AIER

11|13 BUSINESS-CYCLE CONDITIONS

Private Sector Marches On

by Robert Hughes, Senior Research Fellow

Continued modest growth is the most likely path for the economy, despite the weakness created by government cutbacks.

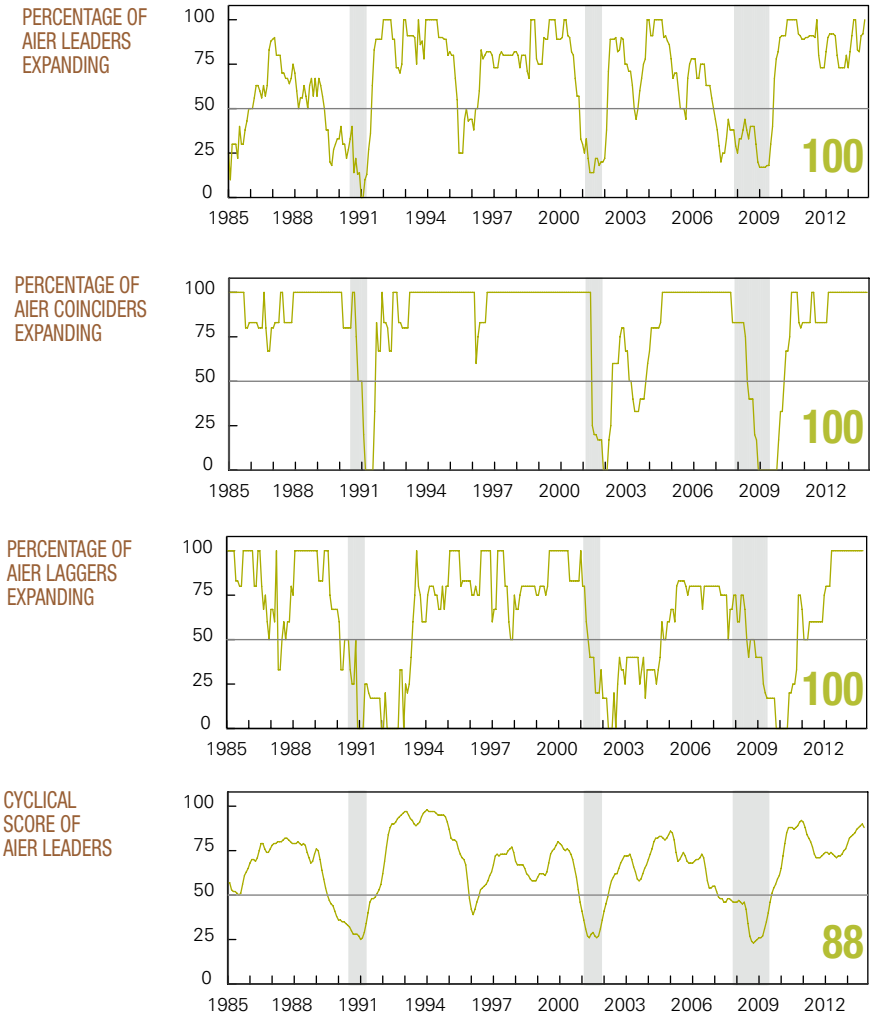
The latest update to AIER's indicators of Business-Cycle Conditions suggests economic growth is likely to continue.

Despite cutbacks in government payrolls due to sequestration and policy uncertainty surrounding the recent shutdown of the federal government and the risk of debt default, the private sector appears to be grinding ahead.

AIER's primary leading indicators registered 100 percent in our latest evaluation, with 10 out of 10 indicators with a discernible trend judged to be positive (two indicators were judged to be trending sideways). This is up from

THE INDICATORS AT A GLANCE

Shaded bars represent official recessions. A score above 50 indicates expansion.



a reading of 92 percent last month. Our cyclical score of leading indicators, derived from a separate mathematical analysis, declined slightly to 88 in the latest month from 90 in the prior month. Despite the mixed performance month-to-month, taken together, the high levels for both the leaders and the cyclical score suggest continued moderate growth is the most probable path for the U.S. economy.

Supporting the leaders and cyclical score are perfect 100 readings for both the primary roughly coincident indicators and the primary lagging indicators. The coinciders posted their 21st straight month with a reading of 100, while the laggers recorded their 17th month in a row with a perfect score. Strong performances by these indexes offer further evidence that economic growth, while a bit sluggish, is well established.

