ECRI
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U.S. CYCLICAL OUTLOOK

RISING RISKS TO U.S. GROWTH

A Shift in Risks

Last spring, with the U.S. Future Inflation Gauge (USFIG) in a steep uptrend, the risk of an overheating U.S. economy was rising rapidly, and the Federal Reserve raised interest rates for the sixth time. However, the summer months saw a cooling in inflationary pressures, making it increasingly clear that the U.S, economy was headed for a soft landing, as inflation risks receded while the U.S. growth outlook remained positive. The key to the benign inflation outlook was not so much a downshift in U.S. growth as the likelihood of a global industrial slowdown.

The risks have shifted again of late, as the leading indicators of U.S. growth have begun to turn more pessimistic even as inflation pressures have continued to cool. In other words, the sustainability of U.S. growth has now become much more of an issue than concerns about an overheating economy.

A recession is not yet on the horizon – in fact, the trajectory of the U.S. Long Leading Index remains consistent with a slowdown. However, the U.S. Leading Diffusion Index, incorporating all 30 components of ECRI's leading indexes of economic activity and employment, has dropped to levels not seen in this expansion. In that sense, the risk of a recession has never been so high at any time during this expansion (see pages 2 to 3).

The sustainability of growth is now a greater concern than overheating.

If these leading indicators recover soon, a soft landing is still likely. However, if these indicators remain gloomy or weaken, a hard landing will become more probable. Fundamentally, the weakness in the leading indicators points to a window of vulnerability to external shocks like further oil price spikes.

As we have noted before in this publication (Vol. V, No. 7, July 2000), higher energy prices boost nondiscretionary spending on gasoline and heating fuel, crowding out discretionary spending. This substitution effect, along with the psychological impact of a sudden jump in energy prices, hurts consumer spending on other items. Such checks on consumer spending can be particularly damaging around the holiday shopping season.

While the rise in energy prices impairs consumer spending, it can also squeeze profit margins by raising the cost of doing business. In that sense, a slowdown triggered by an oil price shock packs a double whammy for equity prices.

Shrinking profits also pinch corporate investment budgets, hurting stocks of companies that depend on business investment. A perception that such oil price increases are inflationary may also boost long term interest rates. If such linkages depress stock prices, in turn hurting consumer confidence, further reducing spending and increasing the risk of a hard landing.

On the other hand, the economy is not as energy-dependent as it was in the 1970's, and real oil prices are still quite moderate. Also, underlying inflationary pressures, as measured by the USFIG, are now declining. This drop in the USFIG allows more leeway for interest rates to decline if the risk of a hard landing becomes clearer (pages 2 to 3).

Hinging on Oil

The near-term direction of oil prices could have a critical impact on U.S. economic growth. We cannot predict oil prices, which remain highly uncertain. However, oil prices are ultimately driven by supply and demand, and ECRI has some insight into the cyclical factors that have a bearing on global demand for oil.

ECRI's 16-Country Long Leading Index (16LLI) incorporates the long leading indexes for the G7 countries as well as Spain, Sweden, Switzerland, Australia, New Zealand, India, Korea, Taiwan and Mexico, while the 16-Country Coincident Index (16CI) incorporates the coincident indexes for the same economies. In effect, the 16CI tracks the current state of the global economy, while the 16LLI is designed to anticipate cyclical turns in the 16CI. As Chart 33 shows, the 16LLI growth rate consistently anticipates the cyclical turns in the 16CI growth rate, and in that sense is a long leading indicator of global economic growth.

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FOCUS

CAN U.S. GROWTH CONTINUE AS OIL PRICE SPIKES UP?

Never in this expansion have the leading indicators been so close to forecasting a recession. Luckily, underlying inflationary pressures have already turned down.

A Broadbased Predictor

Leading indicators usually move in rough unison, though they rarely speak with one voice; but generally, their overall message is clear enough. However, a more precise interpretation is sometimes critical, because it may spell the difference between a forecast of a slowdown and a recession. This is one of those times.

An important insight from business cycle research is that the pace of an expansion is closely tied to its scope. This insight may be extended to leading indicators of the business cycle. For example, the more pervasive the weakness in a set of leading indicators, the slower the future pace of growth is likely to be.

A useful way to consolidate the evidence from ECRI's many leading indexes is to combine all their components into one U.S. Leading Diffusion Index (USLDI), last examined in this publication six months ago (Vol. V, No. 3, March 2000). It is expected that cyclical turns in the USLDI would anticipate cyclical turning points in the growth rate of the U.S. economy.

In fact, as Chart 1a shows, the USLDI reliably anticipates growth rate cycle turning points, which correspond roughly to the growth rate of the U.S. Coincident Index. The USLDI typically leads growth rate cycle peaks by about half a year, whether or not the downturn that follows results in a recession. However, at troughs, the median lead (-) of the USLDI is much greater (nine months) for non-recessionary slowdowns than it is (three months) for recessionary slowdowns (Table 1a).

Slowdown Ahead

In July, the USLDI plunged to its lowest level in the current expansion. In August, it rose above that low, but remained in a sharp downtrend. Given its behavior patterns at growth rate troughs, the next few months should provide a vital clue as to the prospects for a soft landing.

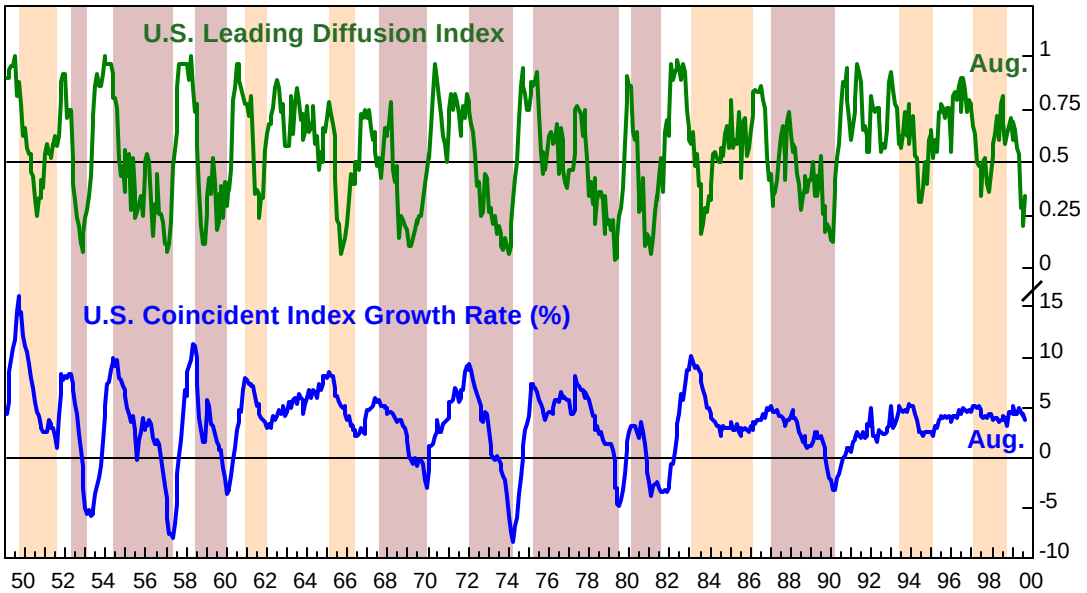
If the USLDI recovers promptly and clearly, that would follow the pattern in non-recessionary slowdowns or soft landings, with growth slowing through early next year and then recovering. Alternatively, if it remains depressed or plunges lower still, this would be consistent with the historical pattern in recessionary slowdowns.

It is not yet clear which scenario is more likely. However, it may be noted that in eight out of the ten instances since

Table 1a: Lead/Lag of USLDI at Troughs: Recessionary and Nonrecessionary Slowdowns

Growth Rate Cycle Trough Dates		USLDI Trough Dates		Lead (-) in Months	
Recession	No Recession	Recession	No Recession	Recession	No Recession
	7/1952		7/1951		-12
1/1954		10/1953		-3	
4/1958		1/1958		-3	
12/1960		11/1959		-13	
	12/1962		8/1962		-4
	5/1967		8/1966		-9
11/1970		2/1970		-9	
3/1975		12/1974		-3	
6/1980		3/1980		-3	
7/1982		1/1982		-6	
	1/1987		7/1984		-30
2/1991		1/1991		-1	
	1/1996		6/1995		-7
			Average Lead	-5	-12
			Median Lead	-3	-9

Chart 1a: U.S. Leading Diffusion Index & U.S. Coincident Index Growth Rate (%)



Brown shaded areas represent U.S. growth rate cycle downturns that were followed by recessions and orange shaded areas represent those that were not followed by recessions.

1950 in which the USLDI dipped this low, a recession followed. On the other hand, for the past decade, monetary policy has moved preemptively when the USLDI faltered.

The Effect of Oil Prices

U.S. economic growth peaked last January, following the June 1999 peak in the USLDI. With the index plunging in recent months, a more serious slowdown now looks likely. However, whether oil price spikes will disrupt the expected soft landing is still an open question.

As discussed in this publication two months ago (Vol. V, No. 7, July 2000), when consumers encounter an unexpected jump in prices, consumption falls and precautionary savings rise. This is known as the Katona effect, which intensifies if the higher prices involve nondiscretionary spending like food or energy, which reduces the money left over for discretionary spending.

Price level volatility is already around a nine-year high, and could rise further this fall or winter if energy prices spike higher. The larger the spike, the stronger the check on consumer spending growth, in which some moderation was already expected due to the lagged effect of the Fed's interest rate hikes. It is conceivable that large and sustained oil price spikes could actually trigger a recessionary drop in consumer spending, which could be particularly damaging in the upcoming holiday shopping season.

Room For Maneuver

Fortunately, a recession is far from inevitable at this point, given both the uncertainties about future movements in oil prices and the leeway for preemptive actions. Such actions include those that could be taken at an administrative level, including the timely use of strategic petroleum reserves.

If energy price inflation does spike up to the extent where there is a serious threat to consumer confidence, the direction of short term interest rates may become critical. As Chart 1b shows, recessionary slowdowns are typified by long lags between the onset of a slowdown and downturns in the Federal Funds rate, while non-recessionary slowdowns involve shorter lags between the starts of slowdowns and interest rate cuts. In some of these cases (1968-70, 1973-75 and 1976-80), it may have been more difficult to ease promptly, since underlying inflationary pressures, as measured by the U.S. Future Inflation Gauge (USFIG), continued to rise well into the slowdowns.

