

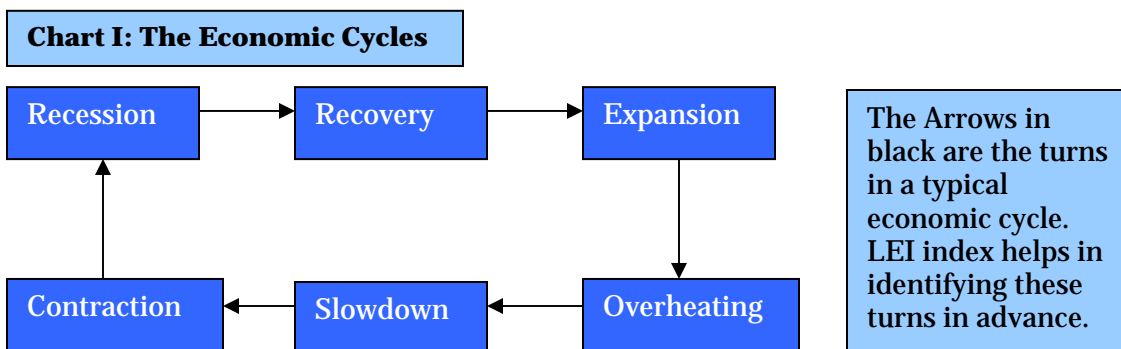
Title: US LEI: Is it really the Mirror to the Future?

Country: GLOBAL Date: 18th December 2009 No of Pages: 5

The US and many other developed countries in the world have an “Index of Leading Economic Indicators” (LEI). What this index does is : it track’s a few economic indicators of the US economy in a prespecified proportion, which are expected to predict or forecast with reasonable accuracy and lag, the state of the US economy in future. These leading indicators change ahead of time, by 6-12 months, prior to the changes in the underlying real economy. That’s precisely why they are known as “Leading or Forward Looking Indicators”, since they lead the economy. *The LEI Index is the “Mirror to the Economic Future of US”*

For instance Consumer expectations is a leading indicator since, if the expectations are positive & rising now, consumers are likely to spend more in coming months and so the US economy probably will do well in coming months.

The LEI helps the policy makers and central bankers to gauge the performance of the economy in coming months, especially the “Turn in the Economic cycles “:



Source: Delta Global Partners Research

Central Bankers and Governments tune there policies in response to the anticipated changes derived from the LEI Index. The LEI index is also closely followed by fund & investment manager’s world over due to the strong influence of economic growth over corporate profitability and so on valuations of asset classes such as stocks ,bonds etc

There are two other types of indicators viz Lagging & Coincident. Lagging are the indicators which change after the underlying economy has undergone changes. For e.g Commercial Loans outstanding. Coincident indicators are the ones which change real time with underlying economy, such as personal income.



