

September Slide, October Bounce

In this week's economic reports, a bounce from weak September numbers produced several positive surprises - at first glance - while another monthly decline in the Leading Economic Index was a negative surprise. The rebounds included strong Housing Starts (up 6.4%, but a misleading number, following a 6.0% decline in September) and Industrial Production (up 0.7% following a minimal gain of 0.1% in September). We see the October rebound in housing and Industrial Production as a normal reaction to the significant decline in activity in September. On the other hand, the fifth decline in a row for the Leading Economic Index projects a negative outlook and reflects the precarious status of this sub-par recovery.

Housing Starts Weak Beneath the Surface

Analysts took the strength in housing as a sign that the economy was warming up again. However, we see these numbers only as a partial rebound from an unusually weak September. In fact, focusing only on the overall housing starts number gives a distorted sense of what really happened in October.

To get a better picture, we need to separate single-family housing starts from multi-family. In September, single-family housing starts fell over 13% in both the Northeast and the West; these areas rebounded only 8% or so in October. For the entire U.S., single-family housing starts fell 8.2% in September but came back only 5.7% in October. In other words, it wasn't single-family housing that created the rebound in overall housing starts in October but an exceptional bounce in multi-family units. In particular, a 20% increase in multi-family starts in the Northeast takes the credit for making the overall rate look so good in October.

In addition to the monthly changes in housing starts, we should also look at the growth rates on a year-over-year basis in order to see the longer-term trend. When viewed this way, growth in single-family housing starts peaked in April and May at about 18% year-over-year growth. But in the last two months, the year-over-year rate has almost completely stalled: 0.1% in October and 0.2% in September, compared to the same month a year ago. This looks like a sign that the housing boom has already reached its growth peak for this cycle.

The Industrial Economy Rolls Along

Just like housing, the industrial economy (reflected by Industrial Production and Capacity Utilization) snapped back following a weak September. Though most industry groups were up in the month, the bounce came in two major areas: durable goods manufacturing (especially motor vehicles and parts), and petroleum and coal products.

When we look at the year-over-year growth in Industrial Production, we find a different pattern from housing. While this growth rate peaked earlier in the year, the current trend is still relatively strong at 5.2%, not much below the peak reading of 6.3% in May. While the industrial economy may have reached a plateau, it has not yet rolled over like some of the housing statistics have.

Leading Index Falls Again

October added one more decline in the Leading Economic Index, bringing the total to five. Because the Index has fallen only a relatively small amount each month, analysts have tended to discount this string of negative monthly comparisons. They conclude that the negative trend simply represents Greenspan's so-called 'soft patch', and that it will soon end.

However, we think that the Leading Index is actually telling us that the peak in this economic cycle has already passed and that this 'soft patch' will continue for at least several more months. Other evidence, beyond the Leading Index, points to this same conclusion. For example, the Weekly Leading Index provided by the Economic Cycle Research Institute (more sensitive than the Leading Index provided by the Conference Board) has fallen since March. In addition, job creation has been quite erratic since the Spring, and still well below historical trend for economic recoveries. Also, announced job layoffs (reported by the firm of Challenger, Gray & Christmas) topped 100,000 in September and October. And even though housing has been a major force in this recovery, we just noted that growth in single-family housing construction peaked earlier in the year, about the same time as GDP growth. The balance of evidence points to continued sluggish economic growth.

Conclusions

It would be misleading to isolate the October rebounds in housing and in the industrial economy from the September declines in these same statistics. If we treated each month's statistics independently, then the conclusions drawn from them would be completely contradictory. In fact, neither month by itself represents faithfully the trend in these statistics: housing has passed its peak while the industrial economy still continues to expand.