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AIER American Institute for Economic Research

BUSINESS CONDITIONS MONTHLY

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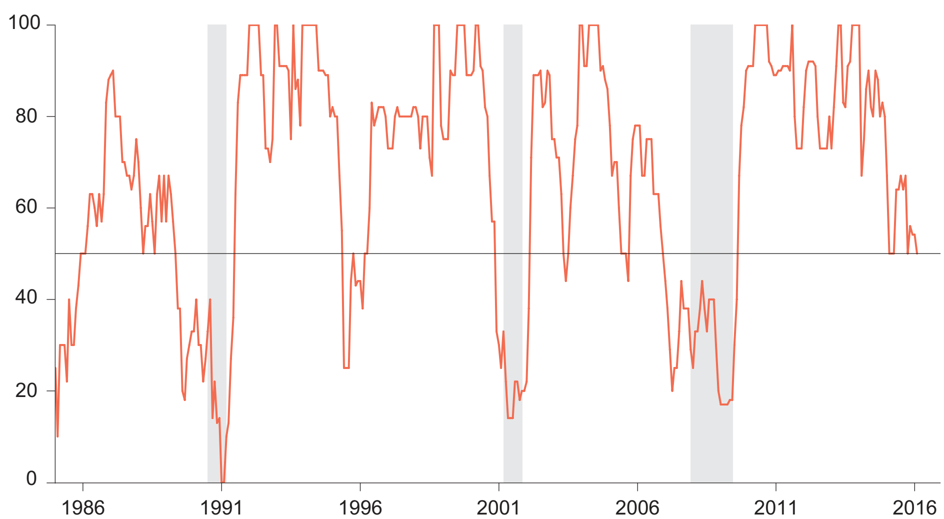
AIER Leaders index falls to 50, suggesting caution but still no recession

AIER founder Col. E.C. Harwood believed that business cycles matter and should be taken into account when making personal financial plans. He wrote his classic, "Cause and Control of the Business Cycle," (https://www.aier.org/sites/default/files/Documents/Research/pdf/eeb197409.pdf) published in 1932, to help people understand their significance.

Remaining true to Harwood's principle that business cycles matter is particularly important now, as our Business-Cycle Conditions model suggests some caution. Our index of leading indicators has fallen in the latest month and is at the neutral 50 level compared with 54 in the previous month (Chart 1). While that does not suggest a recession is imminent, it does reflect a weakened economy and the importance of closely monitoring economic conditions.

The weakness is a result of the ongoing crosscurrents of moderate growth in the core domestic economy partially offset by headwinds from slow global growth, a strong dollar, and weak commodity prices. Those headwinds are having significant negative impacts on U.S. exports and commodity-related industries.

Chart 1. **AIER's index of leading indicators fell to 50 in January.**



Note: Shaded areas denote recessions.
Source: AIER.

Inside this issue

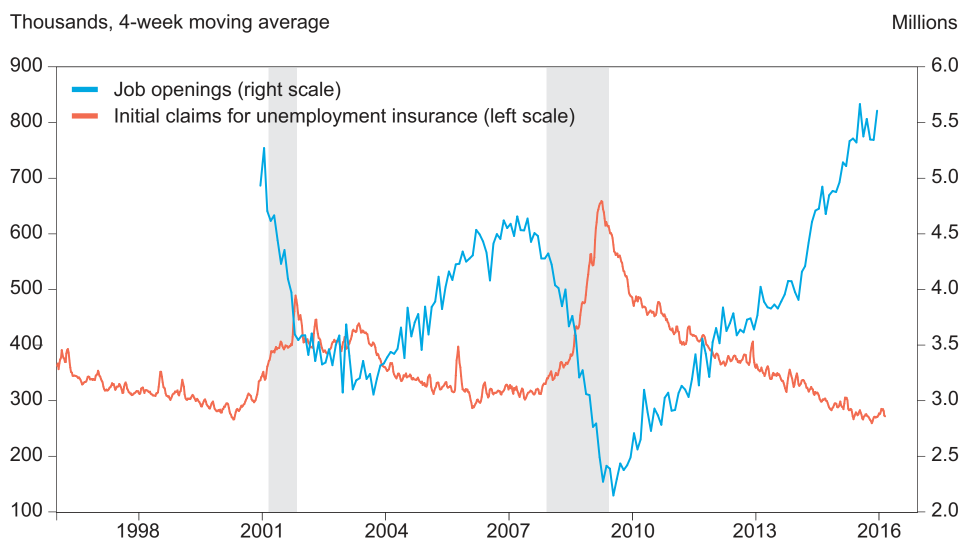
Consumers remain key to the expansion, and consumer-related indicators remain broadly positive.

Last month we highlighted the importance of the core economy—private domestic consumption and investment—to the current expansion. Our hypothesis is that growth in these areas could offset weakness from declining exports, rising imports, and the impact of falling commodity prices on commodity-related industries. This month we take a closer look at consumer spending, the largest part of the core economy, and gross domestic product, or GDP. We expect the expansion to continue but recommend extra caution given the weakened growth trends.

Fourth-quarter real GDP growth was revised higher to a 1 percent annualized rate from an initial 0.7 percent estimate. As Senior Research Fellow Polina Vlasenko wrote in AIER's Daily Economy blog, "GDP growth was revised upwards primarily for two reasons—because business inventories increased more than were originally supposed and because imports posted a decline instead of the increase reported in the earlier estimates. Both changes point to weaker growth in domestic demand than originally believed." She added, "Both the rise of inventories and a decline in imports suggest that U.S. consumers and businesses purchased fewer goods and services than we thought. And the slower overall demand can be a reason to worry, if it persists." (https://www.aier.org/blog/beyond-better-gdp-growth-reasons-concern.)

There are reasons to believe that consumer spending weakness won't persist. First, the job market remains supportive of future spending gains. Initial unemployment insurance claims remain quite low, below 300,000 for the 10th straight month. Job openings in the economy number more than 5.5 million, close to a record (Chart 2). Wages are rising faster, and consumer confidence in the labor market is improving. Second, consumer balance sheets have improved dramatically during this expansion with household net worth at a record high. Third, personal savings rates have increased, though they remain well below average rates in the late 1960s through the late 1970s. Furthermore, consumer-related indicators in our Leaders index continue to expand (see "Economic Outlook").

Chart 2. Initial unemployment claims remain below 300,000, while job openings are above 5.5 million.



Note: Shaded areas denote recessions.
Source: Bureau of Labor Statistics, Department of Labor (FactSet).

