WELLS FARGO

Economic Indicator — September 22, 2022

Heads Up: August LEI Flashes Recession Warning

Summary

August's decline in the Leading Economic Index pushed the six-month average change below a level historically indicative of a coming recession. The trend decline in the LEI since the start of the year is consistent with our view that the economy will slip into a mild recession by the beginning of next year.

Economist(s)

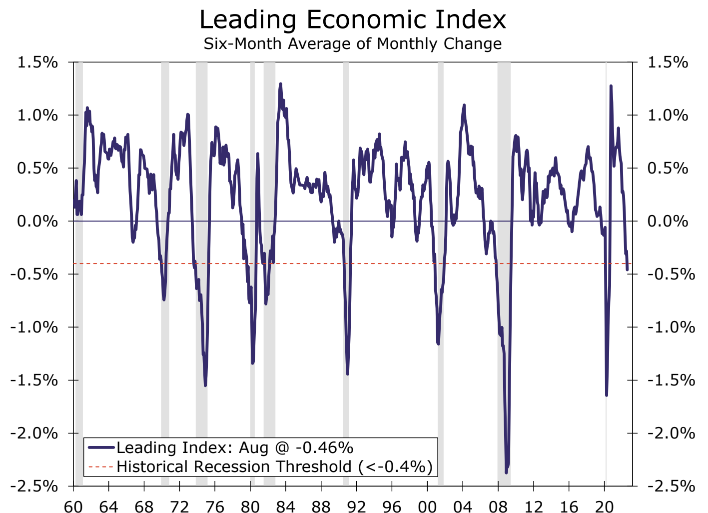
Tim Quinlan
Senior Economist | Wells Fargo Economics
Tim.Quinlan@wellsfargo.com | 704-410-3283

Shannon Seery
Economist | Wells Fargo Economics
Shannon.Seery@wellsfargo.com | 332-204-0693

Source: The Conference Board and Wells Fargo Economics

Signal You've Waited For

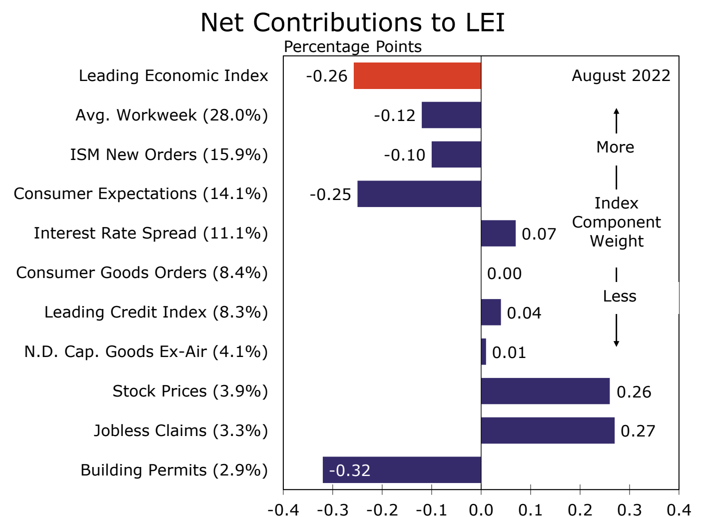
The Leading Economic Index (LEI) declined 0.3% in August, which caused the six-month average change in the index to slide to -0.46% last month, breaching a concerning level (chart). We recently highlighted that the six-month average change in the LEI has never been below -0.4% without a recession over the past 60 years. The longest lead time in which the average change has fallen below this threshold before the start of a recession has been four months, leading into the 1980 recession. Our baseline forecast is for a mild recession to begin at the start of next year, and the decline in the LEI this year supports that view. We will publish an update to our recession probit models tomorrow, which will incorporate the latest LEI and update the probability of recession next year.



Source: The Conference Board and Wells Fargo Economics

While we're looking for a mild recession in coming months, we still do not yet feel broad economic conditions are yet consistent with contraction. The labor market continues to present one of the strongest cases against recession, with still tight conditions even as demand for labor is beginning to show signs of topping out. Initial jobless claims moved lower in August and provided the largest boost to the LEI last month. But when we look at the underlying details of what's driving the LEI lower, however, component-specific declines are becoming more widespread and signal weakening economic conditions.

Consumer optimism has plummeted and led the index lower with the average consumer expectations component providing a negative net contribution to the headline LEI for the 13th consecutive month in August. Despite the hit to consumer optimism, consumer demand for goods is only gradually pulling back and again the manufacturers' new orders for consumer goods component was a neutral force on the LEI last month.



