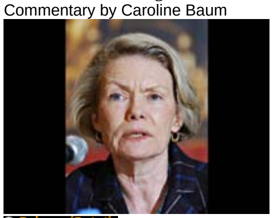
Guardian of Leading Index More Upbeat Than Data: Caroline Baum

Commentary by Caroline Baum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Feb. 25 (Bloomberg) -- ``U.S. recession is unlikely but not impossible,'' starts the January edition of ``Straight Talk,'' the monthly economic outlook of Gail Fosler, president and chief economist of the Conference Board.

Fosler goes on to say that the business sector, outside of the financial sector, remains ``strong,'' benefiting as it is from an ``export boom.'' The retreat in housing is ``nearly over.'' ``Non-financial corporate profitability looks solid.''

In short, ``the business sector is fundamentally stronger than at any time since the 1960s,'' Fosler writes in her latest forecast, published earlier this month.

Why is this woman smiling? The Conference Board, a non- profit business research organization in New York, is entrusted with maintaining the Index of Leading Economic Indicators, a gauge designed to predict turning points in the economy. And right now the LEI is flashing signs of a recession.

Forget the three steps and a stumble rule, loosely adapted from stock-market investing lore: the idea that three consecutive monthly declines in the LEI presage a recession. The Conference Board's business cycle gurus use the six-month annualized change in the LEI and the six-month diffusion index to assess the depth, duration and diffusion of the decline in economic activity.

The ``Three Ds'' rule ``helps to refine the signal and better interpret the LEI,'' says Victor Zarnowitz, senior fellow and economic counselor at the Conference Board. Zarnowitz is also a member of the National Bureau of Economic Research's Business Cycle Dating Committee, the official arbiter of the economy's peaks and troughs.

Color Coded

Zarnowitz's research found that recessions are generally characterized by a six-month annualized decline in the LEI of at least 4.5 percent and a sub-50 reading in the six-month diffusion index, indicating that more than half of the 10 components have fallen in the past six months.

In January, the six-month annualized decline in the LEI was 4 percent, the biggest drop since the 2001 recession. The six- month diffusion index stood at 20, the lowest since June 2004. Periods of recession coincide with multiple low readings in the diffusion index.

Fosler was traveling abroad and couldn't be reached for comment. Her colleague, economist Ken Goldstein, who works with her on the forecast, spoke with me instead. He says the U.S. is ``on the cusp of recession.'' The warning so far is ``a strong yellow, not a full red.''

So why the expectation that the economy will pull back from the edge?

``Gail's view is that if business profits remain OK, businesses have the money to invest and hire,'' Goldstein says. ``If earnings stay there, GDP will not drop from the current pace of 1.5 to 2 percent.''

Problem with Profits

Profits aren't OK. They're ``falling on a year-over-year basis,'' counters Paul Kasriel, chief economist at Northern Trust Co. in Chicago. ``S&P operating profits were down 11 percent in the third quarter from a year earlier. The last time profits contracted on a year-over-year basis was 2001,'' when the economy was in recession.

Fourth-quarter S&P profits fell as well, based on companies that have reported so far, with financials providing the primary drag.

Another problem with Fosler's profits-into-jobs forecast is where U.S. companies are earning money. Domestic profits fell 4.6 percent in the third quarter from a year ago, according to the Bureau of Economic Analysis's National Income and Product Accounts, which includes the universe of all U.S. companies. ``Domestic profits have to do with hiring here,'' Kasriel says.

Fosler and Goldstein are equally upbeat on the consumer. ``If the labor market remains okay, it will be a prop under the consumer,'' Goldstein says.

Labor Lost

The labor market isn't OK. It's deteriorating. Initial jobless claims, the total number of people receiving unemployment benefits and the unemployment rate are all trending higher. Consumer confidence, another indicator published each month by the Conference Board, is sagging.

Kasriel is flummoxed by the seeming disconnect between the Conference Board's forecast and the Conference Board's indicators.

``Almost every economic indicator published by the Conference Board is pointing toward recession, yet Ms. Fosler's 2008 real GDP growth forecast in the February Blue Chip survey was 2.3 percent, among the highest estimates,'' he says. ``Why is Ms. Fosler so optimistic when the indicators her organization publishes imply much weaker economic performance?''

Present or Future?

Goldstein points to the fact that the index of coincident economic indicators is still rising (barely). The index is made up of components, including employment and industrial production, that are the basis for the business-cycle dating committee's determination of when an expansion ends and a contraction begins.

Which indicator should be more important in forecasting the economy: one that tells you where we are or where we're going?

``If Ms. Fosler doesn't believe in the signal being sent by the LEI and collection of economic indicators published by the Conference Board, perhaps her organization should cease to publish them,'' Kasriel says. ``Or at least not charge for historical data.''

Maybe they should throw in the forecast for free, too.

(Caroline Baum, author of ``Just What I Said,'' is a Bloomberg News columnist. The opinions expressed are her own.)

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