ECONOMIC OUTLOOK

The ongoing trend of inconsistent economic performance and mixed data continues to be reflected in our Business-Cycle Conditions model. February marks the 78th consecutive month with our leading indicators at or above 50 percent. Consistent readings above the midpoint suggest a low probability of recession over the next six to 12 months. Conversely, a drop below 50 percent may portend an increased chance of a contraction over the same period.

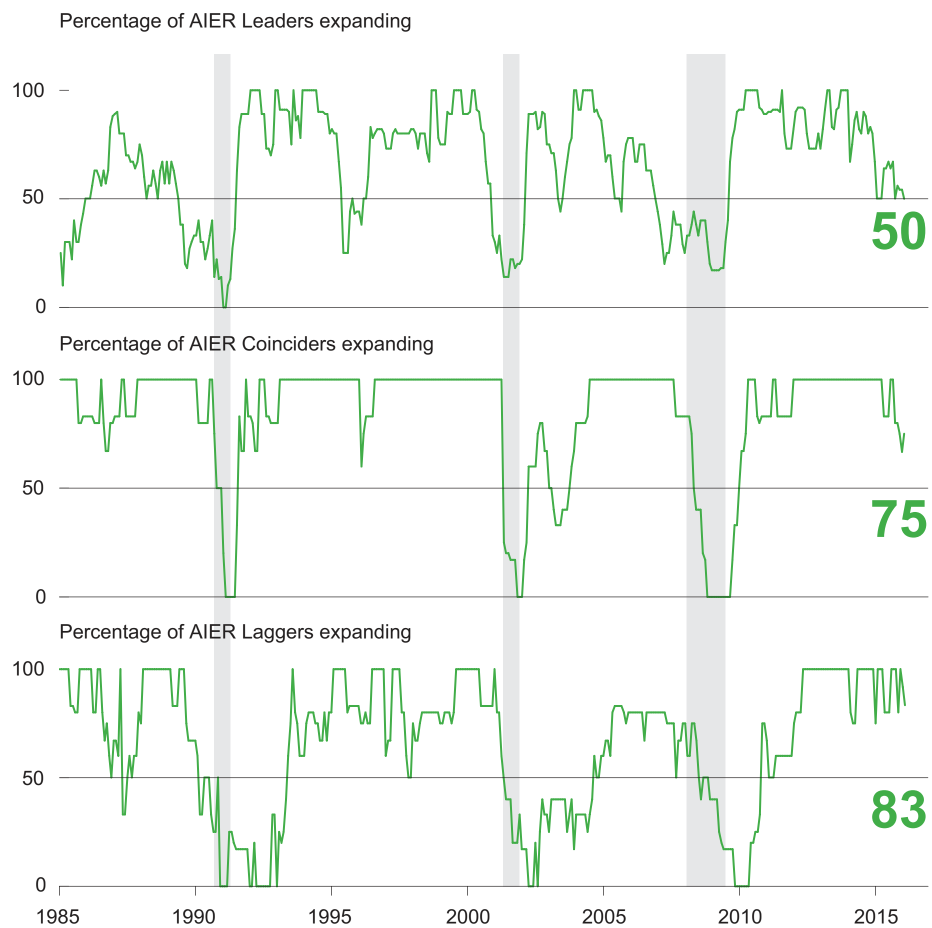
It should be noted that consumer-related indicators, such as real new orders for consumer goods and real retail sales, remain on an upward trend in the latest reading, supporting our view that the consumer continues to be the key to ongoing economic expansion. Strong favorable trends also continued for housing permits and the interest-rate yield curve.

On the negative side, the ratio of manufacturers' sales to inventories, real new orders for core capital goods, real stock prices, and debit balances in margin accounts at broker/dealers are showing weak trends. As we noted in previous months, the poor performance by core capital goods likely reflects the impact of falling energy and commodity price declines (see Chart 1, January BCM, https://www.aier.org/bcmoverview2016jan).

Overall, with our Leaders right at the neutral 50 percent level, the model confirms our view that the U.S. is on a sustainable but moderate growth path. However, the outlook remains fragile given the strong crosscurrents affecting various parts of the economy.

Chart 3. Indicators at a glance

Shaded areas denote recessions.
A score above 50 indicates expansion.



Source: AIER.

SCORECARD

Price pressures firmed significantly in our Inflationary Pressures Scorecard, with 12—a net gain of four—pointing to rising pressures and 10 suggesting falling pressure, down four. One indicator remained stable.

Even so, the Scorecard is only slightly tilted toward rising inflationary pressures. Balanced supply and demand indicators suggest that pipeline pressures may not be passed along very easily by producers and retailers. Wages and productivity are key. As the labor market tightens, higher wages become more likely. Faster productivity growth, price increases, lower profits, or a combination of these can mitigate that pressure.

Ten Scorecard indicators switched direction, with seven going to rising from falling pressure and three to falling. Trends in supply and demand suggest rising pressure if they persist.

Our money, banking, and credit indicators had offsetting changes, suggesting falling pressure. Finally, a net of eight cost and productivity indicators pointed higher. Pipeline pressures measured by the producer price index, or PPI, either rose, or in two cases, fell less quickly. As with the Consumer Price Index, services provide the strongest pressures.

AIER INFLATIONARY PRESSURES SCORECARD

We track 23 indicators and evaluate their performance over the past three months compared with the prior three months. That is, we compute moving averages of the monthly changes for two consecutive, non-overlapping three-month periods. Finally, we evaluate the inflationary pressure of each indicator through the framework of supply, demand, money/credit, and costs and productivity, and show whether the monthly change points to rising or falling inflationary pressure or stability.

Table 1. The outlook for inflation firmed from last month.

