1 The Resurrection of Risk

In the Road Runner cartoon the joke is always the same. Wile E. Coyote chases the Road Runner, misses a sharp turn, and runs right over the edge of the cliff. He looks down and, realizing too late that he is in midair, plunges into the chasm below.

This may seem uncomfortably familiar to those who found themselves carried away by the excitement of the 1990s economic boom. Too late they realized that profits, jobs, or stock prices were already in a free fall. But, unlike the cartoon, it was not funny. A shift from boom to bust, from economic expansion to recession, like the one we experienced in 2001, can be painful, even tragic, for those blindsided by the downturn. That is why it is so critical to be forewarned of turning points in the economy.

Is that even possible? Many would say "no." It is true that economic forecasters rarely get recession calls right. In fact, as a recent study concluded, "The [worldwide] record of failure to predict recessions is virtually unblemished."[1]

But we are here to tell you a different story. It really *is* possible to predict recessions. And we will show you how, so that you will no longer be at the mercy of economic cycles. Whether you are an employee or a student, a business manager or a policy maker, you can learn to navigate the economy's ups and downs.

We will describe a cyclical framework for viewing the economy that relies on an array of objective indicators that, if used properly, warn of turning points *before* they happen. We will also tell you why many of the commonly followed economic indicators can be misleading. You'll discover you don't need a Ph.D. in economics or even a full-time focus on the economy to use our techniques.

But if recessions have historically been so hard to predict, why should you listen to us? Because we have accurately predicted recessions and recoveries when others have failed.[2]

We were able to do this not because we are smarter than other forecasters, or because we have some secret formula, but because at the Economic Cycle Research Institute (ECRI) an eighty-year tradition of business cycle research gives us a unique vantage point. By standing on the shoulders of the giants of business cycle research who pioneered our approach, we have, over time, designed objective tools that accurately predict turning points in the economy. In *Beating the Business Cycle,* we share this information so that you, too, can create your own customized "economic dashboard" that will help steer your future financial decisions in the right direction before you find yourself plunging into the abyss.

Our research tradition was handed down to us by Geoffrey H. Moore, the legendary business cycle scholar whom *The Wall Street Journal* called "the father of leading indicators." Moore was the protégé of Wesley C. Mitchell and Arthur F. Burns, who, early in the twentieth century, pioneered modern business cycle research. Moore's career spanned six decades and focused on the development of practical tools to monitor and predict economic cycles. His approach stands in stark contrast to the views of a generation of economic researchers who shrugged their shoulders long ago, resigned to the belief that forecasting turns in the cycle was impossible and therefore irrelevant. Moore founded the independent Economic Cycle Research Institute to advance the tradition of cyclical research, as well as to refine its predictive tools and make those results available to as many people as possible.

We believe these tools are invaluable in helping you make decisions about your business and your personal life. Why? Because there are both opportunities and dangers linked to the ups and downs of the business cycle that you need to know. When will the next turning point in the economy arrive? How can you avoid getting hurt in a bust? When can you capitalize on the opportunities a boom will offer? This book will give you those answers. It will help you to reduce the risk of being blindsided by an economic downturn and allow you to take full advantage of the good times. So while most economic books are liable to put you to sleep, this book should help you to sleep better.

Wile E. Coyote, after scraping himself off the canyon floor, again gives chase, heedless of the dangers ahead, oblivious to any lessons he might learn. Because he is only a cartoon character, no matter how many times he gets splattered, he never really gets hurt. But life is not a cartoon. And if you are the one to take a nosedive when the economy makes an unexpected turn, the pain is real. It may not be so easy to peel yourself off the canyon floor.

A DIFFERENT PERSPECTIVE

The 2001 recession was the first time many of us experienced what it feels like to go from a boom to a bust. The fact is, with forewarning, the pain could have been considerably less. But the din of the late-1990s euphoria was simply too loud for most people to hear any voice not in harmony with the boom-market revelry.

In September 2000, ECRI warned of a recession ahead[3] to our clients, and later on the evening news shows. Few listened. Most kept upping the ante, convincing themselves and one another that any economic rough spots were only minor speed bumps. It was easy to be swept along by the enthusiasm of the New Economy.

For much of the 1990s, it was worth joining in on the fun. Contrarians missed out on the longest expansion in U.S. history, as the stock market climbed from well below 4,000 to over 11,000. Clearly, during the boom, the important question was "When is it the right time to break away from the bulls?" And in the wake of a bust, it is just as important to know when to part company with the pessimists. The bottom of an economic cycle is the perfect time to ask, "Is now the time to add to my business by buying out competitors while prices are low?"

These questions are answerable. You need not live in a constant state of fear, wondering where the economy is headed. The tools we employ to forecast recessions and recoveries for our major clients can be used by any business or individual. The objective indicators we have developed will tell you when we are approaching a turning point in the economy. We will show you how to read them and use them when making different kinds of financial decisions. But you must be strong enough to trust them—especially when they cut against the grain of popular opinion. And believe us—at the most critical times, they will.

