Economic Indicator — April 20, 2023

And the Bottom Drops Out: LEI Digs Even Deeper

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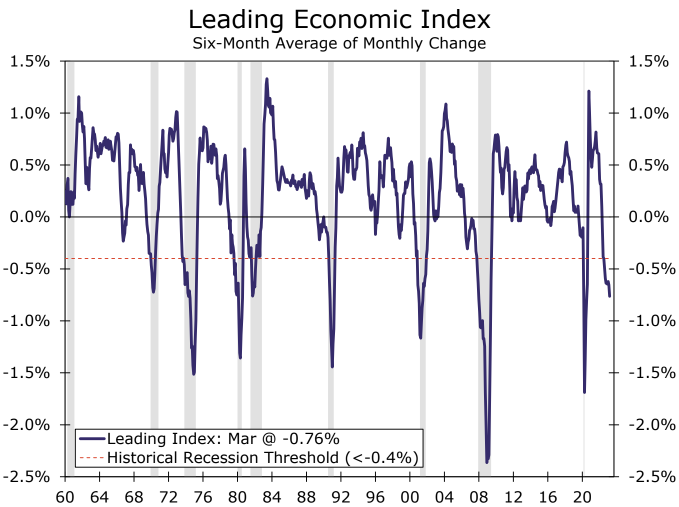
Summary

The sharp drop in the March LEI adds to a string of declines that marks the sharpest reversal on record outside of a recession. The index continues to present a clear message that recession is ahead.



Source: The Conference Board and Wells Fargo Economics

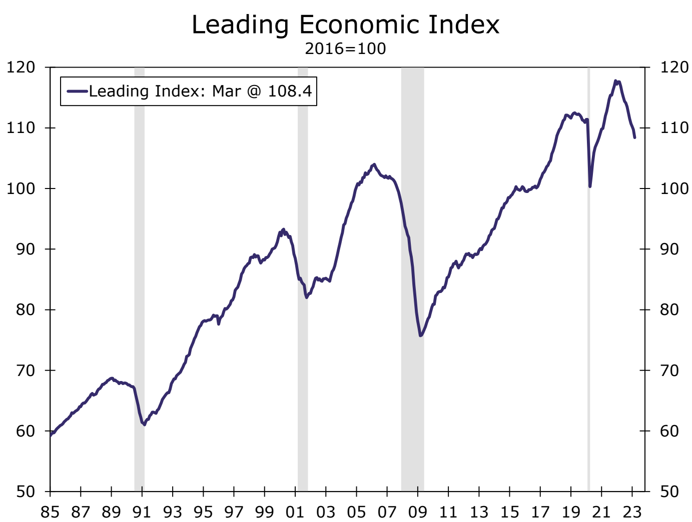
LEI Suggests We Brace for Impact

The Leading Economic Index (LEI) continues to signal the economy is headed for recession. The index has now declined for twelve straight months and the 1.2% drop in March marks the largest monthly decline since April 2020 when the economy was in the worst of the pandemic. The large decline in March pushed the six-month average change to -0.8%, well-below the threshold historically consistent with recession (chart). The LEI is now nearly 8% below its peak last year, which as can be seen in the nearby chart, marks the largest slide outside a recession in the history of the index going back to the late 1950s.

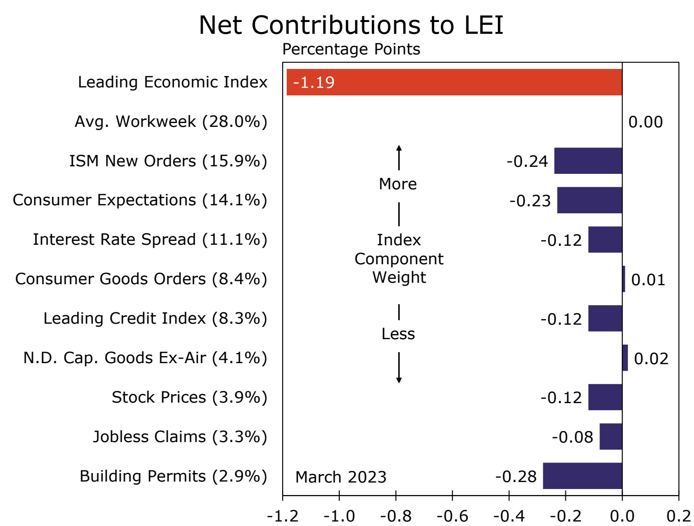
As we detail below, the consumer expectations component has been a steady downward force on the LEI for over a year and a half. Looking past that weakness, however, the other components tracking hard economic data have increasingly shown signs of contraction. Overall the LEI continues to demonstrate economic weakness is ahead for the U.S. economy.

One Foot in the Hole One Foot Getting Deeper

While the LEI has been signaling recession for months, there has been at least some silver linings in the individual components in recent months. That was not the case in March as weakness was more widespread. In fact, as seen in the nearby chart, only two of the LEI's components contributed positively to the index last month, and only modestly so. Most components weighed on the index, with building permits exerting the largest drag, subtracting nearly 0.3 percentage points alone. The ISM new orders component continued to be a notable area of weakness as well, along with consumer expectations. Recent banking system stress added pressure to the leading credit index, while stock prices declined and the interest rate spread inverted further. The labor market's strength is starting to lose steam, with initial jobless claims rising during March and average weekly hours in the manufacturing sector remaining unchanged.



Source: The Conference Board and Wells Fargo Economics



Source: The Conference Board and Wells Fargo Economics

Interest-rate sensitive sectors, such as housing and manufacturing, have demonstrated notable weakness in recent months. Building permits slipped nearly 9% in March. Single-family permits picked up during the month, while multifamily permits saw a steep contraction. Apartment construction has run at an exceptionally strong pace over the past few years. The onslaught of building deliveries has started to outpace rental demand, however, and is leading to a rise in vacancies. Taken together with elevated mortgage rates still biting into single-family home demand, residential construction is set to remain sluggish this year.

After weighing on the LEI for 13 consecutive months, the ISM new orders component is emblematic of the ongoing correction in the goods sector. Manufacturing production has trended lower amid a thinning pipeline of new orders and dwindling backlogs. Small business capital expenditure plans have materially softened and consumer demand for durable goods has subsided. We suspect weakened demand and tighter credit conditions will continue to pressure manufacturing activity.

The most persistent source of weakness in the LEI has been the consumer expectations component, which has been a drag on the overall index for each of the past twenty months. This is at odds with the resiliency we've seen in the hard data on consumer spending, and somewhat helps explains why the LEI has so visibly been pointing to recession while some other economic data have demonstrated resilience. Sentiment measures have remained under pressure amid elevated inflation and concern over recession, and that has exerted material weakness on the LEI. But even looking past this component, weakness is starting to spread and the LEI suggests a slowdown is ahead.

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