

Recovery Signposts

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A popular view these days is that the U.S. recession will end later this year. But the risk is it won't. This isn't your garden-variety downturn caused by tight monetary policy and cured by low interest rates. The current downturn stems from a financial crisis, and may end only after a protracted and painful period of deleveraging. This makes forecasting the next recovery even more difficult than usual. Forward-looking indicators could provide a better signal of the turning point than popular leading indicators like equity prices and yield curves. Here is what we are watching for early hints of a U.S. recovery.

1. House Sales: The credit crisis and housing bust are inextricably linked. At the least, home prices need to stabilize before the credit crisis can end. This requires the overhang of unsold homes to decline from a near-record 11-months supply to a more normal 6-7 months. But the supply glut will persist unless demand increases. After steadying through most of 2008, existing home sales have turned down again due to tight credit conditions and hefty job losses. Thankfully, housing affordability is the best in three decades, reflecting a sharp decline in prices and, more recently, in mortgage rates. A recent bounce in mortgage applications is encouraging but may reflect an increase in filings rather than acceptances (*Chart 1*). Meantime, the dearth of prospective buyers at homebuilder sites suggests sales could remain soft for some time.

2. Early Mortgage Delinquencies: Rising foreclosures have added to the glut of unsold homes. The mortgage delinquency rate hit an all-time high 7% in Q3, flagging more foreclosures ahead. However, the rate of early delinquencies (payments past due two months or less) has steadied at levels below previous cycle highs. Of note is a recent decline in late payments by subprime borrowers with adjustable-rate mortgages. Among this group, one-in-five have already lost their home, while others have refinanced into cheaper loans. The delinquency rate looks to increase along with unemployment; however, it should begin to fall before the jobless rate peaks (*Chart 2*). This would indicate that the stress in mortgage markets is abating.

CHART 1
STILL NO ONE HOME

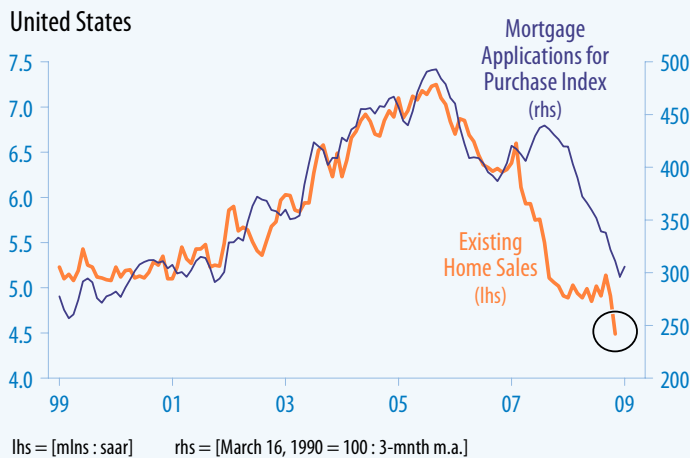


CHART 2
FALLING BEHIND

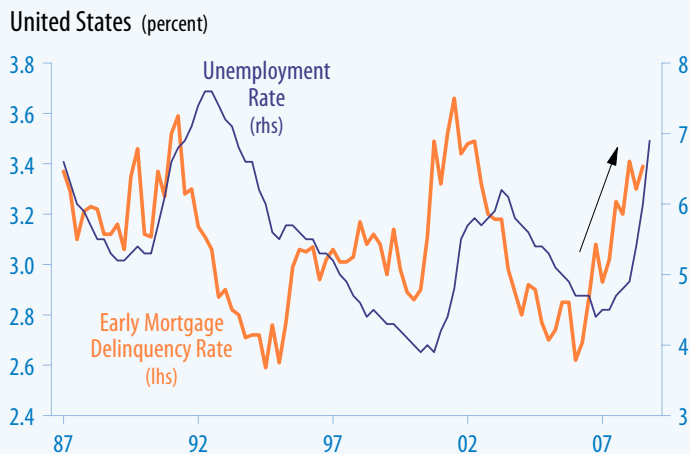


CHART 3
RISKY BUSINESS

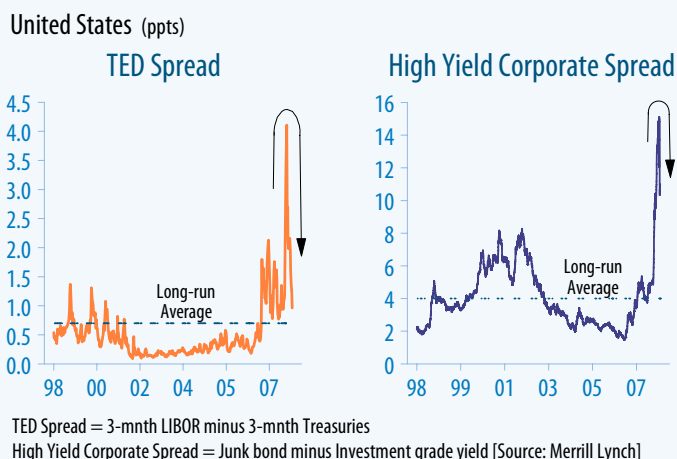


CHART 4
SAVE NOW, PAY LATER
United States (percent)

