

U.S. CYCLICAL OUTLOOK

GROWTH OUTLOOK GETTING WORSE

Recession Fears

According to a recent poll, nearly two-thirds of the public believes the U.S. economy is already in a recession or on the cusp of one. The worries are no surprise, given the profusion of high-profile observers predicting a recession in the past year, in the context of a housing slump, high oil prices and a credit crisis.

The irony is that the economy has thus far proven to be much more resilient than most economists had expected. In fact, U.S. GDP growth accelerated this year, handily beating Eurozone GDP growth through the first three quarters of 2007. Furthermore, the current U.S. economic expansion turned six years old this month.

One problem with recession predictions is that few people know what a recession really is, other than being a "bad" economy in some amorphous sense. Others think a recession is synonymous with two successive quarters of negative GDP growth. Both conceptions are off the mark.

Indeed, the 2001 recession was marked not by two straight quarters of negative GDP growth, but by more of a zigzag pattern, while the 1990-91 recession saw GDP falling in the fourth quarter of 1990 and the first quarter of 1991. In the 2001 recession, industrial production declined by 6.3%, and nonfarm jobs by 2.1%, or 2.7 million jobs; in the 1990-91 recession, industrial production declined by only 4.2%, while employment fell by 1.5%, or 1.6 million jobs. In some sense, the 1990-91 recession was milder. Clearly, there is more to a recession than GDP.

Given the size of the shocks hitting the economy, it is critical that ECRI's leading indexes do not switch to a recessionary track.

A recession is actually a contraction in the general economy, marked by a snowballing vicious cycle of falling output, employment, income and sales. With GDP, nonfarm jobs, personal income, and manufacturing and trade sales all at record highs in their latest readings, following one-year gains of 2.6%, 1.2%, 4.4% and 1.9% respectively, the key coincident indicators that determine whether the economy is in a recession show quite clearly that it is not. Only industrial production has dropped by 0.5% for one month after a one-year advance of 2.1% through September. In other words, future data revisions aside, there is little indication that a recession has already begun.

Certainly, U.S. economic growth is now downshifting after this year's surge. Growth in every one of ECRI's U.S. leading indexes is now in a cyclical downturn. It is notable that growth in the leading index for nonfinancial services, which accounts for 61% of U.S. jobs, has now dropped to a four-and-a-half-year low. The real question, therefore, is whether a recession is now in sight.

How Vulnerable an Economy?

Following ECRI's accurate prediction of the 2001 recession, we have not predicted another recession, despite Fed rate hikes, major oil shocks, a 100-year flood and a serious housing downturn. It desisted from calling a recession despite an inverted yield curve, which many economists have long considered to be the best predictor of a recession. In fact, ECRI's belief in the resilience of the U.S. economic expansion over this time period has been amply vindicated – and most economists now concede that U.S. GDP growth in the third quarter of 2007, already estimated at almost 4%, will be revised up to around 5%.

This is a notable track record, because it is just as important to not call a recession wrongly as it is to correctly predict one. How did ECRI manage to be correct so far?

There is no perfect recession forecasting method. However, what we have found is that it takes the combination of a cyclically

vulnerable economy – as indicated by good leading indexes – and external shocks to precipitate a recessionary downturn. In this context, it is worth examining how, over the last four decades, the U.S. Long Leading Index (USLLI) has correctly signaled recessionary weakness, which, in combination with significant shocks, has triggered every past recession. The absence of such a combination has also been key to avoiding wrong recession calls.

As Chart 1 shows, the USLLI has exhibited cyclical downturns before every recession, signaling the vulnerability necessary for the economy to succumb to shocks. In each case over this time period, Fed rate hikes have been associated with the recessionary downturns in the USLLI. In the 1969-70 recession, there was no oil price spike, but the Penn Central bankruptcy – the largest in history at the time – along with a General Motors strike, acted as recessionary catalysts. All subsequent recessions were preceded by oil shocks. The Savings and Loan crisis set the stage for the credit crunch that made the economy vulnerable to the oil shock following Iraq's 1990 invasion of Kuwait. The popping of the dot-com bubble, of course, also acted as a shock that helped trigger the 2001 recession.

