

March 25, 2002

The Liscio Report

On the Economy

For John Liscio 1949-2000

The Recession in Pictures

It's often said — we've said it ourselves — that this hasn't been an ordinary recession. But despite being repeatedly said, it's really true.

The charts inside look at some major cyclical indicators. Almost all are out of whack with history. What makes this news of more than historical interest is that it might have some bearing on the shape of the recovery. That recovery, the charts show, seems clearly underway; they assume a trough last December, which looks plausible in light of earlier recoveries.

Labor markets have been far stronger in this recession than earlier ones. The drop in employment was far less severe, and initial claims (not shown here) peaked lower and earlier than in earlier recessions. Confidence was weaker than average, though the final drop was probably more the result of terrorism than economic anxiety. Retail sales, despite a lot of volatility around last September, rose on balance through the recession. Last month's real retail sales were over 2% higher than the recession peak; in earlier downturns, they typically fell by almost 3%.

Manufacturing peaked almost a year ahead of the broad economy — usually it peaks just a little bit ahead. The Fed's industrial

production index has turned up, though sluggishly; recovery snapbacks are usually quite sharp. Capital goods spending peaked earlier than usual too — and fell far harder than in earlier downturns. The ISM/NAPM survey, though, put in a convincing bottom months ago, and is acting like the index does in early recoveries. The forward-looking indicators — confidence, the ISM, and the leading indicators — are among the strongest — which is encouraging, unless you want to worry that expectations are running too far ahead of reality.

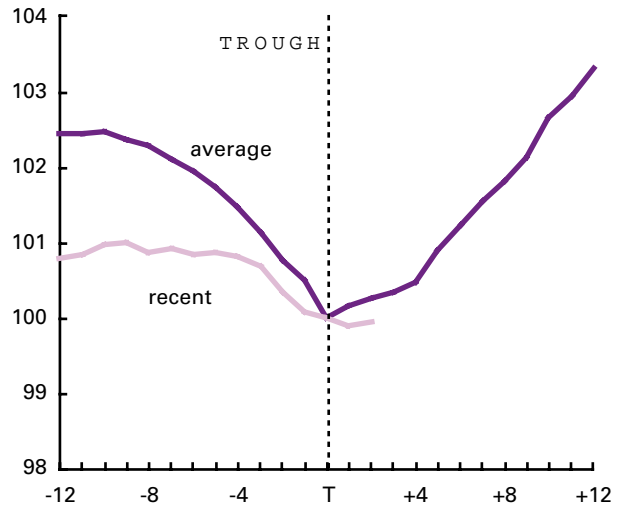
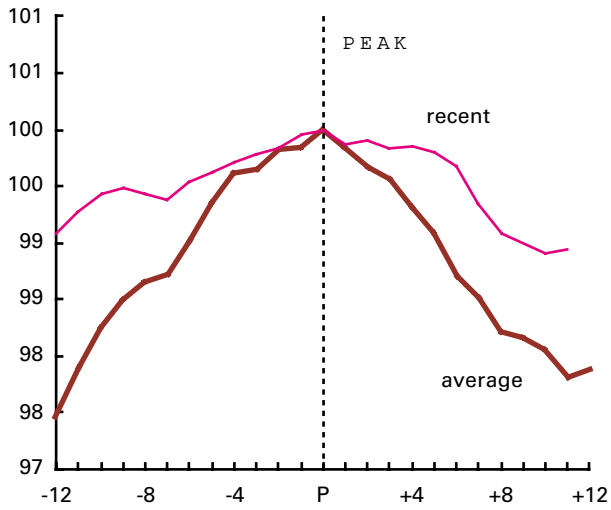
What really stands out as anomalous is the behavior of major financial indicators during this cycle, especially the sharp, virtually unprecedented fall in fed funds, one that came early and stuck around. In the average cycle, the Fed began pushing down the funds rate just after the cyclical peak, ultimately knocking about 30% of the initial rate. This time, the funds rate started falling 3–4 months ahead of the peak, and appears to have bottomed out around 75% off its peak. The bond's behavior was equally odd. Instead of rising into the peak, the yield on the 10-year fell sharply. And, assuming a December trough for the recession, bond yields bottomed earlier than usual, and have risen more sharply in earlier cycles. The rise in bond yields, in fact,

