

**ECONOMICS:** US PERSPECTIVES—JULY 9, 2010

# No Sign of Double Dip Recession in US Leading Economic Indicators

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Following economic slumps, leading indicators usually detect a revival of GDP growth before it materializes. But after the initial surge, patterns are much less consistent. We think the recent trends of leading indicators point to sustainable US economic growth and not another slide into recession.

Fears that the US economic recovery may stumble have been driving the sell-off in equity markets during recent months. Some of these concerns were prompted by weak economic data in areas such as jobs and consumer spending. However, the real source of investors' worst nightmare—a double dip recession—was triggered by a decline in some components of the leading economic index, which is widely seen as an important harbinger of shifts in GDP growth trends.

Recent declines in a few leading indicators—especially stock prices—have led some analysts to lower their real GDP growth estimates for the second half. Other economic forecasters say that leading indicators point to another slide into recession for the US economy. However, we think that signals from leading indicators are more complex than meets the eye.

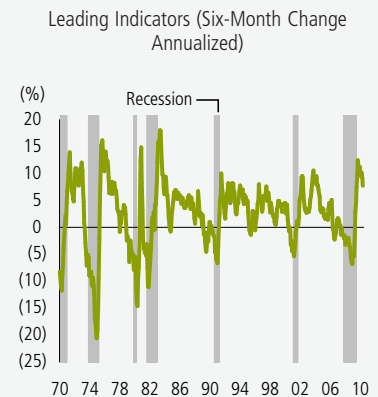
Following a recession, leading indicators usually jump and anticipate a revival of GDP growth. But after the initial surge,

there is little consistency in the pattern **(Display 1)**. Sometimes leading indicators hit a peak and then move steadily lower over several years—as in the late 1970s. But in the early 1980s, the leading indicators tumbled quickly. In order to interpret the recent dip in leading indicators, we must take a closer look at how they work.

## Understanding Leading Indicators

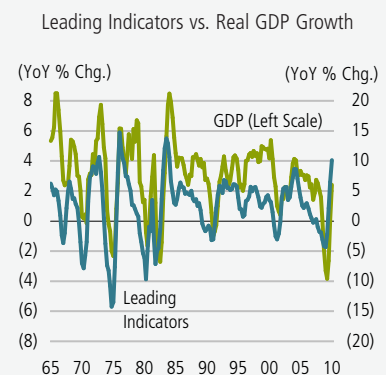
Leading indicators are important because they capture the recurring patterns of economic cycles in several key economic series and indicators. Those individual measures that have a consistent record in successfully forecasting changes in the business cycle are combined in a composite index. Trends in labor markets, manufacturing, construction and the financial markets are aggregated into a composite index of leading indicators in order to increase the chances of getting true, unambiguous signals while reducing the possibility of getting a false signal by looking at a single indicator in isolation.

Display 1  
Complex Patterns in Leading Indicators



Source: Haver Analytics and The Conference Board

Display 2  
Strong Signals at Peaks and Troughs



Source: Bureau of Economic Analysis, Haver Analytics and The Conference Board

We tend to monitor changes in leading indicators over three, six and 12 month periods, in order to help anticipate changes in the business cycle. Yet it is equally important to understand that the leading index itself has a cycle of its own.

### Capturing Early Trends

The index of leading indicators tends to record relatively large gains in the initial phase of an economic recovery. In almost every case, the gain in the first 12 months is the largest advance recorded during the recovery, regardless of whether the economic rebound proves to be short or long. This recurring pattern happens because many components of the leading indicators capture trends in early cyclical industries and combine them with several financial series that tend to rebound before the real economy recovers.

Historically, the size of the rebound during the early stages of an economic recovery correlates tightly with the strength in real GDP growth. So strong gains in leading indicators tend to forecast rapid economic

growth, while a modest improvement generally predicts a more moderate increase in GDP.

In some cases, after the initial surge, growth in the leading index tapers off. This sometimes results in a brief dip below the zero line, but the index often bounces back within a few months. When this pattern unfolded in the mid-1980s and mid-1990s, leading indicators foreshadowed a slowing trend in real GDP—but no double dip materialized.

### Correlation with Growth Cycle

Importantly, the relationship between leading indicators and real GDP growth tends to be robust during the early stages of recovery as well as during the later stages of a cycle when the economy is beginning to contract. During the growth or expansion phase, the relationship between the leading indicators and real GDP is not robust, and real GDP growth often exceeds gains in the leading index by a wide margin (**Display 2, previous page**). This happens because when the GDP growth cycle matures, several

industries and sectors contribute to the gain—and not just the early cyclical industries that are reflected in the leading indicators.

### Slower GDP Growth or Double Dip?

So what are leading indicators telling us today about the direction of the US economic recovery? Leading indicators have risen by 7.7% annualized in the past six months, which is below the readings of about 11% to 12% in the fall of 2009. Recent trends in the index of leading economic indicators suggest that the economy is still expanding although, based on history, they suggest that growth may slip back to the pace of the past year or a bit slower.

However, for a double dip to become an immediate concern the series of leading indicators would have to contract for a sustained period of at least six months and fall by more than 3%. In our view, a historical analysis of leading indicators and GDP trends should defuse fears over the potential development of a double dip recession in the US economy. ■

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