Table 1b: Lead/Lag of USFIG & Fed Funds Rate at Peaks: Recessionary and Nonrecessionary Slowdowns

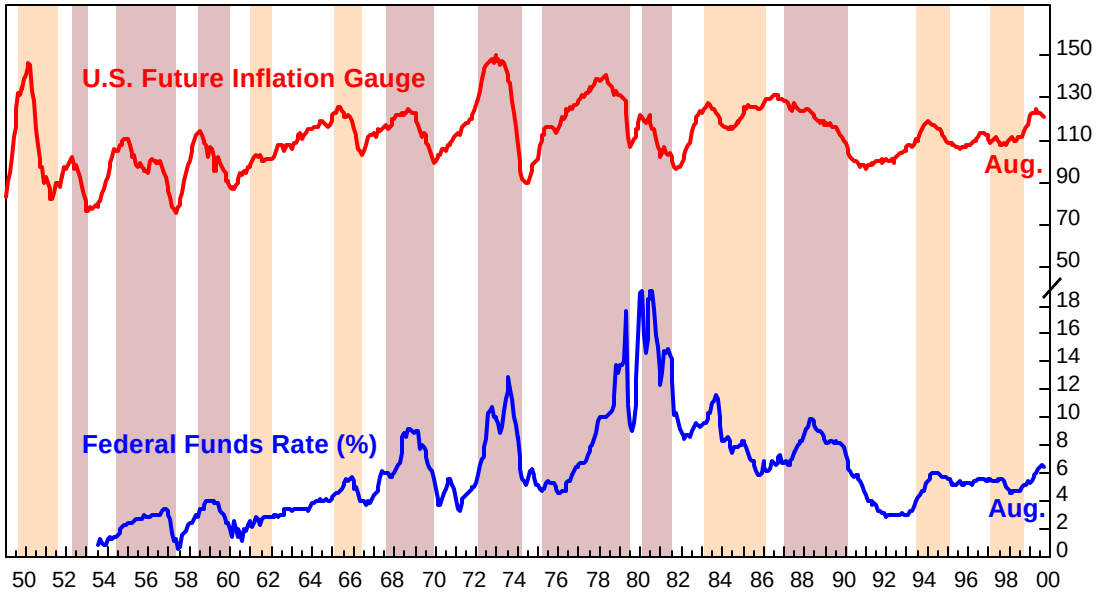
USFIG Peak Dates		Fed Funds Rate Peak Dates		Lag (+) in Months	
Recession	No Recession	Recession	No Recession	Recession	No Recession
12/1955		10/1957		+22	
6/1959		11/1959		+5	
	3/1966		11/1966		+8
8/1969		8/1969		0	
11/1973		7/1974		+8	
4/1979		6/1981		+26	
	3/1984		8/1984		+5
7/1987		3/1989		+20	
	12/1994		4/1995		+4
	7/1997		8/1998		+13
			Average Lead	+14	+8
			Median Lead	+14	+6.5

In other cases, where the drop in the USFIG started before or soon after the slowdowns began, there may have been more leeway for the Fed Funds rate to have declined sooner, but it continued to rise (1955-58, 1959-60 and 1988-91), and recessions followed.

As Table 1b shows, the median lag (+) between the USFIG and the Fed Funds rate at peaks is 6.5 months in non-recessionary slowdowns, but as long as 14 months in recessionary ones. The latter figure may actually be understated because in 1959-60 and 1968-70, the Fed Funds rate remained high for months after it technically peaked. Thus, long lags between peaks in the USFIG and the Federal Funds rate are associated with recessionary slowdowns. The difficulties are worse when the USFIG does not peak until long after growth has peaked.

Currently, however, while U.S. growth peaked early this year (around January), the USFIG followed suit in April and is now clearly easing. Therefore, unlike the 1970s, when the USFIG kept rising well after growth turned down, there is room for the Fed Funds rate to come down if a recessionary drop in confidence occurs in the coming months. Hopefully, such options will allow any potential recession to be averted.

Chart 1b: U.S. Future Inflation Gauge & Federal Funds Rate (%)



Brown shaded areas represent U.S. growth rate cycle downturns that were followed by recessions and orange shaded areas represent those that were not followed by recessions.

Table 2: ECRI's U.S. INDEXES:

A READING OF THE U.S. LEADING INDICATORS OF INFLATION, EMPLOYMENT, AND AGGREGATE ECONOMIC ACTIVITY

Summary

	LEVEL (1992=100)				GROWTH RATE (%)			
	6 months earlier	3 months earlier	Latest Month		6 months earlier	3 months earlier	Latest Month	
Future Inflation Gauge	122.5	122.9	121.1	Aug.	13.9	8.8	1.5	Aug.
Leading Employment Index	130.0	128.5	128.3	Aug.	2.6	-1.3	-2.3	Aug.
Coincident Employment Index	119.1	119.1	119.2	Aug.	2.5	1.4	0.8	Aug.
Long Leading Index	134.8	136.1	137.4	Aug.	3.7	4.4	4.3	Aug.
Short Leading Index	137.8	135.4	135.7	Aug.	5.2	-1.4	-2.2	Aug.
Coincident Index	133.5	135.1	136.1	Aug.	4.3	4.5	3.8	Aug.
Leading Services Index	129.4	130.2	131.4	Aug.	2.9	2.7	3.0	Aug.
Coincident Services Index	123.9	125.1	125.8	July	3.3	3.7	3.1	July
Leading Financial Services Index	155.0	156.5	160.9	Aug.	0.6	1.8	6.0	Aug.
Coincident Financial Services Index	143.1	145.4	146.6	Aug.	1.7	2.9	2.5	Aug.
Leading Manufacturing Index	146.6	138.9	136.4	Aug.	10.1	-6.0	-9.8	Aug.
Coincident Manufacturing Index	156.2	158.7	161.7	Aug.	6.7	6.8	7.1	Aug.
Leading Construction Index	119.5	116.5	116.3	Aug.	-1.7	-5.6	-3.4	Aug.
Coincident Construction Index	163.2	164.3	162.6	Aug.	6.9	5.5	1.2	Aug.
Leading Imports Index	195.6	203.4	207.2	Aug.	8.4	13.2	12.6	Aug.
Leading Exports Index	172.9	177.5	179.7	June	7.7	9.2	7.2	June
Leading Trade Balance Index	98.3	98.9	98.6	June	-0.4	0.5	-0.3	June

U.S. FUTURE INFLATION GAUGE

FUTURE INFLATION GAUGE HITS NINE-MONTH LOW

ECRI's monthly U.S. Future Inflation Gauge (USFIG), designed to anticipate cyclical swings in the rate of inflation, fell to 121.1 (1992=100) in August from 121.7 in July, while its smoothed annualized growth rate dropped to 1.5% from 3.7%.

The gauge was pulled down in August by slower growth in real estate loans and a decline in the percentage of purchasing managers reporting slower deliveries, offset in part by modest increases in the growth rates of employment and the JOC-ECRI industrial price index, along with a movement of the yield spread into negative territory. The insured unemployment rate was unchanged for the third successive month.

The USFIG has now declined for four straight months from April's 11-year high, suggesting a clear decline in underlying inflationary pressures. U.S. growth is set to slow, and the imminent global industrial slowdown is likely to check imported inflationary pressures. Thus, notwithstanding the immediate effect of rising oil prices on headline inflation, the longer-term inflation outlook has become more benign.

Chart 2: FIG (1992=100)

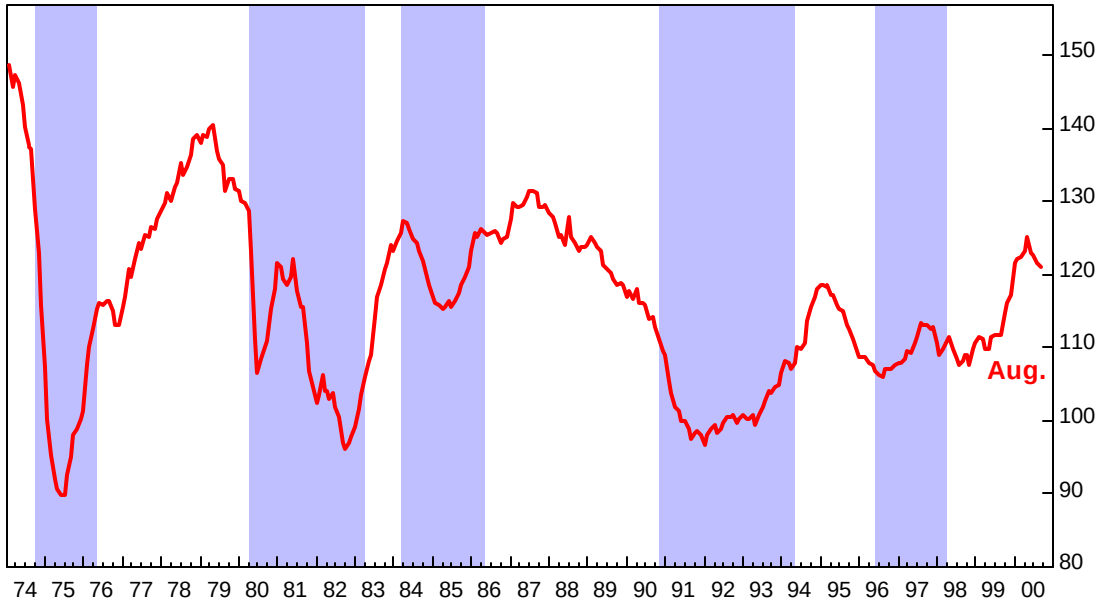
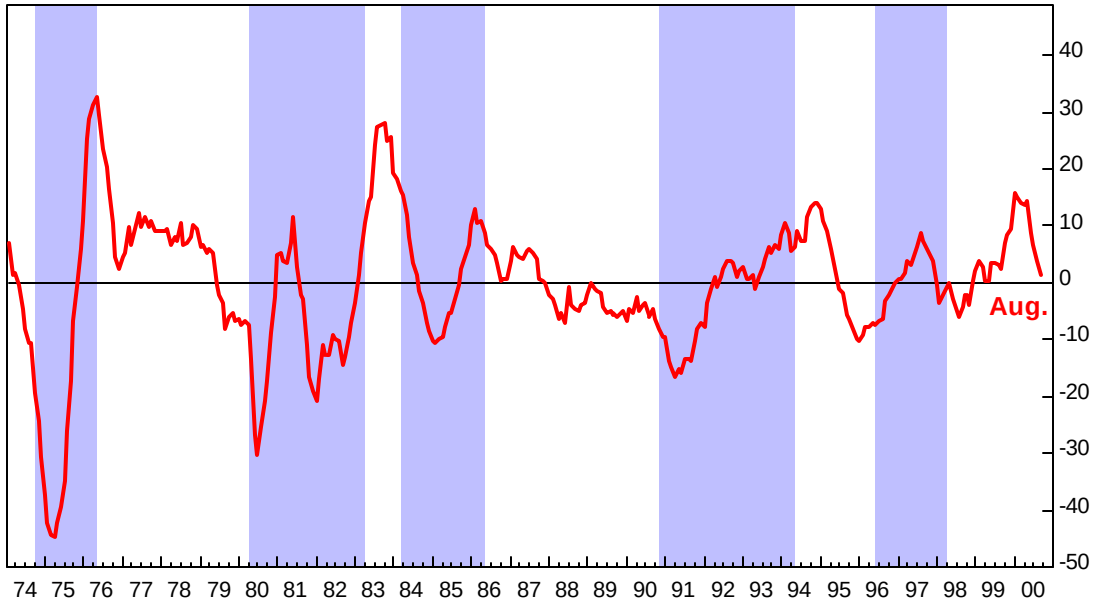


Chart 3: FIG Growth Rate (percent, annualized)



Shaded areas represent U.S. inflation cycle downturns.