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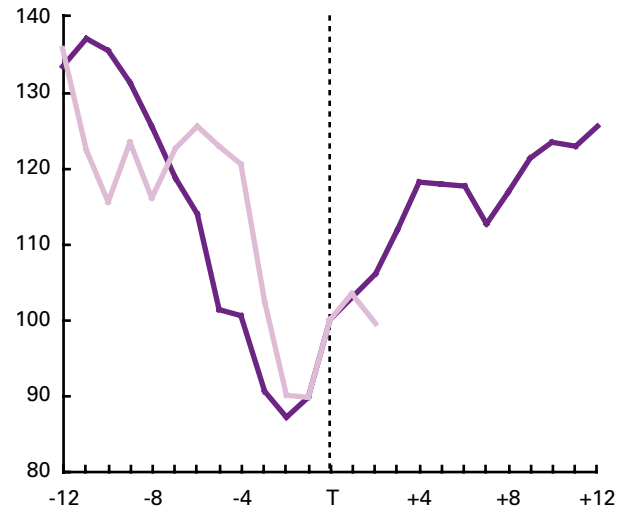
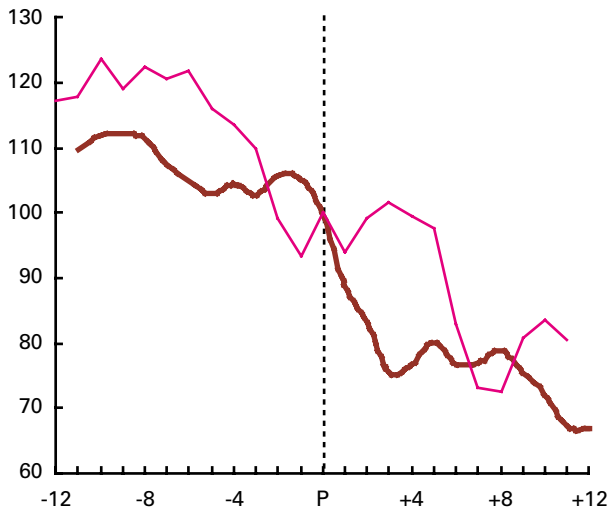
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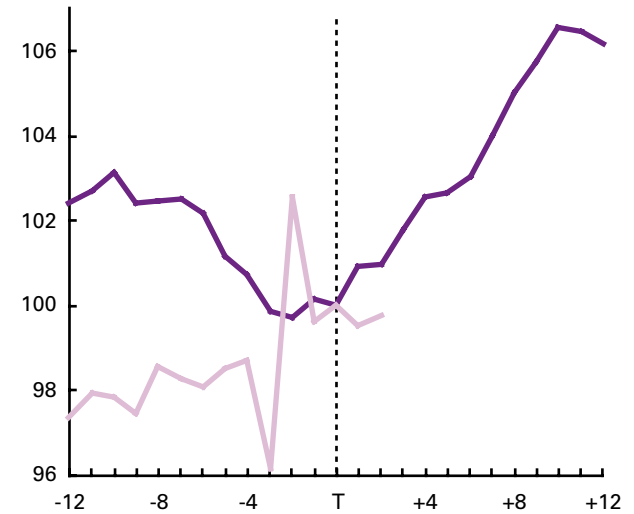
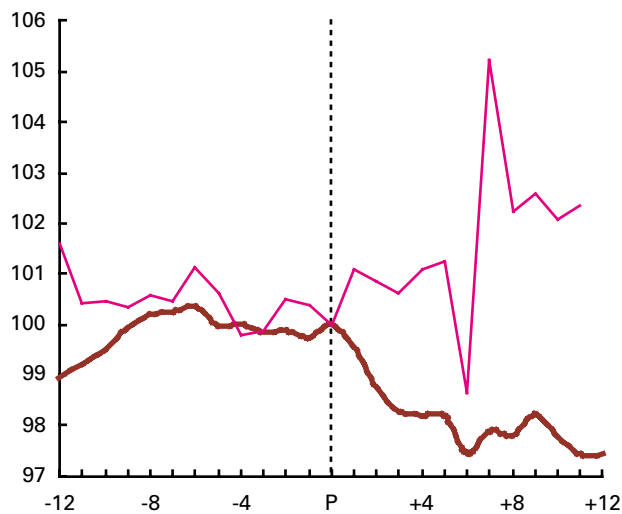
employment



