Veering Away from Recession Track

ECRI's leading indexes are no longer on the recession track, but a revival in growth is not in clear sight.

Double-Dip Danger Dwindles The double-dip debate flared up a few months back when U.S. economic growth began to show signs of flagging. ECRI had predicted – well in advance – both the deceleration in growth and the renewed recession worries, reiterating our forecast of a slowdown starting by mid-year *(↗U.S. Cyclical Outlook, Vol. XV, No. 3, March 2010)*, after having first made that call three months earlier in December 2009 *(↗U.S. Cyclical Outlook, Vol. XIV, No. 12)*. But in our March report, we went on to explain why we would not know until this fall, at the earliest, whether the slowdown would result in a hard or soft landing.

Sure enough, when we performed a detailed analysis four months ago in this publication *(↗Vol. XV, No. 6, June 2010)*, the conclusion remained that it was still "premature to predict a new recession." Using the same disciplined approach, we have now repeated and expanded that analysis. This time, the results are more definitive *(↗pages 6 to 9)* and show the economy moving away from the recession track.

Two months ago, while not in a position to predict a soft landing, we featured a detailed discussion of the cyclical behavior of stock prices in that scenario *(↗U.S. Cyclical Outlook, Vol. XV, No. 8, August 2010)*, while also making a categorical prediction of an upturn in global industrial growth starting around year-end *(↗International Cyclical Outlook, Vol. XV, No. 8, August 2010)*. Last month in this publication *(↗Vol. XV, No. 9, September 2010)*, we highlighted the concerted one-month upticks in ECRI's leading indexes of U.S. economic activity, which we characterized as "encouraging, but hardly decisive." Our latest analysis reveals that, in terms of the patterns of movements of the U.S. Long Leading Index (USLLI), Weekly Leading Index, U.S. Short Leading Index, and the three main sector-specific leading indexes, the post-recession upturns are about as pronounced, pervasive and persistent as they were during the early 1990s and early 2000s recoveries, as opposed to the corresponding patterns during the short-lived 1980-81 revival that was followed by a new recession *(↗pages 6 to 9)*.

Separately, we have also examined all the post-World War II downturns in the USLLI leading up to both hard and soft landings. As expected, the USLLI downturns culminating in hard landings were clearly more pronounced, pervasive and persistent than they were before soft landings. During the current

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slowdown, the decline in the USLLI has been about as pronounced, pervasive and persistent as it was, on average, prior to the earlier soft landings, and much less so than before the earlier hard landings (↗*pages 6 to 9*). Put another way, the USLLI is unmistakably veering away from the recession track.

Growth to Ease Further While hewing to the soft landing track, ECRI's leading index growth rates are not yet exhibiting definitive cyclical upturns. In fact, USLLI growth has now declined to a 21-month low. Therefore, it is too soon to predict a revival in U.S. economic growth.

Revival in Growth not in Clear Sight. Job Growth to Worsen Further.

Considering the historical durations of periods of cyclical deceleration in economic growth that did not turn into recessions, this is not surprising. After all, the current growth rate cycle downturn began only around mid-2010, while the median duration of such downturns in soft landings is a year and a half. Therefore, if the current slowdown is near typical, we will not see a clear reacceleration in economic growth until the end of 2011.

Given the variation in the duration of growth rate cycle downturns, it is not a good idea to use their average duration to forecast the duration of the current slowdown. Rather, it is likely to be better signaled by a cyclical upturn in USLLI growth, which has not yet begun.

The current slowdown is already taking its toll, especially in terms of a sharp deterioration in job growth across the country. In that context, Charts 1a and 1b revisit the job gain/loss maps that we had shown in July in this publication (↗*Vol. XV, No. 7*). Within these maps, the states colored in blue had shown employment rising over the most recent three and/or six months, while not declining over the most recent three-month or six-month period. The states colored in red had shown employment dropping over the most recent three and/or six months, having shown no increase over those time spans. The remaining states, colored yellow, had shown a changing trend, i.e., employment rising or staying flat over the most recent six months while falling or staying unchanged over the most recent three months – or vice versa.

The picture as of June 2010 (shown in that report) was what we called "a sea of blue, signifying a geographically widespread increase in employment." At the time, we pointed out that "the percentage of states ... showing sustained job gains [was] higher than the percentage of states showing sustained job losses at the end of 2008, when the U.S. economy had just fallen off a cliff."

