Economic Indicator — August 18, 2022

July Drop in Leading Index Adds to String of Declines

Summary

The Leading Economic Index declined for the fifth consecutive month in July and continues to point to a deterioration in economic activity. We don't yet think broad economic conditions are consistent with recession. But activity is slowing, and the trend decline in the index supports our view that the economy may slip into a recession by the beginning of next year.

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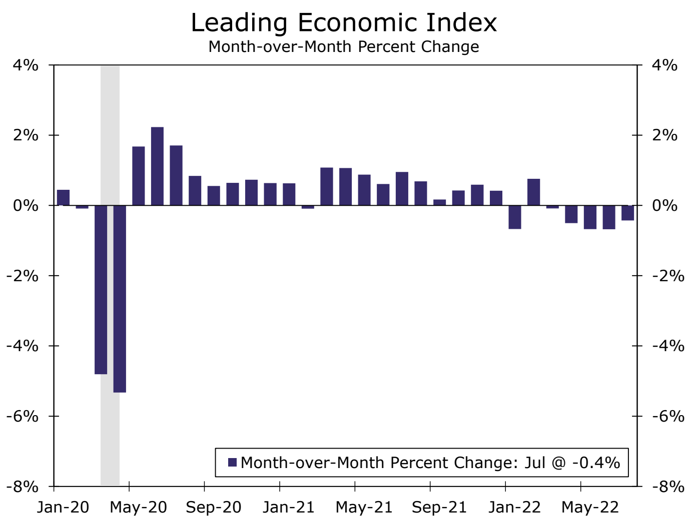


Source: The Conference Board and Wells Fargo Economics

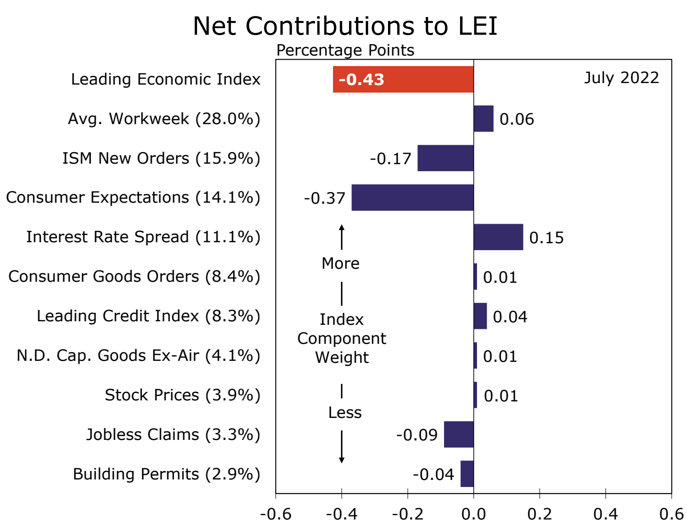
Broad Signs of Weakness

The Leading Economic Index (LEI) slid 0.4% in July, adding to a string of recent declines (chart). Consumer sentiment has buckled amid raging inflation and increasing concern of recession. With the University of Michigan's measure of consumer expectations sliding to its lowest reading in data going back to 2000 in July, it's little surprise the component sliced 0.37 percentage points off the LEI for the month (chart). While inflation continues to impact optimism, lower gas prices in August provided some lift to the preliminary reading for sentiment and suggests this component may not be as large a drag in next month's LEI. Consumers resiliency has been evident in recent spending data, and, while goods spending is moderating, it's not falling off a cliff and was a pretty neutral force on the overall LEI in July.

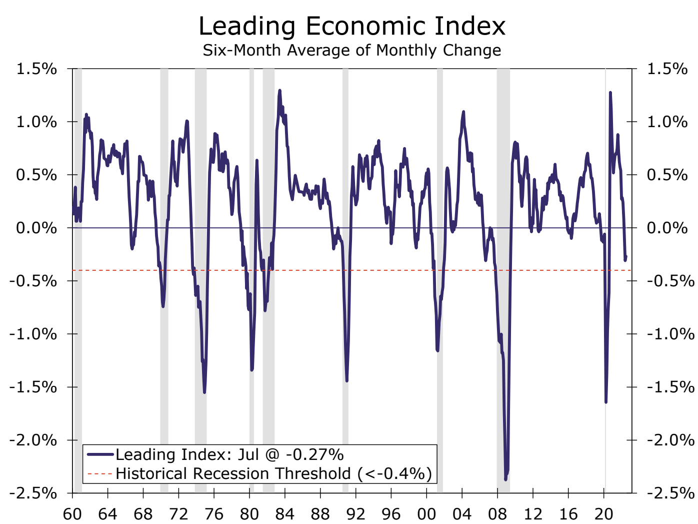
The labor market, however, provided some mixed signals in July. Most measures exhibit a still-historically tight environment, but conditions are showing signs of cooling. While employers reported adding over 500K jobs in July, and both job openings and small business hiring intentions remain near historic highs, they've begun to roll over. Initial jobless claims picked up in July, causing the component to weigh on the LEI, but since they still remain historically low and continuing claims have only edged up slightly, we believe this demonstrates recently laid-off workers are still finding it relatively easy to find new employment. Average weekly hours for factory workers also rose in July, boosting the LEI.

Factory-sector activity is slowing, though we expect the fulfillment of backlogs as supply chains continue to ease will help offset weakness coming from new demand. Core capital goods orders were a fairly neutral factor on the LEI in July, but the ISM manufacturing new orders component remained in contraction territory for the third consecutive month in July, slicing a sizable 0.17 percentage points off the index.

The residential sector remains under pressure from the weight of higher rates adding to affordability issues. Fewer applications for building permits last month resulted in a slight drag on the index. The largest positive contribution, however, came from the interest rate spread, which added 0.15 percentage points to the LEI. This component is based on the spread between the 10-year Treasury and federal funds rate specifically, which has narrowed so far in August and suggests it will provide a smaller contribution in August.



Source: The Conference Board and Wells Fargo Economics



Source: The Conference Board and Wells Fargo Economics

Don't Lead Me Astray

In a recent special report we described how the LEI behaves headed into a downturn and observed a historical recession threshold: the six-month change has never been below -0.4% without a recession over the past 60 years (chart). Today's release caused the LEI to back off the line a bit and puts the figure at -0.27% through July, up from -0.31% previously. Still, the trend decline in the LEI since January is concerning.

We do not yet think the economy is in recession with the solid state of the labor market still presenting the strongest case against a downturn. But the probability of recession is trending higher, and our preferred Probit model, which also includes the S&P 500 index and the ISM manufacturing index's employment component, puts the probability of recession in the next two quarters around 40%. Our baseline expectation, however, is that the economy slips into recession by the beginning of next year as aggressive monetary tightening saps confidence and weighs on demand.

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