



Economics Group

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A Gain for LEI, but Watch out for the Head-Fake From Permits

The sixth straight monthly gain in the Leading Economic Index (LEI) is consistent with our outlook for continued growth in 2011. However, gains in the LEI may be overstating the strength of the recovery.

Another Increase in LEI, but a Spike in Homebuilding? Really?

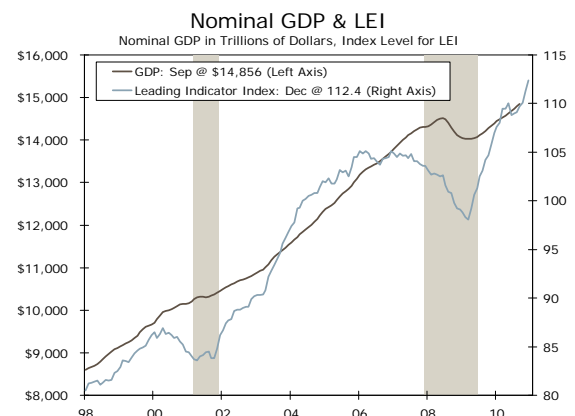
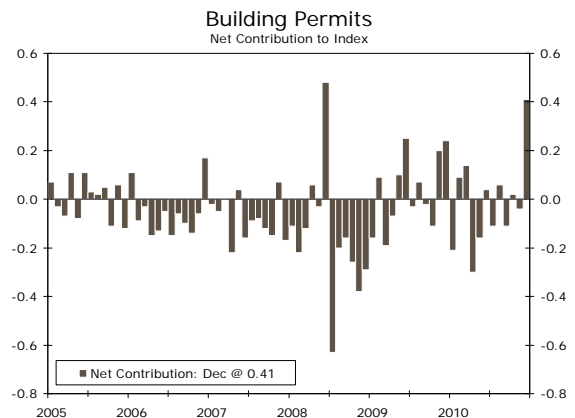
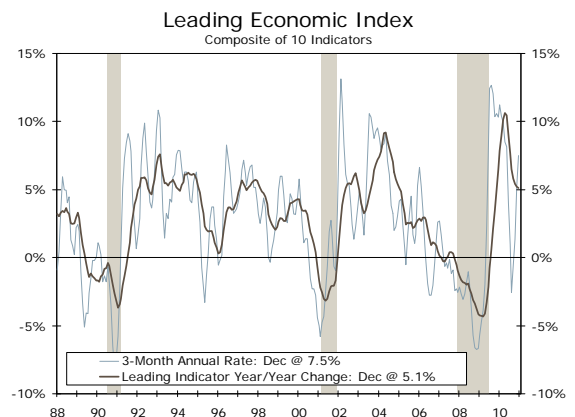
The Leading Economic Index (LEI) added 1.0 percent in December, marking the 20th month of growth for the index in the last 21 months. The component that did most of the heavy lifting this month in terms of positive contribution to the LEI was building permits. In fact, December marked the second largest positive contribution on record for this component which is included in the index to reflect changes in the residential construction sector. It may sound out of touch with reality to think that residential construction is going to lead economic growth in coming months.

There are a few factors that help explain the unusual pop in permits. According to the Department of Commerce, the increase in December permits may have something to do with building code changes which became effective on January first in various states. In California, new green building codes go into effect; in Pennsylvania, a requirement for fire sprinklers for single and two-family homes and in New York, January marks the implementation of new energy-related restrictions. Builders may have rushed to apply for permits before new codes became effective. If that were the case, December's gain is not likely sustainable. Combine these one-off factors with a very low base for building permits and you have a unique set of circumstances that overstates the role of residential construction in the recovery.

Growth May not Meet High LEI Expectations

Outside of the big jump in permits, gains were broad-based but more modest. The second largest contribution came from the interest rate spread, a component that reflect the Federal Reserve's efforts to keep short-term rates extremely low and which has been a positive contributor to the LEI since February 2008. Another notable positive this month was the boost from the improvement in equity markets in the final month of 2010. Also, shorter lines at the unemployment office showed up as a boost to LEI from jobless claims.

The improvement in LEI, which began nearly two years ago, correctly anticipated the end of the recession. That said, the trajectory of the LEI's recovery has begun to pull ahead of actual growth and suggests an even faster pace of growth than we expect to materialize in the coming year. The year-over-year growth rate in the Leading Economic Index has been above five percent every month since November 2009. While we most assuredly anticipate economic growth to continue into the coming year, the full year growth rate for 2011 is more likely to come in around 3 percent, a number somewhat short of what the runaway growth in LEI seems to portend. We expect real GDP likely grew 2.9 percent in 2010, so a number north of 3 percent in 2011 would mark a slight acceleration in the pace of recovery.



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