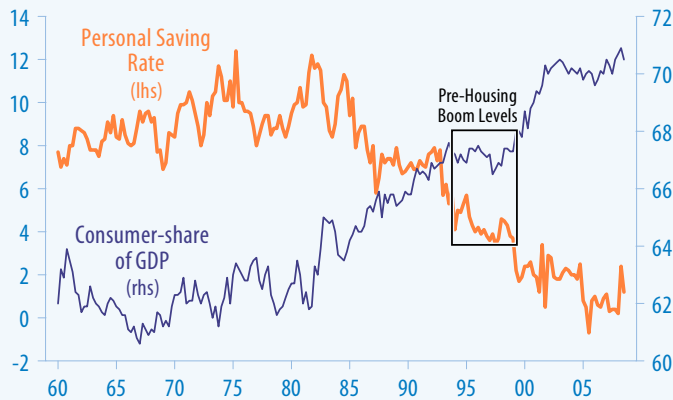
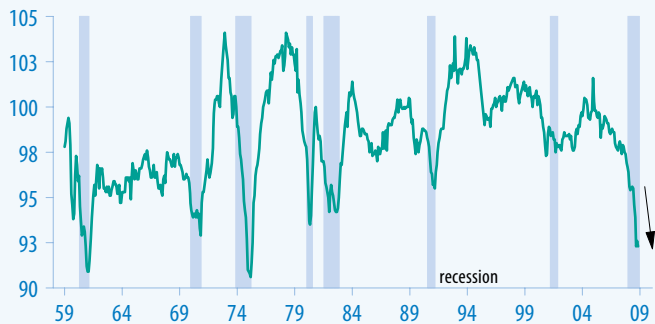
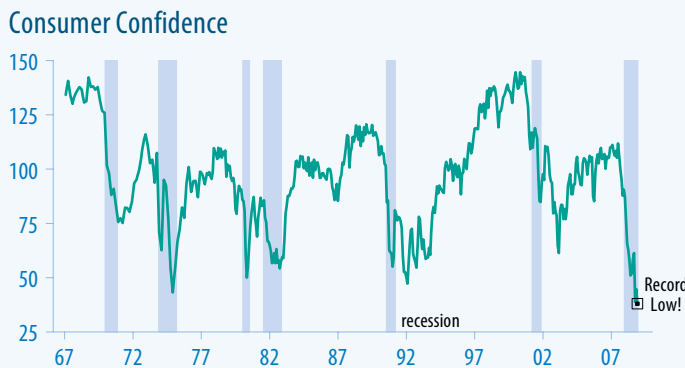


CHART 5
NO MOJO
United States (2004 = 100)
Coincident/Lagging Indicators Ratio



Source: Conference Board

CHART 6
CRISIS OF CONFIDENCE
United States (1985 = 100)
Consumer Confidence



Source: Conference Board

3. Credit Spreads: Tight credit has kept the consumer at home, undercut home sales and restrained business investment. Two good indicators of credit conditions include the rate spread between Libor and T-bills, and between junk- and investment-grade corporate bonds. The first peaked shortly after the collapse of Lehman Brothers and has trended down since. The second has fallen just recently and remains high. Further narrowing in credit spreads would signal a return of investor confidence. Although spreads are unlikely to revisit pre-crisis lows (when risk was underpriced), they should move towards long-run norms. A TED spread of 70 bps versus 102 bps currently, and a junk-bond spread of 5 ppts versus 11 ppts, would suggest the credit crisis is ending (*Chart 3*).

4. Savings Rate: After a decade of using homes as ATMs and equity gains as future retirement income, households are saving more and cutting debt (for the first time in 56 years). However, consumer deleveraging probably won't end until the savings rate returns to mid-1990s levels of 5% from 2% (*Chart 4*). This would reduce the consumer's share of the economy to pre-housing boom levels of 68% from a record-high 70%. Similarly, debt-service payments likely need to fall to 12% of income from 14% before purse strings are loosened. These benchmarks probably won't be hit until later this year.

5. Ratio of Coincident-to-lagging Indicators: This ratio has a great track record at flagging business-cycle turning points (*Chart 5*). It includes a number of indicators that the NBER uses to date recessions, and tracks the economy's momentum (or lack of). There is no hard and fast rule, but if the ratio is flat-to-higher for three consecutive months, then the recession is probably over. So far, no cigar.

6. Consumer Confidence: Confidence has bottomed in the final months of four of the past six recessions. While the consumer is unlikely to lead the next recovery, a less gloomy mood wouldn't hurt. Clearly, improved confidence is needed to revive sickly auto sales, giving the Big-Three a better chance of survival. Sentiment has hit rock bottom of late, with little to suggest a quick turnaround.

Bottom Line: The signal from our recovery signposts remains faint. It may start to beep louder as massive fiscal stimulus kicks in later this year.

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