# Leading Indicators' Bleeding Edge

Every economist learns sooner or later forecasting is difficult, especially when the future is involved. This is why econometricians spend the better part of their lives, with varying degrees of success, trying to backcast the past with increased accuracy. The smart ones in the bunch figure out the Iron Law of Forecasting: Give 'em a number or give 'em a date, but don't ever give 'em both.

But we must forecast, and as the alchemists of yore figured out, if there is a demand for forecasts – and there always will be – someone has to be involved in the supply thereof. In addition to the aforementioned econometric models, some of which could forecast snow in January if given sufficient time, there are simple sets of leading economic indicators produced by organizations such as the Conference Board and the Economic Cycle Research Institute (ECRI). Both organizations produce monthly indices of leading indicators in addition to coincident and lagging indicators; ECRI also publishes a weekly index of leading indicators.

The two indices have matched each other for more than four decades until the expiration of the first-time homebuyers' tax credit at the end of March 2010. The two indices then diverged because of their different inclusions of housing-related factors.

Leading Economic Indicators Long March
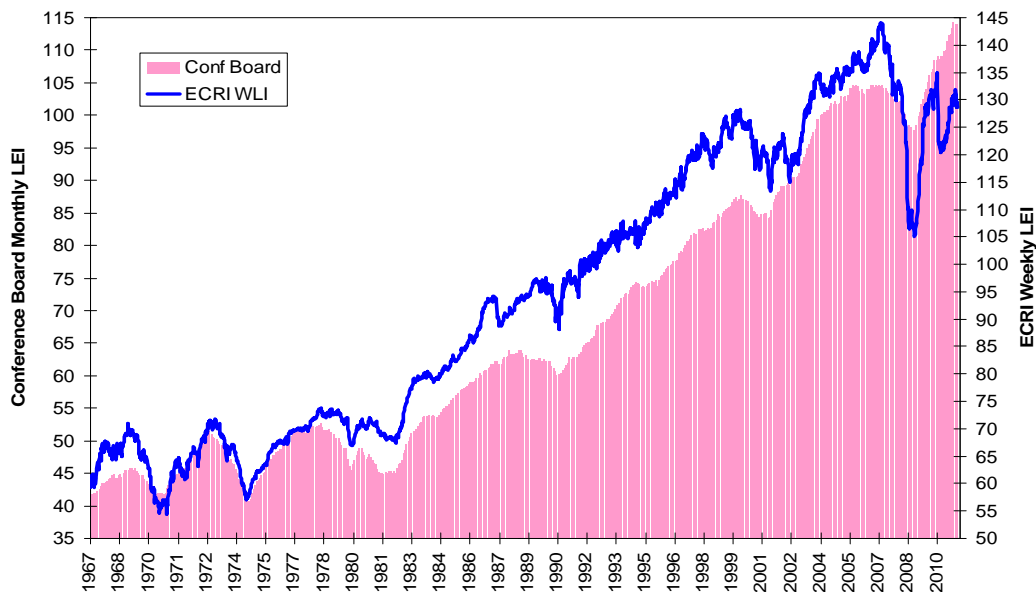
ECRI index components not included materially in the Conference Board index are:

1. Mortgage applications, purchase index;
2. Moody's seasoned Baa corporate bonds;
3. Baa - ten-year UST yield spread; and
4. JOC-ECRI industrial price index

Other components of the ECRI index include the growth rate in M2 plus long-term household mutual funds, initial unemployment claims and the New York Stock Exchange's Composite index.

Conference Board components not included materially in the ECRI index are:
1. Average weekly work hours;
2. New manufacturing orders;
3. Vendor performance;
4. Building permits;
5. The yield curve spread; and
6. Consumer expectations

Other components of the Conference Board index include the S&P 500 index, the yield curve spread from federal funds to ten-year Treasuries, average weekly initial jobless claims and M2.

When we consider four of the seven ECRI components and six of the ten Conference Board components are not represented in the other index, we have to marvel how well the two indices matched for four decades. As noted above, the source of the mid-2010 divergence is easy to find: The mortgage applications for new purchases collapsed from 291.3 on the week of April 30, 2010 to 163.3 on the week of July 9, 2010. Perhaps the federal government will discover at some point people respond quite rationally to tax credits, penalties and subsidies; if you subsidize something and then remove the subsidy, should you be surprised demand falls?

The Stock Market As Indicator
One of the demands of any profession is its practitioners need a way of keeping things sufficiently complicated so as to discourage the riff-raff. Licenses, guilds, funny hats and the occasional secret handshake will suffice. Consider the horror, then, of the chart below, which maps the logarithm of the ECRI Weekly LEI led one week against the logarithm of the S&P 500.