Claims for unemployment insurance are within the range that is consistent with healthy jobs growth.

STATISTICAL INDICATORS OF BUSINESS-CYCLE CHANGES

Change in Base Data					Cyclical Status		
JUN	JUL	AUG	SEP	PRIMARY LEADING INDICATORS	AUG	SEP	OCT
-	+	+	+	M1 money supply (1)	+	+	+
+	+	+	+	Yield Curve Index (1)	+	+	+
-	+	+	+	Index of manufacturers' prices (2)	-?	-?	?
-	+	+		New Orders for consumer goods (3)	+	+	+
+	-	+		New Orders for core capital goods (4)	+	+	+
-	+	-		New housing permits (3)	+	+	+?
-	+			Ratio of manufacturing and trade sales to inventories (3)	+	+	+?
+	+	+	+	Vendor Performance (2)	?	+	+
-	+	-	+	Index of common stock prices (constant purchasing power) (2)	+	+	+
nc	-	+	-	Average workweek in manufacturing (3)	+	+	+
+	+	+	+	Initial claims for state unemployment insurance (inverted) (3)	+	+	+
+	-r	-		Change in consumer debt (4)	+?	+?	?
				PERCENTAGE EXPANDING CYCLICALLY	91	92	100
				PRIMARY ROUGHLY COINCIDENT INDICATORS			
+	+	+	+	Nonagricultural employment (1)	+	+	+
+	-	+		Index of industrial production (1)	+	+	+
-	+r	+		Personal income less transfer payments (1)	+	+?	+
-	+			Manufacturing and trade sales (2)	+	+	+
+	+	-	+	Civilian employment to population ratio (2)	+	+	+
+				Gross domestic product (quarterly) (1)	+	+	+
				PERCENTAGE EXPANDING CYCLICALLY	100	100	100
				PRIMARY LAGGING INDICATORS			
+	-	-	-	Average duration of unemployment (inverted) (2)	+	+?	+?
+	+			Manufacturing and trade inventories (1)	+	+	+
+	-	+		Commercial and industrial loans (1)	+	+	+
+	+	+		Ratio of consumer debt to personal income (1)	+	+	+
+	+			Change in labor cost per unit of output, manufacturing (2)	+	+	+
nc	nc	-	-	Composite of short-term interest rates (1)	?	?	?
				PERCENTAGE EXPANDING CYCLICALLY	100	100	100

nc No change. r Revised. Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter; blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions; question marks indicate doubtful or indeterminate status.

INDEX COMPONENT HIGHLIGHTS

Among the component leading indicators, *initial claims for unemployment insurance* continues to fall towards levels associated with sustained economic growth. The latest weekly reading for initial claims came in at 336,000, down from 345,000 in the prior week, and back within the 300,000-350,000 range that is consistent with healthy job growth.

Job data has been a bit volatile in recent weeks because of the government shutdown as well as the switch by the California state employment agency to a new computer system. Despite the recent volatility, the downward trend in initial claims since the beginning of 2013 suggests ongoing gradual improvement in the labor market. Another sign of the improving labor market may be seen in the length of the

average workweek in manufacturing, which continues to push higher. Reaching 41.8 hours in September, it is now just 0.2 hours shy of its pre-recession high.

New orders for consumer goods rose again in the latest month, sustaining the slow, upward trend in place since mid-2010. While still well below its pre-recession levels, ongoing moderate gains in consumer activity is consistent with our overall expectation for continued expansion for the broader economy.

Stock prices, as measured by the S&P 500 index, have hit new all-time highs recently. Stock price gains have been driven by rising valuations—partially a result of aggressive monetary policy and low interest rates—as well as by rising corporate profits. Consensus earnings per share estimates for the S&P 500 suggest actual earnings are on pace to hit a record high for 2013.

Among AIER's coinciders, the *index of industrial production* recorded a 0.4 percent increase in September, led by a jump in utility output.

The manufacturing sector rose a more modest 0.1 percent and is up 2.6 percent from a year ago. Though the 2.6 percent gain over the past 12 months is relatively tame by historical standards, manufacturing output has a well-established rising trend, posting gains in seven of the past 11 months, and is just 4.9 percent below its pre-recession peak. Likewise, *manufacturing and trade sales* has risen at a 3.7 percent annualized rate since the low in 2009 and is within 1.3 percent of its all-time peak.

