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MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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Downunder Daily

America's Top Model

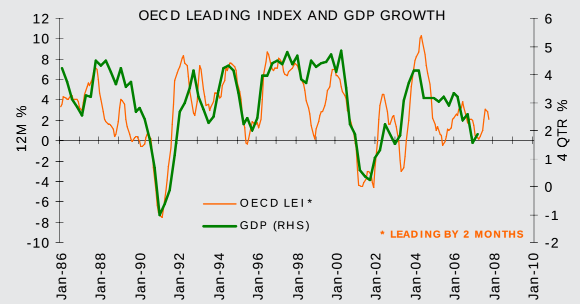
There are a number of commonly used indicators designed to pick turning points in US growth – and hopefully provide early warning of recession. The good news for economists is that none of them is perfect (that is, they don't put us out of a job). The bad news for investors is that the message now is mixed, confirming that it is right to be uncertain about the outlook. Here's a review of what they're saying:

Two of the best-known indicators are the leading indexes produced by the OECD and the Conference Board. Both have two drawbacks. First, neither is particularly far-sighted: They tend to provide a 3-6 month lead on the cycle (which, in practice, is shorter given publication lags). Second, while both seem to have a good (but not perfect) historical track record, this is flattered by regular re-estimation that ensures that the *ex-post* performance is better than the *ex-ante,* which confirms that forecasting the future is more difficult than forecasting the past.

Now, the message from the two indicators is mixed. Both signaled the deceleration in growth evident through the past year, but the OECD index now points to improvement, with annual GDP growth rising to 2½-¾% (Exhibit 1), while the Conference Board anticipates more 2%-type growth (Exhibit 2).

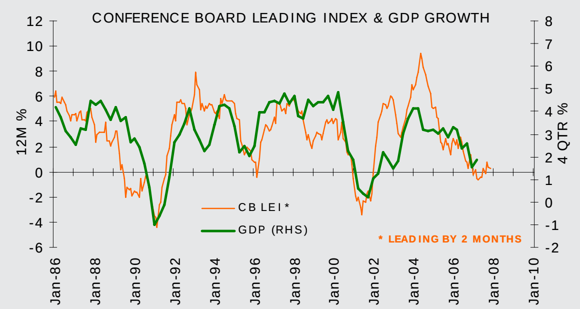
A variation on the Conference Board index is to compare the coincident index with the lagging index. While looking backwards to look forwards may seem counterintuitive, the logic is that if current conditions are markedly weaker relative to recent history, then the loss of economic momentum warns of recession.

Exhibit 1
This One Says Recovery…



Source: OECD, BEA; Morgan Stanley Research

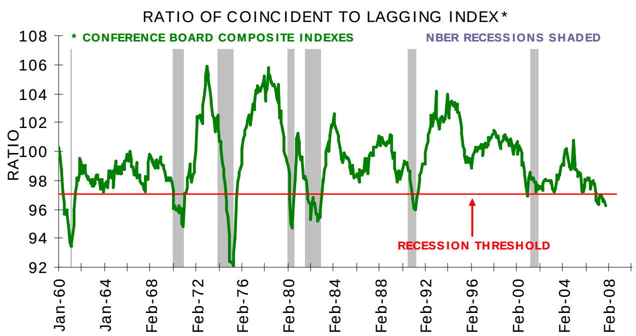
Exhibit 2
…This One Isn't Sure



Source: Conference Board, BEA; Morgan Stanley Research

Regardless of the logic, the simple fact is that the ratio of coincident to lagging has a reasonable track record as a recession indicator – although, admittedly without a lot of foresight. This ratio now suggests recession is likely (Exhibit 3).

