
THE FIVE FINGER GUIDE: ECONOMIC DATA THAT PROVIDE A HEADS-UP TO A U.S. RECESSION

Recession cries for the U.S. economy reached a feverish pitch among investors at the start of this year, as less-than-encouraging data were released on employment, manufacturing activity and retail sales. Some analysts have even gone so far as to postulate that the U.S. is currently in the midst of a recession, but because of reporting delays of data, the evidence won’t become known for some months yet. Alongside the doomsayers are those, like ourselves, who believe the U.S. is not in a recession, but that doesn’t mean that the economy will avoid hardships. And, most analysts in this camp can agree that the risks are quite high for a U.S. recession, with our odds placed at 40%.

So what might investors look at to gauge recession risks and the tipping point? There isn’t a single silver-bullet leading economic indicator that can perfectly predict recessions every time, but we’ve put together five indicators that have historical precedence in calling it right. These include: interest rate spreads, manufacturing ISM index, initial jobless claims, residential building permits, and private sector employment. Readers should note that these indicators are not meant to reflect an exhaustive list or perfect predictors of recessions. But, they do provide an easy-to-follow short-list that help gauge economic momentum. They are available with minimal delay and are not subject to great revisions (except in the case of employment data). In addition, each one contains a nugget of information or basic rule of thumb that has generally withstood the test of time. The recession markers used in this paper follow the official NBER definition, usually consisting of two or more quarters of declining real GDP, but not in all cases since they use a broader array of indicators than just real GDP.

HIGHLIGHTS

- Economic uncertainty in the U.S. has heightened calls of a recession, but the data still show otherwise.
- To gauge economic momentum and when the pendulum might shift towards a recession, we’re keeping our eyes on 5 indicators:
  1. Interest rate spreads
  2. Manufacturing ISM index
  3. Initial jobless claims
  4. Residential building permits
  5. Private sector employment

Alongside the five economic indicators, we have devised a quick-reference traffic light system to capture whether a particular indicator is signaling recession or not. An indicator that receives a green light means that current patterns or levels are not consistent with its behaviour during past recession episodes. A yellow light means that we are more cautious on the indicator, as it is already signaling an economic slowdown that could eventually deteriorate or approach past recession levels. A red light indicates that the economic indicator is already behaving in a similar fashion to past recession episodes. The economic indicators below are in no particular order of significance.
1. 10-year Treasuries - fed funds rate spread

Historically, an inverted yield curve has been a good predictor of an impending economic recession, generally providing a 9-12 month lead to the episode. The broad sweeping logic is that an inverted yield curve reflects soured market sentiment over the long-term outlook, which pressures down long-term fixed income yields due to dampened economic growth and inflation expectations.

While yield inversion is a guiding light, it is not 100% reliable. In the eight episodes that the 10-year Treasury-fed fund spread has turned negative since the mid-1960s, two of these were false signals of a recession. These occurred in 1966 and 1998. In the case of the latter, long term yields plummeted due to investor flight to safety when the Asian flu struck. During the 1966 episode, an economic slowdown ensued, but not a recession.

What does seem to hold true, however, is that the wider the negative spread, the higher the odds of a recession. In the instances where the negative spread called it right during the last 6 recessions, the average spread prior to the recession was no less than -0.70 and as high as -1.98. The trough in spreads was particularly steep in many cases. In the non-recession 1998 and 1966 episodes, the average spread was -0.43 and -0.33, respectively, with much narrower troughs in each cycle. (see table) In the current cycle, the spread is averaging -0.42 with a trough so far of -0.77. Neither of these has the depth that typically occurs ahead of a recession.

Aside from just focusing on the spread, the current low level of the fed funds rate must also be given consideration. In the months leading up to past recessions, the central bank was often hiking rates and the level of the fed funds rate was considerably higher than it is today, even when inflation was stripped away. This time around, there is more stimulus in the pipeline. The combination of a relatively low fed funds rate and only shallow negative spreads would normally warrant a green light. However, this cycle has a unique element. The ongoing impact of the credit crunch has caused financial institutions to tighten lending standards to consumer and businesses, which, in effect, dampens the effectiveness of the lower rates. Estimates place the implicit tightening from the credit crunch at 25-50 basis points, which leaves rates only slightly below what is considered a neutral stance on monetary policy. Within this already fragile environment, the inverted yield curve is squeezing the net interest margins of financial institutions (the interest rate given for deposits relative to that which financial institutions receive on loans), which could prompt further conservative lending behaviour. As a result, a widening of the negative spread, even with low short-term rates, could prove to be quite onerous on consumers and business due to the lending response that it would elicit from financial institutions. Putting it all together, we give this indicator a yellow light.
2. Manufacturing ISM index

There was considerable investor angst at the start of this year when the manufacturing ISM index broke below the 50 threshold in December to rest at 47.7. The significance of the 50 threshold is that it reflects a break-even point for manufacturing activity. A reading above this level indicates that the manufacturing economy is generally expanding; below 50 indicates that it is generally contracting. So, December’s disappointing 47.7 reading reflected the first month that the manufacturing sector failed to grow in nearly a year. Red light? No.

