A Spreading Slowdown

With economic growth set to stay in a cyclical downtrend, hopes for a "second-half rebound" are likely to be dashed. However, a recession is not yet at hand.

Collision Course The Fed's rate hike plans are on a collision course with the economic cycle. According to Fed Chairman Janet Yellen's congressional testimony last week, "economic conditions likely would make it appropriate at some point this year to raise the federal funds rate target," i.e., if not by September, then by December. But while the Fed clearly expects a pickup in growth, ECRI's leading indexes suggest the opposite.

At the beginning of the year *(↗USCO Essentials, January 2015)* we asked a rhetorical question about rate hike timing: "If not now, when?" This was because – contrary to the consensus, which expected economic growth to improve even further as the year progressed – ECRI's leading indexes foresaw a U.S. growth rate cycle (GRC) downturn driven by a two-speed economy in which industrial growth slowed while service sector growth held up.

It is evident in hindsight that the GRC peaked in December 2014, following which U.S. economic growth has stayed in a cyclical downswing that was exacerbated – but not caused – by a harsh winter and West Coast port strikes in Q1 2015. The Fed sees those events as the reason for disappointing growth. Yet the slowdown has proved to be broader and more protracted, with U.S. Coincident Index (USCI) growth declining further in June to a 16-month low *(↗EWU, July 17, 2015)*.

And as we recently noted *(↗USCO Focus, July 2015)*, this is no longer a two-speed economy. Services growth has joined the industrial growth downturn foreseen earlier by the U.S. Leading Manufacturing Index (USLMI), in the context of which "industrial production has declined a bit, on balance, since the turn of the year," as Ms. Yellen just acknowledged.

Any potential stock price correction is unlikely to be magnified by valuation concerns in the absence of a major recession, which is improbable at this time.

Following the recent upturn in USLMI growth, which touched a seven-month high in June, industrial production actually inched up in June, as did its smoothed growth rate after six straight months of decline. But should this uptick develop into a cyclical upswing in U.S. industrial growth, it may not be enough to counter an intensifying services slowdown. As we concluded recently, "[w]ith services growth slowing, the current slowdown in overall U.S. growth is set to intensify to the extent that even a manufacturing upturn may be unable to end the broader slowdown" *(↗USCO Focus, July 2015)*.

This downbeat growth outlook is corroborated by the U.S. Long Leading Index (USLLI), whose growth rate remains in a three P's downturn *(↗EWU, July 17, 2015)* despite edging up in June. The bottom line is that, spearheaded by a deepening downturn in nonfinancial services growth *(↗EWU, June 19, 2015)*, service sector growth will continue to slow in the coming months, to the extent that it will likely overshadow any nascent upturn in manufacturing growth. The good news is that, notwithstanding the continued slowdown, ECRI's indexes are not yet pointing to recession.