Source: The Conference Board and Wells Fargo Economics

Broader manufacturing activity, however, has weakened in recent months. The ISM new orders contribution was negative for the sixth straight month. Nondefense capital goods orders excluding aircraft have been a bit more volatile on a month-to-month basis and provided a modestly positive contribution last month, but weaker activity caused average weekly hours of factory workers to subtract 0.12 percentage points from the LEI.

The largest drag came from building permits (chart), as housing activity continues to buckle under the weight of higher mortgage rates. Increased affordability challenges are weighing on demand and leading builders to offer incentives to attract potential buyers. But the pullback in home values and still-elevated building costs are making it less profitable for builders today.

The financial-focused components of stock prices (+0.26pp), the leading credit index (+0.04pp) and interest rate spread (+0.07pp) positively contributed to the LEI. While this may be potentially surprising given recent volatility in markets, the S&P was on average higher in August than in July, despite ending the month on a softer note, and credit spreads narrowed modestly. The interest rate spread is based on the 10-year Treasury and federal funds rate specifically, which has narrowed but remained positive in August.

Overall the August LEI continues to present an economy that is losing momentum. The fact that the six-month change has breached the historical recession threshold does not guarantee that a recession is imminent, but it does signal economic weakness is broadening. That combined with a continued tightening in financial conditions due to aggressive Fed tightening suggests a recession may be harder to avoid.

Subscription Information

To subscribe please visit: www.wellsfargo.com/economicsemail

Via The Bloomberg Professional Services at WFRE

Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Shannon Seery	Economist	332-204-0693	Shannon.Seery@wellsfargo.com
Nicole Cervi	Economic Analyst	704-410-3059	Nicole.Cervi@wellsfargo.com
Jessica Guo	Economic Analyst	212-214-1063	Jessica.Guo@wellsfargo.com
Karl Vesely	Economic Analyst	704-410-2911	Karl.Vesely@wellsfargo.com
Patrick Barley	Economic Analyst	704-410-1232	Patrick.Barley@wellsfargo.com
Jeremiah Kohl	Economic Analyst	704-410-1437	Jeremiah.J.Kohl@wellsfargo.com
Coren Burton	Administrative Assistant	704-410-6010	Coren.Burton@wellsfargo.com

Required Disclosures

This report is produced by the Economics Group of Wells Fargo Bank, N.A. (“WFBNA”). This report is not a product of Wells Fargo Global Research and the information contained in this report is not financial research. This report should not be copied, distributed, published or reproduced, in whole or in part. WFBNA distributes this report directly and through affiliates including, but not limited to, Wells Fargo Securities, LLC, Wells Fargo & Company, Wells Fargo Clearing Services, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Europe S.A., and Wells Fargo Securities Canada, Ltd. Wells Fargo Securities, LLC is registered with the Commodity Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. WFBNA is registered with the Commodity Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. Wells Fargo Securities, LLC and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this report.

This publication has been prepared for informational purposes only and is not intended as a recommendation offer or solicitation with respect to the purchase or sale of any security or other financial product nor does it constitute professional advice. The information in this report has been obtained or derived from sources believed by WFBNA to be reliable, but has not been independently verified by WFBNA, may not be current, and WFBNA has no obligation to provide any updates or changes. All price references and market forecasts are as of the date of the report. The views and opinions expressed in this report are not necessarily those of WFBNA and may differ from the views and opinions of other departments or divisions of WFBNA and its affiliates. WFBNA is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report, neither WFBNA nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this report and any liability therefore (including in respect of direct, indirect or consequential loss or damage) is expressly disclaimed. WFBNA is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company. © 2022 Wells Fargo Bank, N.A.

Important Information for Non-U.S. Recipients

For recipients in the United Kingdom, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority (“FCA”). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (“the Act”), the content of this report has been approved by WFSIL, an authorized person under the Act. WFSIL does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. For recipients in the EFTA, this report is distributed by WFSIL. For recipients in the EU, it is distributed by Wells Fargo Securities Europe S.A. (“WFSE”). WFSE is a French incorporated investment firm authorized and regulated by the Autorité de contrôle prudentiel et de résolution and the Autorité des marchés financiers. WFSE does not deal with retail clients as defined in the Directive 2014/65/EU (“MiFID2”). This report is not intended for, and should not be relied upon by, retail clients.

SECURITIES: NOT FDIC-INSURED - MAY LOSE VALUE - NO BANK GUARANTEE