A below-50 reading does not imply that the broader economy is contracting. Rather, it generally indicates that the overall economy is growing, while the manufacturing sector is contracting. In contrast, an index of 41.9 or lower that is sustained for a period of time does correspond with a contraction in the overall economy. The current level, if annualized, is more consistent with real GDP expanding by 1.8% annually.

However, waiting for the index to move to 41.9 or lower would probably mean that the economy is already in a recession or extremely near, so it would not make for an effective leading indicator. For an advance heads-up, it does look like the index has a point of no return at the 46 level. Since the 1960s, there are two instances (1967 and 1995) when reaching this level sent a false signal of a recession. Outside of those, however, downward momentum seemed irreversible when the index went to 46, and eventually it deteriorated to recession levels.

Although the ISM index has not hit either of the two critical thresholds, it has slipped 8 percentage points in just 6 months and is awfully close to our break-even point. This indicator earns a cautionary yellow light.

3. Initial jobless claims

The number of new claims filed for unemployment insurance tends to be more sensitive than other employment or unemployment indicators, making it a good guide in predicting turning points in economic activity. While many investors tend to focus on the overall level of initial jobless claims or near-term fluctuations in the four-week moving average, the better indicator is the year-over-year change in the monthly moving average. There needs to be a significant deterioration in this measure in order to signal a recession. The rate of change of the year-over-year measure tends to rise to 19% or higher in the 4-8 months period preceding a recession. One false signal was sent in 1967 corresponding with an economic slowdown not contraction, but it has been an accurate measure in every episode since then.

Currently, the annual rate of growth in initial jobless claims is less than 6%, well below pre-recession levels, which is why this indicator gets a green light.
4. Residential building permits

Housing permits are a reflection of residential construction activity, which typically leads most other types of economic production. Unfortunately, residential building permits are also a highly volatile data series, and this can blur the interpretation of how significant a movement in permit issuances are in predicting shifts in economic momentum. Nevertheless, past recession episodes have occurred within 3-4 months of permits contracting at a double-digit annual pace, the exception being the 2001 downturn, which was not a consumer led recession, but rather investment led.

In this cycle, however, permit issuances are breaking all the rules. Permits have had double-digit declines (averaging -25%) in annual growth for the past 19 months. The contraction in permits has also been steeper and more extended than historical experience. If this indicator alone stood the test of time for recession-accuracy, the U.S. economy should have been in a recession at the start of 2007, which clearly it was not. So while this indicator at -34.4% (y/y) in December qualifies for a red light, we think the traffic signal is broken.

5. Private sector employment

Although employment data generally reflect coincident or lagging indicators of economic cycles, some limited insight into the soundness of the economic foundation can be gained through early movements in the 6-month annualized change in private sector jobs. This indicator stood at just 0.6% in December 2007, steadily decelerating over the course of the entire year. The current level is definitely low by historical standards. There are no instances since the 1960s when the 6-month annualized change of private sector employment was decelerating and went as low as 0.6% without a recession eventually ensuing. Two periods in the 1960s came close (March 1963 and July 1967) when 0.8% and 0.9% growth marked the trough before strengthening. The latter episode corresponded with a slowdown in economic activity, but the former did not.

We can’t deny that this employment indicator sends a bearish signal on the economy, but for now it receives a yellow light. We’ll have to wait for further confirmation with the February data on whether to downgrade this indicator to a red light. That’s because the employment report is highly susceptible to revisions. For instance, in the August employment report of last year, a reported 4,000 net loss in total nonfarms jobs was subsequently revised to an 89,000 net job gain in the next month’s jobs report. That figure was then revised a second time to 93,000.
Conclusion

All told, the mixed readings on the indicators are consistent with a considerable economic slowdown or possibly even a technical recession. Although we believe that the U.S. economy will slow to a 1.8% pace in 2008 – the worst showing in six years – most of that weakness is expected to occur in the first half of the year with the quarterly pace averaging 1.2% (annualized) following an equally weak fourth quarter in 2007. Since our predictions for the first half of the year are so close to zero, it wouldn’t take much for the U.S. economy to experience small contractions in one or two quarters, especially in the first quarter where we are currently predict only 0.6% growth. However, there is no need to run out and buy canned goods.

Unless the leading indicators start flashing red, we would not be alarmed by a technical recession, as it would be quite mild and short lived.

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