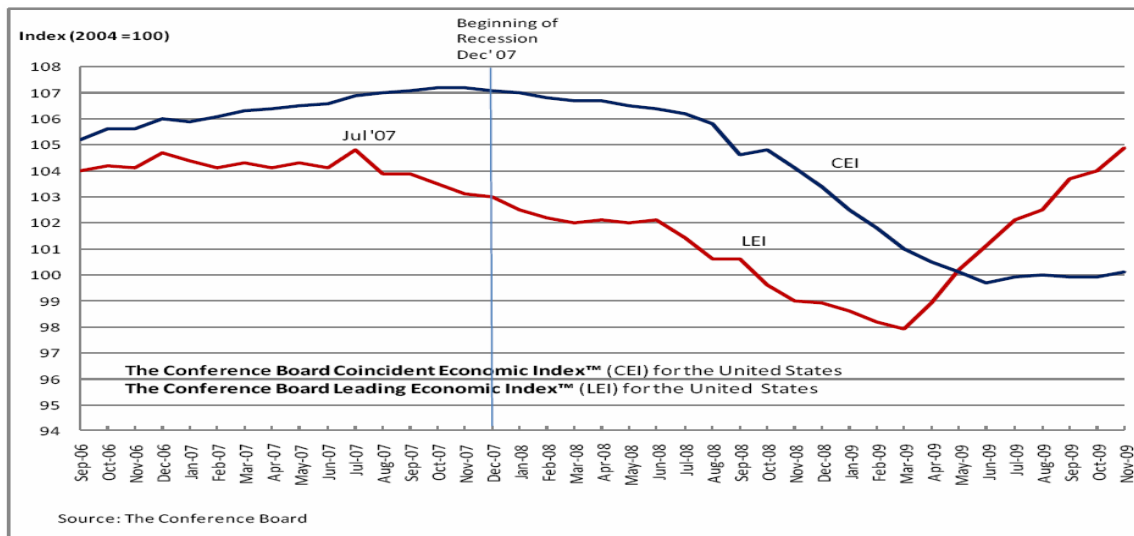
Source: Delta Global Partners Research

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The following chart III takes a recent instance of a recession- recovery cycle and how the LEI index had turned before the underlying economy did.

Chart III: US Leading Economic Indicators



Source: The Conference Board

In US, The Conference Board is responsible for collating the data on the LEI index constituents and releasing it every month. The index seems to be a fair advance indicator of the turns in the US economic cycle though not 100% precise.

The following chart IV compares the predictive power of LEI index on the GDP growth rate from 1959 onwards. It can be noted that just before the recession (grey shaded years) has ended in US, the LEI index has started looking up. And conversely, the LEI index has turned lower before the economy had gone into recession. The composition of the LEI as follows (Table I):

Table I: Composition of US LEI Index

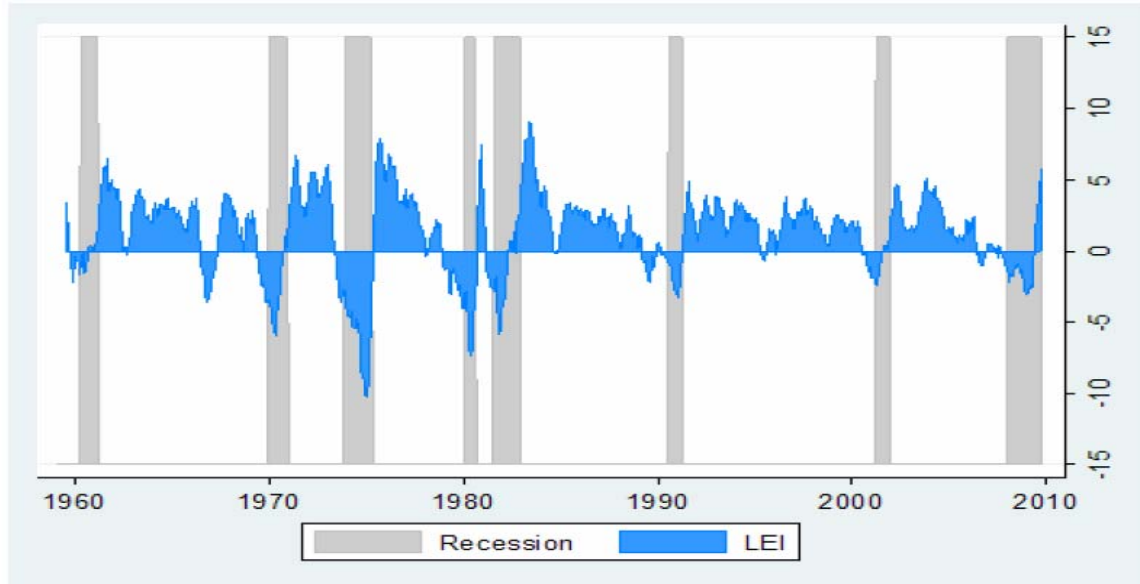
Leading Economic Indicator	Weights in Index of LEI	Sector
Money Supply M2	36%	Financial
Average weekly Hours, Manufacturing	25%	Manufacturing
Interest Rate Spread 10 year less Federal Funds	10%	Financial
Manufactures New Orders, Consumer Goods & Materials	8%	Manufacturing
Index of Suppliers Deliveries-Vendor Performance	7%	Services
Stock Prices 500 Common stocks	4%	Financial
Average Weekly Initial Claims for unemployment Insurance	3%	Services + Manufacturing
Index of Consumer expectations	3%	Consumers
Building Permits and New Housing Units	3%	Housing
Manufactures New Orders, on defense Capital Goods	2%	Manufacturing
	100%	

