



(MIS)LEADING INDICATORS?

INTRODUCTION

The recent downdraft in the equity markets coupled with generally weaker economic data and continuing concerns over European sovereign debt have prompted economic forecasters to lower their growth expectations for the U.S. economy. In turn, this has squeezed the perceived margin of error between expansion (growth) and contraction (recession) to a razor thin level. Traditionally, there have been several measures the market has come to rely upon to serve as a predictor of future recessions. We will focus on two measures, the Conference Board Index of Leading Economic Indicators (LEI) and the yield curve, to examine their reliability in the current environment.

CONFERENCE BOARD LEI

The Conference Board publishes leading, coincident and lagging economic indicators intended to signal peaks and troughs in the business cycle. For more information on the indices, including a description of the components, click on the following link (<http://www.conference-board.org/data/bci/index>).

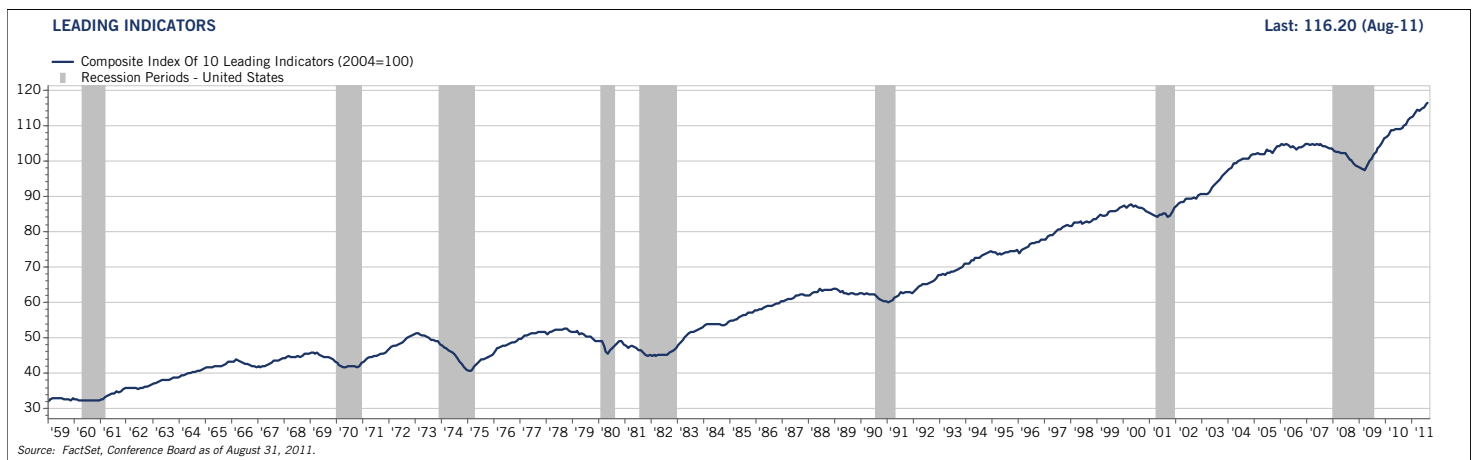
The LEI index has historically been a good barometer of signaling changes in the business cycle before those changes are more apparent in aggregate economic activity (Figure 1). In each of the eight recessions since 1960, the LEI index has shown a decline in advance of the onset of a recession.

The index has two components, M2 money supply and interest rate spread (10 Yr Treasury less Fed Funds rate), which are directly influenced by monetary policy decisions. As these two factors combine to have a 43% weighting on the index, we can readily see that the Federal Reserve has the ability to sway the LEI. The other eight components directly reflect “underlying economic activity” or market sentiment (e.g. consumer expectations, stock prices).

As we see from Table 1, the “Fed components” and “other components” have exhibited a positive correlation with the LEI over the long term. In the case of the other components, the relationship is quite strong indicating the broad economic factors are the key drivers of the LEI despite its 57% collective weighting. This relationship also holds true since the Fed started its quantitative easing (QE) program in September 2008.

The same cannot be said for the Fed components. Since QE began, the correlation between the Fed components and LEI has changed drastically, turning to a moderately negative level. Additionally, the relationship between the Fed components and other components has decoupled as well at -.70. The divergence could be an indictment on the efficacy of the Fed’s accommodative monetary policy as liquidity and low rates had a questionable impact on

FIGURE 1: INDEX OF LEADING ECONOMIC INDICATORS



the “other components” category, especially toward the end of the QE2 program (Figure 2). While QE2 ushered in a rise in commodity prices, inflation and stock prices and a decline in the USD, the underlying economic impact remains debatable.

As the market contemplates the probability of QE3 or impact of Operation Twist, it certainly calls into question whether additional monetary stimulus will incite a rebound in economic growth or a meaningful change in the financial condition of the average consumer. On a more ominous note, the last time we saw a divergence of the current magnitude was during the last recession.

