Current Economic Conditions

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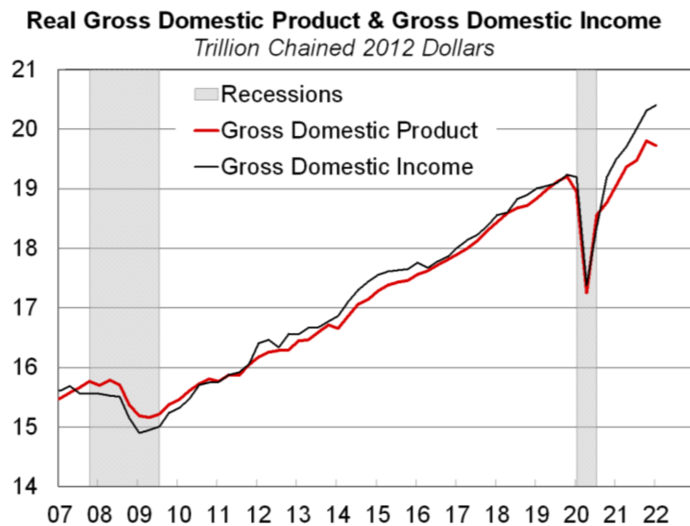
IT'S HARD TO TELL WHERE YOU'RE GOING IF YOU DON'T KNOW WHERE YOU ARE

U.S. Real Gross Domestic Product **declined** at a 1.6% annual rate in the first quarter. Real Gross Domestic Income **rose** at a 1.8% rate. Over the last six quarters, GDP has grown at a 4.1% rate versus 7.3% for GDI. In theory, the two measures of economic activity should be identical; they differ only by a "Statistical Discrepancy." In reality, the measures differ, but subsequent data revisions tend to reduce the difference between them. As data are revised over the next few years, I expect GDP growth to be revised up, GDI growth to be revised down, or some of both. Strong growth in payroll employment and industrial production in the first quarter suggests a bigger (upward) revision to GDP. Retailer reports suggest that may happen through higher inventories.



Strong growth in payroll employment, from a survey of employers, continued through the second quarter. Payroll employment rose by 372,000 in June and was up by 1.124 million from March to June. But civilian employment, from a survey of households, **fell** by 315,000 in June and was **down** by 347,000 from March to June. While economists and financial markets tend to pay more attention to payroll employment, it is noteworthy that civilian employment usually turns down 1-3 months before payroll employment at business-cycle peaks.

Taken together, the relative strength of GDI vis-à-vis GDP and the relative weakness of civilian employment vis-à-vis payroll employment suggest that the economy was growing faster in 2021 and early 2022 than GDP data indicate but has slowed more in recent months than payroll employment data indicate. More generally, the discrepancies between fundamentally similar measures of economic activity make it hard to determine just how much momentum the U.S. economy has, which in turn makes it difficult to determine when economic growth will turn negative, marking the beginning of a recession. Economists use leading indicators to help them predict when such a turning point will occur. Most leading indicators I follow point to a coming recession, but they differ greatly over when that recession will begin.

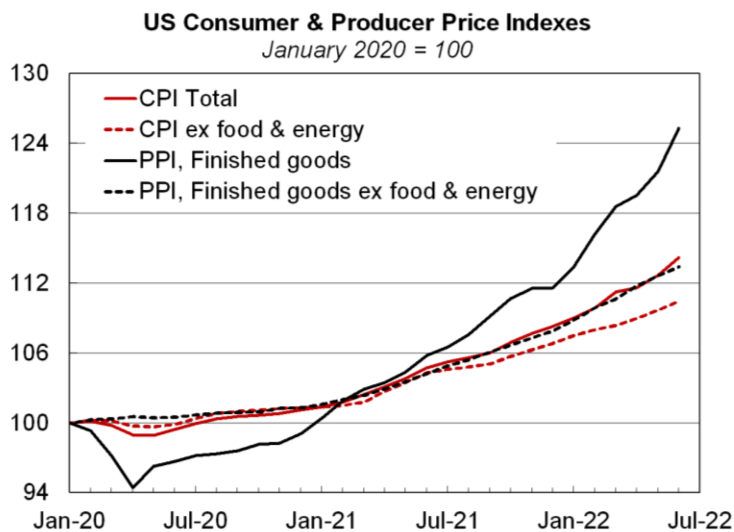
The Wilshire 5000 stock price index peaked in November 2021 and has fallen 22%. At the six business-cycle peaks from 1973 through 2007, this index peaked, on average, about five months before the economy, but it led by 11-12 months twice and by three months or less four times. (I ignore the 2020 recession in this analysis; it was caused by a pandemic that could not be predicted by economic indicators.)