Yet, other comparable shocks were unable to tip the economy into recession, despite widespread fears at the time. One example was

[Continued...](#)

IN THIS ISSUE

Future Inflation Gauge: Fell in October to a 29-month low.

Leading Home Price Index: Dropped for the eighth straight month, further worsening the home price outlook.

Leading Employment Index: Growth slipped in October, dimming job growth prospects.

Long Leading Index: Growth fell to a two-year low, as longer-term economic growth prospects deteriorated.

Short Leading Index: Growth ticked up but stayed well below July's 15-month high, suggesting restrained near-term economic growth prospects.

Leading Services Index: Fell to a 25-month low, further dimming the service sector growth outlook.

Leading Financial Services Index: Growth edged up from a three-year low, but underscored downbeat financial sector growth prospects.

Leading Nonfinancial Services Index: Growth dropped to a 55-month low, darkening growth prospects for nonfinancial services.

Leading Manufacturing Index: Growth ticked up from a seven-month low while suggesting restrained prospects for manufacturing sector growth.

Leading Construction Index: Growth stayed at a one-year low, confirming a gloomy construction sector growth outlook.

Focus:

Recession Risks

pages 3 to 4

WEAKNESS IN LEADING INDEXES NOT YET RECESSIONARY

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the stock market crash of 1987, which arrived when the USLLI was not exhibiting recessionary vulnerability. That was the case as well in 2002, when stock prices plunged to multi-year lows amid fears of a double-dip recession. It is also notable that the shock of the 1941 attack on Pearl Harbor was unable to set off even a brief recession before wartime spending boosted the economy, with the USLLI in a clear upturn in the lead-up to that attack (*U.S. Cyclical Outlook, Vol. X, No. 9, September 2005*).

More recently, following a series of Fed rate hikes, we experienced an oil shock in 2005, followed by the housing downturn. In contrast to past cycles, with the USLLI still holding up, these shocks were not able to trigger a recession.

This summer saw the start of a credit crisis, which has clearly not abated. This fall, we have had another oil price spike to nearly \$100 a barrel. As we discuss in detail later ([pages 3-4](#)), 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 difference this time is that, even though the shocks have arrived, good leading indexes like the USLLI are not yet showing recessionary weakness, whereas in the past such recessionary vulnerability was *followed* by the shock. This is a key reason why the economy is not yet in a recession.

The growth rates of ECRI's leading indexes have clearly turned down in concert, predicting a major economic slowdown. In fact, as Chart 1 shows, the level of the USLLI is already a little lower now than it was three months earlier. However, this weakness is not pronounced, pervasive and persistent enough to be recessionary.

In earlier episodes, the fact that the vulnerability of the economy developed first, and the shocks followed, meant that we could predict a recession well in advance, in the expectation that some shock or another would soon arrive. That was certainly the case in 1990, when we predicted a recession in early February, but it was not until August 1, the day of Iraq's invasion of Kuwait, that we knew the source of the shock. The point is, however, that we knew on that very day that the economy was in recession, given its vulnerability, while most economists, along with the Fed, did not figure this out for months.

This time, the shocks have already arrived. Therefore, *if* our leading indexes start exhibiting recessionary vulnerability, we could quickly change our view on the likelihood of recession.

Storm Clouds and Silver Linings

Further weakness in the growth rates of ECRI's leading indexes would be a warning that recessionary vulnerability could soon develop. One key danger is a sustained credit crunch, because the credit crisis is clearly not over.

It is troubling that spreads in several key markets have widened afresh since last month after tightening earlier. This includes credit default swap spreads and spreads between asset backed commercial paper and direct issue commercial paper, as well as the Treasury-Libor yield (TED) spread. The yield spread between junk bonds and BAA-rated bonds has also widened sharply in recent weeks. Jumbo mortgage spreads remain wide, forcing homebuilders to drop prices in some cases to take advantage of conforming loans. In short, there is still plenty of distrust and risk aversion in the financial markets that could make a prolonged credit crunch a reality.