LEADING & COINCIDENT EMPLOYMENT INDEXES

JOB GROWTH TO SLOW

ECRI's Leading Employment Index (LEI), designed to anticipate cyclical turns in employment conditions, fell to 128.3 (1992=100) in August from 130.9 in July, while its smoothed annualized growth rate dropped to -2.3% from 1.7%. The index was pulled down in August by unfavorable movements in all components: initial jobless claims, overtime hours in manufacturing, the short-term unemployment rate, the layoff rate, the average employment diffusion index and the average workweek.

ECRI's Coincident Employment Index (CEI), which tracks current employment conditions, was unchanged at 119.2 (1992=100) in August, while its six-month smoothed annualized growth rate fell to 0.8% from 1.0%. In August, unfavorable movements in the jobless rate and the number of nonfarm payroll jobs neutralized increases in civilian and nonagricultural employment.

Growth rates of both the LEI and the CEI have dropped sharply since the early spring, and both are now at four-and-a-half-year lows. With LEI growth remaining in a downtrend, job growth is likely to ease in the coming months, as a slowdown in overall growth takes hold.

Chart 4: LEI & CEI (1992=100)

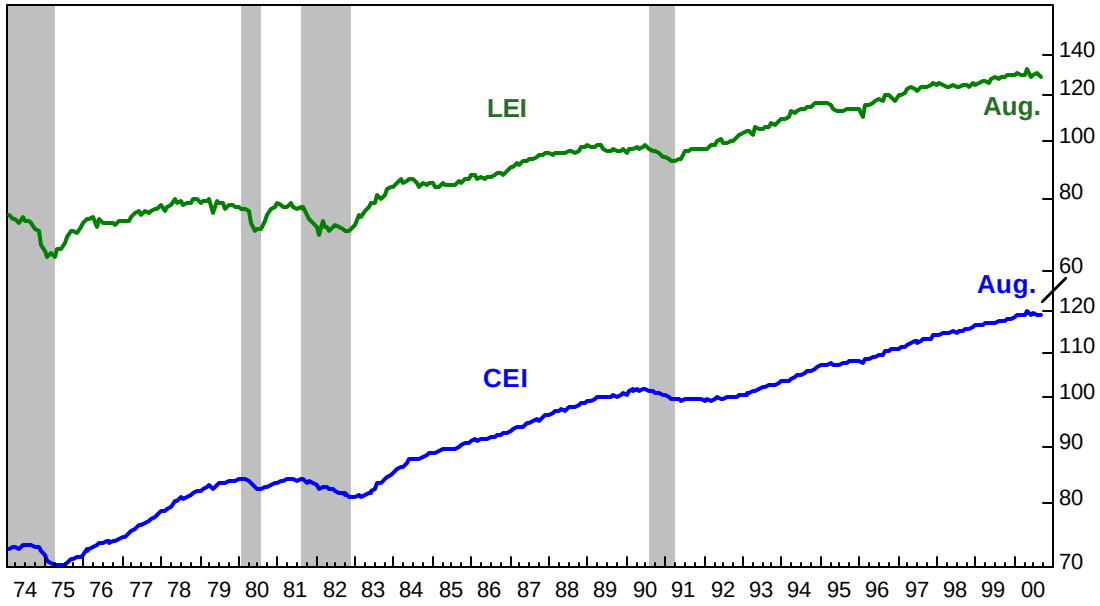
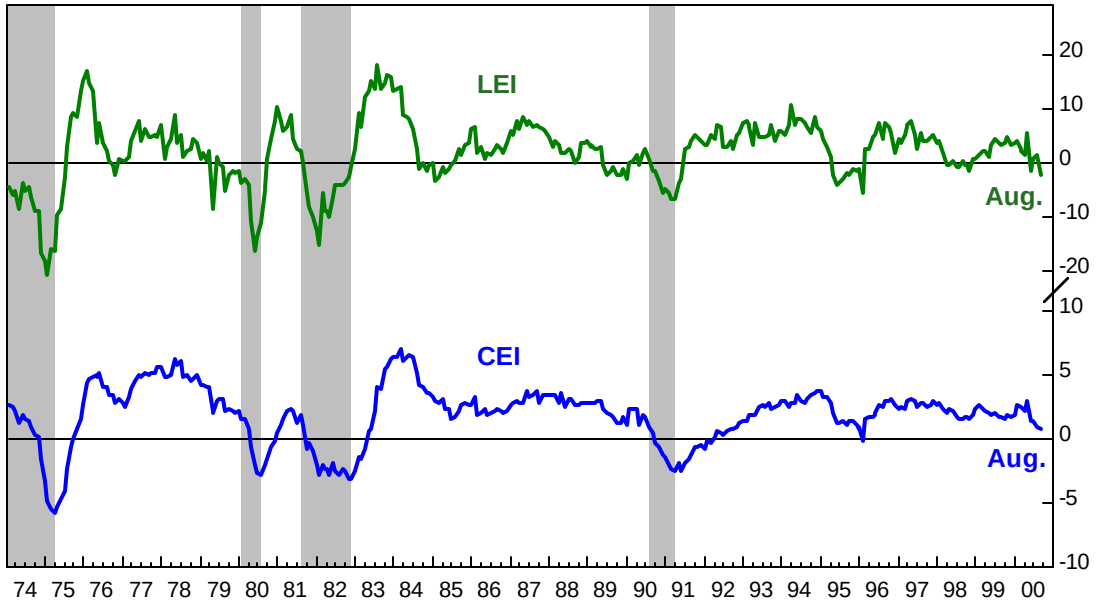


Chart 5: LEI & CEI, Growth Rate (percent, annualized)



Shaded areas represent U.S. business cycle recessions.

U.S. LONG LEADING INDEX

LONG LEADING INDEX SEES SOFT LANDING AHEAD

ECRI's U.S. Long Leading Index (USLLI), designed to anticipate cyclical turns in the U.S. economy, rose to 137.4 (1992=100) in August from a downwardly revised 136.9 in July, while its smoothed annualized growth rate remained at 4.3%.

In August, favorable contributions from money supply, bond yields and productivity growth were mostly offset by declines in consumer expectations and building permits.

USLLI growth remains below earlier highs, but has improved a little since early spring as interest rates have come down. While the picture may very well change in the near term, at this point it remains consistent with a soft landing.

Chart 6: USLLI (1992=100)

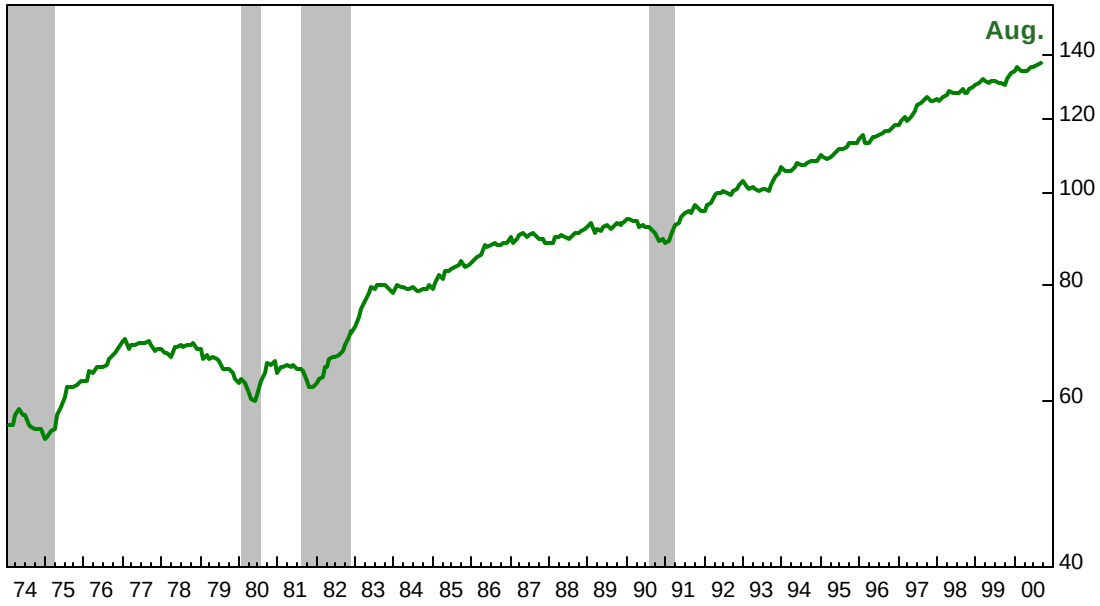
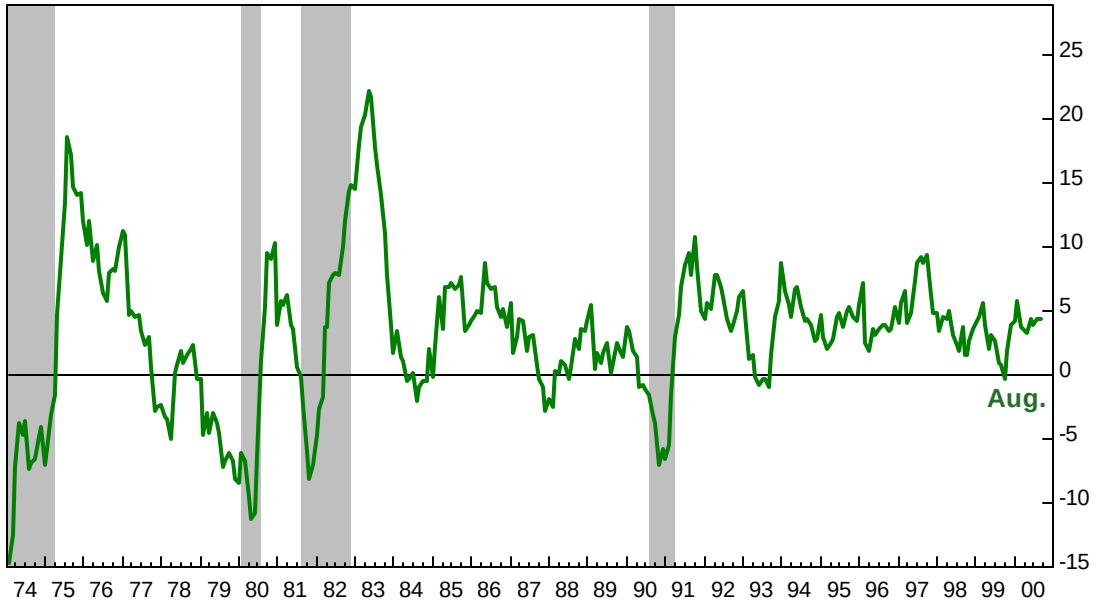


Chart 7: USLLI Growth Rate (percent, annualized)



Shaded areas represent U.S. business cycle recessions.