Building permits have usually peaked about 10-14 months before the official business-cycle peak but have led by as much as 27 months. Permits peaked in December 2021, suggesting a business-cycle peak between October 2022 and February 2023. Monthly data on initial claims for unemployment insurance have bottomed an average of 13 months before business-cycle peaks, with a range of four to 22 months. Claims bottomed in March. They have risen steadily since then but are still low by historical

standards. Finally, the federal funds rate has risen above the 10-year Treasury yield an average of 13 months before business-cycle peaks, with a range of 8 to 18 months. Such an “inverted yield curve” has been one of the most reliable leading indicators of recessions, correctly anticipating every recession since 1969. So far, this measure of the yield curve has not inverted. However, market interest rates and the fed funds futures market suggest that the yield curve will invert in September.

To summarize these and other leading indicators, various organizations combine several leading indicators into leading indexes. The Conference Board Leading Economic Index®, which was once a government index but is no longer in the public domain, peaked in February. According to the Conference Board’s website, the LEI leads turning points in the economy by about seven months. The Leading Business Barometer created by Thomas Kevin Swift, former Chief Economist of the American Chemistry Council, uses data related to the production of materials to predict turning points in the overall economy. It also peaked in February. It leads business-cycle peaks by an average of eight months.

While seemingly similar measures of real economic activity disagree over whether and how fast the real economy is growing, there is much less disagreement over inflation. It’s high, and June data showed no evidence of a deceleration. The Consumer Price Index rose 1.3% in June, leaving it up 9.1% from a year earlier, the highest since 1981. Excluding food and energy prices, the “core” CPI rose 0.7%, leaving it up 5.9% year-over-year. My favorite measure of underlying inflation, the Producer Price Index for finished goods excluding food and energy, rose 0.7%, pushing the year-over-year increase to 9.3%, a 41-year high. There is more disagreement about wage costs. The rate of increase in Average Hourly Earnings has slowed in recent months, but the data are so affected by the composition of the workforce that they are not a good measure of wage growth. It’s best to wait for the quarterly Employment Cost Index.



Big declines in commodity prices in recent weeks suggest that inflation may have peaked in June, but it’s at such a high level that getting it back to the Federal Reserve’s 2% target will require much higher interest rates. The June CPI report raised market expectations for the federal funds rate, the overnight interest rate that the Fed targets and controls. Fed funds futures suggest that the Fed will raise the funds rate by three-quarters of a percentage point at both its July and September meetings. Unless long-term bond yields reverse their recent declines and rise to new cyclical highs, this would invert the yield curve and signal a coming recession. Unfortunately, high inflation has pushed the Fed to the point where a recession is “a feature, not a bug.” They won’t admit publicly that a recession is necessary to get inflation down to their target, but they’ve probably come to that realization, and they further realize that a mild recession in the near future is preferable to a deeper recession later.

Long and variable lags from turning points in leading indicators to turning points in the economy imply great uncertainty about **when** the U.S. economy will fall into recession. Stock prices suggest it will happen very soon (if it hasn’t already). The yield curve suggests it won’t happen before mid-2023. Taking everything into account, I think it’s most likely to happen around the end of 2022, but it could happen six months sooner or six months later. Barring big data revisions, the economy was **not** in a recession in June. The National Bureau of Economic Research is unlikely to declare a recession when payroll employment is still rising, even with industrial production down 0.2% in June and even if GDP is falling. But the June CPI report likely eliminated any chance of a soft landing, reminding me of what Mohammad Ali said about Joe Frazier’s chances of winning their fight: “He has two chances. Slim and none. And Slim just left town.”

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