Earnings per share are on pace to hit a record high for 2013.

PUBLIC EMPLOYMENT LOSSES OFFSET PRIVATE GAINS

Average Monthly Change in Payrolls (in thousands)

Period	Total	Private	Government
April 1985-March 1988	212	183	29
October 1994-September 1997	231	221	10
July 2003-June 2006	168	160	9
October 2010-September 2013	177	187	-10

Source: Bureau of Labor Statistics, AIER

GOVERNMENT CUTBACKS CREATE DRAG

By many measures, the economic recovery that began in 2009 has been tepid, with real GDP growing at an annualized 2.2 percent over the past 16 quarters. Of particular concern to the Fed—with its dual mandate of promoting stable inflation and maximum employment—has been the weak job recovery. Politicians, whose re-elections rest with a happy electorate, and businesspeople, whose profit growth is contingent on gains in personal income and spending, join the Fed in desiring healthy gains in the labor market.

AIER's analysis of the labor market shows that while job growth in the latest recovery has been somewhat weaker than past recoveries, the weakness has been concentrated in the government sector while private-sector jobs growth has been on par with recent past expansions.

Every business cycle is different, and differences in the pattern of job changes at the beginning and the end of economic expansions can confound comparisons. To minimize these differences, we compared the rate of job growth during the most recent expansion with similar periods in each of the previous three expansions.

Specifically, we compared average monthly job growth by sector for the three-year period in the middle of each of the prior three expansions to the three-year average monthly job gains through September 2013 (the current expansion).

Growth in total nonfarm jobs has averaged 177,000 per month over the past three years, well below the growth rate for the late 1980s and the 1990s expansion, though slightly ahead of the 2000s expansion.

However, excluding the government sector, private nonfarm payroll growth has averaged 187,000 per month over the past three years, ahead of both the 1980s and early 2000s expansions.

The government sector has gone from being a net jobs

The government has gone from being a net jobs creator to a net jobs loser.

creator in each of the past three expansions to a net jobs loser in the current expansion. The results are shown on the table on page 3.

WHERE THE JOBS ARE

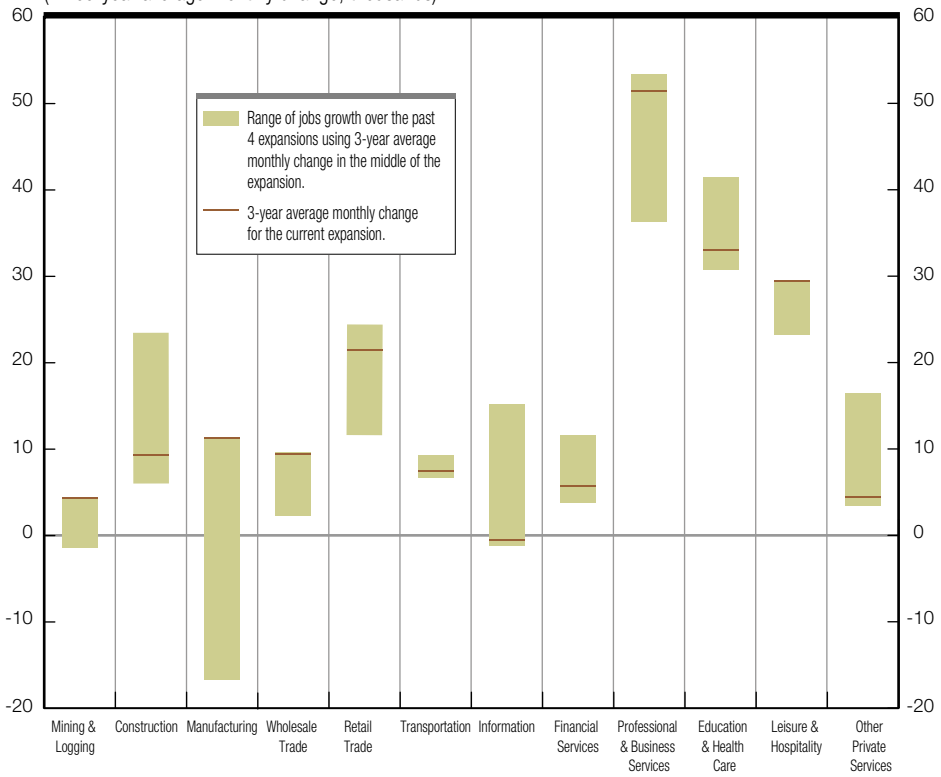
In the chart at right, the brown lines show the average monthly private-sector jobs gain for the three years ending September 2013. The green verticle bars show the range of average monthly job gains over the previous three expansions. The top of the bar is the strongest job growth of the previous three expansions while the bottom of the bar is the weakest growth.

