

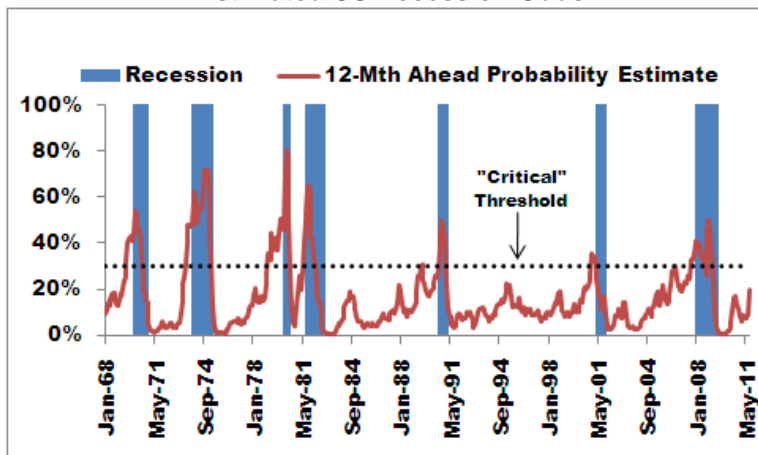
In Brief

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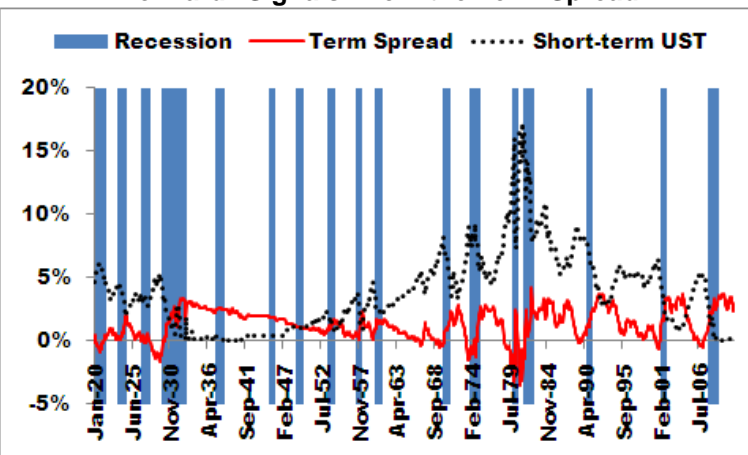
US: Recession Fear & Signal

- In the current environment, in light of the intense financial market volatility globally, the prospect of another US business cycle recession has received much publicity. While we recognize that the probability of another recession has risen recently, it is not yet definitive at this time. Our High-Frequency Activity Tracker suggests that 3q11 real GDP growth still seems to be tracking around 2% currently, perhaps with downside risks of about 0.5%-point.
- Our analysis--using a proprietary composite index of leading indicators (consisting of seven indicators covering labor, housing, manufacturing, consumer and financial) together with a probit regression framework--suggests that the odds of a recession over the next 12 months are estimated to be in the vicinity of 20% at this juncture (still based on preliminary data). Importantly, the recession-alert or critical threshold of the foregoing model is 30% (i.e., if the current probability exceeds 30%, the risk of another recession over the next 12 months rises significantly). (See chart 1.)
- The National Bureau of Economic Research (NBER), the official arbiter of US business cycles, defines recessions as widespread, notable and recurrent contractions in "aggregate economic activity". Although the official definition of "economic activity" is far from rigid, the NBER Business Cycle Dating Committee uses several indicators--namely real GDP, real GDI, employment, real sales, real income, employment and industrial production--to determine the chronology of US business cycle episodes.
- Therefore, one should avoid the use of a single indicator to attempt to accurately capture the essence of recessions. For example, the term spread or the yield curve (i.e., the difference between the interest rate on long-term and short-term Treasury securities), which has been identified as an "above average" leading indicator by the Conference Board and others, tends to be a poor indicator when short-term interest rates are at the zero-bound (circa 1937-1940s) or/and when there are distortions to the conduct of monetary policy (circa 1940s-1950). (See chart 2.) Indeed, it is more appropriate to rely on the so-called "system" of economic indicators (grouped into leading, coincident and lagging categories), initially developed in the 1930s, to determine turning points in economic activity. A useful approach to summarize and communicate the signals from a bunch of indicators is via a composite index of indicators. Since no single indicator can reliably identify all turning points, a composite index approach effectively lowers the risk of erroneous signals.
- Still, it is important to be reminded that the task of forecasting turning points in the economy is undeniably daunting. As the late Victor Zarnowitz, an eminent business cycle scholar, once opined, the "main defects of macro-forecasts from the point of view of policy are the errors of missing cyclical turns and shifts in the average rates of inflation".

Estimated US Recession Odds



Forward "Signals" from the Term Spread?



Source: NBER, FRED, Fed, US Treasury and Author's estimation

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