since the 2001 recession… Also, the breadth of deterioration evident in the latest data on the components of ECRI's many leading indexes has rarely been seen except near the cusp of a recession."

The Fed was far more complacent, as reflected in its official assessments of the balance of risks, as well as in its decision to cut rates by only 25 basis points in December, while the markets were hoping for a 50-basis-point cut. In fact, as the chart suggests, the Fed's assessment actually shifted to somewhat greater concern about inflation risks and lesser concern about risks to growth (contrast the two points on Chart 1a marked 12/07, which are very far apart).

The Fed's foot-dragging on rate cuts, even as late as last December, was the critical monetary policy mistake in terms of timing. When they woke up to the urgency of the problem and started slashing rates in late January, it was already too late, because recession was beginning to take hold.

Amazingly, by June, the Fed was again focusing squarely on inflation, rather than recession. ECRI's stance was radically different, as the chart shows, and as we have discussed. It took September's financial crisis to arouse the Fed's concerns about growth and the fall in oil prices to allay its inflation fears. Since last month, we surmise that the Fed's inflation concerns have been assuaged further, while its growth concerns have mounted. In essence, the two lines on the chart are finally set to converge in the upper left-hand corner, representing the reality of recession, not needless concerns about inflation. Unfortunately, the Fed's tortuous path to this end-point has doomed the economy to recession and, given the popping of the housing and credit bubbles, an enormously expansive financial crisis.

Of course, as we have described before, the rapid builddown of business inventories in 2007 also afforded a brief window of opportunity for timely fiscal policy action to push off recession (*U.S. Cyclical Outlook*, Vol. XIII, No. 1, January 2008). Sadly, that was yet another opportunity squandered by policy makers preoccupied with the content rather than the timing of policy.