The research that gave rise to these indicators has too long been hidden from public view. Back in the 1920s and 1930s, there was a great deal of interest in business cycles as a result of the boom of the 1920s and the Great Depression that followed. But memories fade. Most forecasters have forgotten the work of Mitchell, Burns, and Moore. This is part of the reason so many economists and financial experts were blindsided by the 2001 recession, and why much of what you read here will seem new.

In March 2001, six months after we issued our initial warning of a recession, it became clear to us that a recession was unavoidable. We were not shy about saying so. *The New York Times* published our call on its front page.[4] In hindsight, it is agreed that was precisely when the recession began.[5]

We do not want to suggest that it was easy to make the call. Far from it. Over a decade had passed since our last recession call in February 1990, five months before the previous recession started. Because we are experts in business cycle forecasting and had the record to prove it, we were under enormous pressure. To make things even more stressful, this was the first recession forecast we would make without the help of Moore, who had passed away a year earlier. (Some believed that it was Moore's uncanny intuition about the direction of the economy that helped us make calls, rather than his research.) In spite of these challenges, we knew that our well-tested methods would steer us correctly. The entire ECRI staff gathered together, spending two weeks poring over each and every indicator. Only then did we steel ourselves to go public; we concluded that it would be irresponsible to do otherwise.

What led us to that conclusion? Not since the mid-1970s had the world's three largest economies—the United States, Japan, and Germany—contracted in sync. We saw that kind of synchronous contraction again in 2001. Nonetheless, for most of the year, few believed that the party was over. Confident that the economic boom would soon resume, the stock market rallied through late May—three months into the recession. Denial persisted even as corporate profits plunged and job losses mounted. In fact, cheerleaders of the boom economy continued their good-times refrain through September 10, 2001, even though stock prices had been dropping sharply since May.

By September 11, the recession was six months old. In the wake of the terrorist attacks, the confusion and the boost from emergency economic stimuli allowed some pundits to continue denying the reality of recession. Others blamed the economy's woes on the unpredictable shock of those attacks.

In the months that followed, many viewed the emerging corporate scandals at Enron, WorldCom, and Arthur Andersen, as well as the intensification of the Israeli-Palestinian conflict and the continued threat from al-Qaeda, as evidence of a "perfect storm" of freak events that caused the recession. Such a view implied that the storm would pass and things would return to the way they were. But the recession did not result from any such storm. In fact, it preceded it. Like earlier busts, it resulted from the wide gap between perceptions and reality, as the wishful thinking about an ever-expanding economy got a wake-up call from the business cycle.

The momentum of the late-1990s boom carried perceptions of growth forward, beyond the downturn that marked the onset of recession. Business managers planned for demand that suddenly vanished; individuals made important career or financial decisions based on a roaring economy; investors held on to large positions in stocks because they believed double-digit returns would continue. Few factored the risk of a recession into their plans, and when one hit with the force of a falling Acme safe, many people were left feeling like the flattened Coyote.

Why were so many caught off guard by the downturn? Certainly the cheerleaders of the New Economy were partly to blame, along with a general belief that the business cycle was dead. But the fundamental reason rests with human nature. When looking to the future, people naturally project from the recent past. Just like Wile E. Coyote, we think that because the road has been straight for some time, it will remain so.

As long as the economy is proceeding in the same general direction, you can easily adjust major business decisions, such as whether to expand your company, hire new employees, or implement cost-cutting measures; in your personal life, you can postpone or accelerate major decisions such as buying or selling a house or changing jobs. But as a turning point in the economy approaches, the gap between reality and one's expectations can lead to painful consequences, and you can find yourself quickly heading in the wrong direction.

During the downturn of 2001, many businesses and individuals experienced this devastation firsthand. The severity of the drop was worsened by the extent to which CEOs believed the hype that recessions were a thing of the past. The fiber-optics and telecom industries built up tremendous overcapacity as a result. Cisco Systems, for example, continued to order equipment from its vendors long after customer orders began to dry up. The bust, in effect, was ensured by the growing dismissal of risk, which led to reckless behavior.

When business leaders, the media, government officials, economists, and individuals make such mistakes together, things go wrong in a big way. A herd mentality takes over and otherwise sane and rational people do crazy things. This tendency lay at the foundation of the biggest stock market bust of our generation. The urge to believe that the future would be like the recent past, combined with a kind of mass euphoria, blinded people to the possibility that the economic times may change.