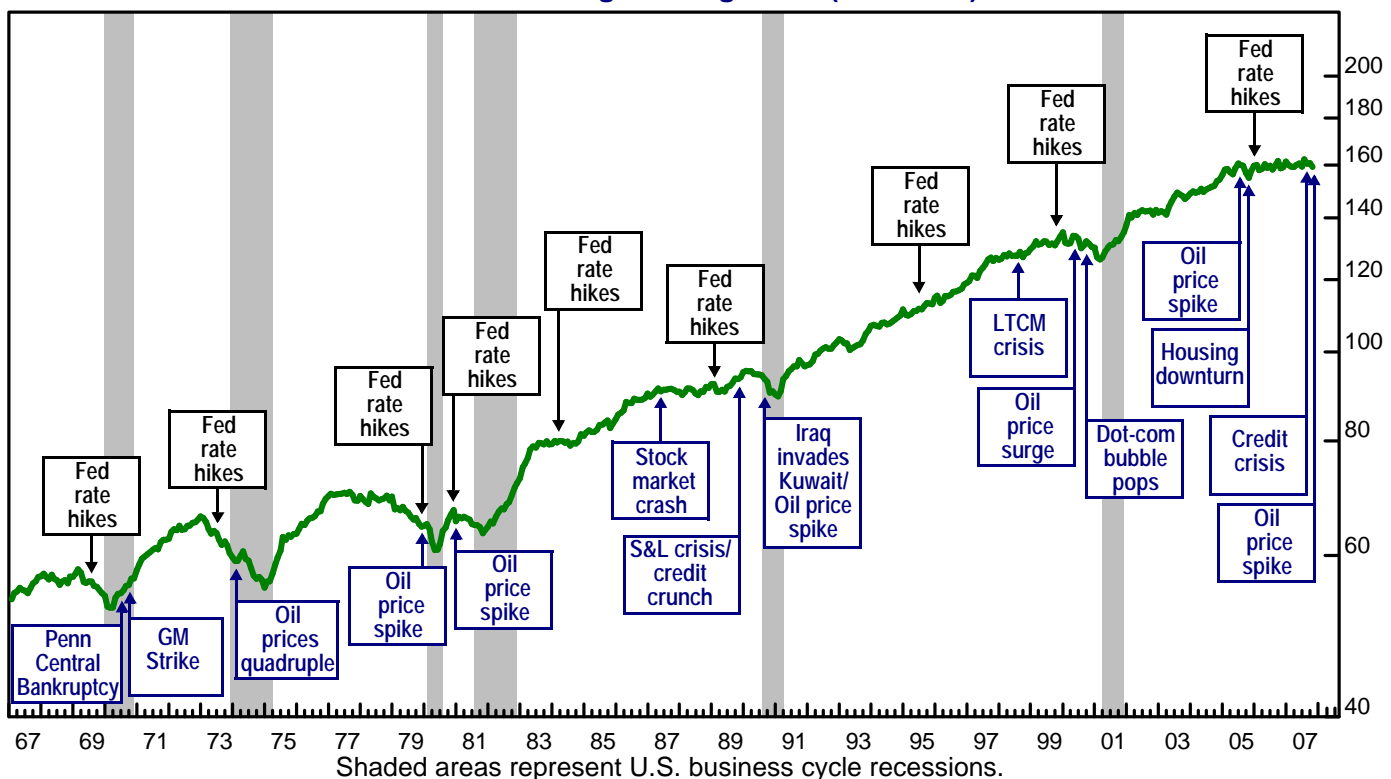
Because credit is a key driver of the business cycle, this is a worrisome situation. But there are a couple of silver linings.

First, the leading indexes are not yet in a recessionary configuration, thus a recession can still be averted. Separately, rhetoric aside, the Fed has leeway to cut interest rates further as needed, because underlying inflation pressures are falling, according to the U.S. Future Inflation Gauge (Chart 3, [page 6](#)). True, the dollar has plunged and oil prices have soared, but the impact has been to curtail the willingness of consumers to pay full price, inducing Wal-Mart, for example, to cut the prices of 15,000 items in the face of price increases from Chinese suppliers. Thus, the consumer may have lost the battle against inflation in the arena of nondiscretionary purchases of food and energy, but may be winning the war in terms of overall inflation for discretionary purchases.

Secondly, with ECRI's indicators pointing to an imminent global industrial slowdown, inflation in the prices of industrial commodities, including oil, may become more subdued. If that results in a drop in the price of oil, it would reduce the size of the oil shock, just as further Fed rate cuts would mitigate the interest rate shock. In fact, as Chart 2a ([page 4](#)) underscores, those would be very welcome developments.