	3-MTH. AVERAGE CHANGE		INFLATION
	Previous	Latest	PRESSURE
DEMAND AND SUPPLY			
Demand			
Average hourly earnings (Jan.)	2.91%	2.89%	Falling
Nonfarm payrolls, total mil. (Jan.)	142.35	143.10	Rising
Personal income (Jan.)	3.06%	4.40%	Rising
Retail sales (Jan.)	-0.15%	2.69%	Rising
Supply			
Ind. prod. - consumer goods (Jan.)	-1.13%	0.89%	Falling
Manufacturing utilization (Jan.)	76.20%	75.95%	Falling
Retail inventory/sales ratio (Dec.)	1.37	1.38	Falling
MONEY, BANKING, AND CREDIT			
Fed funds rate (Jan.)	0.13%	0.29%	Falling
Interest on excess reserves (Jan.)	0.25%	0.37%	Falling
Money supply (M2) (Jan.)	4.93%	8.26%	Rising
Money velocity (Dec.)	6.44%	0.12%	Falling
Revolving consumer credit (Dec.)	7.37%	5.89%	Falling
COSTS AND PRODUCTIVITY			
Producer price index (Jan. 2016)			
Final demand	-3.57%	1.10%	Rising
- Food	-3.67%	-0.34%	Rising
- Energy	-28.52%	-27.75%	Rising
- Goods less food and energy	-1.80%	0.36%	Rising
- Services	-2.16%	4.82%	Rising
Import price index (Jan. 2016)			
Autos	-1.40%	-0.71%	Rising
Consumer goods ex. autos	0.00%	0.00%	Stable
Commodity prices (Jan. 2016)			
S&P GSCI Commodity Index	-14.88%	-53.16%	Falling
Wages and productivity			
Private compensation (Q4–2015)	8.08%	5.96%	Falling
Nonfarm business productivity (Q4–2015)	2.10%	-3.00%	Rising
Nonfarm business unit labor costs (Q4–2015)	1.90%	4.50%	Rising

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, U.S. Census Bureau, Federal Reserve Board, Standard & Poor's, AIER (Haver Analytics, FactSet).

CONSUMER PRICE INDEX ANALYSIS

Overall consumer prices were unchanged in January. However, that result hides some influential details. The plunge in crude oil prices that began in mid-2014 continues to restrain the Consumer Price Index, a trend we have highlighted recently. The CPI for energy fell 2.8 percent in January and 6.5 percent over the past year. Food prices remained flat in January and rose a meager 0.8 percent in the past year.

The other significant ongoing trend is the sharp divergence between core goods prices, which have been essentially flat for most of the past two decades, and core services, which have been rising at a pace well above the Federal Reserve's 2 percent annual inflation target. The big surprise in January was that the core goods index rose a robust 0.2 percent on widespread gains. Apparel prices climbed 0.6 percent while new vehicle prices increased 0.3 percent.

The weak price pressures suggested by our Scorecard should be weighed when evaluating the latest CPI data and its effects. Despite seasonal adjustment, January data can be unusually volatile, particularly for consumer goods like apparel. Retailers often react to the strength or weakness of the prior holiday shopping season with deep or shallow discounts. A few more months of data will be necessary to determine whether core goods prices are truly starting to rise at a faster pace or whether January was an outlier.

The other key trend, the persistent pace of gains in core services prices, continued in January with a 0.3 percent increase. Core services rose 3 percent over the past year. The rate remains somewhat above its long-term average of 2.5 percent annual growth over the past five years and 2.8 percent over the past 20 years. While shelter, medical-care services, and transportation all contributed to the monthly rise, education was unchanged, bringing the three-month growth rate down to just 2.3 percent, well below the long-term average pace of 3.6 percent over five years and 5.1 percent over 20 years.

Table 2. Consumer prices remained in check in January.

Data for January 2016	Share	m/m%	3-mth.*	12-mth.*	5-yr.*	20-yr.*
Consumer Price Index	**100.0**	**0.0**	**0.3**	**1.3**	**1.5**	**2.2**
Food	14.0	0.0	-0.9	0.8	2.2	2.5
Energy	6.7	-2.8	-19.2	-6.5	-3.9	2.9
CPI excl. food and energy	79.3	0.3	2.5	2.2	1.9	2.0
Goods excl. food and energy	**19.6**	**0.2**	**0.3**	**-0.1**	**0.3**	**0.2**
Apparel	3.1	0.6	0.9	-0.6	0.9	-0.3
New vehicles	3.8	0.3	1.1	0.6	1.2	0.2
Medical-care commodities	1.8	0.4	2.5	2.1	2.3	2.8
Services excl. energy	**59.7**	**0.3**	**3.3**	**3.0**	**2.5**	**2.8**
Shelter	33.2	0.3	3.2	3.3	2.6	2.6
Medical-care services	6.6	0.5	3.9	3.3	3.1	3.8
Transportation services	5.9	0.4	5.2	2.7	2.2	2.6
Education	3.0	0.0	2.3	3.3	3.6	5.1
AIER'S EPI	**35.1**	**-0.1**	**-5.3**	**-0.3**	**0.5**	**2.6**

Notes: *= annualized rate. AIER's EPI share is the share of the CPI.
Sources: Bureau of Labor Statistics, AIER (Haver Analytics, FactSet).

Everyday Price Index

AIER's Everyday Price Index fell 0.1 percent in January from December and 0.3 percent over the past 12 months. The EPI measures the change in prices that people pay for routine purchases, such as groceries, gasoline, utilities, and housekeeping supplies.

The more widely known Consumer Price Index, reported by the Bureau of Labor Statistics, increased 0.2 percent in January and has increased 1.4 percent over the past year, prior to seasonal adjustments. Since the EPI is not seasonally adjusted, the unadjusted CPI is the proper point of comparison.

The decline in the EPI stems primarily from a drop in energy-related prices. Motor fuels slid 4.5 percent in January and 7.7 percent over the past 12 months. Home heating oil has dropped 20.7 percent over the past year, while natural gas has registered a more modest decline. Because the EPI assigns a greater weight to energy, the decline in energy-related prices has a much larger effect on the EPI than on the CPI.

Over the past 15 years the EPI has tended to rise faster than the CPI. The pattern has changed recently, with the EPI falling while the CPI inches higher.

https://www.aier.org/epi

How would negative interest rates work?