consumer confidence

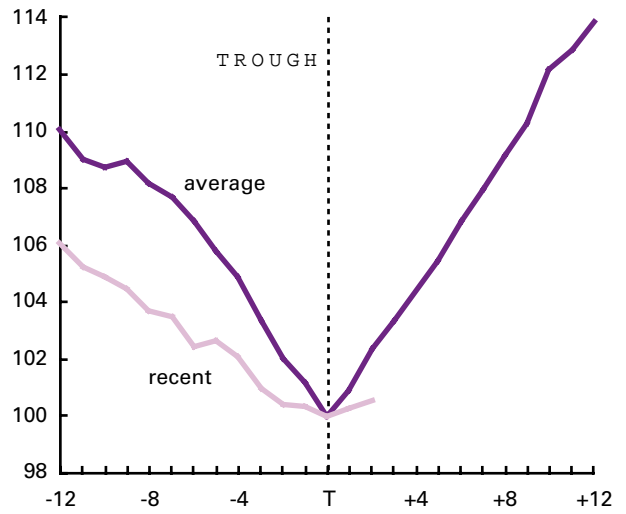
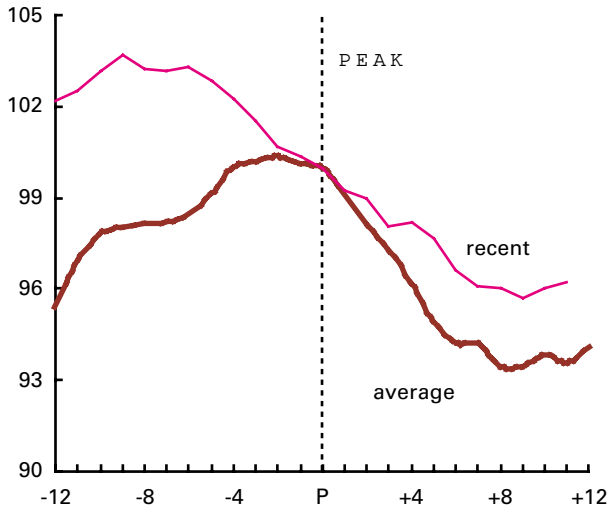


retail sales (real)

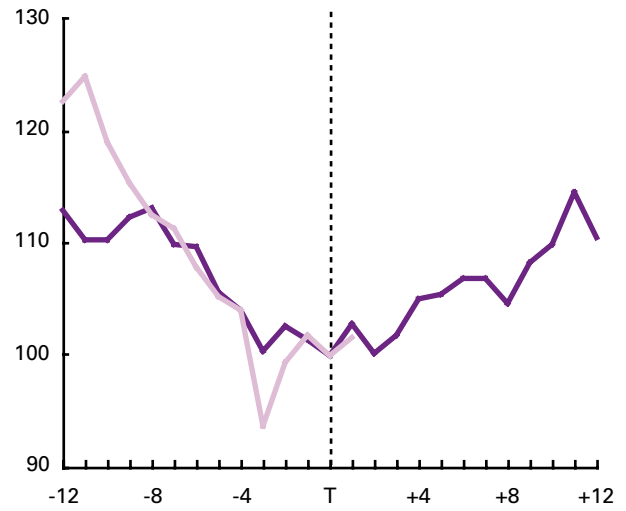
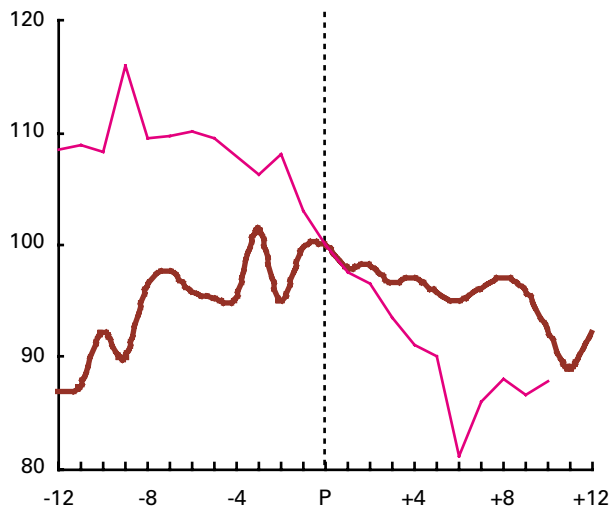