If bullish behavior during booms and bubbles feels rational at the time, so can pessimism and anxiety during downturns. Like it or not, our assessment of the future is colored by emotion. Subjective interpretations are driven by both the recent past and the prevailing wisdom, and will always lag at economic turning points. Although many people were hurt when the economy turned down, as time passes those scars, too, will fade, and caution will eventually again give way to complacency. When the next recession hits, most people, oblivious of the turn in the cycle, will make the same mistake as before. In the same way, we may, with the recent recession in mind, fail to take advantage of the next boom in the economy. To break from this pattern of basing economic decisions on the recent past, you need to use a decision-making framework that can see through the delusions of the crowd, and anticipate the next turn in the economy.

Good judgments are easy to make after the fact. But it is difficult to make the right decision in the heat of the moment. When it comes to gathering information for making decisions, most of us rely on sources that reflect the consensus view. Yet the consensus, like Coyote, has a dismal record of spotting turns in the road ahead.

Prevailing wisdom on the economy is delivered to you by the news media, whose ratings depend on the excitement that extreme views generate. Politicians and business leaders with their own agendas contribute to the hype. The purveyors of this collective wisdom are focused on advancing their own interests, not yours. As with most things in life, ultimately you need to watch out for yourself.

AN OBJECTIVE FRAMEWORK

As business cycle researchers, we use methods that set us apart from other economists. Our record validates our approach. We correctly forecasted major economic turning points in the United States and abroad over the past decades.[6] While there is no Holy Grail in forecasting, the discipline and objectivity of our approach have allowed us to step away from the crowd at the right time and predict turning points when most forecasters fail (see Appendix A).

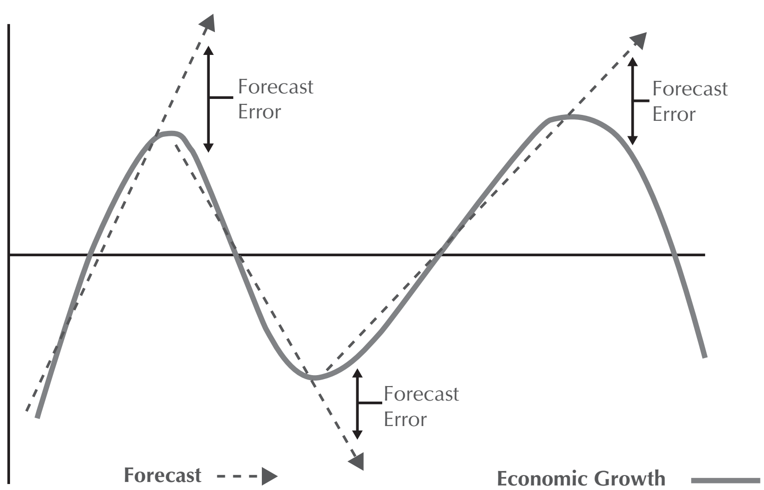
Economic forecasting deserves its bad reputation in predicting recessions and recoveries. As *The Economist* noted, "In March

2001, 95% of American economists thought there would not be a recession, yet one had already started."[7] The reason for this failure is simple. Most economists forecast by extrapolating economic trends. While this methodology has its merits, forecasting turning points is not one of them.

Why does this approach fail to predict turning points? One key reason is that these forecasting models assume the recent past to be a good guide to the near future (see chart below). Most of the time this is true. But as we approach economic turning points, by definition, the pattern changes. The gap between such forecasts and reality balloons, resulting in large forecast errors.

There is a better way. By using our approach, and focusing on the right cyclical leading indicators, you can tell objectively and

A Turning Point Is Difficult to Forecast

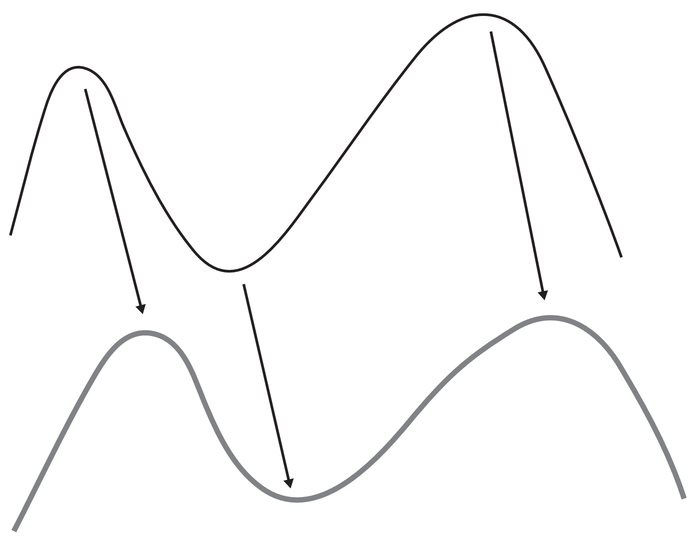


Projecting the future from past patterns can result in big errors at turning points in the economy.

unemotionally when a turn in the cycle is ahead. Unlike models that extrapolate from past trends, these cyclical indicators are specifically designed to predict future changes in the direction of the economy. They turn before the economy does. The focus is on the *timing* of a change in direction (see chart below).