For the time being, however, the objective leading indexes are still holding up sufficiently for a recession to be averted. It is important that the shocks to the economy subside while that is still true.

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





ECRI WEEKLY UPDATE

OVERALL OUTLOOK

With growth in the Weekly Leading Index now approaching its worst reading since the 2001 recession, and growth in ECRI's Leading Indexes of Construction and Services falling noticeably further, the outlook for overall economic growth has clearly darkened.

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.

Still, given the positive export growth outlook and room for further policy action, a recession is not inevitable.

Meanwhile, underlying U.S. inflation pressures remain in retreat.

RECENT DEVELOPMENTS

- Growth in the Long Leading Index (LLI, Chart 3) dropped in November, as did the LLI, due to adverse moves in measures of [redacted] partly offset by a favorable move in a measure of [redacted]
- Growth in the Leading Services Index (LSI, Chart 4) fell in November, but the LSI edged up, due mainly to a favorable move in a measure of [redacted] mostly offset by declines in measures of [redacted]. Meanwhile, growth in the Coincident Services Index (CSI, Chart 4) ticked up in October.
- Growth in the Leading Manufacturing Index (LMI, Chart 5) increased in November, as the LMI was pushed up by favorable moves in measures of [redacted] partly offset by adverse moves in measures of [redacted]. Meanwhile, growth in the Coincident Manufacturing Index (CMI, Chart 5) edged down in November.
- Growth in the Leading Construction Index (LCI, Chart 6) fell in November, as did the LCI. The index was pulled down by declines in measures of [redacted] partly offset by favorable moves in measures of [redacted]. Meanwhile, growth in the Coincident Construction Index (CCI, Chart 6) rose in November.
- The smoothed growth rate of the Weekly Leading Index (WLI, Chart 1b) of economic activity fell further, as did the WLI, mainly due to negative contributions from measures of [redacted] partly offset by an increase in a measure of [redacted]. The monthly WLI fell in November, as did its growth rate (Chart 1a), due to adverse moves in measures of [redacted] partly offset by favorable moves in measures of [redacted].
- The weekly U.S. Future Inflation Gauge (USFIG, Chart 2b) fell in the latest week, mainly due to disinflationary moves in measures of [redacted]. The monthly USFIG (Chart 2a) rose in November due to inflationary moves in measures of [redacted] partly offset by disinflationary moves in measures of [redacted].

ECRI Indexes	Latest Month Ending			Prior Period	
	Period	Level	Growth	Level	Growth
LLI	11/07	158.6	-1.7%	159.5	-0.6%
LSI	11/07	162.6	2.3%	162.5	2.6%
LMI	11/07	147.8	3.5%	147.0	3.3%
LCI	11/07	122.1	-6.1%	123.2	-5.0%

ECRI Indexes	Latest Month/Week Ending			Prior Period	
	Period	Level	Growth	Level	Growth
WLI, Weekly	12/14/07	136.2	-4.8%	137.9	-3.9%
WLI, Monthly	11/07	137.4	-3.1%	139.3	-0.2%

ECRI Indexes	Latest Month/Week Ending			Prior Period	
	Period	Level	Growth	Level	Growth
USFIG, Weekly	12/7/07	118.4	-3.1%	118.9	-2.4%
USFIG, Monthly	11/07	119.7	-0.9%	119.0	-2.1%

CHART 1a: WEEKLY LEADING INDEX, GROWTH RATE (%)

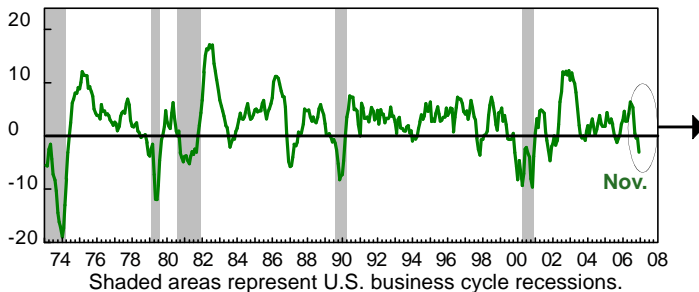


CHART 1b: WEEKLY LEADING INDEX, GROWTH RATE (%)

