Current Economic Conditions

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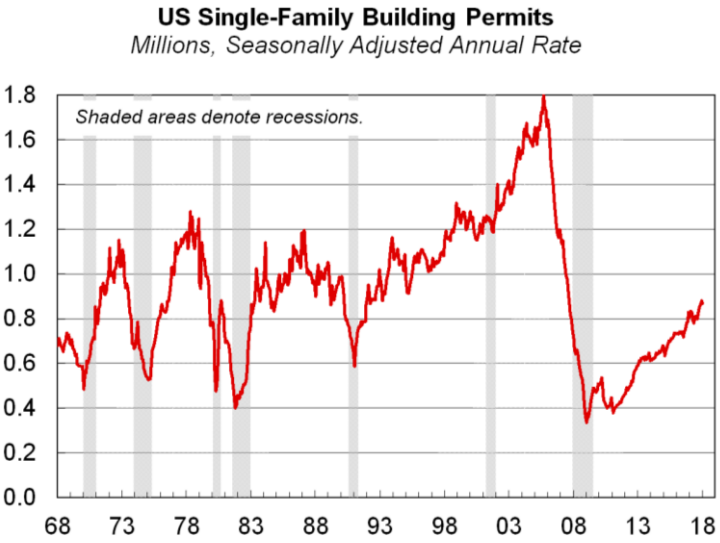
LEADING INDICATORS POINT TO SOLID GROWTH

Nobel Prize-winning physicist Niels Bohr famously said that "prediction is very difficult, especially about the future." To make predicting the future course of the economy less difficult, I follow a variety of leading indicators. Leading indicators are economic data series that turn up or down in advance of turning points in overall economic activity. While intended primarily to forecast the beginnings and ends of recessions, they also provide useful information about future growth rates. The leading indicators I follow are pointing to continued expansion in the U.S. economy, with growth stronger than in recent years.



The most important item in the Census Bureau's monthly residential construction report is the number of new single-family homes authorized by building permits. Building permits are a better indicator than housing starts because they are less affected by weather. Construction of a single-family home also generates much more economic activity than construction of an apartment or condominium. The seasonally adjusted annual rate of single-family building permits hit a 10-year high in December before slipping in January. With millennials just starting to buy single-family homes and inventories of homes for sale extremely lean after years of under-building, building permits and housing starts are likely to continue to rise this year and next.

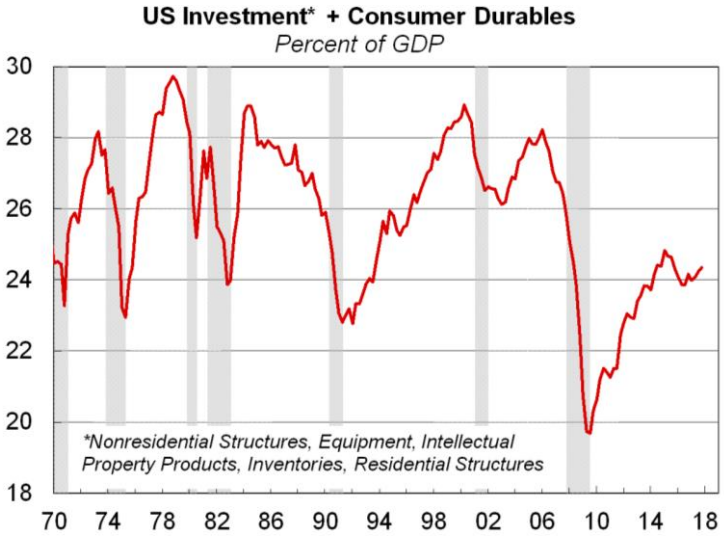
Several measures of orders are used as leading indicators. The Institute of Supply Management's new orders index, a component of its manufacturing PMI, measures the percentage of companies reporting rising orders. In recent months, the index has been well above 60, very strong by historical standards and suggestive of strong growth in industrial production in manufacturing. Manufacturers' new orders for durable goods, reported by the Census Bureau, were up 11.5% year-over-year in December. Orders for nondefense capital goods excluding aircraft, a leading indicator for capital spending, were up 8.0%.