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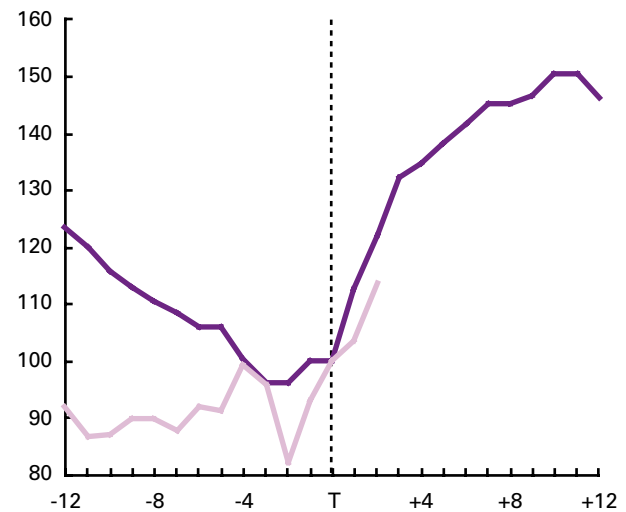
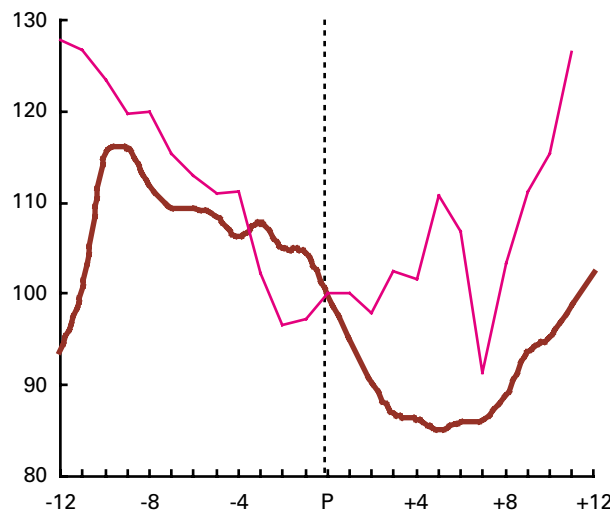
industrial production (manufacturing)



nondefense capital goods (ex-aircraft)

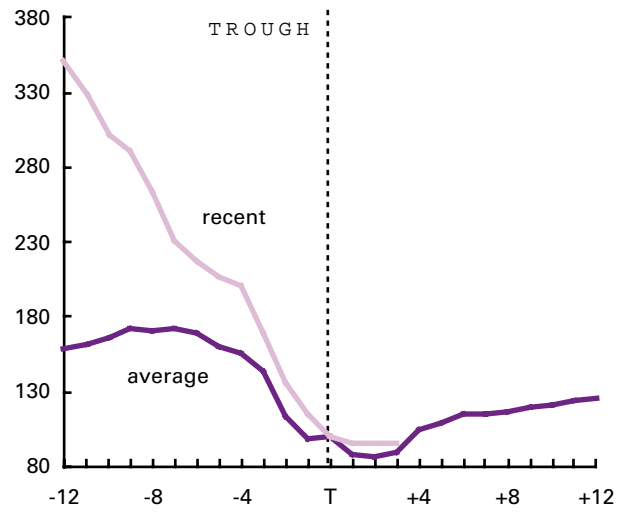
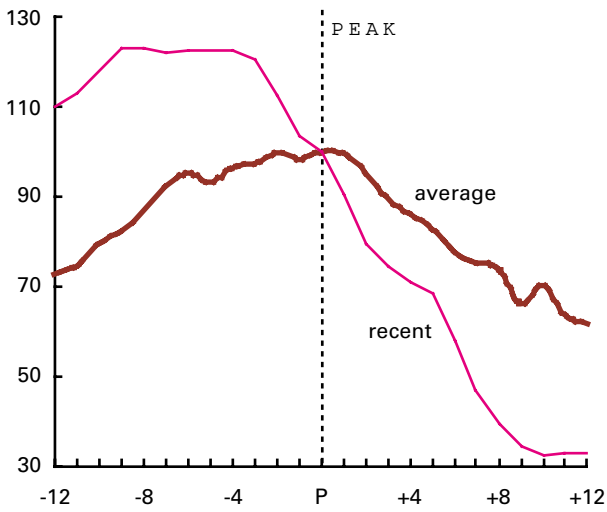


