US Macroeconomics

July 21, 2023

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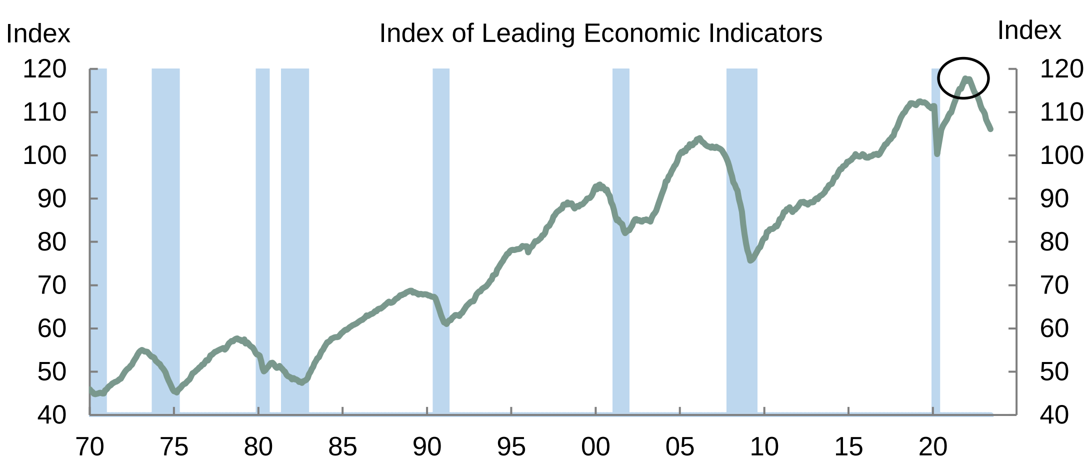
Lower, Lower and Lower — What Could Go Wrong?

The Index of Leading Economic Indicators (LEI)—compiled by the Conference Board—is comprised of 10 series that historically lead turning points in the broader economy. They are the factory workweek, initial jobless claims, new consumer goods orders, nondefense capital goods orders excluding aircraft, ISM new orders, building permits, the S&P 500 stock index, the interest rate spread between the fed funds rate and the 10-year Treasury note, consumer expectations, and the leading credit index (a hodgepodge of various financial sector indicators).

The LEI peaked in December 2021 and essentially has been in freefall ever since. In June, the series fell 0.7%, after shrinking 0.6% in May. The LEI is now down 15 consecutive months and about 8% over the past year. The current string of declines coupled with the magnitude of declines always has been associated with recession. In fact, history suggests that we should already be in one. But that is not the case at present because the unemployment rate is up only two-tenths from its cyclical low of 3.4%. Typically, recessions start when workers are let go, and the unemployment rate increases by half of a percentage point or more from its trough. Consequently, some economists now wonder whether the series is broken. How so?

The LEI is heavily weighted toward the goods sector. The factory workweek, consumer goods orders, nondefense capital goods orders and ISM new orders are all correlated with changes in manufacturing. And even building permits are connected to factory production through the construction of a house. This means that half of the LEI is manufacturing related. And since the latter accounts for an increasingly smaller share of the economy, it is possible the LEI is losing its predictive power. But there is another factor to consider — lags.

While the average lead-time from the peak in the LEI to the peak in the economy is 11 months (consistent with recession beginning in November 2022), the lags vary. For example, **there was a record 21 month lead from the peak of the LEI in March 2006 and the peak in the economy in December 2007**. A similar lead-time in this business cycle lines up with a September 2023 peak. Of course, the anticipated recession could happen even further out into the future because of lingering anomalies and distortions related to the pandemic such as excess savings and labor hoarding among other factors.



Sources: Conference Board, Haver, SMBC Nikko

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