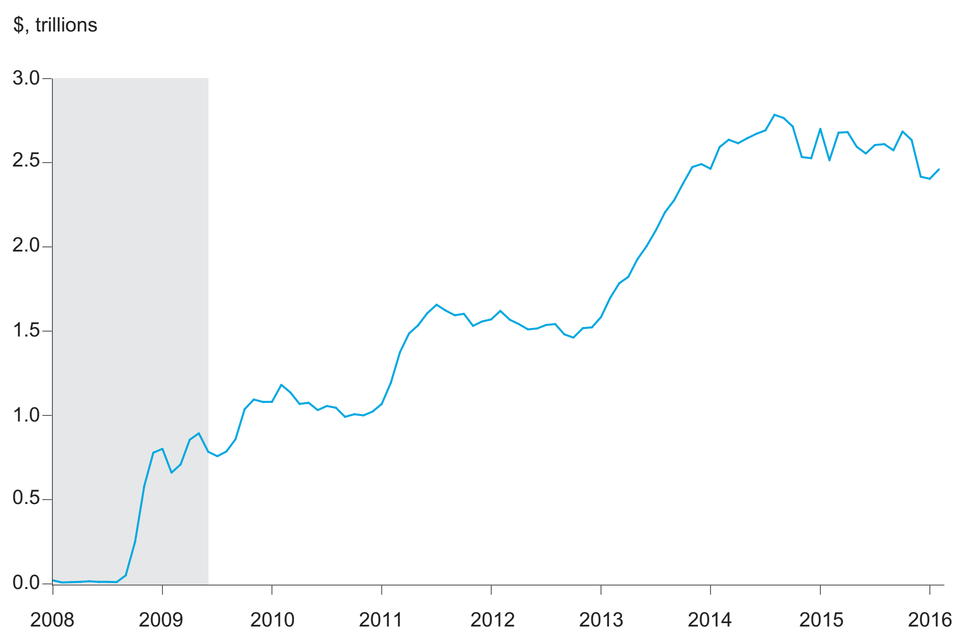
During her Feb. 11 testimony before a U.S. Senate committee, Federal Reserve Chair Janet Yellen was asked whether the Fed had considered imposing negative interest rates on banks. She made it clear that the Fed does not plan to implement negative interest rates absent a severe deterioration in economic conditions. But five other central banks around the globe—in Japan, Sweden, Switzerland, Denmark, and the Eurozone—have already done so in attempts to boost their respective economies. In effect, negative rates provide an incentive to banks to increase lending.

Negative interest rates were unheard of only a few years ago, and most people are unfamiliar with them. Here we explain how, in theory, this policy would work, should the Fed impose it.

The U.S. central bank controls two interest rates that are important to banks. One is the interest on excess reserves, which the Fed pays to banks on money they deposit with it. The Fed sets this rate, currently at 0.5 percent. The other is the federal funds rate, which the Fed influences by offering funds on the interbank market, where banks borrow from one another. The Fed raised its target for this rate to 0.25 percent to 0.5 percent on Dec. 16, 2015, the first increase since mid-2006.

If the Fed were to decide that the U.S. economy needs a significant boost, it could set both of these rates below zero to spur lending. With negative interest on excess reserves, banks would have to pay the Fed to hold their funds. This should give them an incentive to loan the money rather than keep it at the Fed. The increased lending would boost economic activity.

Chart 4. Bank reserves kept at the Fed ballooned after the financial crisis of 2008.



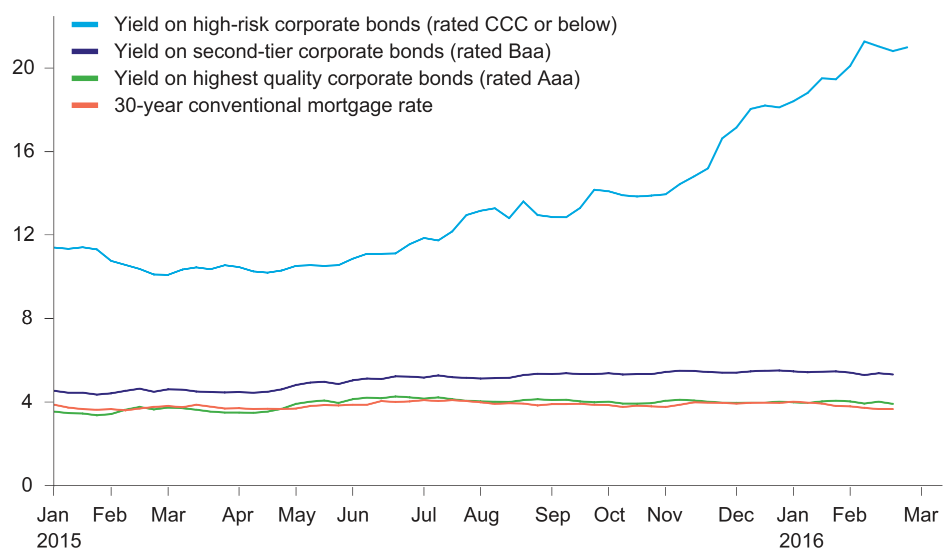
Note: Shaded area denotes recession.
Source: Federal Reserve Board (Federal Reserve Economic Data - FRED).

The potential to increase lending is significant, because large bank reserves have been accumulating since the financial crisis in 2008 and are currently over $2.4 trillion (Chart 4). However, it is not clear how effective lending some of the cash would be in boosting economic activity. Interest rates are already quite low, so borrowing is fairly cheap for businesses and individuals. Interest rates paid by high-quality borrowers (both businesses and individuals) hover around 4 percent to 5 percent, close to all-time lows (Chart 5). It is unlikely that a further decline in these rates would boost this type of borrowing much.

But the picture is different in higher-risk lending. Interest rates on riskier, high-yield bonds have been rising since late 2015. If banks increased their lending significantly to avoid paying fees on excess reserves, they may venture into riskier loans by lending to lower quality borrowers. This might boost economic activity for a time, but it would also expose banks to potential dangers. Taking on higher risks may not be a good idea for banks, as the last financial crisis showed.

If the Fed sets negative interest rates for banks, will those institutions in turn impose a fee on depositors instead of paying interest? Not likely. Savers typically have options other than keeping their money in a bank. The interest that banks pay on deposits likely would narrow but not fall below zero. This would not be much of a change from the current situation, where interest rates that savers earn are already close to zero.

Chart 5. Interest rates for various types of borrowers.



Sources: BofA Merrill Lynch, Freddi Mac, Moody's (FRED).