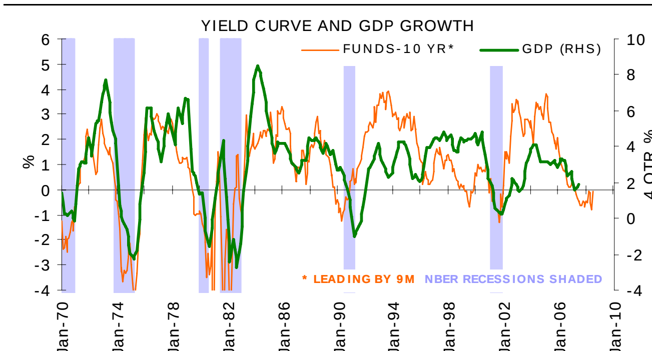
Exhibit 3
This One Says Recession



Source: Conference Board, NBER; Morgan Stanley

The yield curve is another much-watched leading indicator. It is far-sighted, timely (real-time), and doesn't get revised. But it can be wrong. However, as Exhibit 4 shows, it is right more often than not, and is now flagging recession.

Exhibit 4
So Does This One

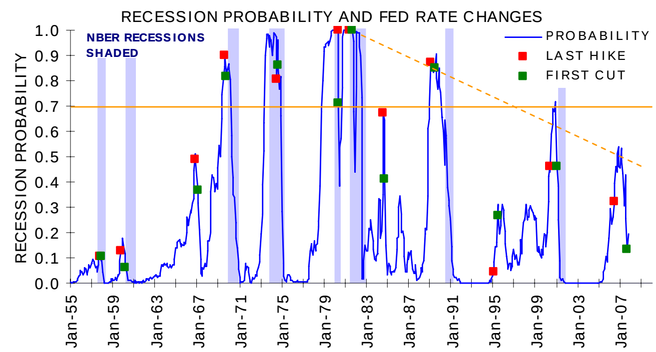


Source: Bloomberg, BEA, NBER, Morgan Stanley Research

A variation on the theme is to take account not just of the curve but also the level of short rates. Several models do this; Exhibit 5 shows one of them (taken from a Fed research paper, and watched by our European strategy team). It is designed to estimate the risk of recession in the following year.

Over the past 40 years, the model has a perfect track record picking recessions: recession follows whenever the probably hits 70% – and there's no recession when it doesn't. Of course, it is only with hindsight that we know that the magic number has been 70%. (It is also worth noting that the recession probability is almost always falling from its peak when the actual recession starts, reflecting the first curve-steepening easing of short rates.)

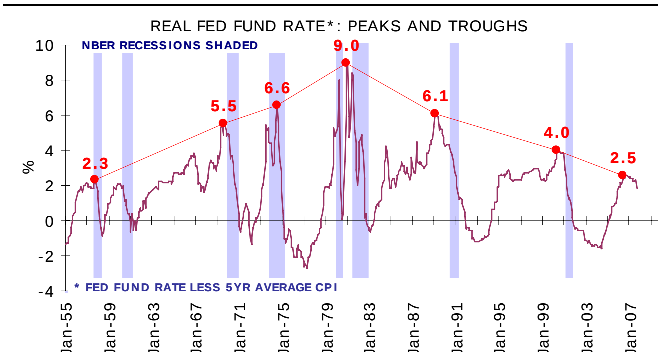
Exhibit 5
Confused?



Note: Based on 2006 Federal Reserve Bank paper by Jonathan Wright (*The Yield Curve and Predicting Recessions*): the risk of a recession within the next 4 quarters is a normal distribution function: Probability = ƒ(-2.17 - 0.76 x **S** + 0.35 x **R**). With **S** the spread (spread between 10yr Treasury and 3m T-bill) and **R** the Fed fund rate.
Source: Bloomberg, NBER; Morgan Stanley Research

The other point about this model is that the recession threshold seems to be coming down. This matches the successively lower peaks for the Fed funds rate seen over the past 25 years – a pattern that I think reflects the rising leverage in the system which makes monetary policy more effective (Exhibit 6). On that basis the 55% recession-risk signal earlier this year is, in my view, a serious warning.

Exhibit 6
Was That Low High High Enough?



Source: Bloomberg, BLS, NBER; Morgan Stanley Research

I'm away for the next few days, so next DuD will be Friday. Cheers, GM

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