What a difference a couple of months makes! The July data (Chart 1a) already showed a dozen of the erstwhile "blue" states turning yellow. The latest available data (Chart 1b) is from August, and shows a sea of yellow, with patches of red, especially in the western United States. In fact, except for a dozen states – a few in the Northeast and a narrow band stretching

Chart 1a: U.S. Job Gain/Loss Map, July

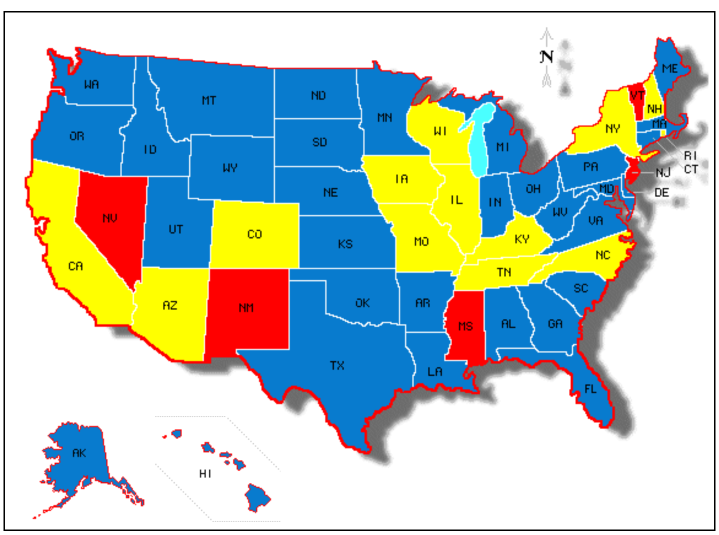


Chart 1b: U.S. Job Gain/Loss Map, August

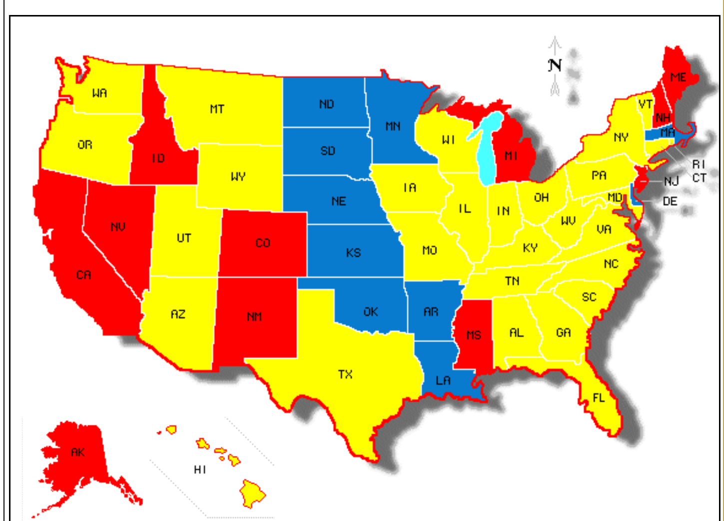
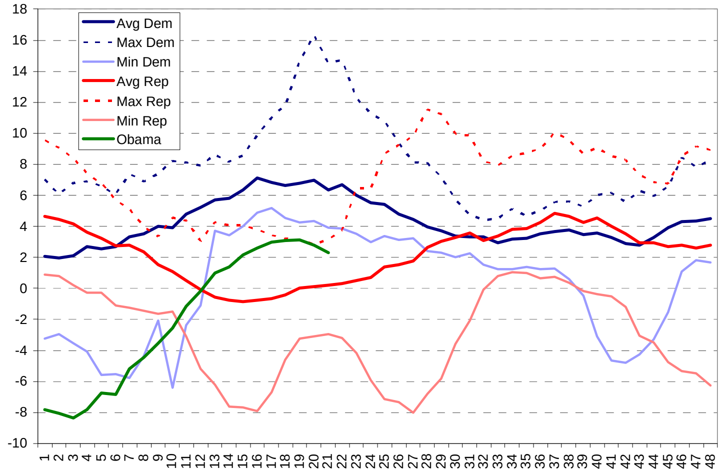
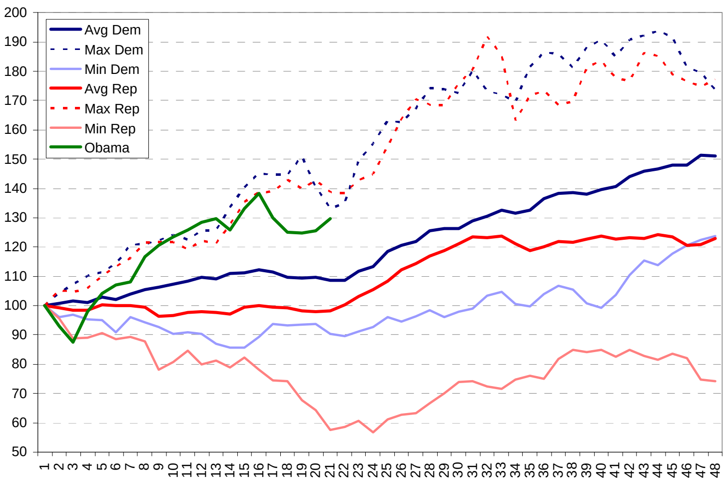