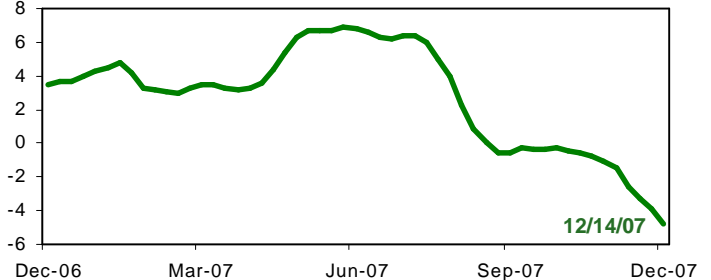


CHART 2a: U.S. FUTURE INFLATION GAUGE (1992=100)

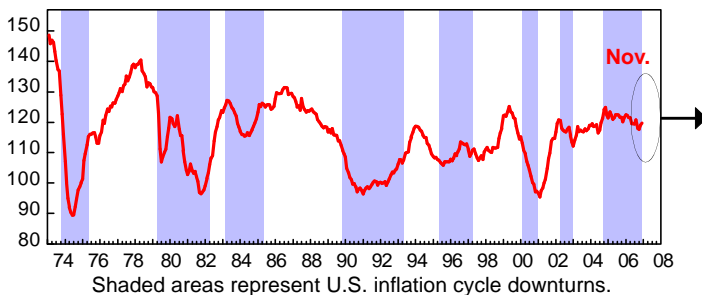


CHART 2b: U.S. FUTURE INFLATION GAUGE (1992=100)

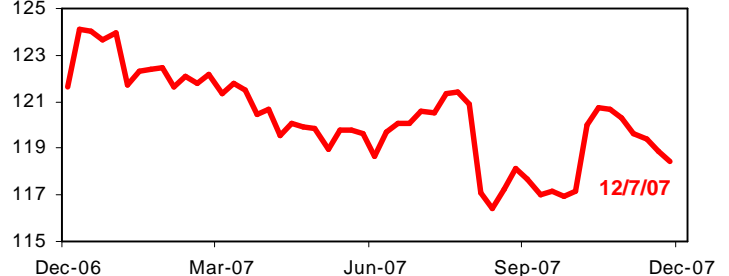
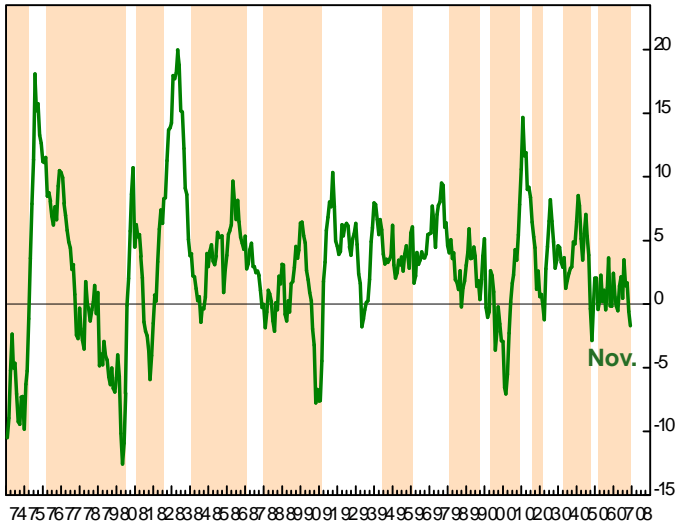
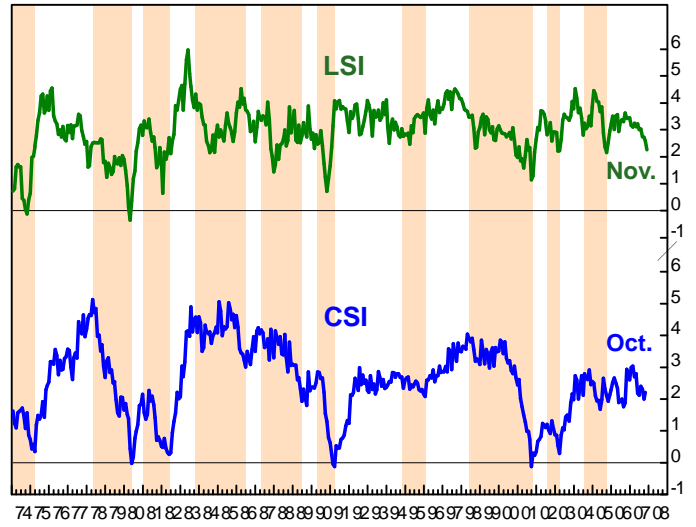


