Misleading Indicators

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Published Sep 5, 2023

Jay Powell's oratory hit a rather poetic vein, in his recent Jackson Hole speech, when he compared the current management of monetary policy to "navigating by the stars under cloudy skies."

It is easy to appreciate his predicament. For the last year and half, the Federal Reserve has been engaged in an aggressive campaign to slow the economy in order to reduce inflation to its 2% target. However, the data have left Fed officials very confused, with growth proving resilient even as inflation has fallen sharply.

Part of the confusion may stem from an over-reliance on traditional indicators and relationships that just don't work as well in the economy of the early 2020s. In particular, portents of recession, such as a heavily-inverted yield curve or a slump in the index of leading economic indicators, may be less reliable than in the past. In addition, there are good reasons to believe that a tight labor market may not be as inflationary as was the case a few decades ago. One step to understanding the economic and financial environment of the 2020s is to see why these indicators may have lost their predictive ability.

Yield Curve Inversion

First, let's look at the Treasury yield curve. Normally, the yield curve slopes upwards – that is to say, the interest rate on long-term bonds is higher than on short-term bonds. As an example, since 1976, the 10-year yield has been higher than the 2-year yield 85% of the time and, on average, has been 0.89% higher.

However, 15% of the time, long-term yields have fallen below short-term yields and that has been a pretty reliable indicator of recession. Since 1976, there have been six U.S. recessions and the monthly average spread between ten-year yields and two year yields has turned negative before five of them, with an average lead time of 15 months. (Just for the record, this didn't quite happen before the pandemic recession but the yield curve can be excused for not forecasting a virus). Moreover, since 1976, there have been no cases of a prolonged inversion of the spread between 10s and 2s that didn't precede a recession.

Most recently, this spread turned negative in July 2022 and has stayed this way for 14 consecutive months. So why has there been no recession yet?

On balance, it is a troubling statistic. However, to see why it might be misleading this time, it's important to understand why it has worked in the past.

Logically, the yield curve should normally slope upwards. Due to their higher duration, the total return on long-term bonds is more volatile than on short-term bonds and investors should be compensated for this volatility with a higher yield. In fact, the only reason someone should accept a lower-yield on long-term bonds than short-term bonds is because they expect interest rates to fall, generating capital gains on long-term bonds and reinvestment risk for short-term bonds.

And this is exactly how interest rates and recessions have played out in the past. When investors sense that the economy is in trouble and that the Fed is likely to respond, they pile into long-term bonds, driving long-term yields lower and inverting the curve.

However, things may be a little different this time around as the Fed has, very unusually, stated that it has pushed monetary policy to a restrictive mode and intends to cut the federal funds rate over the next few years as inflation fades, *whether the economy falls into recession or not*. It should also be noted that, prior to 2012, the Fed never provided explicit guidance on where the federal

funds rate would be in the long run and that, since then, there has never been a bigger negative gap between their long-term expectation (currently 2.50%) and where they are holding it today (currently between 5.25% and 5.50%).

Index of Leading Economic Indicators

Another warning sign of imminent recession is the now 16-month continuous decline in the index of leading economic indicators.

By way of background, the index of leading economic indicators traces its origins to work done at the National Bureau of Economic Research in the 1930s and 1940s to try to predict U.S. business cycles. In the early 1960s, the U.S. Department of Commerce took over the publication of the index and in 1995 they, in turn, passed the job on to the Conference Board, a private sector economic consulting firm. The index is composed of 10 economic series and changes in each of these series are divided by their individual standard deviations so that they should each, over time, have a roughly equal weight in determining the change in the overall index. The word "leading", in this context, doesn't mean most important. It means economic series that tend to lead, chronologically, turns in the business cycle. According to the Conference Board, the index leads changes in the business cycle by about 7 months.[1] If this is true, then the economy ought to have fallen into recession by the end of 2022 and not still be seeing healthy growth as we enter the fall of 2023. So why the false alarm?

The answer seems to lie in the evolution of the economy over the years and the peculiar nature of the pandemic recession and its aftermath.