Source : The Conference Board

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Chart IV: US LEI Index – The Track Record with some false warnings



If one notices the composition of LEI closely, there does exist some disconnect with the underlying US economy, which might lead to “distorted” conclusions on the US economy.

Out of the 10 components, only 4 are manufacturing sector related carrying weight of 38% in the index. Whereas the industry sector contributes only around 20% to the US GDP. The broader service sector is drastically underrepresented in the index. The weights are less than 10% but services sector contributes almost 80% to the US GDP. On the expenditure side of the US GDP, the consumption drives almost 70% of the US GDP, but gets a weightage of only 3% in LEI index.

And more important the financial/monetary (or non real economic) factors have a very high weightage of 50%, with Money Supply being the highest at 36%, more than one third, followed by S & P 500 and Interest Rate spreads at 4% & 10% respectively.

Thus the 50% of the weightage of the LEI index is influenced by “Market Driven” factors. Some of these factors are susceptible to sentiments, speculation, intuitive biases, human psychology, herd mentality etc of the financial markets participants world over, especially the stock markets (S & P 500). Stocks prices tend to be irrational at times in short run, though in the long run they are hopefully expected to reflect the changes in underlying economy. Since March 09, the S&P 500 (4% weightage in US LEI index) has rallied by more than 60%.

Moreover the Money Supply and the Interest Rate spreads are more or less in control of the Federal Reserve or Government.

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The following Chart V (though a little outdated) gives us an insight on how the Money Supply growth has powered the recent rise in US LEI Index. Since the crisis has engulfed the US economy in 2008, the US Federal Reserve has been pumping money into the banking system to reflate their economy.

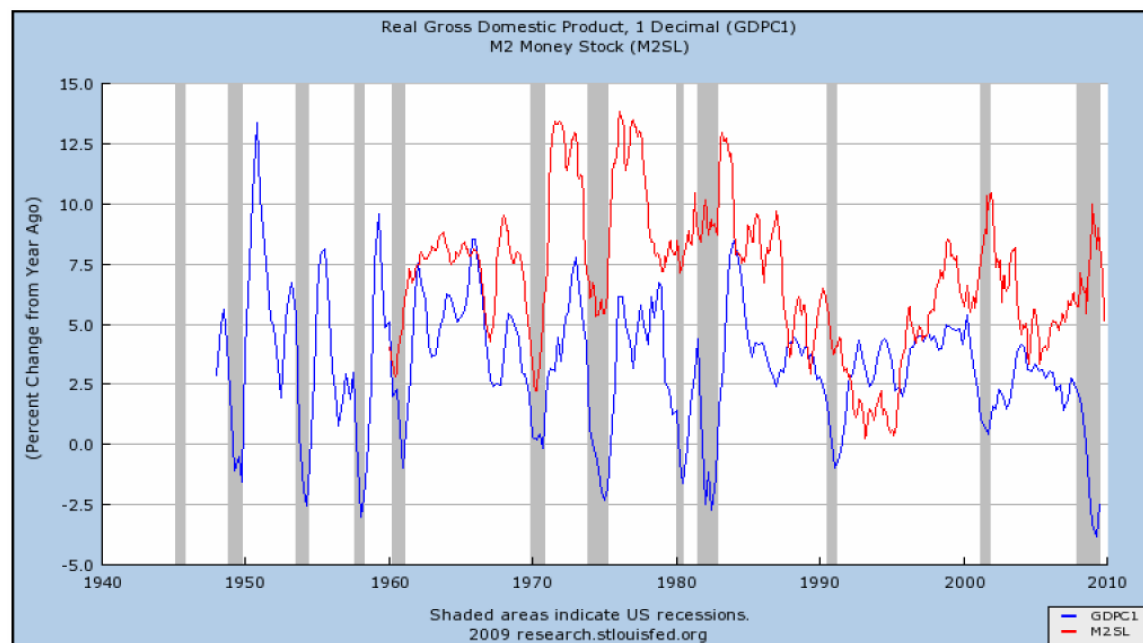
Chart V: The Monetary Muscle behind US LEI



Source : Financial sense online Oct 2009.

