LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

Our Five Forecasters collectively point to economic growth ahead.

Leading indicators are still rising, but the pace has slowed recently.

Yield curve inversion looks manageable given positive signs from other indicators.

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FIVE FORECASTERS: FEW WARNING SIGNS

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It's been a difficult year for Wall Street forecasts. The Federal Reserve's (Fed) pause and global uncertainty have forced many economists and market prognosticators to adjust their 2019 predictions. LPL Research is in that camp, too: We adjusted a few of our 2019 economic and fixed income forecasts in February.

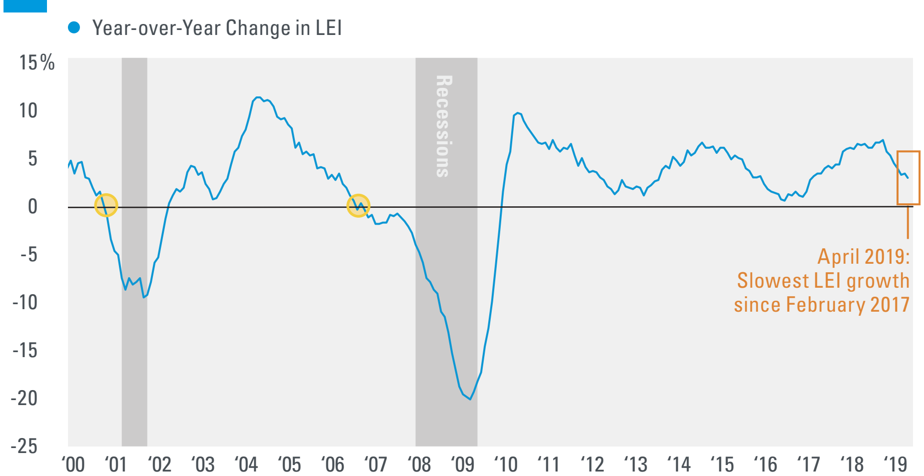
Near-term forecasting has been a futile effort this year, thanks to headline risk from trade and political headwinds. However, our Five Forecasters (in the *Recession Watch Dashboard*), which measure the longer-term health of the economy and financial markets, point to a continued economic expansion. This week, we're highlighting two of the five leading indicators we watch: the Conference Board's Leading Economic Index (LEI) and the U.S. yield curve. For analysis on the other three indicators, check out this week's *Weekly Market Commentary* and today's Macro Market Movers Blog.

LEADING INDICATORS: HEALTHY, BUT SLOWING

While coincident economic data help capture current economic health, leading indicators forecast the near-term economic trajectory. The LEI is calculated from 10 individual indicators, including weekly jobless claims, manufacturers' new orders, building permits, and stock prices.

The LEI also is one of our favorite economic indicators because of its predictive power: The Index has turned negative year over year an average of 14 months before all recessions since the 1970s [Figure 1].

1 LEADING INDICATORS SHOW GROWTH SLOWING, BUT STILL POSITIVE



Source: LPL Research, Conference Board 05/23/19
LEI = The Conference Board's Leading Economic Index
The economic forecasts set forth may not develop as predicted.

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The LEI rose 2.7% year over year in April, its 113th straight increase. Because of this, we see the LEI as a "green light" for economic growth. However, we're monitoring the LEI more closely these days. While the LEI has been resilient amid this year's headwinds, April's reading was its slowest pace of year-over-year growth since February 2017.

Although the Index is still positive year over year, some investors have pointed out slowing LEI growth as a reason for caution. While weakening economic indicators point to moderating growth ahead, the LEI has been weighed down by deteriorating manufacturing data. In the past two LEI readings, only 2 of 10 components were net drags on the index: the Institute for Supply Management's New Orders Index and new orders of nondefense capital goods. At the end of each of the past four economic cycles, more than half of the LEI components were in decline. Trade uncertainty has weighed on business and consumer demand over the past several months, so weakness in manufacturing-related indicators isn't surprising. We'd like to see improvement in that sector, but we don't expect much progress until U.S.-China trade tensions die down.

Overall, leading indicators are rising, and look solid to us.

YIELD CURVE: ON WATCH

Our Five Forecasters also include the shape of the U.S. Treasury yield curve, a closely watched indicator on Wall Street that has recently become a mainstream talking point. On March 22, the 3-month Treasury yield closed below the 10-year Treasury yield for the first time since 2007. The inversion spooked investors because yield curve inversion (long-term rates falling below short-term rates) has preceded each of the nine recessions going back to 1955.

Currently, the spread between the 3-month and 10-year Treasury is essentially flat, which we see as a "yellow light" for economic growth. Much of the recent yield curve flattening happened as long-term yields have stalled, in part from intense global buying pressure on the longer end. The decline in long-term rates has overshadowed a similar (but slower) drop in short-term rates as the bond market has priced in a Fed rate cut. Lower short-term rates typically help steepen the yield curve, but not when long-term rates are falling faster.

Recent inversions have also been quick and shallow, and these occurrences are common later in economic cycles [Figure 2].

2 YIELD CURVE "FALSE POSITIVES" ARE COMMON LATER IN CYCLE

Economic Cycle Trough	Economic Cycle Peak	First Inversion*	Time to Peak After First Inversion (Months)	Length of First Inversion (Days)	Number of Inversions Before Recession
November 1970	November 1973	June 1973	5	168	1
March 1975	July 1981	November 1978	32	2	15
November 1982	July 1990	March 1989	16	1	10
March 1991	March 2001	September 1998	30	1	8
November 2001	December 2007	January 2006	23	1	7
June 2009	?	March 2019	?	5	?
	Average (Before Current Cycle)		21		8

Source: LPL Research, Bloomberg 05/23/19

*Inversion refers to the 3-month Treasury yield closing below the 10-year Treasury Yield.

Past performance is no guarantee of future results.

The 3-month and 10-year yield spread typically flickers between positive and negative several times before the U.S. economy peaks, which has happened an average of 21 months after the first inversion. We've seen three "false positives" so far in this cycle—the latest being two one-day inversions on May 13 and May 15.

We would become more concerned if that negative spread were to widen significantly. Historically, the spread between the 3-month and 10-year yields has become much more predictive of a recession at -50 basis points (-.50%). In the 10-year-long 1990s expansion, the economy peaked seven months after the 3-month and 10-year yield spread fell to -50 basis points in August 2000. In the most recent expansion, the economy peaked 13 months after the 3-month and 10-year yield spread fell to -50 basis points in November 2006.

We're encouraged by positive signals in other fixed income indicators. Other parts of the yield curve, such as the 2-year and 10-year yield spread, have yet to invert, and there are no significant signs of stress in other credit markets.

FIVE FORECASTERS

Because every cycle is different, there is no magic formula for predicting recessions and bear markets. But we believe the Five Forecasters cover a variety of perspectives, including economic, market, fundamental, valuation, and technical/sentiment, to capture a more complete view of the economic and market environment. They are meant to be considered collectively, not individually.

CONCLUSION

Currently, we see minimal warning signs from the Five Forecasters that might signal the end of the economic cycle. However, we're not complacent, and we understand investors' skepticism nearly 10 years into this expansion. We will continue to monitor data for any late-cycle or recessionary signals. For now, though, economic fundamentals look sound, and odds of a near-term recession appear to be low. ■

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