The foreign exchange value of the U.S. dollar has little predictive value for growth in the overall U.S. economy, but is very important for the manufacturing sector. The decline in the U.S. dollar that began in January 2017 will boost the competitiveness of U.S. manufacturers in global markets, but this effect works with a very long lag. The weaker dollar did little for U.S. manufacturing in 2017 but will lift industrial production in U.S. manufacturing in 2018 and 2019.

Interest rates generally lead economic activity. While there are many to choose from, I favor the yield on Baa corporate bonds. This picks up the impact of monetary policy and inflation, which are reflected in yields on Treasury securities, but also picks up risks of default that are specific to the corporate sector. While Baa bond yields have risen in recent weeks, they are still very low by historical standards. It would take a significant further increase to flash a cautionary signal for growth.

One of the very best leading indicators of recessions is the spread between the federal funds rate, the overnight rate the Federal Reserve targets, and the yield on 10-year Treasury securities. Historically, an inverted yield curve (federal funds rate about 10-year bond yield) has reliably signaled a recession within the next six-to-eighteen months. The yield spread narrowed last year but did not invert. Recent increases in the 10-year bond yield have moved the yield curve farther from inversion.

Stock prices are a useful leading indicator, but one must keep in mind Paul Samuelson's quip that the stock market has predicted nine of the last five recessions. Past recessions have been associated with declines in the stock market of 20% or more, but there have been declines of that magnitude that have not led to recessions, notably in 1962 and 1987. The recent downdraft in stock prices didn't come close to signaling a downturn in economic activity, and even a much larger decline would have to be confirmed by other leading indicators before I'd let it push me towards a recession forecast.



The leading indicators I track point to further growth, particularly in U.S. manufacturing, but most of these indicators lead economic activity by only six months or so. They don't tell us much about how long the current economic expansion might last. Since 1970, expansions have not ended without the share of Gross Domestic Product accounted for by cyclical sectors (private investment plus consumption of durable goods) rising above 28%. The cyclical share is not even close to that threshold. Past expansions have ended, on average, about six years after the Conference Board's Index of Leading Economic Indicators has first exceeded its previous cyclical peak. That didn't happen in this expansion until 2017.

If history is any guide, this expansion is likely to end as the result of a big increase in oil prices and/or a rise in inflation that induces the Federal Reserve to raise the federal funds rate above the 10-year bond yield. Every recession since 1973 has been preceded by at least a doubling in oil prices. Every recession since 1969 has been preceded by an inverted yield curve. The price of Brent blend crude oil rose from a monthly average of $30.70 in January 2016 to $69.08 in January 2018. Because this increase followed a sharp decline and because I think prices will decline from current levels, I don't think it threatens the expansion, but the associated rise in gasoline prices took a bite out of consumer spending in January. An unexpectedly large increase in average hourly earnings in January sparked fears of rising inflation, but the increase was a statistical artifact, caused by a reduction in hours worked by salaried supervisory workers. Besides, rising labor compensation is only inflationary if it isn't supported by productivity growth. Nevertheless, the jump in hourly earnings triggered a quick 10% decline in stock prices.

Of much greater concern is January's 0.5% increase in the Consumer Price Index. While gasoline accounted for much of this increase, the CPI was up a more-than-expected 0.3% even when food and energy prices were excluded. Ultimately, inflation is caused by neither higher wages nor higher oil prices. It's caused by aggregate demand growing faster than aggregate supply. That usually occurs when loose monetary policy boosts demand for housing and consumer goods more than it boosts productive capacity through higher business investment. Some now fear that higher budget deficits, resulting from tax reform and the two-year budget deal, will boost demand in an economy that already **appears** to be operating near full capacity. That's fair criticism of the budget deal. It likely applies to tax reform in the short run, but when the new plant and equipment bought in response to tax reform comes online, the resulting expansion in capacity (i.e., supply) will dampen the increase in inflation. If that's not enough to keep inflation in check, the Fed will **eventually** raise interest rates enough to invert the yield curve and end the expansion.