U.S. SHORT LEADING INDEX

GROWTH LIKELY TO SLACKEN

ECRI's Short Leading Index (USSLI), designed to anticipate near-term cyclical turns in the U.S. economy, dropped to 135.7 (1992=100) in August from 138.0 in July, while its smoothed annualized growth rate plunged to -2.2% from 1.1%.

The index was pulled down in August by unfavorable movements in jobless claims, the percentages of purchasing managers reporting higher inventories and slower deliveries, the risk differential between yields on gilt-edged and lower-rated bonds and the average manufacturing workweek, partly offset by increases in stock prices and the growth rate of industrial materials prices.

USSLI growth is now in a clear cyclical downtrend that points to a slowdown in overall economic growth.

Chart 8: USSLI (1992=100)

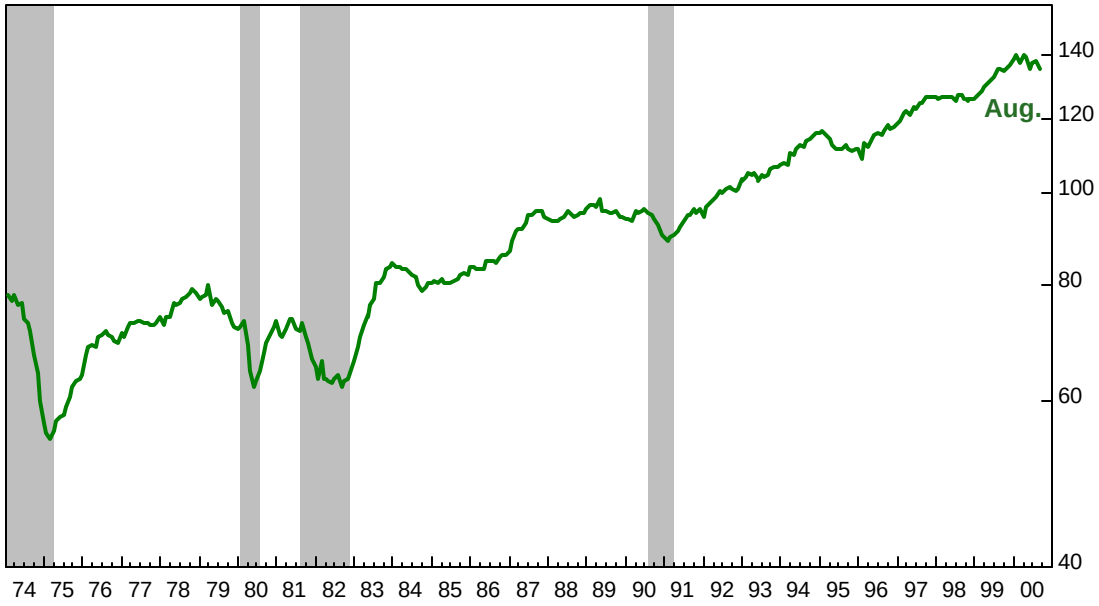
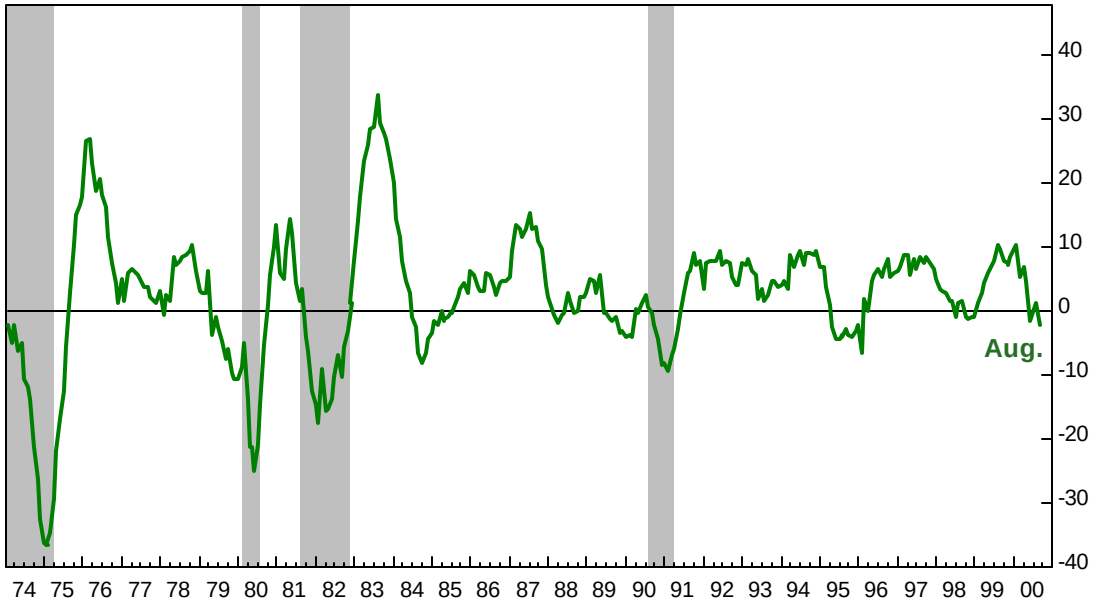


Chart 9: USSLI Growth Rate (percent, annualized)



Shaded areas represent U.S. business cycle recessions.

LEADING & COINCIDENT SERVICES INDEXES

MODERATE GROWTH LIKELY FOR SERVICES

ECRI's Leading Services Index (LSI), designed to anticipate cyclical turning points in the growth of the service sector, rose to 131.4 (1992=100) in August from 131.0 in July, while its smoothed annualized growth rate remained at 3.0%. The index was pushed up by favorable movements in services stock prices, corporate bond yields and money supply, offset in part by a dip in consumer expectations.

Meanwhile, ECRI's Coincident Services Index (CSI), designed to track turning points in the growth of the service sector, rose to 125.8 (1992=100) in July from 125.3 in June, while its smoothed growth rate edged up to 3.1%. The CSI was pushed up in July by increases in services wages and personal consumption expenditures for services, offset in part by unfavorable movements in employee hours and the unemployment rate for services. The jobless rate and employee hours were both unchanged in August.

Thus, service sector growth is likely to stay reasonably healthy, although with LSI growth below earlier highs, some moderation in services growth is likely.

Chart 10: LSI & CSI (1992=100)

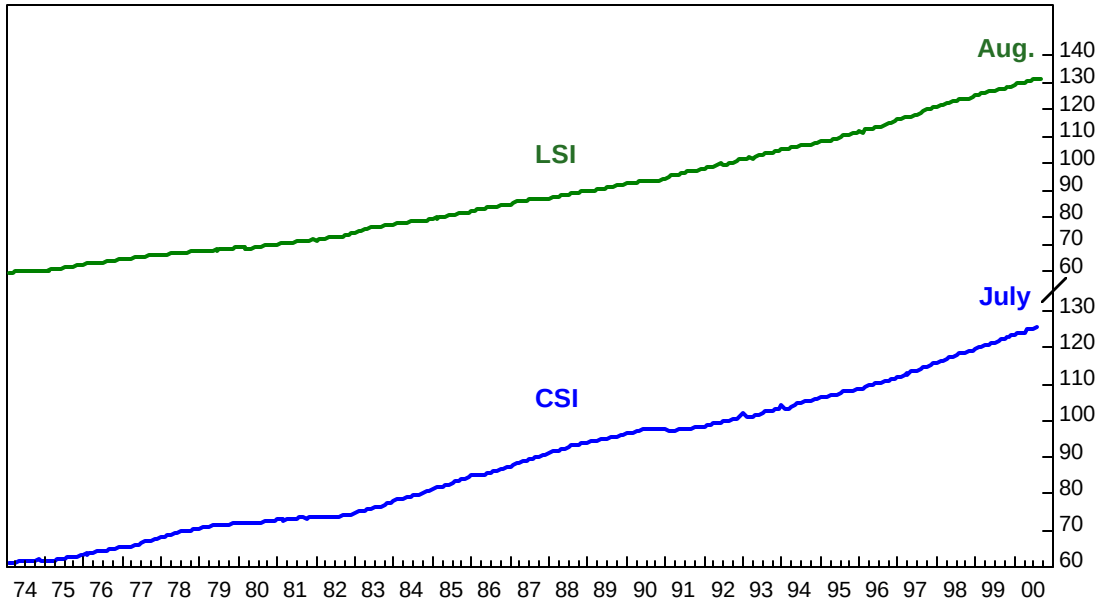
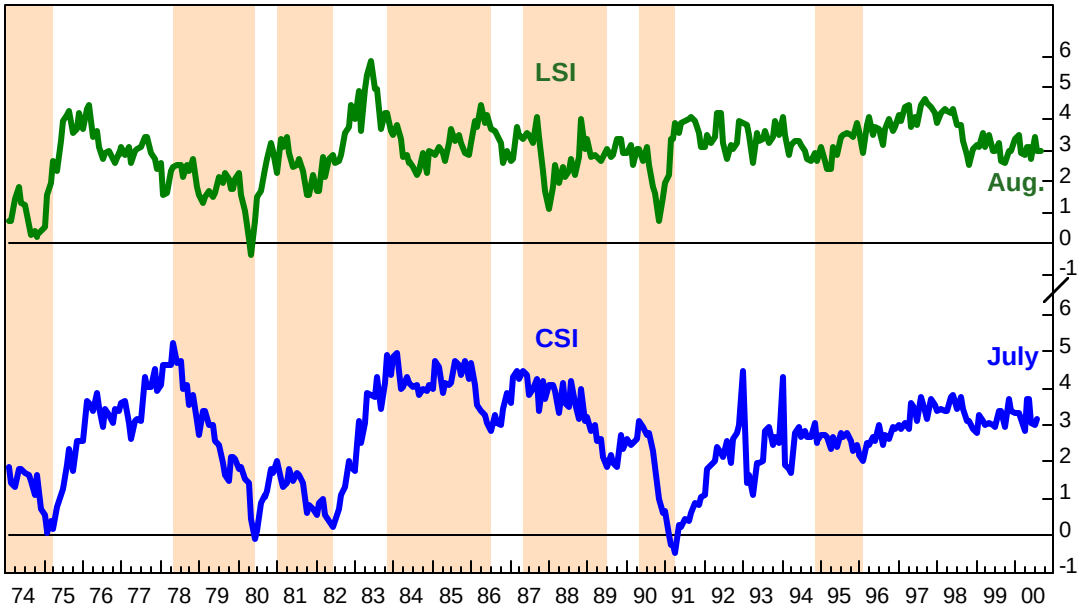


Chart 11: LSI & CSI, Growth Rate (percent, annualized)



Shaded areas represent cyclical downturns in the growth rate of U.S. services activity.