As can be observed in Chart VI, not every time the money supply has gone up, the GDP growth rate has followed with lag. Velocity of money and money multipliers can cause distortions in the relationship, especially during a credit driven crisis.

Chart VI: The US Money Supply & GDP Growth



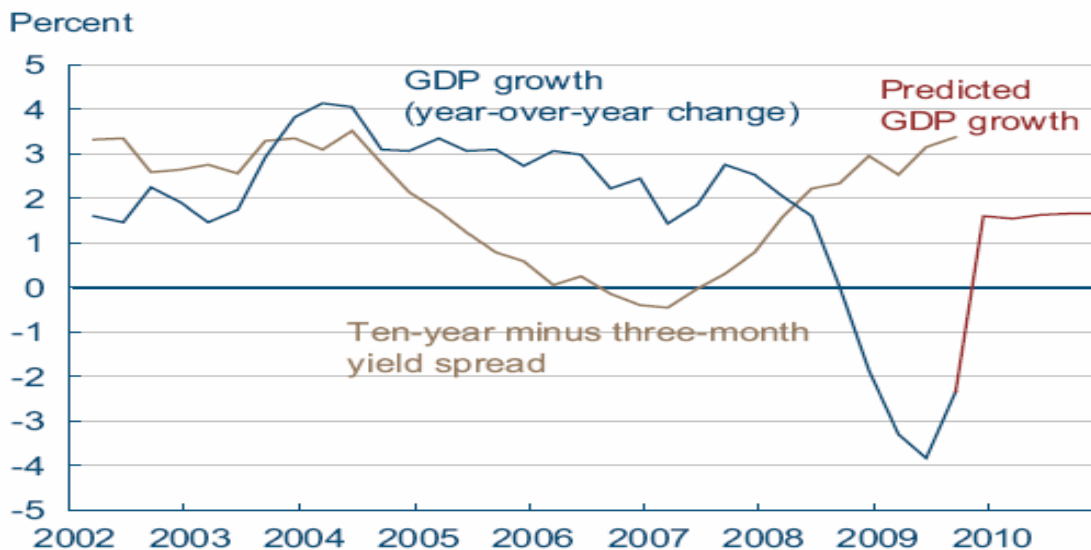
Source: Federal Reserve St Louis

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Similarly the other financial leading indicator, the Interest Rate spreads (the shape of UST Yield Curve). In recent times the global imbalances and the foreign exchange policies by global central banks have resulted into an abnormal demand for US treasuries, being a safe asset. This influences the spreads sometimes irrespective of the state of US economy. As the Federal Reserve of Cleveland puts it “While this approach predicts when growth is above or below average, it does not do so well in predicting the actual number, especially in case of recessions. Thus it’s sometimes preferable to focus on using yield curve to predict a discrete event: whether or not the economy is in recession”. The Chart VII compares the growth predicted by interest rate spreads and the actual growth.

Chart VII: Interest Rate Spreads and predicted GDP Growth Rate



Source : Federal Reserve of Cleveland

Though the extent of financialization of US economy is very high, one has to be careful in interpreting the US LEI which has weightage of 50% for its financial/monetary (non real economic) components. These components have the ability to sometimes send out confusing signals, at least in the short run, especially when the US economy is emerging out of recession. The Conference Board does use “volatility smoothing” technique to iron out the effects of the volatile components. It would be more appropriate to track the “Real Economic Leading Indicators” in the LEI index for more stable results along with other economic forward looking research.

Though the LEI index is the “Mirror to the Future”, it’s also important to hold that mirror in the right position to try and see the future without any distortions.

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