Manufacturing, and mining and logging are creating jobs at a very strong pace relative to past expansions (brown lines are at the top of the green bar), while construction is adding jobs at a relatively slow pace (brown lines near the bottom of the green bar).

Job creation in service-producing industries, which account for the majority of jobs in the U.S., has been led by professional and business services, education and health care, leisure and hospitality, and retail trade (brown lines are the highest among the 12 industry groups).

Among these four, job creation in education and health care is relatively weak compared to prior expansions. In contrast, job creation in retail, leisure and hospitality, and professional and business services is proceeding at a relatively strong pace.

Private Payrolls Keep Pace with Past Recessions
(Three-year average monthly change, thousands)



Source: Bureau of Labor Statistics, AIER

Transportation, wholesale trade, financial services, and other private services are all creating relatively small numbers of jobs compared to other industries.

Wholesale trade job creation has been robust during this expansion in contrast to previous recoveries, while transportation, financial services, and other private services are creating jobs at a relatively weak pace.

Information services is the only private-sector industry that remains a net job loser over the past three years, eliminating about 300 jobs per month on average.

As policy makers continue to focus on jobs, media attention on employment data will remain intense. "Weak" job growth and the "jobless recovery" will grab many headlines.

Our analysis shows that job growth has been somewhat lackluster during the current economic expansion, but much of the weakness is a result of government payroll declines. We expect the drag on the overall job market from the government

Private payroll growth is within historical ranges, with some industries doing well.

Understanding that the government is the source of weakness may influence the Fed's view.

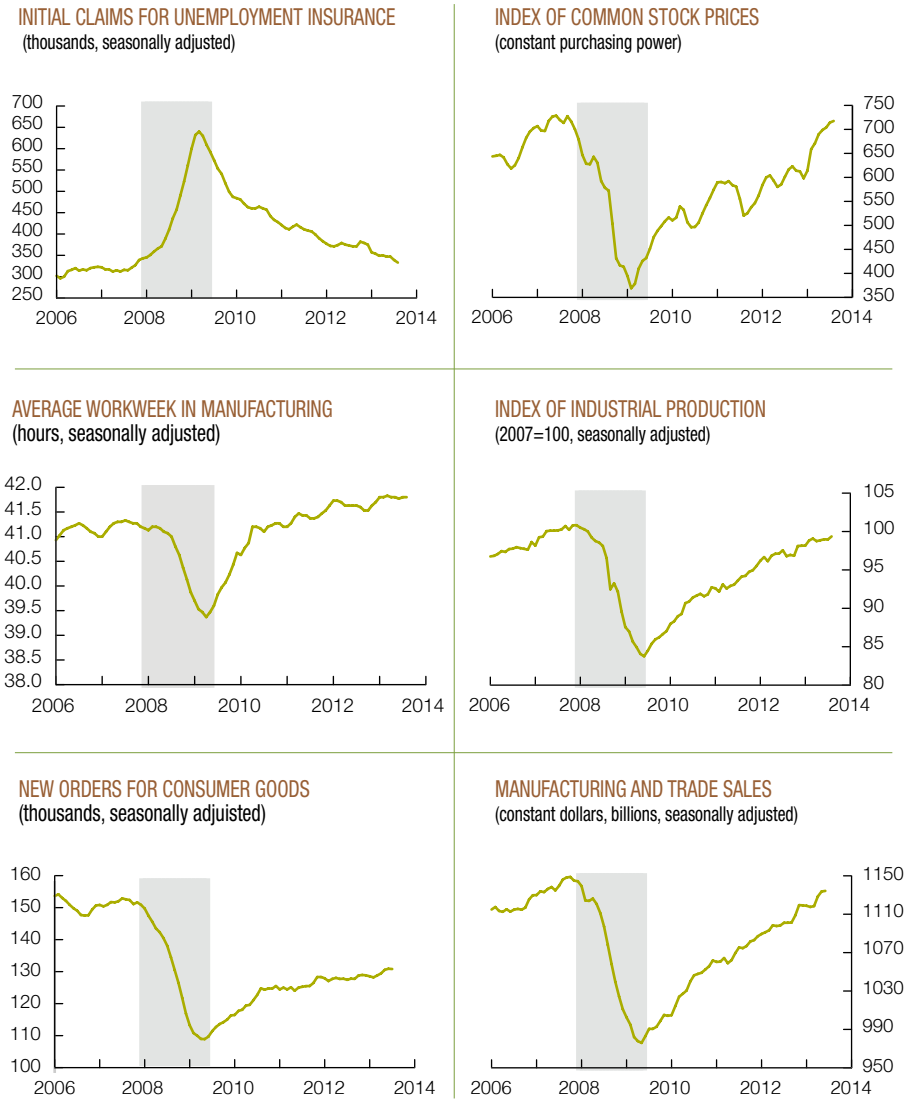
sector to continue for some time. In contrast, private-sector payroll growth is within recent historical ranges, with some industries doing well and some trailing.