FIXED INCOME

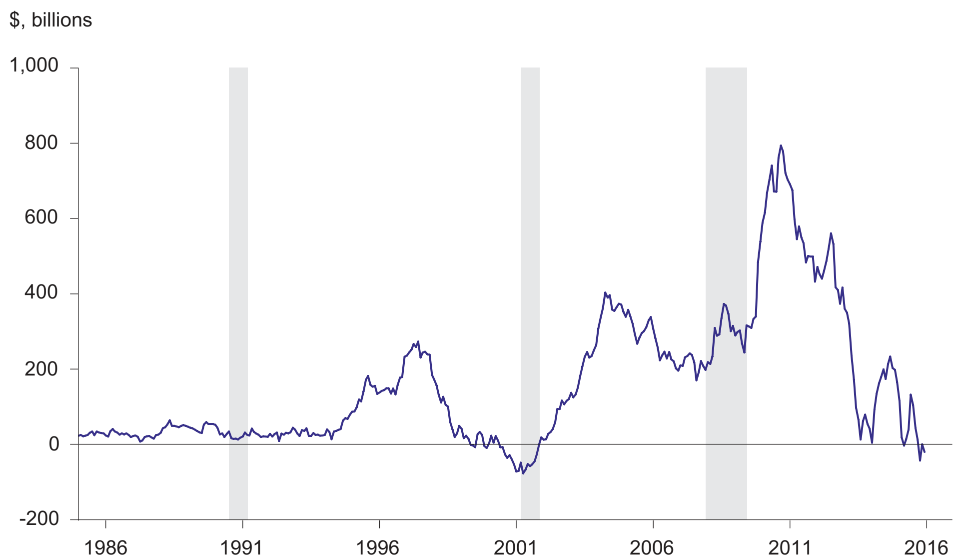
Like the economy in general, the U.S. Treasury market is in the midst of strong crosscurrents. Domestically, Fed policy tightening should be putting upward pressure on yields, particularly on the short end of the yield curve. Tighter Fed policy would be consistent with improving economic conditions. However, the recent run of conflicting economic data may be offsetting the upward policy pressure.

From a risk perspective, Treasurys are a safe haven in times of turbulence. In that regard, volatility in equity markets should lead to some marginal government-bond buying. Offsetting that may be the difficult economic conditions for two of the largest global holders of Treasury securities, China and Japan.

International buying of Treasury bonds has fallen dramatically over the past year (Chart 6). Both China and Japan have now become net sellers of Treasurys.

The bottom line is that while no one can predict markets with great precision, economic theory would suggest that at some point, better economic conditions, firming inflation expectations, and additional policy tightening should lead to higher yields.

Chart 6. Foreign buying of U.S. Treasury bonds and notes has dissipated recently.



Note: Shaded areas denote recessions.
Source: U.S. Treasury (FactSet).

COMMODITIES

Holding gold and gold mining stocks has long been part of the investment philosophy at AIER. While plenty of experts disparage the precious metal as a portfolio investment, AIER views it as a viable option worthy of consideration.

Among the criticisms of gold is that the metal itself does not produce an income stream. Also, as an asset, its risk-to-return profile may not compare favorably with other assets, depending on how that profile is calculated.

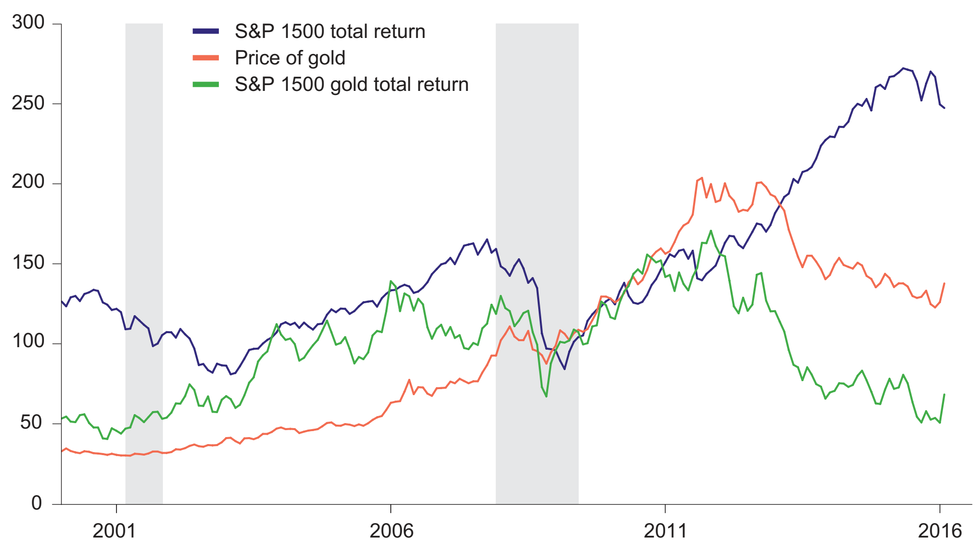
On the positive side, gold and gold mining stocks tend to move in the opposite direction as other types of assets—described as a low price correlation—so over time, they can reduce portfolio volatility (Chart 7).

The role of gold can become more important in times of global instability, when inflation becomes a serious threat, or when systemic risks and threats to all financial markets rise. This was the case in the past when AIER strongly advocated for holding gold.

There are two key messages here. First, each investor has unique goals and circumstances, so the decision to include gold in a portfolio should be made on an individual basis. Gold can play a critical and helpful role for some investors. For investors who are particularly concerned about overall portfolio volatility, using gold to help reduce price swings makes sense.

Second, including gold in a portfolio, and how much, depends on economic conditions. Col. Harwood brilliantly foresaw the various periods of the deterioration of money, weakness in the banking system, poor policy, and the ups and downs of business cycles, and he guided his adherents through them. We at AIER continue to strive to live up to those high standards.

Chart 7. Gold and gold mining stocks tend to move in the opposite direction of U.S. equities.



Notes: Notes: Shaded areas denote recessions. Price of gold is London p.m. fix, $ per troy oz.
Sources: Standard & Poor's, FactSet.

U.S. EQUITIES

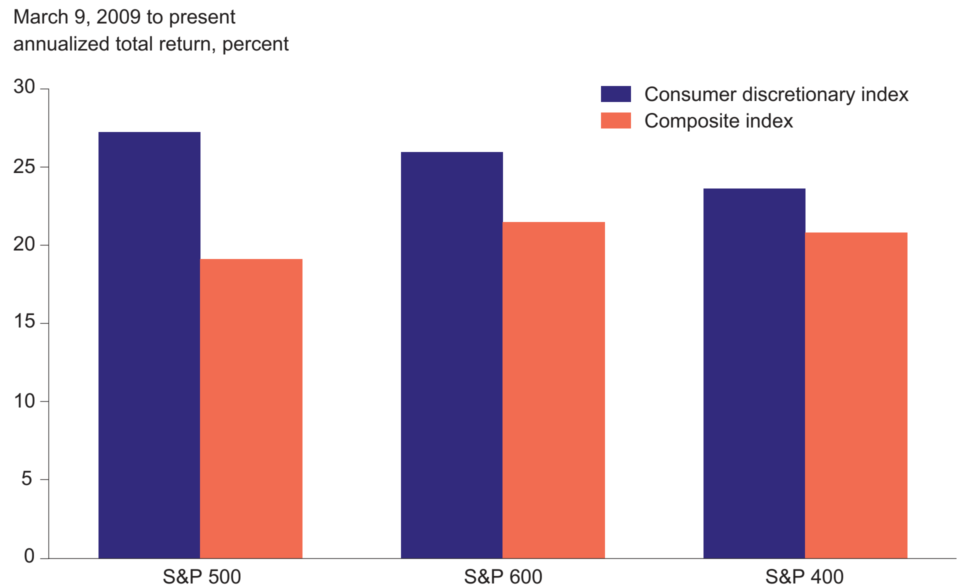
Our focus on the domestic economy has centered on core growth – private consumption and investment. Our analysis suggests that fundamentals for consumer spending and most parts of private investment remain generally healthy. We expect solid core economic growth in the U.S. to offset weak global growth, a strong dollar, and the negative effects of falling commodity prices on certain industries.