LEADING & COINCIDENT FINANCIAL SERVICES INDEXES

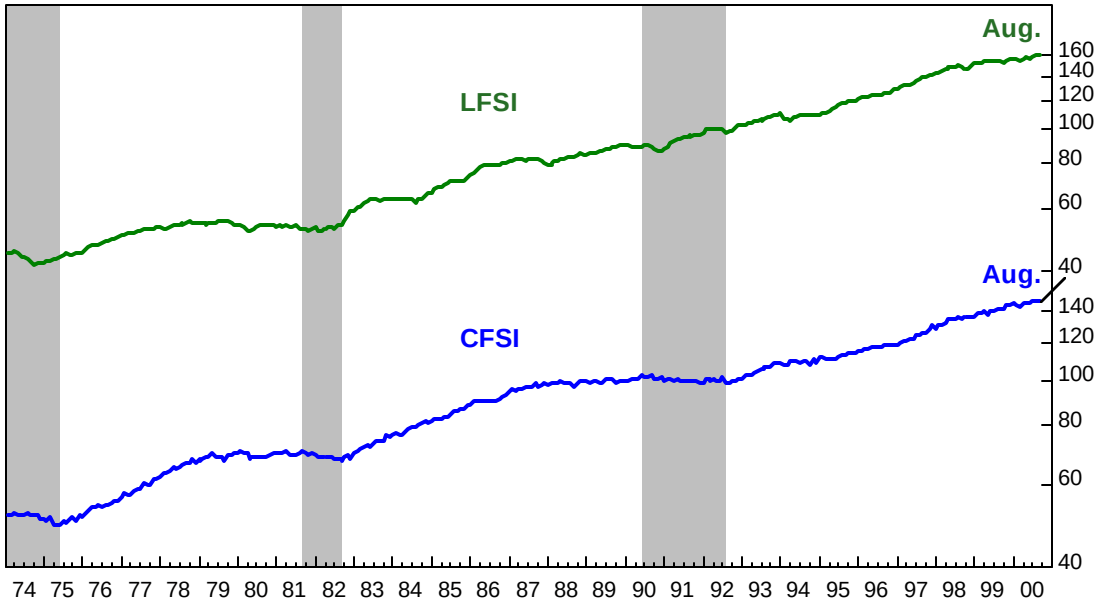
POSITIVE PROSPECTS FOR FINANCIAL SERVICES SECTOR

ECRI's Leading Financial Services Index (LFSI), designed to anticipate cyclical turning points in the growth of the financial services sector, rose to 160.9 (1992=100) in August from 159.4 in July, while its smoothed annualized growth rate climbed to 6.0% from 4.7%. The LFSI was pushed up by favorable movements in financial services stock prices, corporate bond yields and money supply plus mutual funds, offset in part by a drop in building permits.

Meanwhile, ECRI's Coincident Financial Services Index (CFSI), designed to track turning points in the growth of the financial services sector, fell to 146.6 (1992=100) in August from 147.8 in July, while its smoothed growth rate dropped to 2.5% from 4.8%. The CFSI was pulled down in August by unfavorable movements in employee hours and the unemployment rate for the finance, insurance and real estate (FIRE) sector.

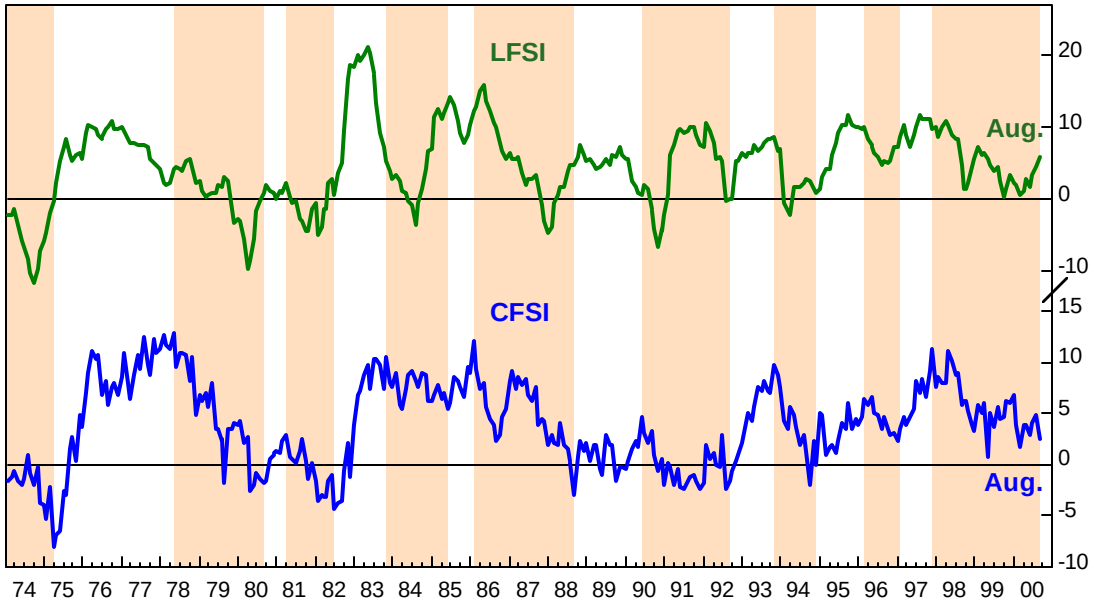
Thus, growth in financial services has declined following the earlier decline in LFSI growth, which has more recently started picking up as interest rates have eased. As long as a soft landing remains in store for the economy, this may be the start of a cyclical upswing in LFSI growth, which would promise an improvement in the longer-term growth prospects for the financial services sector.

Chart 12: LFSI & CFSI (1992=100)



Shaded areas represent cyclical downturns in U.S. financial services activity.

Chart 13: LFSI & CFSI, Growth Rate (percent, annualized)



Shaded areas represent cyclical downturns in the growth rate of U.S. financial services.

LEADING & COINCIDENT MANUFACTURING INDEXES

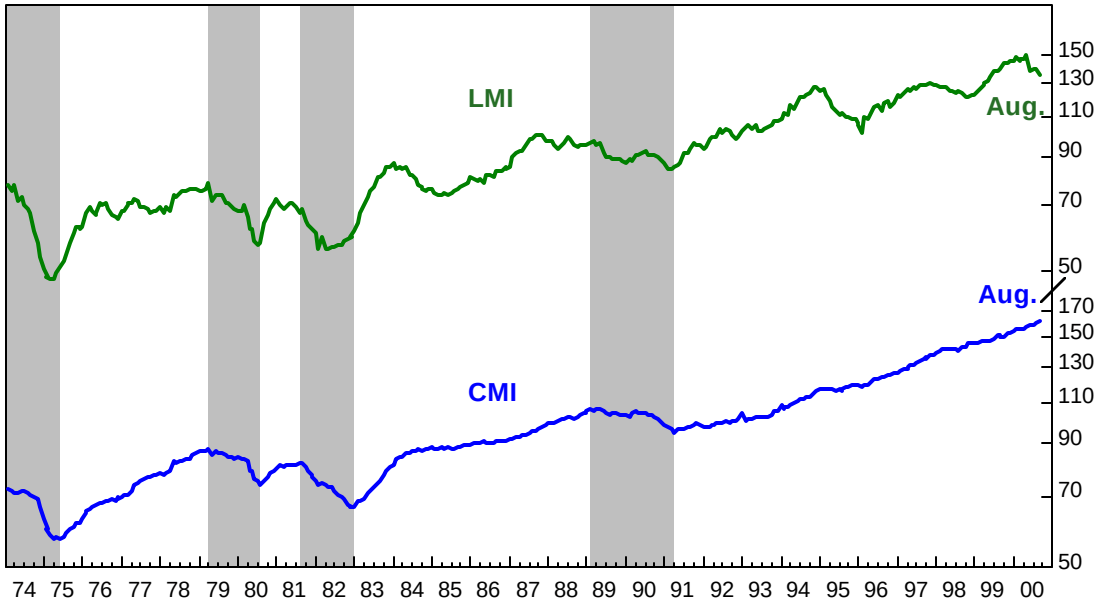
MANUFACTURING SLOWDOWN AHEAD

ECRI's Leading Manufacturing Index (LMI), designed to anticipate cyclical turns in manufacturing activity, dropped to 136.4 (1992=100) in August from 140.6 in July, while its smoothed annualized growth rate plunged to -9.8% from -4.5%. The index was pulled down by unfavorable movements in stock prices for industrials as well as the average workweek and overtime hours in manufacturing, along with declines in the percentages of purchasing managers reporting higher inventories, higher buying prices, slower deliveries and increases in new orders. The only positive was a rise in the growth rate of industrial materials prices.

Meanwhile, ECRI's Coincident Manufacturing Index (CMI), designed to track turning points in manufacturing activity, edged up to 161.7 (1992=100) in August from 161.4 in July, while its smoothed annualized growth rate fell to 7.1% from 7.9%. The index was pushed up by an increase in industrial production and a drop in the jobless rate in manufacturing, offset by a decline in manufacturing sector employment.

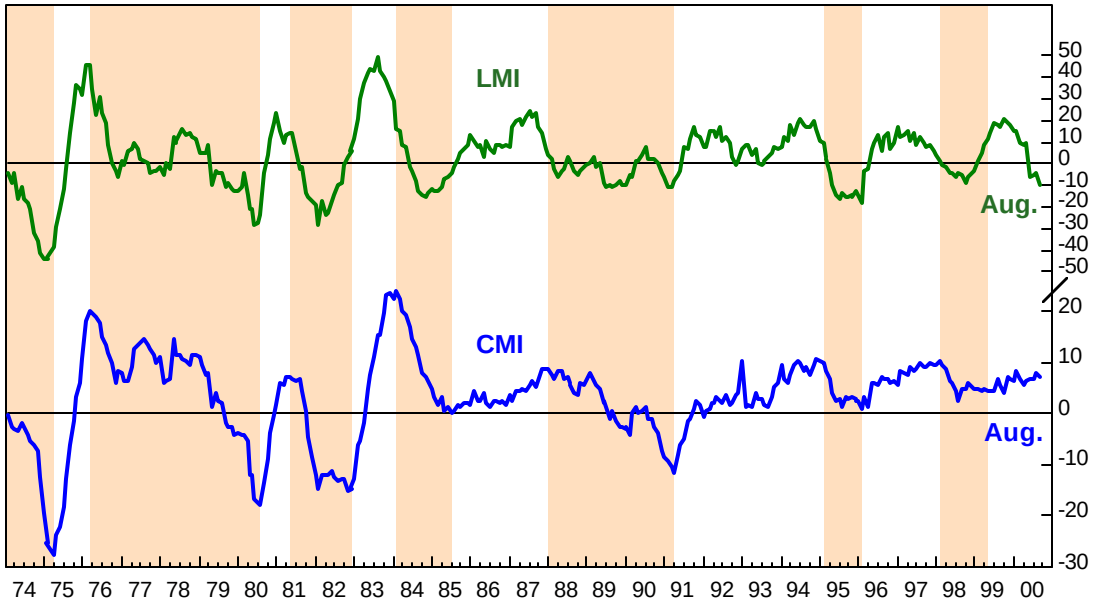
The LMI growth rate has remained in negative territory for the fourth straight month and it is now at a 55-month low. Almost all components of the LMI have weakened compared with six months earlier, and this suggests that growth in the manufacturing sector will slow further in the months ahead.

