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Leading Index Points to Better Days for the U.S. Economy

The Leading Economic Index (LEI) gained 1.2 percent exceeding last month's gain and posting the first back-to-back monthly increase in almost three years. This report is consistent with our forecast that the recession will end later this year. Jobs data weighed on the LEI, and will remain an impediment to growth during recovery.

Coming this Summer to a Theater near You: A Growing Economy

The second consecutive gain in the LEI is the latest sign that after 18 months, the deepest recession in the post-war era is drawing to a close. The massive drawdown in inventories in the first half of the year helps set the stage for a recovery in the second half. Indeed, the largest positive factor in May was a jump in vendor performance. This component measures the time it takes to deliver orders to industrial companies. Vendor performance is a bellwether for the business cycle because an increase in delivery time can illustrate rising demand for manufacturing supplies. Inventories dropped at an annualized rate of more than $91 billion in the first quarter and detracted from overall GDP. Recent wholesale inventory reports suggest that the drawdown continued into the second quarter as well. If it is taking manufacturers longer to get stocks to industrial companies, it stands to reason that the shelves are finally starting to empty. Even if demand stays constant and does not pick up, depleted inventories mean factories will have to ramp up production again to keep pace with orders. We expect inventory declines to slow in the second half of the year. That slowing in the pace of decline will be additive to GDP and a critical component of the coming recovery.

Employment an Impediment to Growth

While it is encouraging to consider the economy finally pulling out of this recession, challenges in the job market will be a drag on growth. The average work week and weekly jobless claims both weighed on the leading index. This is consistent with our expectation that the unemployment rate will continue to rise well into next year. Challenges in the labor market also weighed on the coincident index as nonfarm payrolls continue to contract. The coincident index was down another 0.2 percent in May and has now fallen for eight straight months. On a peak-to-trough basis we have lost more than six million jobs since this recession began. We expect the magnitude of job losses to decrease in coming months and job growth to return by the second quarter of next year.

Challenges in the labor market aside, this is a positive report and a welcome piece of good news. Despite the recent sell-off in equity markets, the recent rally in the stock market has contributed to the overall index for two months in a row. There is a lot less talk about a depression among market watchers and consumers are taking heart in news that is either good or at least "less bad". The component of LEI that measures consumer expectations was up for the third month in a row. Even the struggling housing market which has weighed on the LEI for much of the last two years is showing signs of recovery as building permits start to pick up.