For the Fed, understanding the source of the weakness—in this case, the government—may influence its view of the economy overall. The Fed does not have significant influence over government job creation (or losses). However, it can and has been supporting stronger economic growth in the private sector through extraordinary monetary policy stimulus.

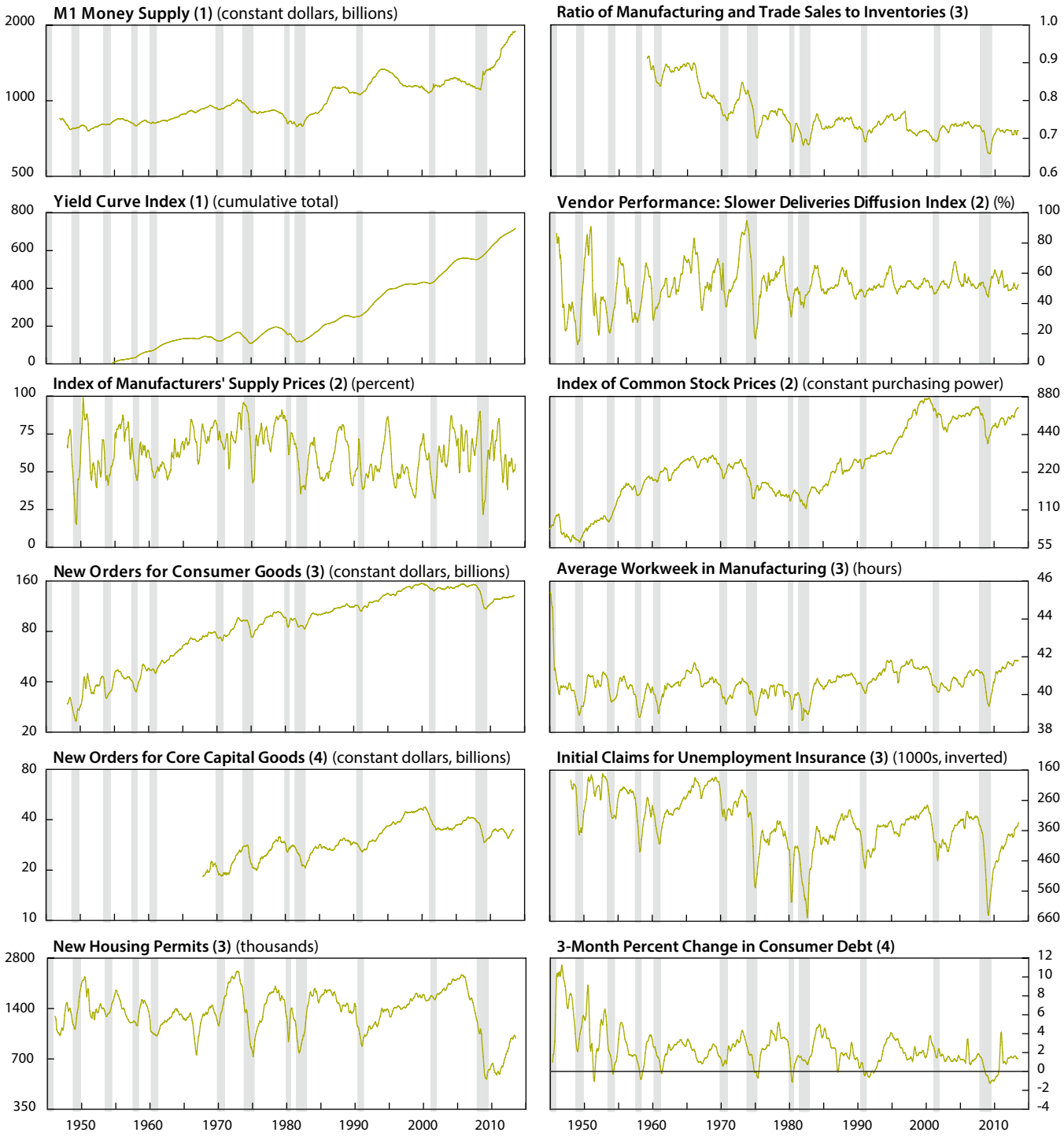
The Fed's challenge will be to determine when the private sector will be robust enough to withstand both the drag from the government sector and the removal of the extraordinary stimulus. This would entail ending the stimulative bond-buying program, neutralizing massive excess reserves in the banking system, and unwinding the Fed's enormous balance sheet. Moving too quickly could cause a new recession, while moving too slowly risks a surge in inflation. ■