Chart 1c: U.S. Coincident Index, Growth Rate (%)



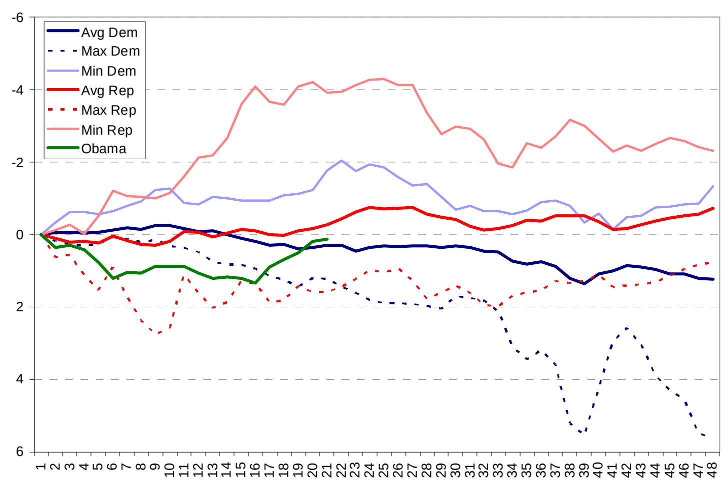
Months into Presidential Administration

Chart 1d: U.S. Stock Prices



Months into Presidential Administration

Chart 1e: U.S. Treasury Yields (Inverted)



Months into Presidential Administration

from North Dakota to Louisiana – every state now has fewer jobs than it did three months earlier, including more than a dozen that have fewer jobs than they did six months earlier.

The diffusion of job market weakness is a classic symptom of the cyclical downturn in job growth that was anticipated by the earlier downturn in the growth rate of the Leading Employment Index (LEI). With LEI growth falling in September to a one-year low (*↗Chart 8, page 13*), the job growth outlook has faded further. Clearly, this implies that the jobless rate will not resume its decline very soon, increasing the probability of sustained policy efforts to support jobs.

Political Patterns The rapid spread of renewed job losses across the states (shown in Chart 1b) has obvious political ramifications. However, it is also worth examining certain historical patterns when there is a Democrat, and when there is a Republican, in the White House.

Chart 1c shows the growth rate of the U.S. Coincident Index (USCI) in postwar administrations. The USCI includes the broad measures of output, income, employment and sales, and is therefore a good measure of overall economic performance.

We segment the history of USCI growth since 1949 into 15 four-year presidential terms and then compute the average USCI growth rate over nine Republican terms (Chart 1c, thick red line) and separately over six Democratic terms (Chart 1c, thick blue line). We can also track the maximum (dashed lines) and minimum (thin solid lines) for the USCI growth rates at each point in the presidential term separately for Republican and Democratic administrations. In general, the blue lines correspond to four-year periods when the president was a Democrat, while the red lines correspond to Republican presidencies, with the green line representing the experience during the Obama administration.

Six years ago we pointed out (*↗International Cyclical Outlook, Vol. IX, No. 10, October 2004*) that "USCI growth rates, on average, were similar at the beginning of Republican and Democratic administrations, as well as after the middle of the third year." But there was, on average, a marked divergence in the second year.

Specifically, midway through the first year, USCI growth, on average, in Democratic administrations begins to outstrip the performance in Republican ones, with the greatest divergence appearing early in the second year. As noted six years ago, "it is interesting, but not necessarily significant," that during most of the second year, the minimum USCI growth rate in the six Democratic administrations beat the maximum USCI growth rate in the nine Republican administrations. "Thereafter, the average divergence narrowed, disappearing by the middle of the third year. For a year or so thereafter, Republican administrations had a slight edge, which disappeared closer to the election."

The Obama administration (green line) started its term with the worst USCI growth on record. However, the economy's performance rapidly improved until the middle of the second year of the administration, after which it began to worsen. Thus far, we have seen the worst USCI growth in any postwar Democratic administration.

QE2 Risks Underplayed. Fed Policy Still Behind the Curve.

We now turn to the performance of stock prices (specifically, the S&P 500 Index) during postwar presidential terms (Chart 1d), indexing the stock price level to 100 in January of the first year of each four-year presidential term. It is evident that, in terms of both the average performance (thick lines) and the worst performance (thin solid lines) in each month of the four-year terms, stock prices in Republican administrations were consistently worse than in Democratic administrations. In terms of the best performance (dashed lines), though, there was little difference between Democrats and Republicans – and the performance of equities during the current administration (green line) is not far from those benchmarks.

