WELLS FARGO

Economic Indicator — June 17, 2022

LEI Points to Trying Times

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Summary

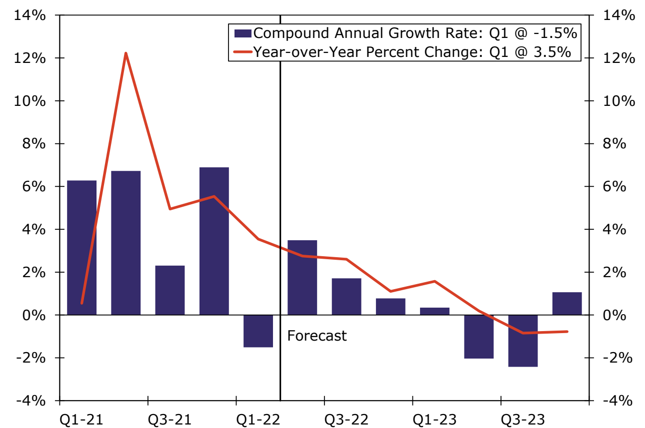
The leading economic index joined in ringing the alarm bells this week as it dropped 0.4% in May, its third straight decline after incorporating downward revisions to March data. Broad-based weakness among components highlights many of the concerns that led us to recently downgrade our forecast.

Source: The Conference Board and Wells Fargo Economics

Bracing for a Mild Contraction

The leading economic index joined in ringing the alarm bells this week as it dropped 0.4% in May, its third straight decline after incorporating downward revisions to March data. The past few months have marked the first string of declines in the index since the spring of 2020 when the economy screeched to a halt. It highlights many of the concerns that prompted us to change our forecast this week and pencil in a mild recession in mid-2023 (chart), as hot inflation makes a soft landing more improbable.

Inflation continues to weigh on purchase plans. ISM new orders contributed a negative 0.01 percentage points (pp) from headline growth, a decline in building permits took away another -0.22pp and consumer goods contributed a mere 0.01pp. Increased borrowing costs will likely put further downward pressure on interest rate sensitive purchases in the near-term as businesses and consumers alike face an even more expensive price tag. The major positive contribution over the month (+0.27pp) came from the interest rate spread, which measures the 10-year Treasury bond yield minus the fed funds rate. But as the fed funds rate rises, even some gains there could be eroded. In short, there is little solace to be found in the broad-based weakness of this report.

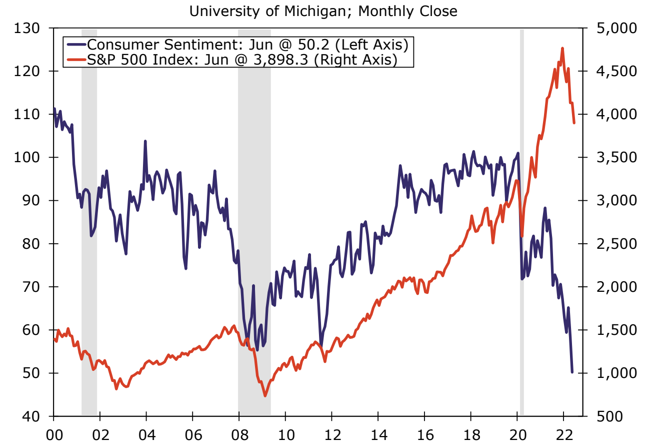


Source: U.S. Department of Commerce and Wells Fargo Economics

It's Been a Rude Awakening for Consumers

The worst of the worst in May's LEI report came from the stock market and consumer expectations, which in no uncertain terms had a bad month. Consumer expectations took away 0.29pp from headline growth while the S&P 500 lopped off 0.35pp. Both of these indicators have dragged down the index for the better part of the year, but things definitely took a turn for the worse last month as financial markets were rattled by everything from uncertain monetary policy to mixed earning reports, while consumers were grappling with the highest gas prices on record at the time.

Unfortunately, these trends have fared even worse up to this point in June and do not look to relinquish their grip on LEI anytime soon. The University of Michigan sentiment index fell to 50.2, its lowest on record in data going back over 50 years, while the S&P 500 is currently at its lowest point in around a year-and-a-half. Gas prices have climbed further, surpassing $5 a gallon on average, and costs are even higher in some states. In the past six months, consumers have gone from having robust stock market gains and ample spending power to having drained bank accounts and spirits.

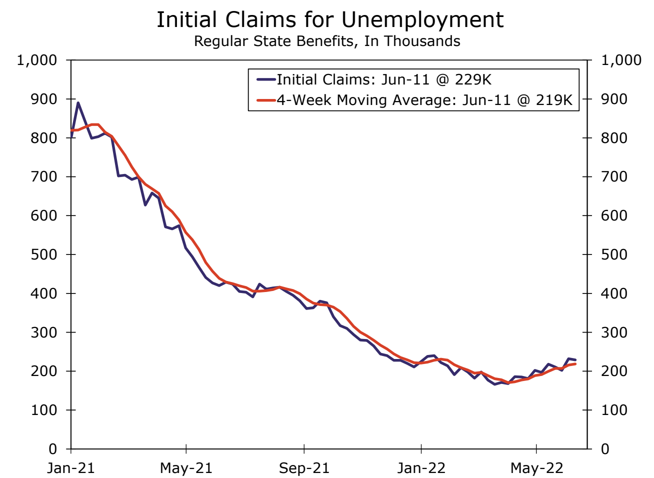


Source: Bloomberg Finance L.P., Univ. of Mich. and Wells Fargo Economics

Employment Moves to the Back Burner

The labor market has been an economic bright spot and contributed a 0.13pp in May to the LEI as claims stayed historically low. That said, we have seen a slight upward trend in initial jobless claims recently (chart). Turbulence in the financial markets and a weaker spending and housing market outlook have led some companies to announce recent layoffs. But as the Fed decides to further crack down on inflation, evidenced by the most recent 75 bps interest rate hike in June, the labor market will likely be put into the second position of the dual mandate.

Employment is starting from an incredibly strong position, but we could see some reversal of trend for jobless claims in the near-term. Wages will likely take time to come back down as labor supply and demand come back into balance, and companies may have to make tough decisions with pinched margins. That said, we still expect a relatively low unemployment rate in 2022 and 2023 at 3.6% and 4.2%, respectively, which is well below the 6% averaged over the last business cycle.



Source: U.S. Department of Labor and Wells Fargo Economics

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