Chart 14: LMI & CMI (1992=100)



Shaded areas represent cyclical downturns in U.S. manufacturing activity.

Chart 15: LMI & CMI, Growth Rate (percent, annualized)



Shaded areas represent cyclical downturns in the growth rate of U.S. manufacturing activity.

LEADING & COINCIDENT CONSTRUCTION INDEXES

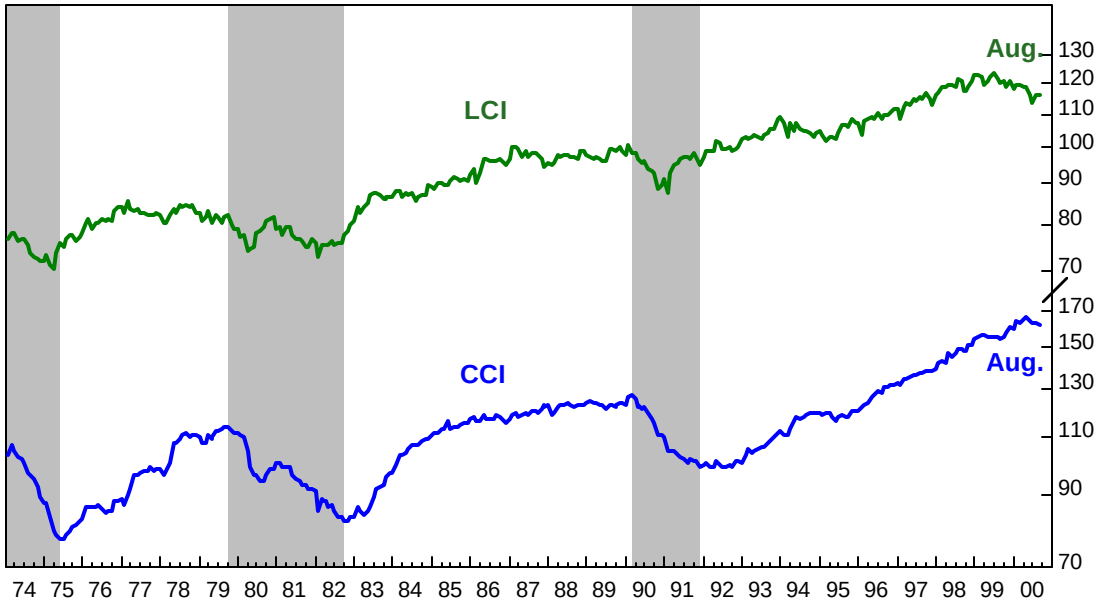
GROWTH TO SLOW FURTHER IN CONSTRUCTION SECTOR

ECRI's Leading Construction Index (LCI), designed to anticipate cyclical turning points in the construction activity, edged down to 116.3 (1992=100) in August from 116.4 in July, while its smoothed annualized growth rate rose to -3.4% from -3.9%. The index was pulled down by declines in new building permits, consumer expectations, the average construction workweek and the growth rate of selected construction materials prices, almost fully offset by favorable movements in stock prices for building materials companies, money supply plus mutual funds, corporate bond yields and homebuilders' survey readings.

Meanwhile, ECRI's Coincident Construction Index (CCI), designed to track turning points in the construction sector, fell to 162.6 (1992=100) in August from 163.4 in July, while its smoothed annualized growth rate dropped to 1.2% from 2.9%. The index was pulled down by unfavorable movements in aggregate weekly earnings and the jobless rate in the construction sector. Employment in construction was unchanged.

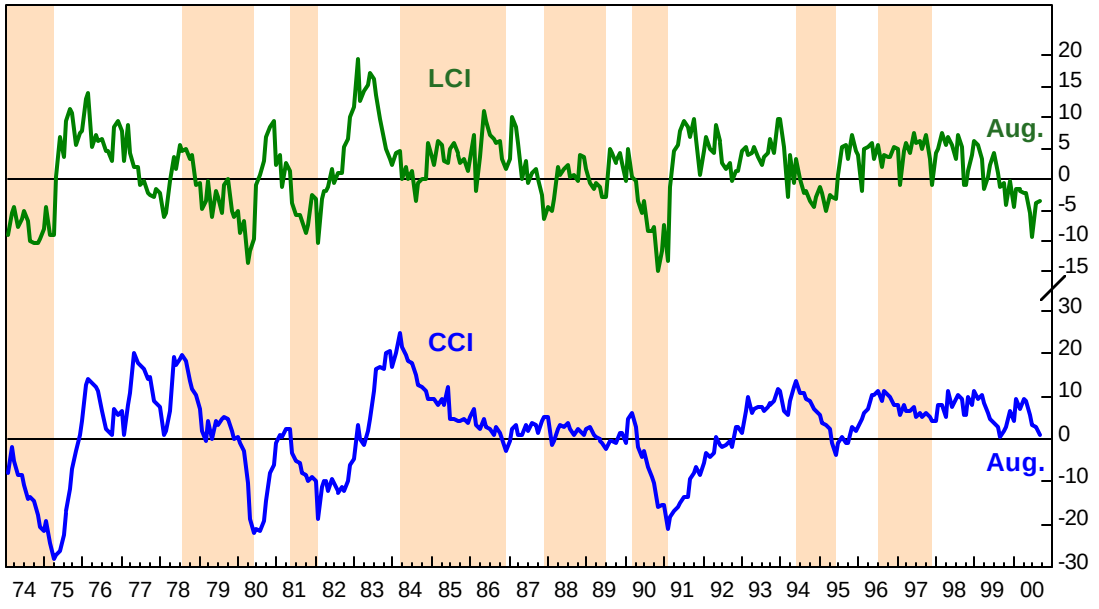
Despite this month's uptick in the LCI growth rate, it still remains in negative territory and is clearly in a downtrend, suggesting that growth in the construction sector which is almost at a five-year low, will slow further in the coming months.

Chart 16: LCI & CCI (1992=100)



Shaded areas represent cyclical downturns in U.S. construction activity.

Chart 17: LCI & CCI, Growth Rate (percent, annualized)



Shaded areas represent cyclical downturns in the growth rate of U.S. construction activity.

THE THREE P'S AS APPLIED TO CONSTRUCTION INDEXES

A FRAMEWORK FOR THE ANALYSIS OF CYCLICAL INDICATORS

The coincident indicators of construction activity included in the Coincident Construction Index (CCI), move in step with construction cycles, while the leading construction indicators included in the Leading Construction Index (LCI), anticipate these cycles, exhibiting cyclical upturns and downturns before the coincident indicators do. If the rises in leading indicators are pronounced, pervasive and persistent (the three P's), compared with the historical record of cyclical upturns, a cyclical upturn in construction may be expected to follow. The movements of the components of the CCI and LCI may therefore be looked at within such a framework in order to gain insight into the outlook for the construction sector.

There has already been a clear slowing in construction sector growth, and the near-term outlook suggests a continuation of this pattern.

Current Conditions in Construction Sector

The current downturns in the growth rates of the CCI and its components are a little more pronounced, pervasive and persistent than in past construction growth rate cycle downturns, while construction sector growth has clearly eased roughly in line with past downturns in construction growth.

We arrive at this conclusion about the patterns of behavior of the CCI in the current cycle by checking the three P's to determine whether the downturns in the growth rates of the five coincident indicators making up the CCI are pronounced, pervasive, and persistent compared with their behavior in comparable past construction growth rate cycle downturns.

In order to perform such an analysis, we must first assume the likely date of the peak marking the start of the current construction growth rate cycle downturn. The CCI growth rate hit a high in March 2000, which is therefore presumed to be the construction growth rate cycle peak for the purpose of the current analysis.

Chart 18 shows that the decline in CCI growth during the current cycle is a little more pronounced than its average during past comparable cycles.

Chart 19 shows that, in the current downturn, the proportion of CCI components more favorable than its average over the preceding six months is a bit lower than it was on average in past comparable cycles. Thus, the decline is a little more pervasive than usual.

Chart 20 shows the average number of consecutive months for which the components have been stronger than their average over the preceding six months. In the current downturn, that proportion shows a slightly more persistent decline than in past comparable cycles.

Table 3:
How Pronounced, Pervasive & Persistent are the Declines?

	Comparison to Past Averages		
	How Pronounced?	How Pervasive?	How Persistent?
CCI	A Little More	A Little More	A Little More
LCI	About the Same	About the Same	About the Same

Chart 18: How Pronounced a Decrease in the Coincident Construction Index?

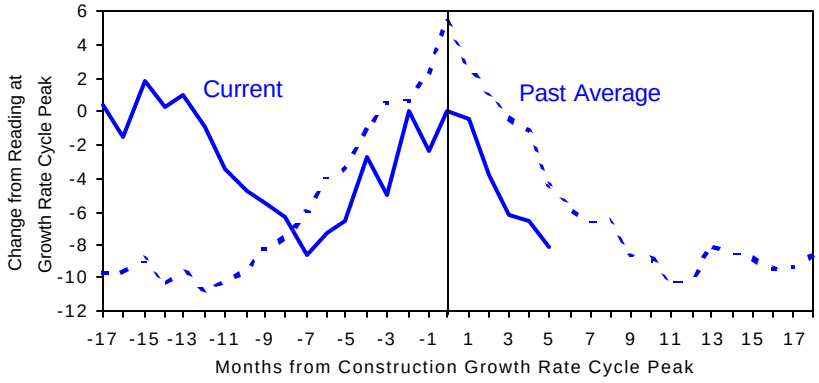


Chart 19: How Pervasive a Decrease in the Coincident Construction Index?