That analysis would appear to be justified by the performance of one stock sector, U.S. consumer discretionary stocks. If stocks are a forward-looking discount mechanism, meaning that their prices reflect the outlook for future earnings, then as forward expectations for this sector improve at a more robust pace than the broader market, consumer discretionary stocks should outperform the broader market.

In fact, since the market low on March 9, 2009, consumer discretionary stocks in all three market-cap segments—large-, mid-, and small-cap—have outperformed their broader benchmarks. It is interesting that the weakest performance among consumer discretionary segments came from mid-cap consumer discretionary stocks, yet this group still beat the best-performing broad index, the small-cap Standard & Poor's 600 (Chart 8).

The risk, of course, is if and when future expectations become too high for these stocks to meet. Unrealistic expectations are a phenomenon that AIER has warned about throughout its history.

Chart 8. Consumer discretionary stocks have been leading the broader markets.



Sources: Standard & Poor's (FactSet).

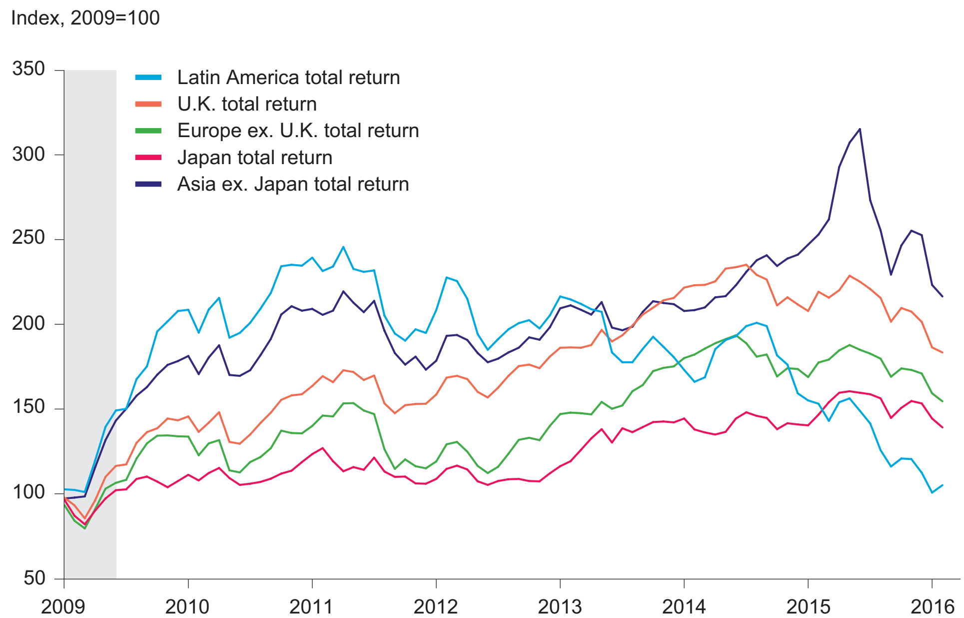
GLOBAL EQUITIES

Global synchronization—the idea that the business cycles in the world's economies are becoming synchronized—was hotly debated in prior decades. But that issue seems to have been replaced by unconventional monetary policy, structural shifts in key economies like China, and fears of persistent slow global growth and deflation.

The apparent lack of synchronization presents some interesting questions. How should investors categorize foreign markets when developing an asset allocation? Is lumping all foreign markets together the best approach? Can we simply divide economies into developed and emerging markets? What about regions – Europe vs. Asia vs. Latin America? With many asset-allocation models breaking U.S. equities down by market cap and sometimes styles (growth vs. value), should these characteristics be applied to foreign markets as well?

Applying our U.S. business-cycle research to foreign economies would seem a natural extension of AIER's long traditions. At some point, AIER may pursue this endeavor if our supporters are interested. In the meantime, investors should be aware of both the opportunities and risks associated with foreign markets, particularly with economies and markets performing very differently.

Chart 9. Global markets have shown little synchronization in recent years.



Note: Shaded area denotes recession.
Sources: Dow Jones, FactSet.

PULLING IT ALL TOGETHER

THE ECONOMY…

Business cycles matter. The economy matters. As our Leaders index falls to the neutral 50 level, close monitoring of economic conditions becomes critical. Our analysis suggests that core economic growth is supported by solid consumer fundamentals, but given the slow pace of growth and strong crosscurrents from slow global growth and a strong dollar, the outlook remains fragile.

…INFLATION…

Inflationary pressures have firmed and prices rose a bit faster in January led by a jump in core consumer goods prices. However, our Scorecard is closely balanced, and significant inflation remains a low probability in the current economic environment.

…POLICY…

Several central banks around the world already have negative interest rates. Only a significant deterioration in the U.S. economy would make the Fed consider taking interest rates into negative territory as a means to boost lending. Negative interest rates would penalize banks for holding on to reserves, thereby giving them incentives to lend money. This would stimulate lending but would raise the danger of inducing banks to engage in risker lending.

…INVESTING

Treasury yields remain very low despite Fed tightening and net selling by foreign investors over the past year. It's impossible to know when or if yields will rise, but with the 10-year Treasury under 2 percent, the expected risk-to-return profile should be reviewed carefully.

Gold prices have risen recently, somewhat offsetting equity declines. Including gold in a portfolio is wholly appropriate for some investors depending on their risk and return objectives.

U.S. consumer discretionary stocks across the market-cap spectrum have outpaced the broader markets. These results fit with our analysis of the business cycle. However, caution would guard against unsupportable future expectations.

Global markets and economies in different regions are following very different paths. Recognizing the differences within this category can help investors more precisely manage risk exposure and tailor asset allocation.