NAPM/ISM

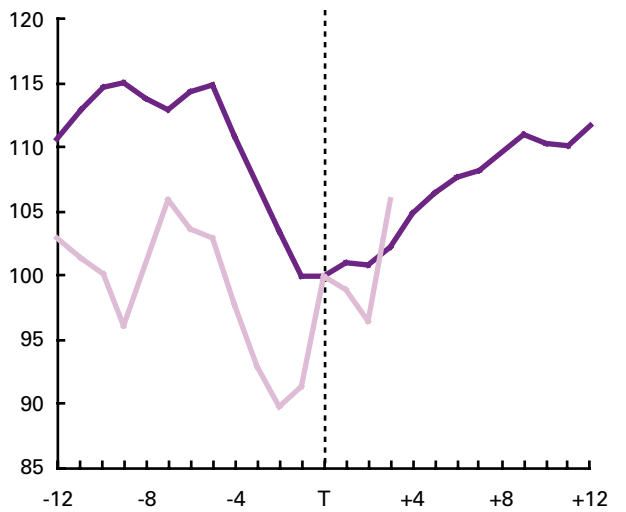
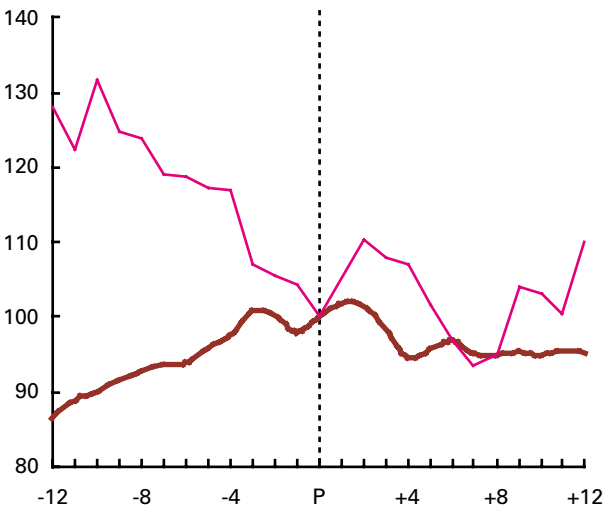


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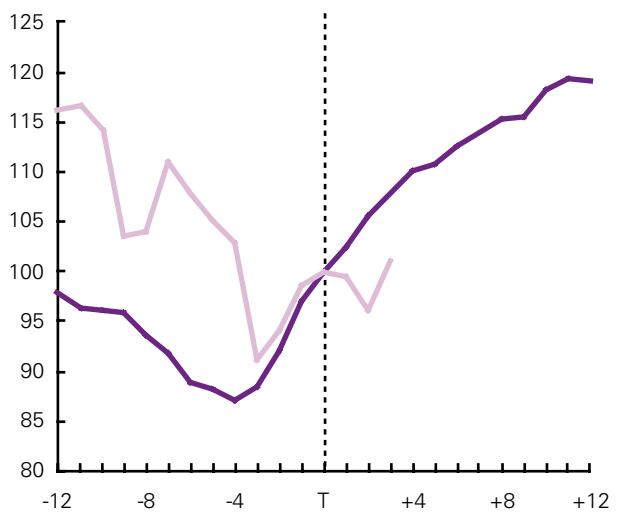
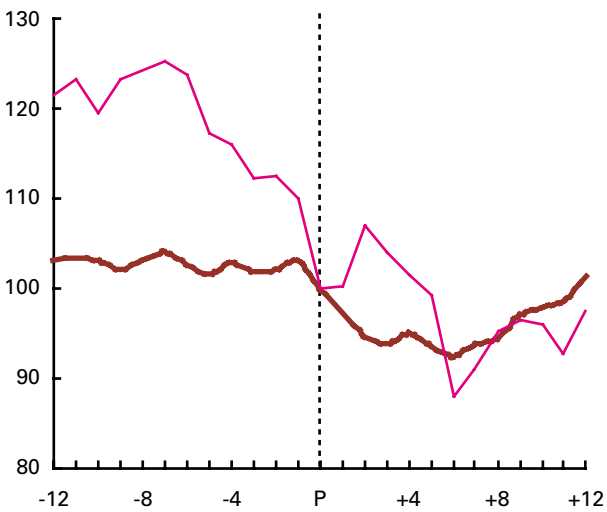
fed funds



