US Macroeconomics

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Irreparably Broken?

In the past, the Leading Economic Indicators (LEI) has been a useful forecasting tool. The series tended to do a good job tracking inflection points in the economy. However, the LEI might be irreparably broken.

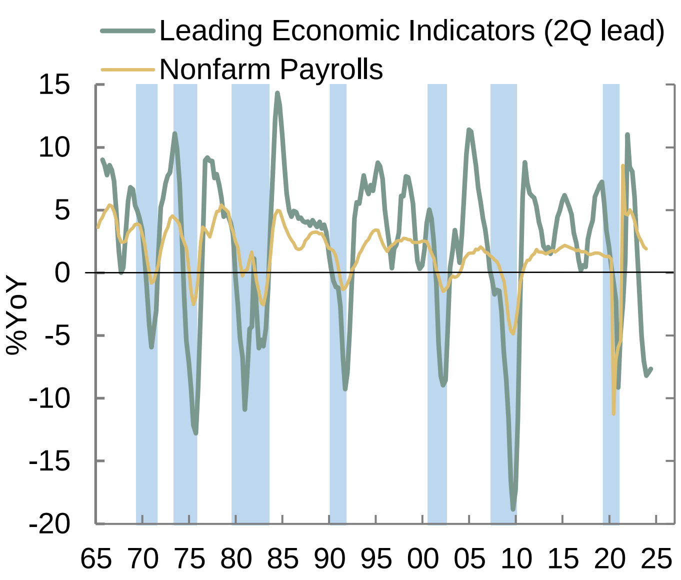
In 2023 nonfarm payrolls grew 2% while the LEI fell 7%, resulting in a large nine point differential. As shown in the left side chart below, there have been larger gaps between the two series before. It happened in 1974-74, 1980, and 2008-09. But in each of these instances, the economy was shedding jobs. At present, the labor market continues to expand.

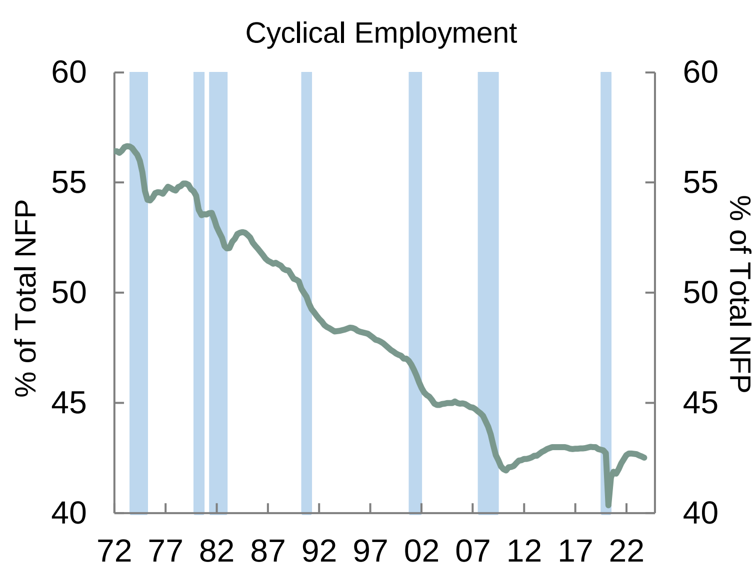
To be sure, the jobs market may still falter. Payrolls could decline this year as the economy enters what turns out to be a mild recession. If so, the LEI would ultimately be proven correct albeit with a ridiculously long lead-time as it peaked way back in December 2021.

So why might the LEI be fundamentally broken? **Our best guess is the LEI overweights the manufacturing sector in its design**, comprising four of the series' 10 subcomponents. Moreover, since the manufacturing share of output has been declining for decades, its movements may be less indicative of broader labor market trends than in the past. If so, the LEI may have lost its forecasting power.

The changing composition of the labor market away from economically sensitive sectors, such as manufacturing, toward acyclical industries is shown in the right chart below. Cyclical employment includes manufacturing in addition to mining, construction, wholesale trade, retail trade, transportation, warehousing, and leisure/hospitality. Its share of total employment is down sharply from its peak.

In 1973, cyclical employment accounted for a record high 57% of all jobs. Today it is just 43%. While the ratio has been relatively steady for the past 10 years, the current boom in AI-led information services spending could be a catalyst pushing the cyclical share of employment even lower. If so, what the LEI is designed to measure could become even more irrelevant. For this reason, economists may need to look to other leading indicators of the economy to ascertain its direction.





Source: Conference Board, BLS, Haver, SMBC Nikko

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