At ECRI we use a cyclical approach that incorporates about one hundred objective indexes to advise governments and central banks, investment managers controlling over a trillion dollars in assets, and global companies ranging from Disney to DuPont, as well as individuals. Seeing a turning point ahead can allow a company to adjust production, inventory, pricing, and hiring. It can help an individual to decide whether it is the right time to change careers or buy a new home. It can assist an investor in making an

Leading Indexes Anticipate Turning Points



Turns in the Leading Index anticipate turns in the economy.

important shift in asset allocation. The risk of making the wrong decision is vastly reduced when the near-term direction of the economic cycle is clear. In this way, a cyclical worldview gives you or your company a critical competitive advantage.

In the following chapters, we will walk you through business cycle basics and provide a framework to help you assess and interpret current events from a cyclical perspective using publicly available information. After all, we developed the first leading indicators of recession and recovery[8] half a century ago. Moreover, you will not need to spend lots of time analyzing economic data in order to benefit from this information.

We have organized a wide range of select data into an array of leading indexes, or gauges, that will help to tell you the likelihood of a turning point taking place. Using those gauges, you can design your own "economic dashboard" to suit your particular needs.

Some businesses and individuals need an economic dashboard as sophisticated as the instrument panel in a jet cockpit. Most of us, however, need only a few warning lights—like the warning gauges in a car—and will probably need only to watch the leading indicators for inflation and economic growth. Whatever your needs, we will tell you where to get this information and how to put it to use.

People whose line of work is sensitive to economic shifts, like fund managers and corporate strategists, will want to keep a sharp eye on their dashboard, watching the indicators' every rise and fall. Most of us, however, can monitor it less closely.

Just as you do not need to know exactly how a car engine works in order to drive safely, once you set up a dashboard, you do not need to understand all the intricacies of the economy to accurately read those gauges. The economic dashboard is a simple way to help businesses and individuals avoid surprises. It acts as an early-warning system that allows you to focus on your business or career without undue worry. Doing so, you will be better positioned to make the decisions that greatly impact your company's future or your personal life.

Are you planning a leave of absence? Thinking of returning to school to get an advanced degree? Checking the leading indicators can help reassure you that the bottom will not suddenly fall out of the job market while you are away. Are you thinking of changing jobs? The gauges we discuss in the book could tell you if the effort is a good use of your energy, or one that puts your existing job at risk at precisely the wrong time. If you foresee a downturn ahead, it may make sense to focus on retaining your current job or consider breaking into a recession-proof industry.

Predicting economic turning points can even help you with respect to your financial investments. If a significant portion of your assets is invested in equities, the gauges you monitor can help you to decide whether a pullback in stock prices is merely a temporary dip, or a recession-driven bear market that calls for a shift of assets into bonds or less volatile investments. If you are a business executive trying to decide whether to expand your business or conserve your resources, our gauges can help you make the right choice at the right time.

Of course, making the right decisions about your business, job, home, or investments requires an ability to withstand peer pressure. Every day you will read or hear views from experts and pundits on where the economy is headed. But especially around turning points in the economy, these views are likely to be wrong.

A wide range of powerful constituencies have a vested interest in promoting their views about where the economy is headed.

Some will be perma-bulls who egg you on even as stock prices plunge. Others are their mirror-image—perma-bears who are so pessimistic they will miss even a history-making expansion. After the fact, these pundits may look in the rearview mirror and analyze events with considerable insight. But will they help you identify the next turning point in time to make a difference?

Since 1790, the U.S. economy has experienced forty-six business cycles. Time and again people came to believe that business cycles had been banished, only to be surprised by a new recession. No sooner had Mark Twain written about the "Gilded Age" in 1873 than a depression enveloped the economy. In the twentieth century alone, we've seen three periods hailed as "New Eras." As remarkable as it may seem, every so often we fall into the trap of believing that some new innovation, technology, or policy has paved the way for a New Era of endless prosperity, where risk and downturns are a thing of the past. It is from these heights of certainty that we tend to crash to the depths of despair, where risk seems to lurk around every corner. Neither extreme is realistic. Cycles always turn; the question is *when*. While every cycle need not exhibit a spectacular boom or bust, it is a sure bet that you will see more recessions and recoveries in the future.

Some people will remain skeptical about predicting turning points. You can choose to believe these naysayers, or join with those who use our approach to guard against unexpected swings in the economy.

Whether a mild recession or a major depression lies ahead, you can be forewarned and forearmed, protecting your interests by staying ahead of the crowd. The tools we offer will give you the confidence you need to break from prevailing wisdom as the economy approaches a turning point, and act decisively in your best interest.