However, the picture is quite different where 10-year treasury yields (with changes in yield from January of the first year of each four-year presidential term shown inverted in Chart 1e) are concerned. While the first year shows fairly similar performance, we find that thereafter, treasury yields, on average, fall a bit during Republican administrations but keep rising during Democratic administrations (thick solid lines). In terms of the decline in treasury yields (considered here to be a positive since it implies a rise in prices), the best performance under Republican presidents is much better, at least after the first year, than that under Democrats (thin solid lines). In terms of the worst performance, however, the performance under Republicans and Democrats is similar, except in the fourth year, when the performance under Democrats is far worse (dashed lines). In the current administration (green line), yields rose somewhat in the first year, but are now back to around where they were when the Obama administration took office.

While there are evident historical patterns here, these may well be instances – especially in the absence of compelling explanations – where past performance is not an indicator of future results. Rather, especially because so much is potentially different this time, we would prefer to base our own near-term forecasts on objective leading indexes.

Causes for Concern It appears from ECRI's leading indexes that the worst-case scenario – an imminent new recession with the attendant risk of deflation – is not likely to materialize. However, with job growth, in particular, continuing to slow for the foreseeable future, there may be sustained pressure for aggressive monetary policy action.

A key controversy regarding Fed policy today has to do with the likely efficacy of a new round of quantitative easing, and the extent of structural versus cyclical unemployment. With regard to its effectiveness, most agree that the degree of impact of a second round of quantitative easing is uncertain, but its advocates argue that, under the circumstances, there is no alternative.

In fact, if unemployment is largely cyclical, as Fed Chairman Bernanke thinks, Fed balance sheet expansion may be effective in lowering the jobless rate if it affects the economy rather than merely boosting asset prices. If a substantial part of the joblessness is structural, however, a cyclical boost to the economy may not reduce unemployment significantly in any case. Rather, the economy may approach "full employment" at a rather higher level of joblessness.

We have presented evidence in this publication *(↗Vol. XV, No. 9, September 2010)* supporting the view that a significant portion of the job losses may indeed be structural in nature. The fact that the long-term (over six months) jobless rate is near record highs while the short-term (under five weeks) jobless rate is near record lows reveals a mismatch of skills in the job market, where those with skills in high demand are quickly snapped up by employers while people with skills not in great demand are effectively sidelined.

In the current circumstances, millions of jobless also have homes that are worth less than the amounts they owe on their mortgages, making it difficult to sell their homes and move to where the jobs are. To the extent that these people stay unemployed while home prices stagnate, their skills atrophy, effectively boosting structural unemployment. In other words, structural unemployment is not only significant already, but may rise further, rendering Fed action less effective.

Because monetary policy acts with the well-known "long and variable lags," the Fed should, in principle, use forward-looking measures to set policy. In practice, it does pretty much the opposite, relying as it does on backward-looking measures of core inflation and hard-to-estimate measures of the output gap, including estimates of "full employment," which Mr. Bernanke seems to believe corresponds to a jobless rate somewhere north of 5% but may be quite a bit higher if much of the unemployment is structural.

Recall that in early 2010, as ECRI was forecasting a mid-year slowdown, the Fed was focused on its "exit strategy." In addition, the Fed has demonstrated – in mid-2003 as well as in mid-2008 – that it can be spectacularly behind the curve in detecting a turn in the cycle. The consequences of the Fed's mistakes of omission and commission associated with those periods played out in the subsequent quarters and years to the severe detriment of the economy, but the fallout from such timing errors could be much greater when the Fed's balance sheet is as large as it is, and poised to expand much further.

Mr. Bernanke, having effectively telegraphed that the Fed's inflation target is between 1.5% and 2%, has also characterized the current core inflation rate as "too low," even though it is only about one percentage point below that target. Core inflation was near these readings in 2003, when the Fed kept rates at 1% – with serious longer-term consequences – and was slightly below such levels half a century ago, when no great deflationary disaster followed. What is left unsaid is that today, as in 2003, the Fed is concerned about a new recession, which would indeed bring with it a deflationary threat.

The point is that the Fed has repeatedly demonstrated its inability to either forecast recessions or rule them out in a timely manner, and has consequently been well behind the curve in setting policy. This has proved to be dangerous enough in recent business cycles, but could be disastrous when, by its own admission, it is in uncharted territory, especially in terms of the size of its balance sheet.

Until today, we had considered the risk of a new U.S. recession to be significant, though ebbing. It is now clear from ECRI's leading indexes that we are no longer on a recession track. Since Fed policy is implicitly premised on a different assumption, and is likely to be once again behind the curve, there could be serious consequences down the road.

Under the circumstances, it will be critical to keep a close eye on the U.S. Future Inflation Gauge – which has begun to creep up again (Chart 3, page 11) – for early clues to a cyclical upswing in inflation. We will also closely monitor USLLI growth (Chart 10, page 14) for an early indication of an exit from the current economic slowdown. ■