FAVORABLE TRENDS CONTINUE

Key Indicators Suggest Moderate Growth Ahead

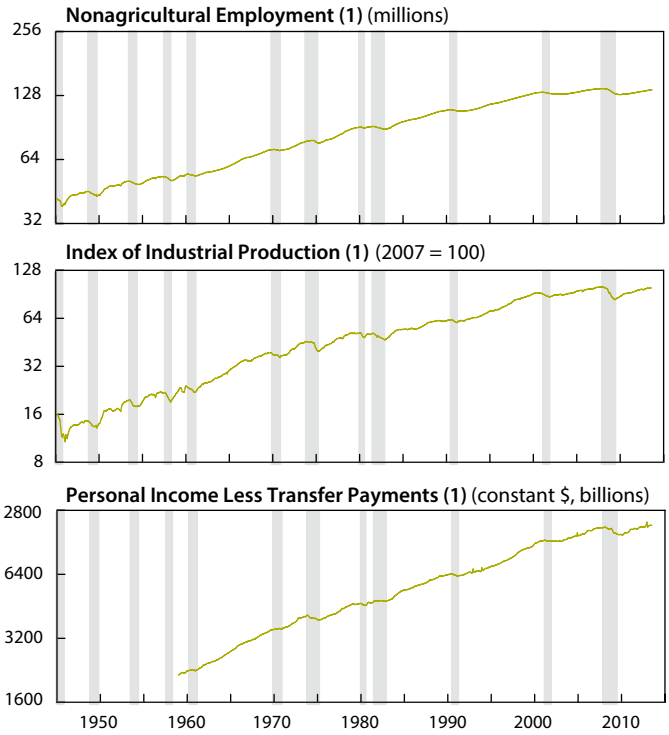


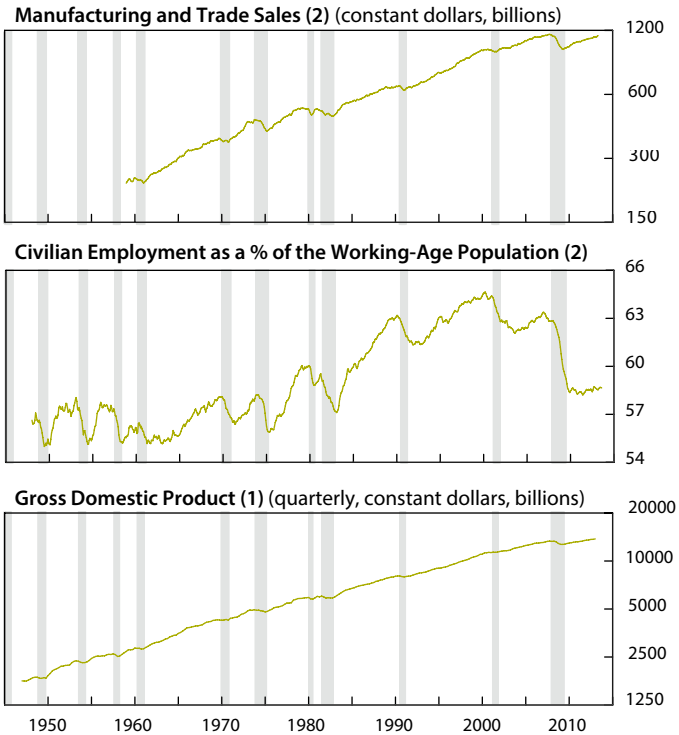
APPENDIX. PRIMARY LEADING INDICATORS



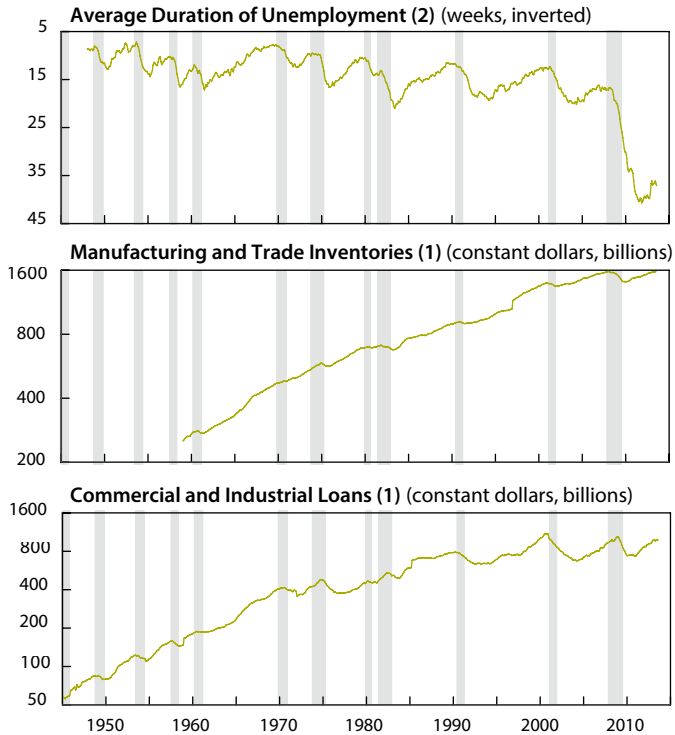
Notes: 1) Shaded areas indicate recessions as dated by the National Bureau of Economic Research.
2) The number in parentheses next to the name of a series is an estimate of the minimum number of months over which cyclical