LPL RESEARCH

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# FORECAST FOR CLEAR SKIES: LEI SHOWS LOW ODDS OF RECESSION

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## KEY TAKEAWAYS

The outcome of last week's FOMC meeting confirmed our long-held view that the Fed would keep rates "lower for longer."

A report that may have been overlooked by financial market participants last week is the LEI, which is designed to predict the future path of the economy.

The LEI suggests the risk of recession in the next 12 months is negligible (4%), but not zero.

**Without question, the key event for financial markets last week (March 16–20, 2015) was the Federal Reserve's (Fed) decision to remove the word "patient" from its policy statement, putting market participants on watch for a rate hike later this year.** But, as always, the devil is in the details. While the Fed's policymaking arm, the Federal Open Market Committee (FOMC), signaled last week that it is ready to raise rates when members are "reasonably confident" that inflation will move back toward its 2.0% target, FOMC members substantially lowered their forecast for the level of the fed funds rate over the next several years. In addition, the FOMC lowered its forecast for gross domestic product (GDP) growth and inflation over the next few years. On balance, the outcome of the meeting confirmed our long-held view that the Fed would keep rates "lower for longer." Fed Chair Janet Yellen's post-FOMC meeting press conference confirmed the "lower for longer" theme, reminding viewers around the world that although the FOMC removed "patient," it did not mean that the FOMC was going to raise rates at the next FOMC meeting in April. Yellen also stressed that a rate hike was not a sure thing and remained "data dependent," i.e., they would need to see the labor market continuing to improve, inflation stabilizing, and inflation expectations moving higher for the period ahead.

We will continue to watch what the Fed is monitoring (the labor market, inflation, and inflation expectations) and will provide updates on the progress of these key metrics as needed. We provided an in-depth look at what the Fed is watching on the inflation side in last week's (March 16, 2015) *Weekly Economic Commentary*, "FOMC Preview: When, How Often, and How Much." The minutes of last week's FOMC meeting will be released in mid-April and the next FOMC meeting is April 28–29, 2015.

## LOOKING AHEAD WITH THE LEI

A report that may have been overlooked by financial market participants last week was the Conference Board's monthly Leading Economic Index (LEI). Please see our *Weekly Economic Commentary* from May 19, 2014, "Snapback," and our *Outlook 2015: In Transit* for more details on the LEI. The LEI is one of our "Five Forecasters" (please also refer to our *Mid-Year Outlook 2014: The Investor's Almanac*), and provides a valuable guidepost as to where we are in the economic expansion each month. As noted in our *Outlook 2015*, when the economy has not been in recession, the S&P 500 has been positive 82% of the time and provided low-double-digit returns. When the economy has been in recession, the S&P 500 has been positive just 50% of the time, with average returns in the low single digits.

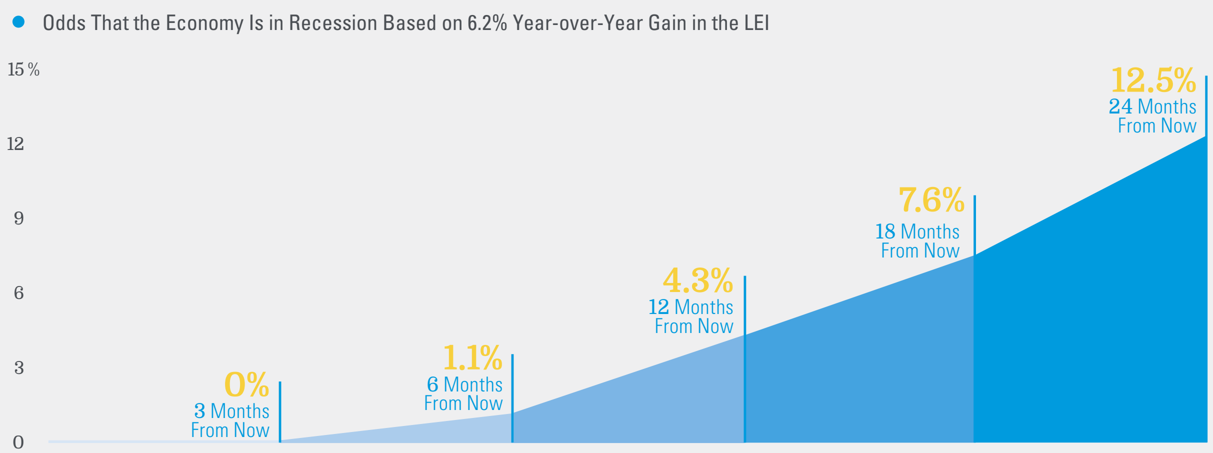
The latest reading on the LEI for February 2015 revealed that the LEI was up 6.2% from February 2014. The LEI is designed to predict the probable future path of the economy, with a lead time of between 6 and 12 months. Since 1960—662 months or 55 years and 2 months—the year-over-year increase in the LEI has been at least 6.2% in 184 months. Not surprisingly, the U.S. economy was not in recession in any of those 184 months. Thus, it is highly unlikely that the economy was in recession in February 2015, despite the impact of the stronger dollar, lower oil prices, and the harsh winter weather in the eastern and southern U.S.

But the LEI is designed to forecast a potential direction for the U.S. economy and tell market participants what may happen, not what has already happened. Three months after each of the 184 months that the LEI was up 6.2% or more, the economy was also never in recession. Six months after the LEI was up by 6.2% or more on a year-over-year basis, the U.S. economy has been in recession in just 2 of the 184 months, or 1% of the time. Looking out 12 months after the LEI was up 6.2% or more, the economy was in recession in just 8 of the 184 months, or 4% of the time. Based on this relationship, the odds of a recession within the next 18 months and 2 years increase to between 10% and 15% [Figure 1].

The LEI is designed to forecast a potential direction for the U.S. economy and tell market participants what may happen, not what has already happened.

On balance, the LEI says the risk of recession in the next 12 months is negligible (4%), but not zero. And while the odds of a recession increase when looking out 18 months and 2 years, they remain low—but again, not zero. We would agree, and note that economic recoveries do not generally die of old age, but end due to excesses building up in one or more sectors of the economy. In the past, overbuilding in housing or commercial real estate, building up too much inventory, or borrowing too much to pay for overbuilding or overspending have all led to overheating and recession. The current recovery has been relatively lackluster by historical standards, and the excesses that have triggered recessions in the past are not present. Still, a dramatic deterioration of the fiscal and financial situation in Europe, a fiscal or monetary policy mistake here in the United States or abroad, or an exogenous event (a major terror attack, natural disaster, etc.), among other events, may cause us to change our view.

**1 LEI CONTINUES TO SUGGEST VERY LOW ODDS OF A RECESSION IN NEXT TWO YEARS**




Source: LPL Research, Conference Board, Bureau of Economic Analysis 03/20/15

Past economic performance is not a guarantee of future results.

IMPORTANT DISCLOSURES

All performance referenced is historical and is no guarantee of future results.

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for your clients. Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

All indexes are unmanaged and cannot be invested into directly.

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Leading Economic Indicators (LEI) Index is a measure of economic variables, such as private-sector wages, that tends to show the direction of future economic activity.



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