In particular, four of the 10 leading indicators refer directly to conditions in manufacturing even though manufacturing, as a sector, now accounts for just 8% of payroll employment. Moreover, the pandemic saw an immediate surge in the demand for goods and a slump in the demand for services followed by the reverse as the economy recovered. An index that emphasized manufacturing would therefore very likely underestimate economic momentum over the past two years. In addition, the slope of the yield curve is one of the indicators, which, as noted above, may currently be providing a too-negative prediction on growth.

However, the single most negative indicator in the index, accounting for 45% of its decline since April 2022, is consumer expectations. This is an equally-

weighted average of indices of consumer expectations for economic conditions 12 months ahead, according to the University of Michigan, and for business conditions 6 months ahead, according to the Conference Board. These numbers have been consistently below average since the pandemic, even relative to what would seem to be implied by economic data themselves. Indeed, overall consumer sentiment in July 2023 was lower than it has been 82% of the time since 1978, even though the combination of unemployment and inflation, the so-called "misery index", was lower than *it* has been 83% of the time over the same period.

This suggests two problems in using consumer expectations as part of a leading economic index. First, because of political partisanship, negative cable and social media feeds and the aftermath of pandemic restrictions, people may feel unreasonably gloomy in ways that don't actually impact their day-to-day spending. Second, the economy counts by dollars, not by heads. Consumer sentiment among more affluent households appears to have recovered from the pandemic much more rapidly than among the less well off. However, more affluent households have a disproportionate impact on aggregate demand so, even if confidence overall is low, a broad sentiment index may overstate the problem.

In short, the index of leading economic indicators may be painting too dire a picture of economic prospects and could well remain that way for some time to come.

Unemployment and Wage Inflation

Finally, traditional indicators also may be missing the mark in predicting persistent inflation. In particular, in the June Summary of Economic Projections, most members of the Federal Reserve's Federal Open Market Committee in effect professed that an unemployment rate of 4% or higher was necessary to attain the Fed's long-term objective of 2% inflation. However, the unemployment rate has now been below 4% for 21 straight months and, yet, since March of last year, year-over-year wage growth has drifted down from a peak of 5.9% to 4.3% last month.

Of course, monetary hawks could still argue that 4.3% wage growth is too high for 2% inflation. However, other data show that benefits are rising more slowly

than wages and that productivity growth is rising, both important offsets to the inflationary impact of wage increases. In addition, many workers may see current wage increases as necessary compensation for past inflation rather than a bulwark against future inflation and, as current inflation moderates, so could the demand for wage increases.

Moreover, two other factors may be even more important. First, workers likely have diminished bargaining power relative to previous decades at any level of unemployment. Just 10.1% of employed workers last year were members of a trade union, down from over 25%, on average, in the 1970s. Moreover, the decline in unions in the private sector has been even more dramatic with just 6% of employed workers being union members last year.

Second, it may well be that the natural rate of unemployment has simply fallen over the years. It is certainly easier for companies to advertise open positions and for candidates to locate them and apply for them than would have been the case a few decades ago. Minimum wage rules act as less of a barrier to entry for low-skilled workers and unemployment benefits, in real terms, provide less of a safety net for the jobless. There are countervailing forces, of course. The high cost of shelter is reducing worker mobility and significant issues of drug use, innumeracy and illiteracy may contribute to long-term unemployment.

Still, it is at least very possible that today's low unemployment rate is compatible with 2% inflation. Indeed, our own models suggest that PCE inflation should fall to roughly 2% by the fourth quarter of 2024, even without any further increase in the unemployment rate, reflecting moderate gains in food and energy prices and the lagged effects of a stalling out in rents and new vehicle prices.

Implications for the Fed and Investors

Upon consideration, Chairman Powell's metaphor of navigating by the stars under cloudy skies may be a little off, as it carries no implication as to the speed with which you should travel. It might be more accurate to say that the Fed is sailing in shallow waters in a thick fog. It should be moving very slowly and be ready to halt or reverse its monetary tightening. While leading indicators of both recession and rebounding inflation have proven faulty in 2023, the risk of the former seems greater. Consequently, investors would do well to maintain a well-diversified position with a strong focus on valuations in case, despite their best

intentions, the Fed allows the expansion to founder on the as-yet-unseen rocks of recession.

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[1] *LEI for the U.S. Fell Again in July,* Conference Board Press Release, August 17th, 2023

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