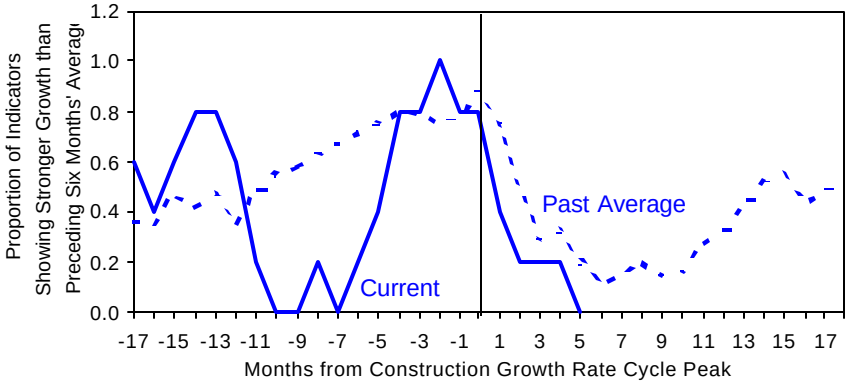
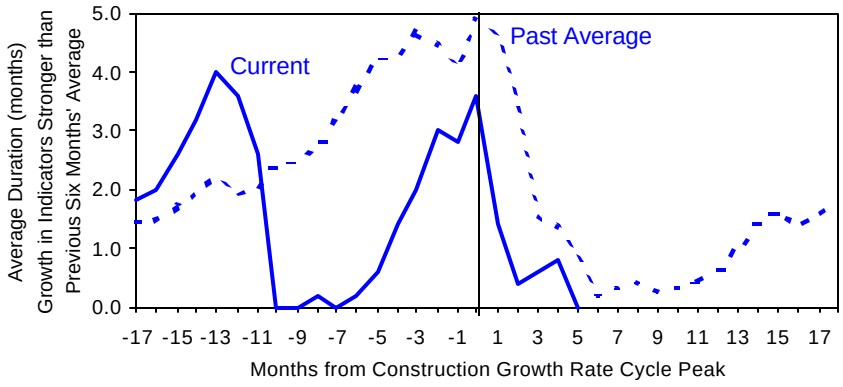


Chart 20: How Persistent a Decrease in the Coincident Construction Index?



THE THREE P'S AS APPLIED TO CONSTRUCTION INDEXES

Construction Sector Outlook

The current downturns in the growth rates of the LCI and its components are about as pronounced, persistent, and pervasive as the normal pattern at this stage of past construction growth rate cycle downturns.

To arrive at this conclusion, we performed a three P's analysis for the LCI and its components.

Chart 21 shows that the downturn in LCI growth is now just about as pronounced in the current period as it was in the vicinity of past construction growth rate downturns.

Chart 22 shows that in the current cycle, the proportion of leading construction indicators showing more favorable readings than their averages over the preceding six months has conformed roughly to the average past pattern, though the latest figures show some improvement. Thus, the decline in the leading indicator growth rates has been about as pervasive as in past downturns.

Chart 23 shows the average length of time during which the indicators have been stronger than their averages over the preceding six months. While there is a hint of improvement in the very latest data, the declines in the current cycle have been about as persistent as in past construction growth rate cycle downturns.

Chart 21: How Pronounced a Decrease in the Leading Construction Index?

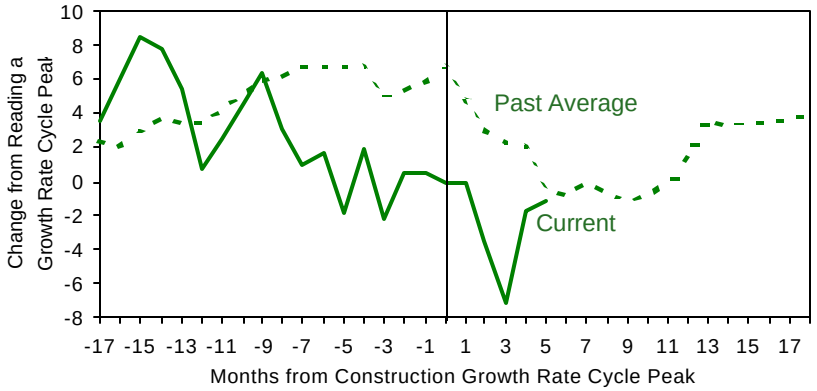


Chart 22: How Pervasive a Decrease in the Leading Construction Index?

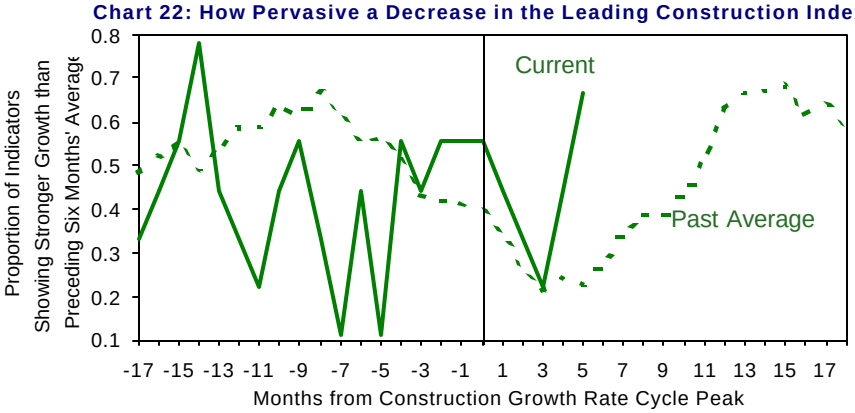
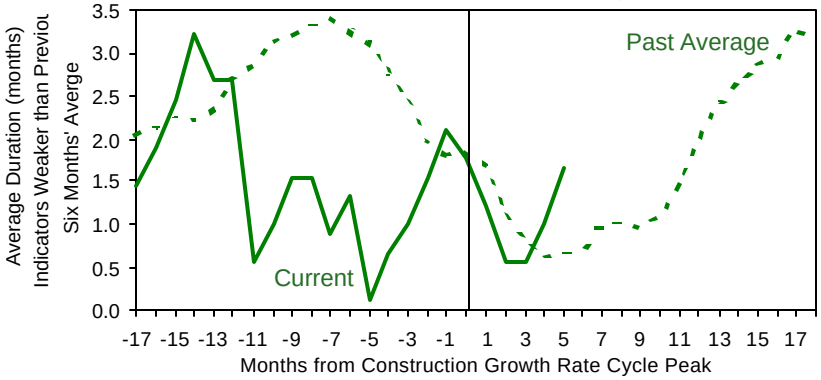
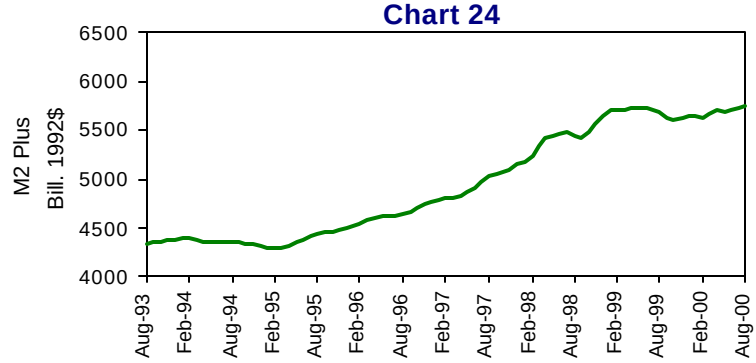


Chart 23: How Persistent a Decrease in the Leading Construction Index?



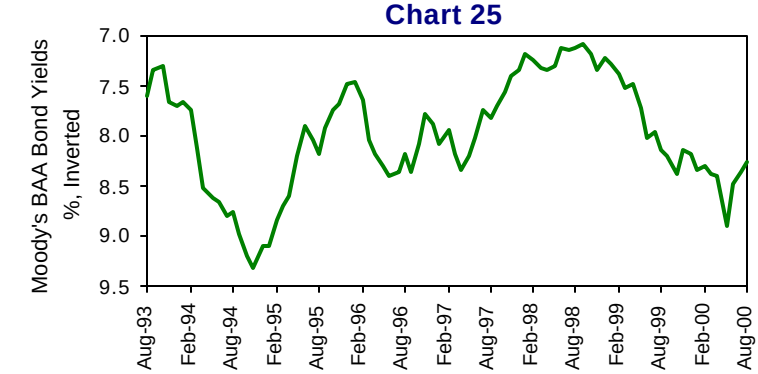
COMPONENTS OF THE LEADING CONSTRUCTION INDEX

Chart 24



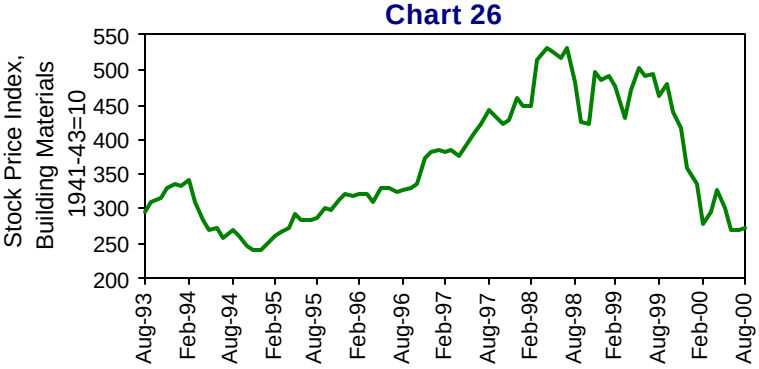
- **Money supply has flattened out since early last year.**

Chart 25



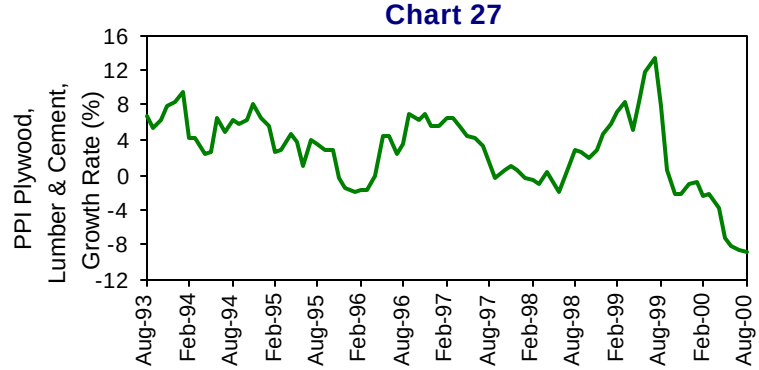
- **Bond yields had risen sharply since the summer of 1998, and it is only very recently that they have begun to drop.**

