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Economics Group

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Leading Index Signals More Growth—Should You Buy It?

The Leading Economic Index posted another monthly gain, signaling continued growth. But, given the boost to the index by the money supply and the yield spread, does this really signal fair skies ahead?

Leading Indicators Signal Modest Growth

The Leading Economic Index (LEI) posted a 0.5 percent increase in July. This marks the 26th gain in 28 months and is consistent with an economy that is firmly on the road to recovery. However, in the context of mixed economic indicators lately, which seem to be waving a caution flag, another "thumbs up" reading from the LEI seems somewhat out of synch.

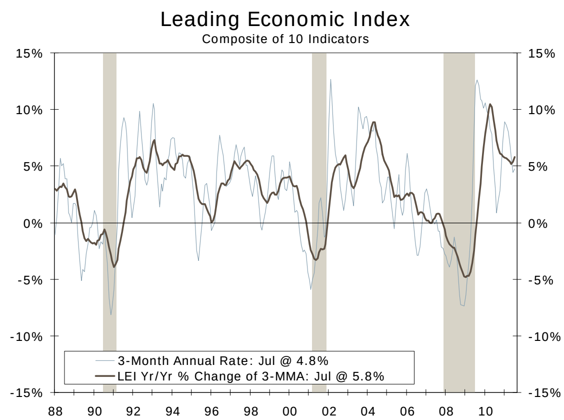
One factor that goes a long way toward explaining the consistently upward trajectory for the LEI is the way the Conference Board captures the impact of monetary policy on the economy. Two of the ten components (the interest rate spread and the money supply) have been a source for much of the growth in LEI in the past two years. When the Federal Reserve engages in quantitative easing, it adds dollars to the money supply. The interest rate spread has been a positive contributor to growth for a staggering 42 straight months. While these components may not be reflective of a self-sustaining organic recovery, it is not as though they should be discounted altogether. After all, the reason for rate cuts and bond buying by the Federal reserve is to make the cost of borrowing cheaper for businesses and individuals. The problem lately seems to be a lack of confidence.

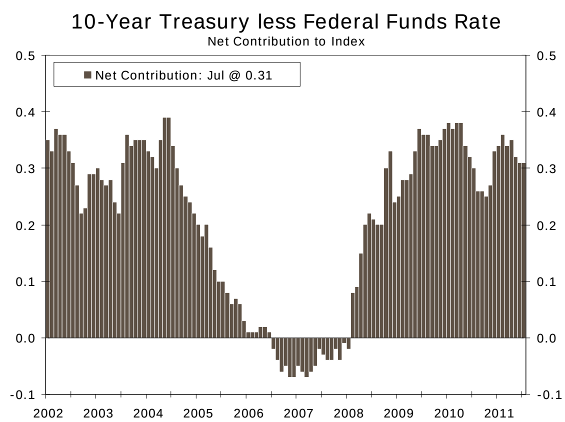
Consumers and Businesses Lacking Conviction in Recovery

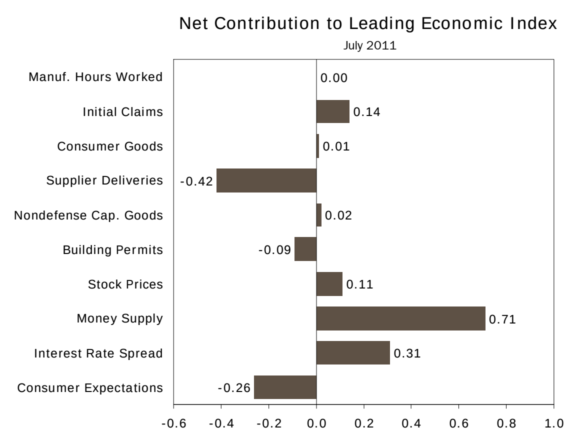
One major drag on the July reading of LEI was consumer expectations. According to the University of Michigan Consumer Survey (which the Conference Board uses for this component of LEI), forward looking sentiment among consumers in July dipped to the lowest level since the recession. That is not the worst of it. We already know that in August consumer expectations fell even more and presently reflect the most dismal outlook among consumers in more than 30 years. Despite their depressed mood, consumers are still spending. Consumer goods orders were a slight upward contributor to growth and July's retail sales report was stronger than expected. Business sentiment has also been lacking as we have seen deterioration in the national and regional purchasing managers indexes. Still, orders of nondefense capital goods posted a scant increase in July, just enough to provide upward nudge to LEI.

So Bottom Line, Do You Buy It or Not?

Declining jobless claims and growing payrolls underpin a job market that is tentatively holding on to recovery. The headline number for the LEI is likely reflecting more of a boost from monetary policy than the actual economy seems to be reflecting at this stage of the cycle and as a result it overstates the health of the economy. In the context of this big positive number from LEI, we feel it is important to acknowledge the growing recession risk—a sentiment that seems to be missed by this report.







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