Economic Indicator — September 21, 2023

LEI: Leading to Recession or Leading Us Up the Garden Path?

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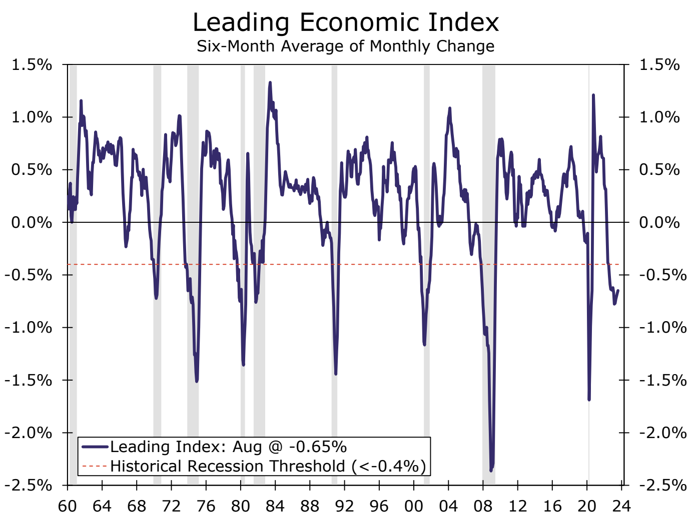
Summary

The 0.4% decline in the Leading Economic Index (LEI) in August marks the 17th consecutive monthly decline. Six of the components barely budged, exerting a contribution smaller than 0.05 percentage points in either direction. A bounce in building permits was the only real positive.

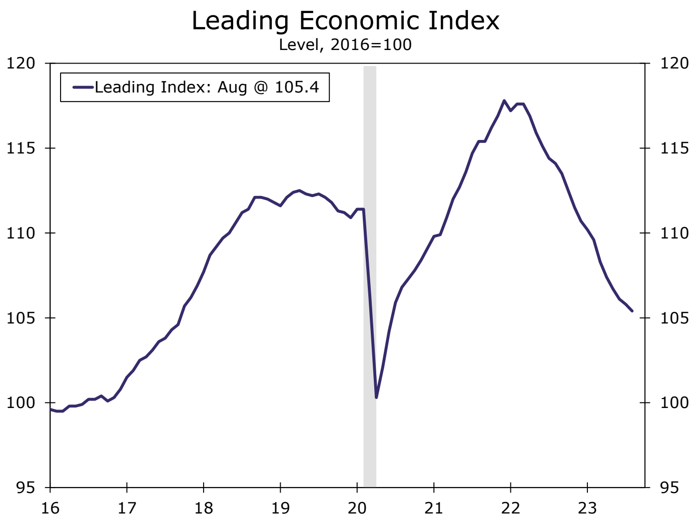


Source: The Conference Board and Wells Fargo Economics

The Alarm May Have Gone Off Too Early, but It's Not a False Warning

The Leading Economic Index, a composite of multiple leading indicators, has been signaling recession for months (chart). The expression "leading (someone) up the garden path" is used to describe an effort to deceive someone by trying to convince them of something which is not true. After 17 monthly declines in this trusted bellwether, one might reasonably ask if a recession is really coming. From our perspective, the worst that can be said of the LEI is that the alarm came too early, but it is consistent with our expectation for a modest decline in GDP early next year.

The LEI slid 0.4% in August and is roughly 5% lower than it was right before the pandemic struck (chart).The six-month average change, a leading indicator of recessions, has been below its recession-prediction threshold for 14 months now. The index's precipitous decline has come at odds with activity data that have shown a resilient economy this year.



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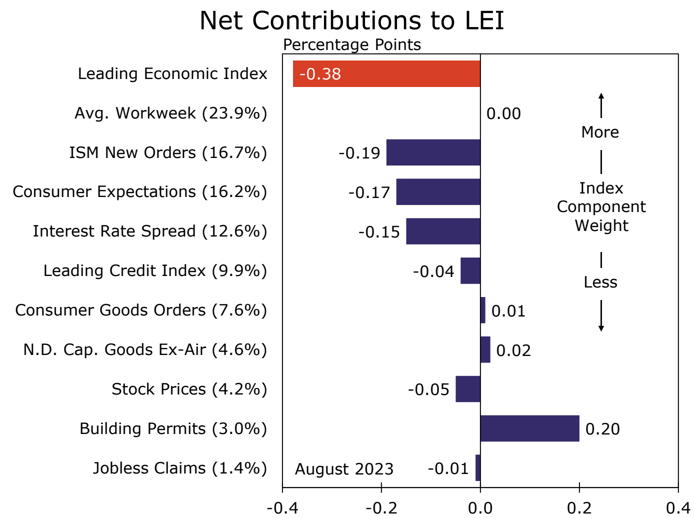

Source: The Conference Board and Wells Fargo Economics

Of the financial components, the S&P 500 ended its four-month streak of gains and nudged the headline index down 0.05 percentage points (chart). The pullback in stock prices has coincided with a steady rise in Treasury yields across the curve. The interest rate spread (the 10-year Treasury yield minus the fed funds rate) remains deeply inverted and pulled the LEI lower. Elevated rates amid the uncertain economic backdrop have underpinned a broad tightening in lending, which has shown up in the leading credit index in August—continuing a 7-month streak of negative contributions.

Initial jobless claims rose modestly during August, amounting to a slightly negative 0.01 percentage point contribution, but have trended lower this month. The gradual loosening in the labor market thus far has been driven by softening demand for new workers rather than layoffs of existing workers, which should help to keep claims in check. Weaker job prospects are poised to restrain household confidence even as inflation improves. Consumer expectations subtracted 0.17pp from the LEI in August.

While we do anticipate a mild recession, we think the downside may be limited for construction activity, and that was evident in today's report as well. The only meaningful boost to the headline LEI came from a bounce in building permits. The pickup in permitting activity may merely reflect volatility on the multifamily side, but we think that a relatively deep pool of potential buyers who have been boxed out of the resale market are leading builders to press ahead with single-family construction plans despite higher mortgage rates.

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