CAPITAL MARKET PERFORMANCE

(Percent change)

	Feb. 2016	Latest 3M	Latest 12M	Calendar Year 2015	2014	2013	Annualized 3-year	5-year	10-year
Equity Markets									
S&P 1500	-0.3	-7.3	-8.5	-1.0	10.9	30.1	8.3	7.7	4.4
S&P 500 - total return	-0.1	-6.6	-6.2	1.4	13.7	32.4	10.8	10.1	6.4
S&P 500 - price only	-0.4	-7.1	-8.2	-0.7	11.4	29.6	8.5	7.8	4.2
S&P 400	1.2	-8.7	-11.4	-3.7	8.2	31.6	6.6	6.7	5.6
Russell 2000	-0.1	-13.7	-16.2	-5.7	3.5	37.0	4.3	4.7	3.5
Dow Jones Global Index	-1.2	-10.1	-13.7	0.4	11.9	16.1	1.3	1.5	1.5
Dow Jones Global ex. U.S. Index	-1.3	-10.8	-17.3	-5.1	7.1	13.0	-4.1	-3.3	-0.8
STOXX Europe 600 Index	-2.4	-13.4	-14.9	6.8	4.4	17.4	4.8	3.1	0.2
Bond Markets									
Ryan Labs Treasury index total return	2.3	4.7	2.8	0.5	9.6	-6.6	3.2	5.2	5.5
Dow Jones corporate bond index total return	1.0	1.2	-0.6	0.6	7.2	-1.9	2.6	5.2	6.3
Commodity Markets									
Gold	8.9	8.8	-3.1	-8.3	-10.3	-15.5	-10.0	-2.8	8.0
Silver	9.0	14.3	0.1	-8.8	-13.3	-36.3	-17.4	-12.3	6.8
CRB all commodities	2.0	-0.2	-8.4	-14.0	1.1	-3.1	-7.2	-7.3	2.1

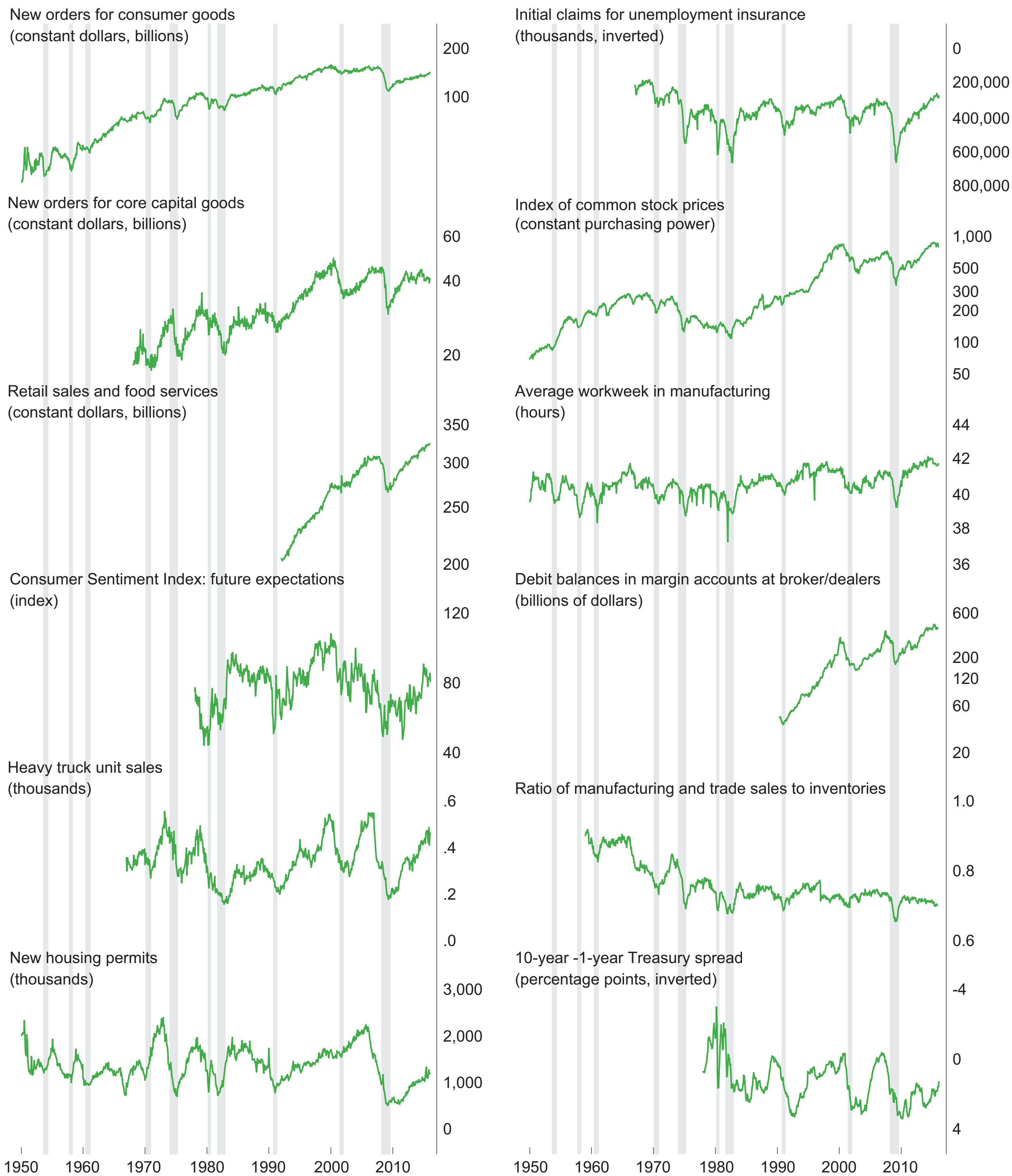
CONSUMER FINANCE RATES

(Percent)

	Feb. 2016	Latest 3M	Latest 12M	Average For Year 2015	2014	2013	Average Over Period 3-year	5-year	10-year
30-yr. fixed mortgage	3.7	3.8	3.9	3.9	4.3	4.2	4.1	4.1	4.9
15-yr. fixed mortgage	2.9	3.1	3.1	3.2	3.4	3.3	3.3	3.3	4.3
5-yr. adjustable mortgage	3.3	3.4	3.4	3.4	3.6	3.4	3.5	3.4	#N/A
Home-equity loan	4.8	4.8	4.5	4.4	4.7	5.1	4.7	4.7	5.4
48-month new car loan	3.3	3.2	3.1	3.0	3.1	2.7	3.0	3.2	5.0

Sources for tables on this page: Barron's, Commodity Research Bureau, Dow Jones, Frank Russell, Standard & Poor's, STOXX Europe 600, Wall Street Journal (Haver Analytics).