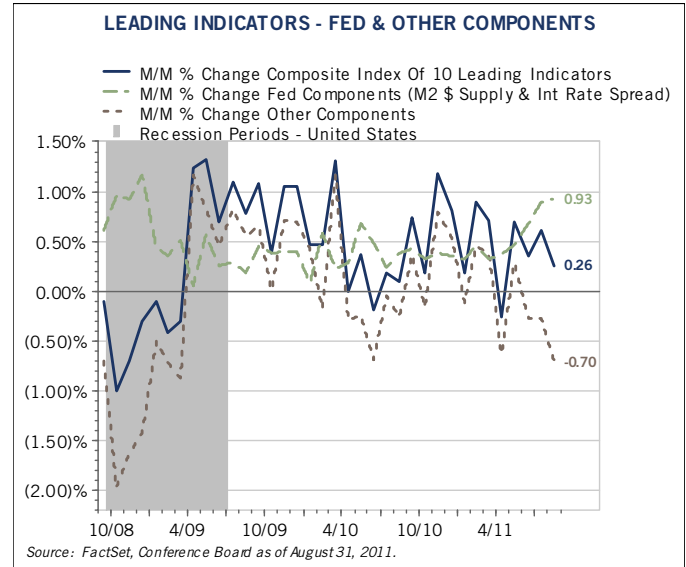
TABLE 1: LEI COMPONENT CORRELATIONS

Long Term Correlation (1/59-8/08)			
	LEI	Fed Components	Other Components
LEI	1.00	0.63	0.94
Fed Components	0.63	1.00	0.35
Other Components	0.94	0.35	1.00

Correlation Since QE (9/08-8/11)			
	LEI	Fed Components	Other Components
LEI	1.00	-0.47	0.96
Fed Components	-0.47	1.00	-0.70
Other Components	0.96	-0.70	1.00

Source: FactSet, Conference Board as of August 31, 2011.

FIGURE 2: LEI COMPONENTS DIVERGE



YIELD CURVE

Another measure intended to signal changes in economic conditions is the spread between long-term and short-term yields. Conventionally, when the spread between the 10-year U.S. Treasury and 3-month U.S. Treasury turns negative, it would signal an impending recession. Much like the LEI, this has also been a good barometer of business cycle changes (Figure 3). As we can see, the slope of the yield curve inverted prior to the last seven recessions dating back to the late 1960’s.

Similar to the “Fed components” of the LEI, monetary policy plays a key role in the term structure of interest rates. FOMC decisions directly influence the short end of the curve and may affect the long end of the curve via expectations. As we have witnessed from Operation twist, the Fed can also directly impact the long end of the curve as well. A curve flattening or inversion is typically associated with slower or slowing economic activity. Therefore, the yield curve tends to be a good indicator of recessions.

FIGURE 3: U.S. YIELD SPREAD



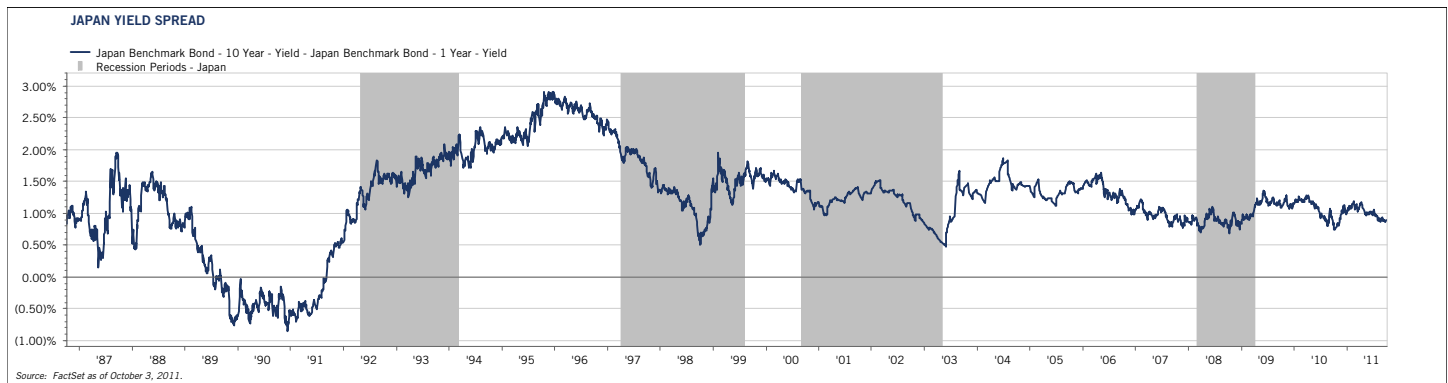
JAPAN'S EXPERIENCE

As we look to the yield curve for clues of the next recession, we need to keep in mind that the short end of the curve is already at historically low levels. In this era of low rates and quantitative easing, it might be more useful to look at Japan's yield spreads for an indication of the predictive ability of the yield curve. In Figure 4, we can see that there has not been one instance in which Japan's yield spreads inverted prior to the onset of a recession; outside of the period between 1989-91 which coincided with the collapse of Japan's real estate and equity markets and the BOJ target rate moving from 2.5% to 6%. Since 1995, when the BOJ target rate was .50%, the yield curve failed to signal the three ensuing recessions¹.

CONCLUSION

The current low rate environment and massive central bank intervention (manipulation?) during this deleveraging cycle calls into question the reliability of previously "time-tested" models to gauge inflection points in the business cycle. As recent economic data point to a slowing of the economy, the odds of recession increase as the margin of error between expansion and contraction narrows. Our view remains that structural imbalances (i.e. "underlying economic activity" – housing, employment) need to be addressed before a sustainable period of economic growth can ensue. In the meantime, we expect the economy to remain in a fragile state as the tug-of-war between monetary policy and economic recovery continues.

FIGURE 4: JAPAN YIELD SPREAD



¹ See <http://www.imes.boj.or.jp/research/papers/english/me28-5.pdf> for more on the impact of monetary policy when nominal rates near zero

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