Chart 26



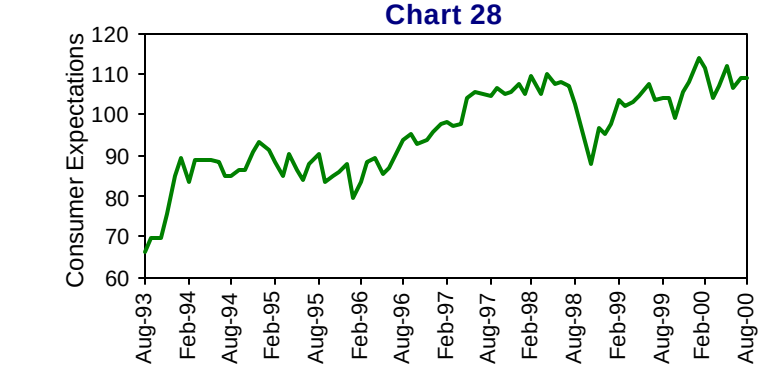
- **Stock prices for building materials are now around their lowest levels in over five years.**

Chart 27



- **Producer price inflation for selected building materials has plunged since the summer of 1999.**

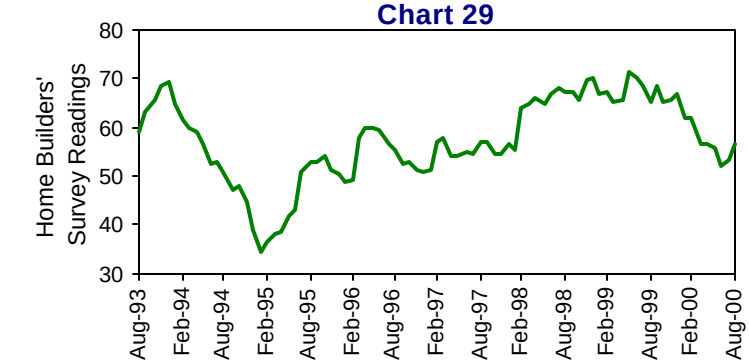
Chart 28



- **Consumer expectations remain elevated, but are now below earlier highs.**

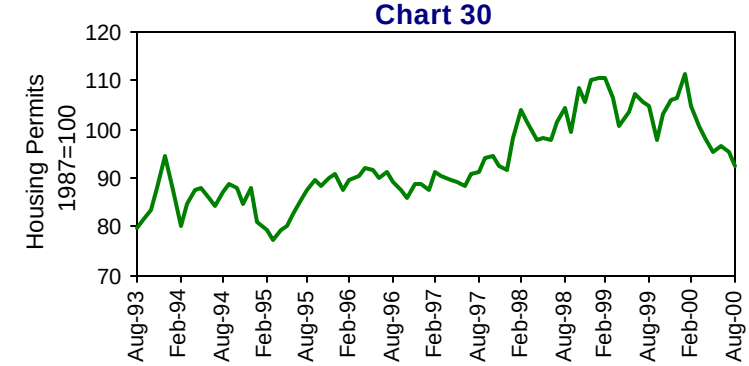
COMPONENTS OF THE LEADING CONSTRUCTION INDEX

Chart 29



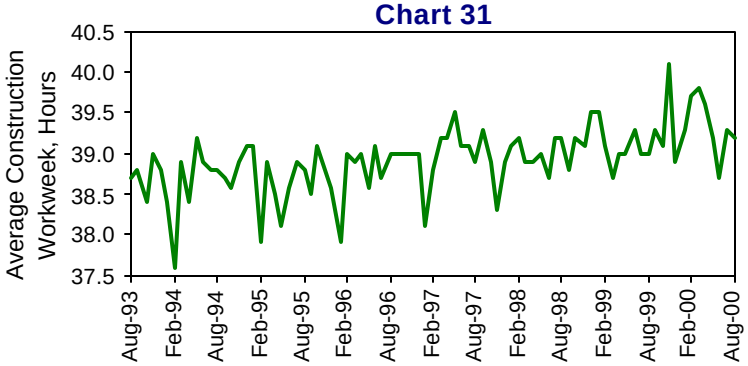
- **Home Builders' survey readings had fallen steadily from early 1999 to mid-2000, but have ticked up since then.**

Chart 30



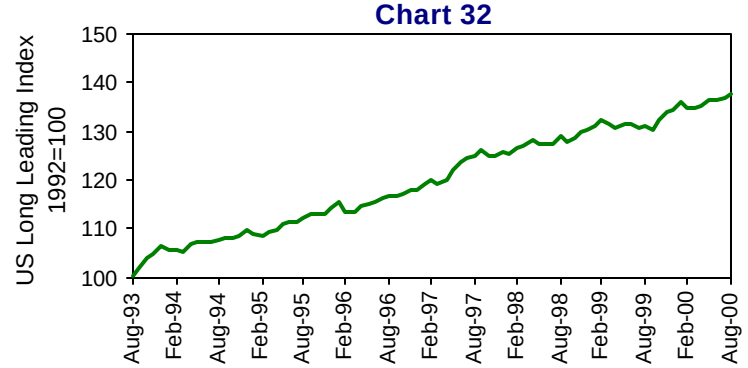
- **The number of new building permits has declined steadily this year.**

Chart 31



- **The average construction workweek has trended down this year.**

Chart 32



- **The U.S. Long Leading Index remains in an uptrend, which is not as steep as it was last year.**

GLOBAL SLOWDOWN BUT U.S. SOFT LANDING LIKELY

...Continued from Page 1

It is well known that the growth rates of industrial commodity prices are short leading indicators of global economic growth. Since oil is also an industrial commodity whose prices are influenced by global supply and demand, it stands to reason that the growth rate of oil prices would tend to lead cycles in global growth. However, the 16LLI is a long leading indicator of global growth, and should therefore have some lead over the growth rate of oil prices.

As Chart 33 shows, during the past decade, during which oil price shocks driven by politically driven supply disruptions were largely absent, peaks and troughs in the 16LLI growth rate consistently led or coincided with peaks and troughs in the growth rate of oil prices. In fact, the 16LLI had a median lead of about three months over the oil price growth rate.

16LLI growth bottomed out in mid-1998, and oil price growth followed suit by the end of the year, followed by a strong upsurge in 1999. But 16LLI growth peaked in early 1999 and was followed by a peak in the oil price growth rate in the fall of 1999. Since that time, 16LLI growth has been in a gentle downtrend, and despite the latest spurt in oil prices, its growth rate remains in a cyclical downturn. Given the historical pattern, this downtrend is unlikely to reverse until 16LLI growth reaches a cyclical trough.

That does not appear to have occurred, and in fact, its downtrend is consistent with the imminent global industrial slowdown that we have forecast for the last few months. Under the circumstances, a cyclical upturn in oil price growth is improbable. Of course, even a lower but relatively high growth rate of oil prices can be problematic, but at least the worst case scenario is not likely.

Also, the rise in oil prices is itself likely to hurt global growth going forward, in turn depressing demand for oil. We do not know where oil prices will go from here, but the global industrial slowdown that is likely to result from the lagged effect of over a hundred interest rate hikes by the world's central banks since 1999 should, at the margin, keep oil prices in check.

The Impact Overseas

As we have explained, higher oil prices are likely to slow U.S. growth. However, many U.S. firms have significant international operations.

In Europe, higher energy taxes take a much larger bite out of the consumer budget than in the U.S., potentially cutting out a larger slice of discretionary spending. In some European countries, the rise in headline inflation is also likely to work its way into later increases in nominal incomes through cost of living adjustments and wage increases, which may be more inflationary, thus complicating policy options.

Such worsening of European growth prospects would not favor the Euro, and any further depreciation in the Euro will exacerbate the problem of imported inflationary pressures, including oil price inflation. Such problems for Europe would challenge the earnings of U.S. firms with significant European operations.

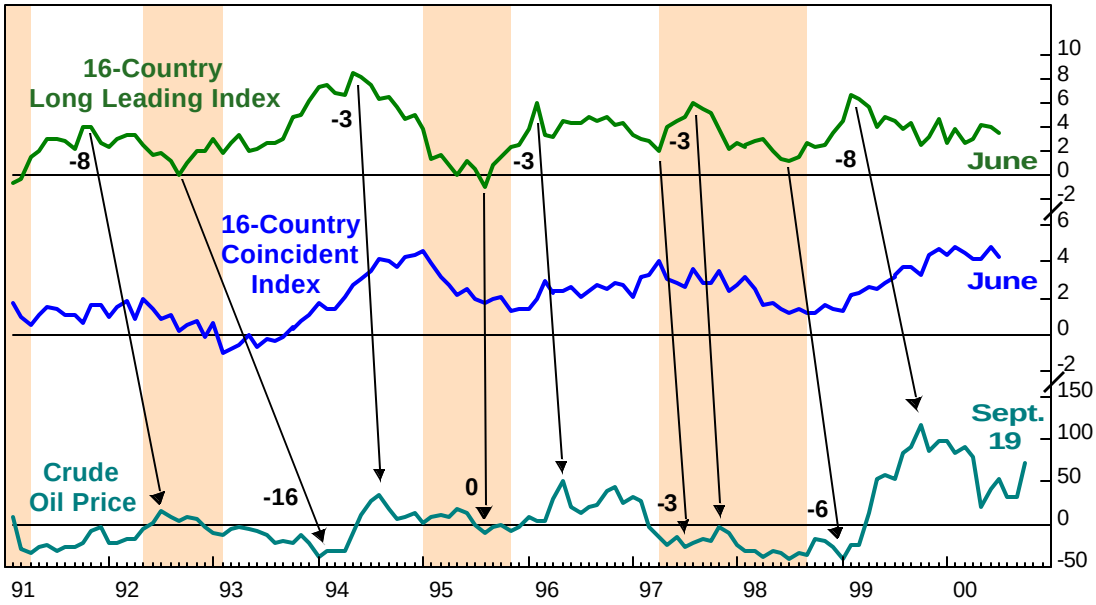
The impact of the oil price rise on most Asian economies is also quite negative, not only because many are oil importers but because slowdowns in Europe and America hurt export demand for Asian economies which have recovered from the Asian crisis on the strength of exports. To the extent that these exports are consumer products involving discretionary spending in developed economies, or inputs to the manufacture of such products, Asian economies are vulnerable to the oil price rise. Again, this could hurt the earnings of U.S. firms with significant Asian operations.

Clearly, the impact of rising oil prices may be at least as negative for Europe and Asia as it is for the United States.

The Silver Lining

U.S. inflationary pressures are already headed down, and a global slowdown worsened by further oil price hikes is likely to further reduce inflationary pressures. Therefore, if a hard landing begins to look more likely for the U.S. economy, there is already more room for short term interest rates to decline. Given the leeway for policy action, a soft landing remains probable.

Chart 33: 16-Country Long Leading and Coincident Indexes & Crude Oil Price, Growth Rates (%)



Shaded areas represent cyclical downturns in the growth rate of the 16-Country Coincident Index.

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