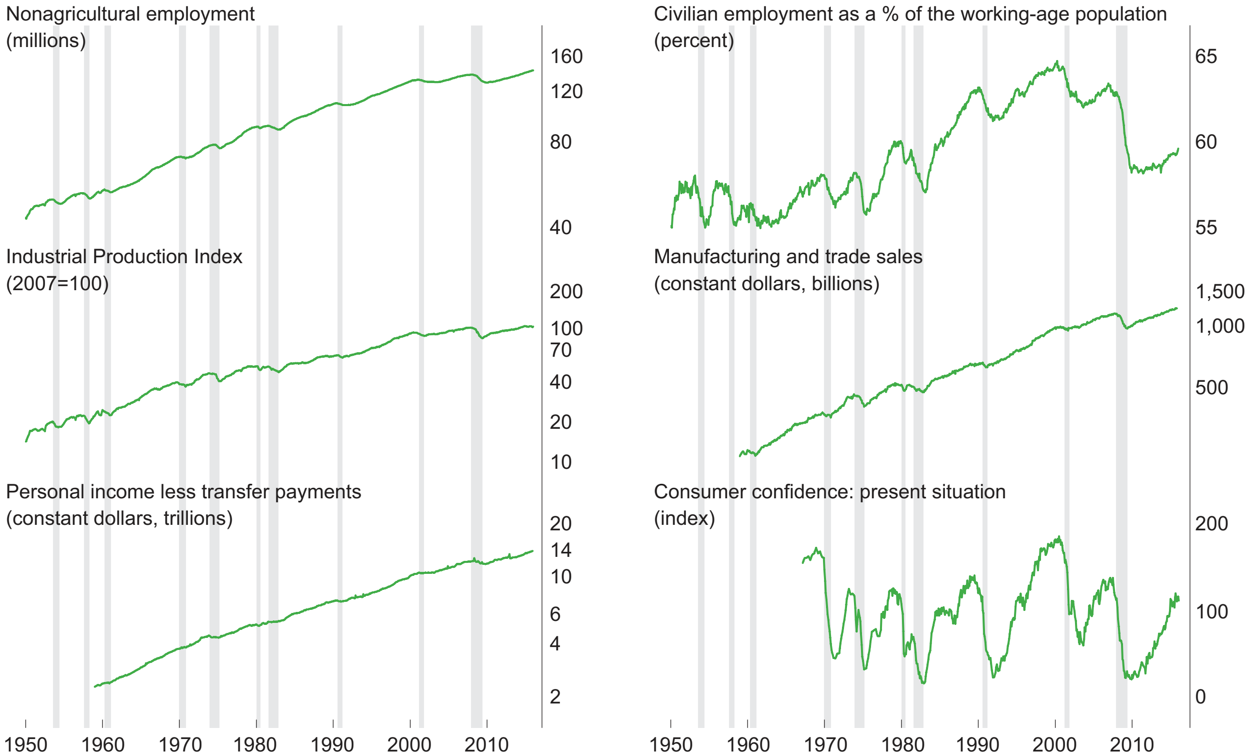
LEADERS (1950–2016)



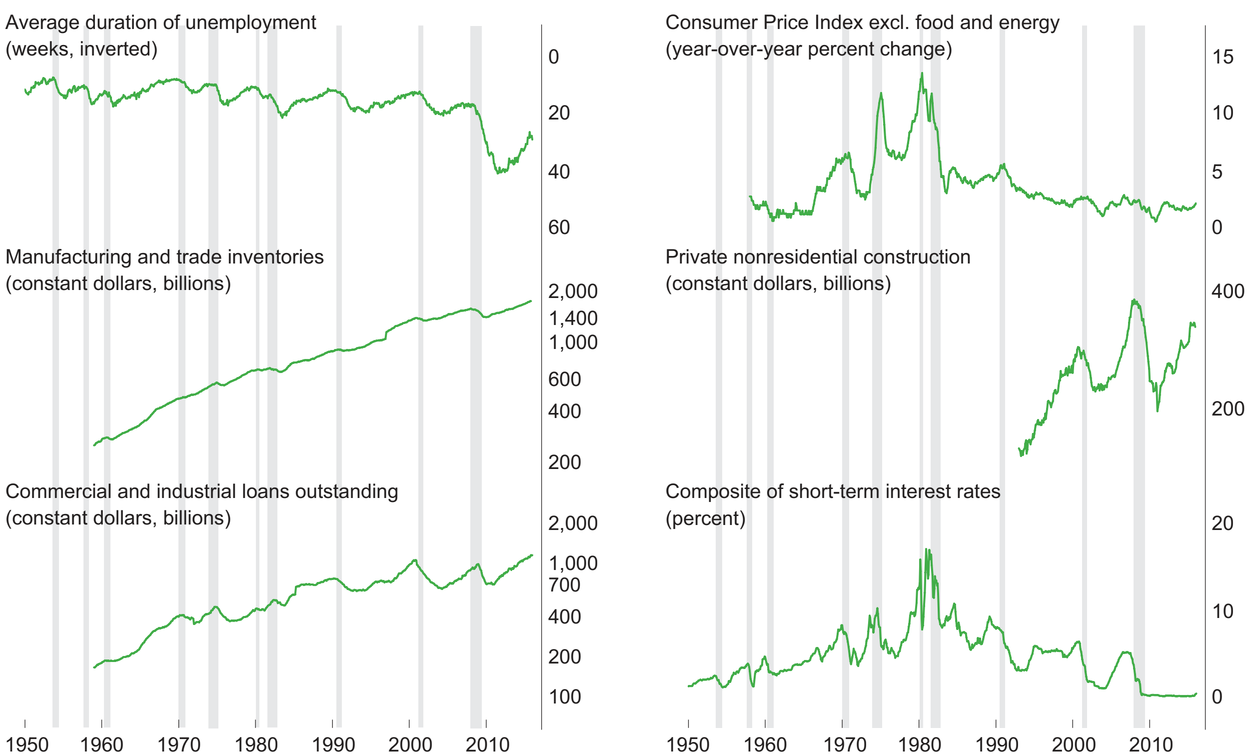
Sources for Appendix: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve Board, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau.

Note: Shaded areas denote recessions.

COINCIDERS (1950–2016)



LAGGERS (1950–2016)



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