**Leading Indicators Linked Closely To Stock Prices**
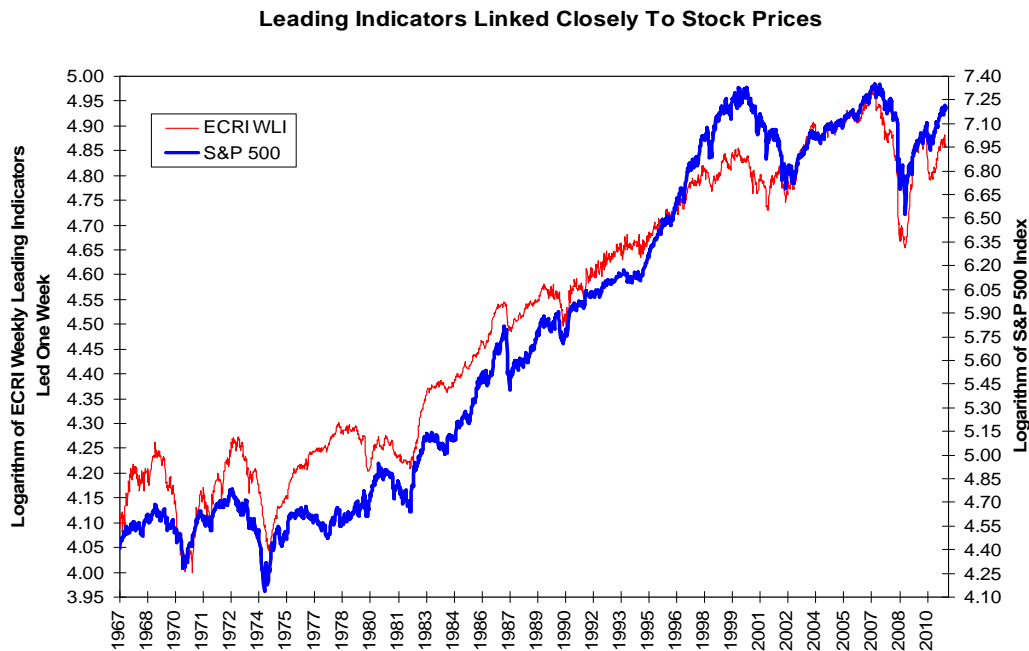
Here is the real horror, though: Anyone who has lived through the stock markets bumps and bruises in recent years has to come away wondering whether any of it is related to external fundamentals or are the driving forces financial crises, monetary subsidies and the vagaries of algorithmic trading. Restated, can anything capable of producing a Flash Crash and that in an earlier day, per Nobel Laureate Paul Samuelson, predicted nine of the past five recessions be trusted as an economic forecasting device? The mind does rebel.

Yield To No One
Now let's rub a little more salt in the wound. One of the textbook comments about the yield curve is a steeper yield curve is a sign of future economic expansion and an inverted yield curve is followed by a recession. The theory is lower short-term interest rates are stimulative as they lower borrowing costs, while higher short-term interest rates remove the carry from credit markets. It is a nice theory; most are, especially the ones you never bother to examine.

Let's map the ECRI Weekly LEI index led six months by the yield curve as measured by the forward rate ratio between one and ten years ($FRR_{1,10}$). This is the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself. The more this measure exceeds 1.00, the steeper the yield curve is.

Leading Indicators… About That Steep Yield Curve
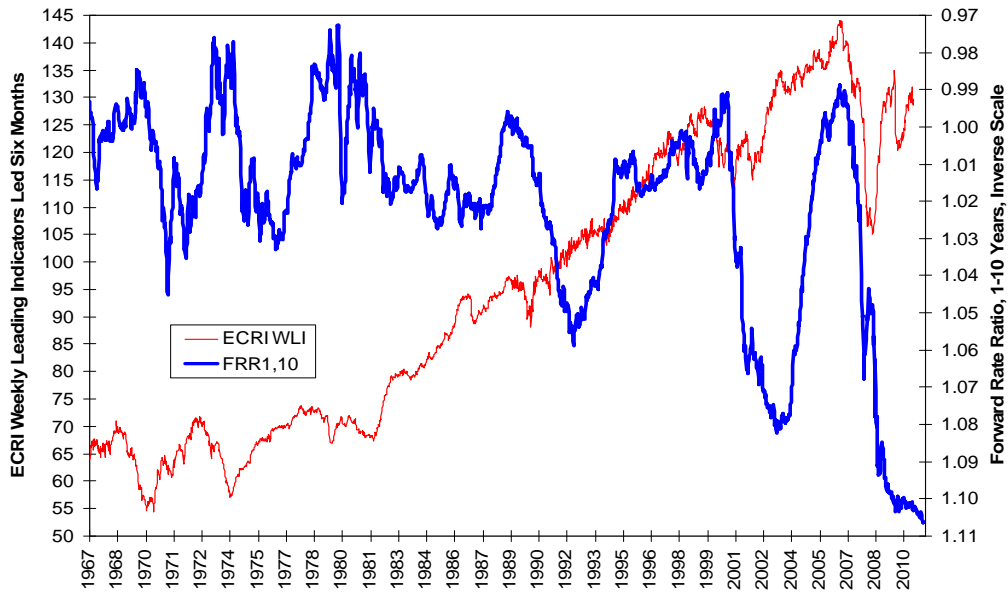
What do we see? The $FRR_{1,10}$ has been trending lower and expanding in volatility since the mid-1980s. As it is plotted inversely, we see its two periods of steepness between 2001 and 2003 and again between 2008 and 2010 were followed by periods of decline in the Weekly LEI, not gains.

Peter Lynch, the long-retired manager of the Fidelity Magellan Fund, used to comment that he spent only a few minutes a year worrying about the economy. He preferred to focus on corporate earnings. Whether this is still possibly in an era where trading algorithms do relative value trades across markets and execute orders based on elementized news feeds of market data is debatable, but he was absolutely correct on one count: These are not GDP futures. Trading a market actively with its short-term movements based on long-term forecasts is unlikely to be correct, except by accident, which does not make a lot of sense.

The best course of action is to react in the short-term to the price movements caused by these leading indicators as they arrive on the scene and then forget about where the economy is going, unless, of course, you have a social gathering to attend. You can banter about fundamentals and sound smart in a way you simply cannot with technical indicators.