movements of a series are greater than irregular fluctuations. That number is the span of each series' moving average, or MCD (months for cyclical dominance), used to smooth out irregular fluctuations. The data plotted in the charts are those MCDs and not the base data.

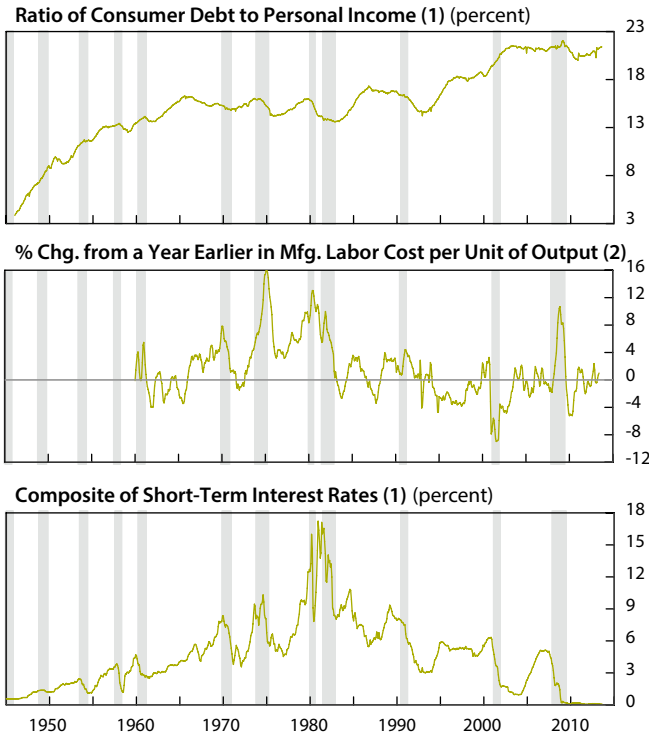
APPENDIX. PRIMARY ROUGHLY COINCIDENT INDICATORS





APPENDIX. PRIMARY LAGGING INDICATORS





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