Chart 3: U.S. Long Leading Index, GR (%)



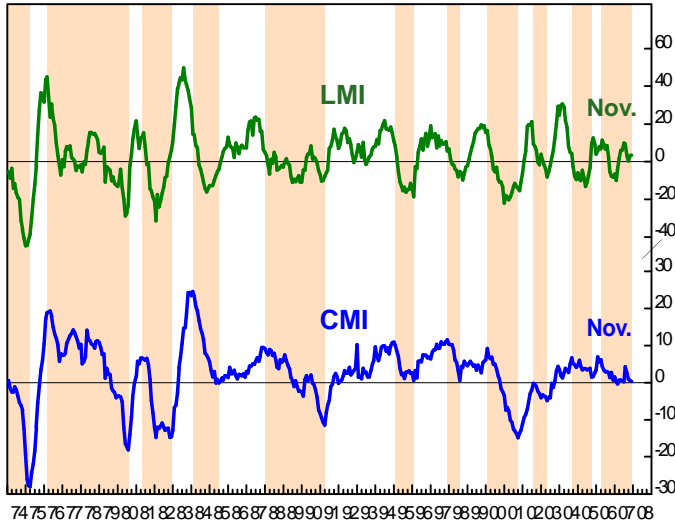
Shaded areas represent U.S. growth rate cycle downturns.

Chart 4: Leading & Coincident Services Indexes, GR (%)



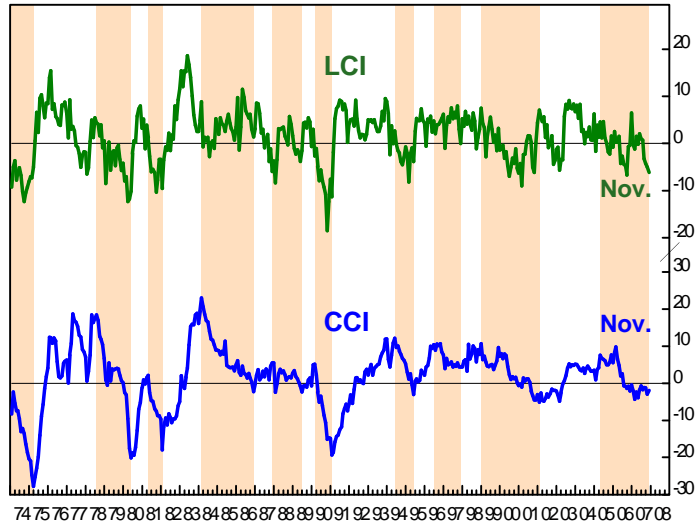
Shaded areas represent cyclical downturns in the growth rate of U.S. services activity.

Chart 5: Leading & Coincident Manufacturing Indexes, GR (%)



Shaded areas represent cyclical downturns in the growth rate of U.S. manufacturing activity.

Chart 6: Leading & Coincident Construction Indexes, GR (%)



Shaded areas represent cyclical downturns in the growth rate of U.S. construction activity.

ECRI WEEKLY UPDATE is a supplement to our monthly reports, *INTERNATIONAL CYCLICAL OUTLOOK* and *U.S. CYCLICAL OUTLOOK*. It is designed to inform readers promptly of changes to ECRI's forecasts. Updates contain the latest weekly leading indexes of growth and inflation, and focus on the latest monthly updates, scheduled as follows:

- Week 1: Future Inflation Gauges (Eurozone, Japan, U.K., Canada, Germany, France, Italy, Spain and Korea)
- Week 2: U.S. Short Leading Index; Leading and Coincident Employment Indexes
- Week 3: U.S. Long Leading Index; Leading and Coincident Services, Manufacturing and Construction Indexes
- Week 4: International Indexes (G7 + eleven countries)

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