10-year bond

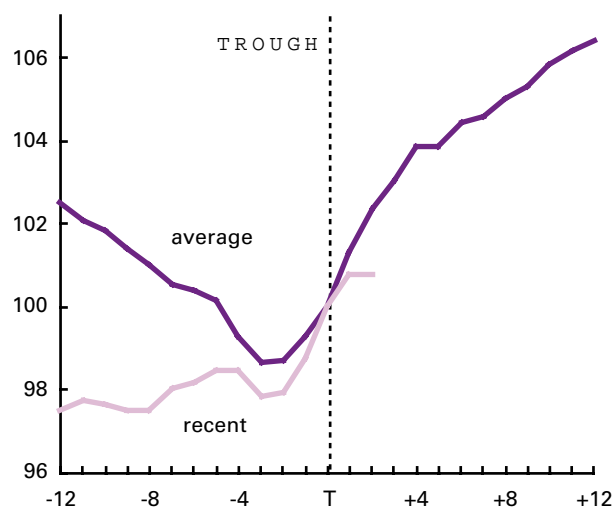
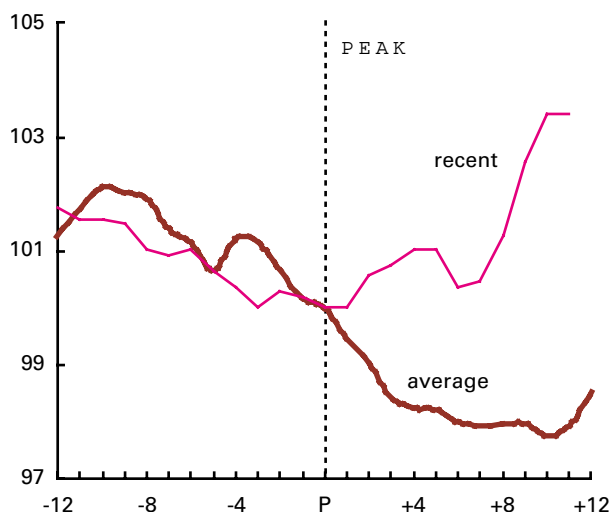


S&P 500



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leading indicators



(cont. from p. 1)

is almost a year ahead of the script written by earlier recoveries. Stocks, though, are telling a much less bullish story than bonds; they fell more sharply going into the recession, and have since risen less than in the average recovery. Stock gains may be inhibited by high valuations, and bonds may be weighed down by anxieties over Washington's deteriorating fiscal outlook. But still, it looks like bonds are pricing in a strong, possibly inflationary recovery, and even an early Fed tightening.

Is that strong a recovery likely? In a normal upswing, we'd soon be seeing job gains of 350,000 a month, industrial production rising by over 1% a month, and retail sales by 0.7% a month. That all seems unlikely, given that employment and industrial production fell at half their usual rate during the recession, and retail sales actually rose. Of course, a snapback in capital goods spending from its depressed levels could power the upturn, just as it powered the downturn. So both the Fed and Wall Street are facing an end-of-recession economy where the labor market is tighter and consumption stronger than in earlier cycles, while the capital spending side is weaker. Though capital spending plans aren't vigorous right now, a strong recovery in investment could

push the economy to a level of tightness that would surprise the current moderate consensus.

One complication: research by Fed economists <www.federalreserve.gov/pubs/feds/2001/200152/200152pap.pdf> shows that initial GDP stats underestimate the strength of recoveries (and the severity of downturns as well). A Goldman Sachs study finds similar misses for retail sales, industrial production, and durable goods. We should keep this in mind as we watch the recovery developing over the next several months: things may be a bit better than they appear — and the FOMC knows that.

by Philippa Dunne and Doug Henwood

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