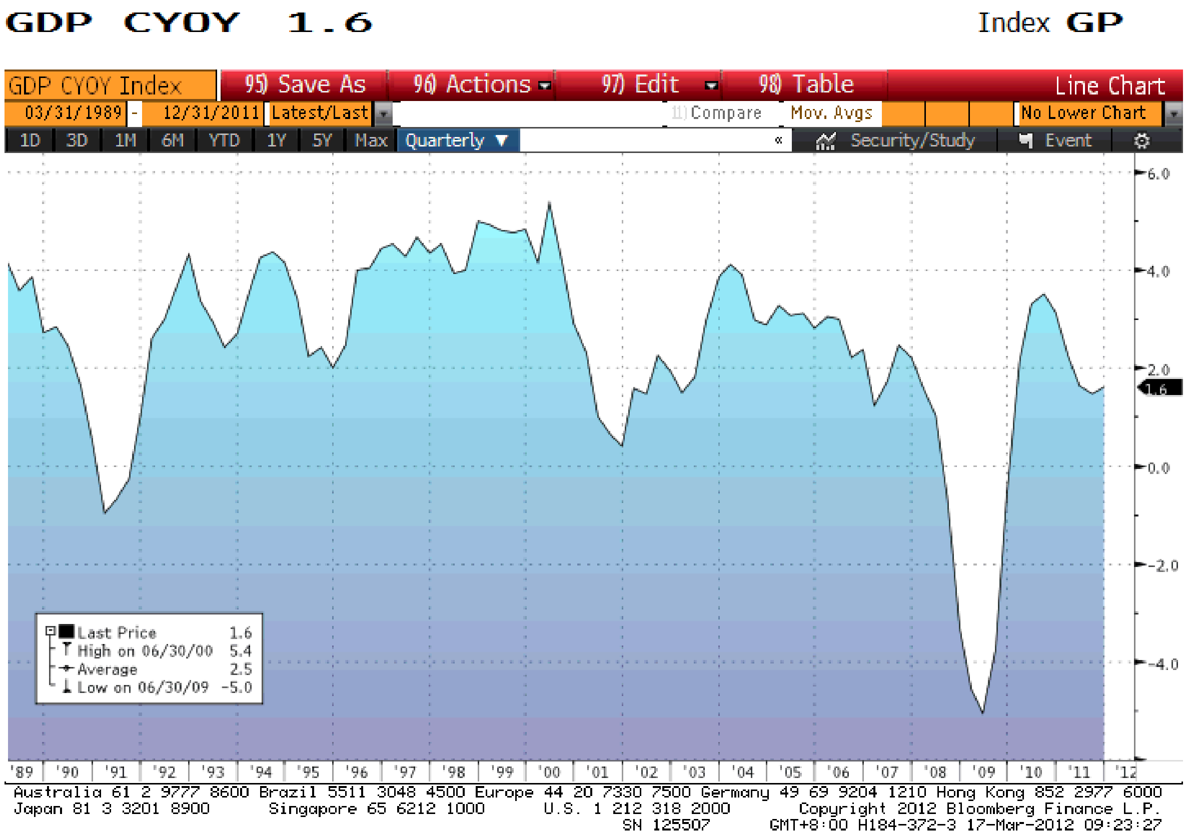
ECRI – ECRWWLI or ECRWGROW

For some time now, I have been a big fan of the Weekly Leading Index on the US economy published by the Economic Cycle Research Institute. There is so much economic data pouring out of the US that one can get easily confused about the overall state of the economy. I have found this index to be the one index that seems to encapsulate everything – "one index to rule them all", as it were.

The problem is the media and market watchers use two versions of this index - the actual index (ECRWWLI) and the YoY growth of the index (ECRWGROW), the latter being derived from the former. As to be expected, they use either one depending on which confirms the story they are trying to spin!

The purpose of this essay is to look back at US GDP growth since 1989 and see which indicator gives a more reliable and consistent account of the state of the US economy.

This is a chart of US Quarterly Real GDP growth (YoY).



For the purpose of this discussion, the key features to focus on are as follows :

1. The recessions (defined here simply as negative growth) in 1990/91 and 2008/09
2. The sharp slowdown in 2001
3. The prolonged period of above 4% YoY growth from 1996-2000
4. The recovery after the 2001 slowdown back to above 4% in early 2004.
5. Two other instances of above 4% growth in late 1992 and most of 1994

Let's first take a look at the history of ECRWGROW and how it has reflected GDP conditions in the US.

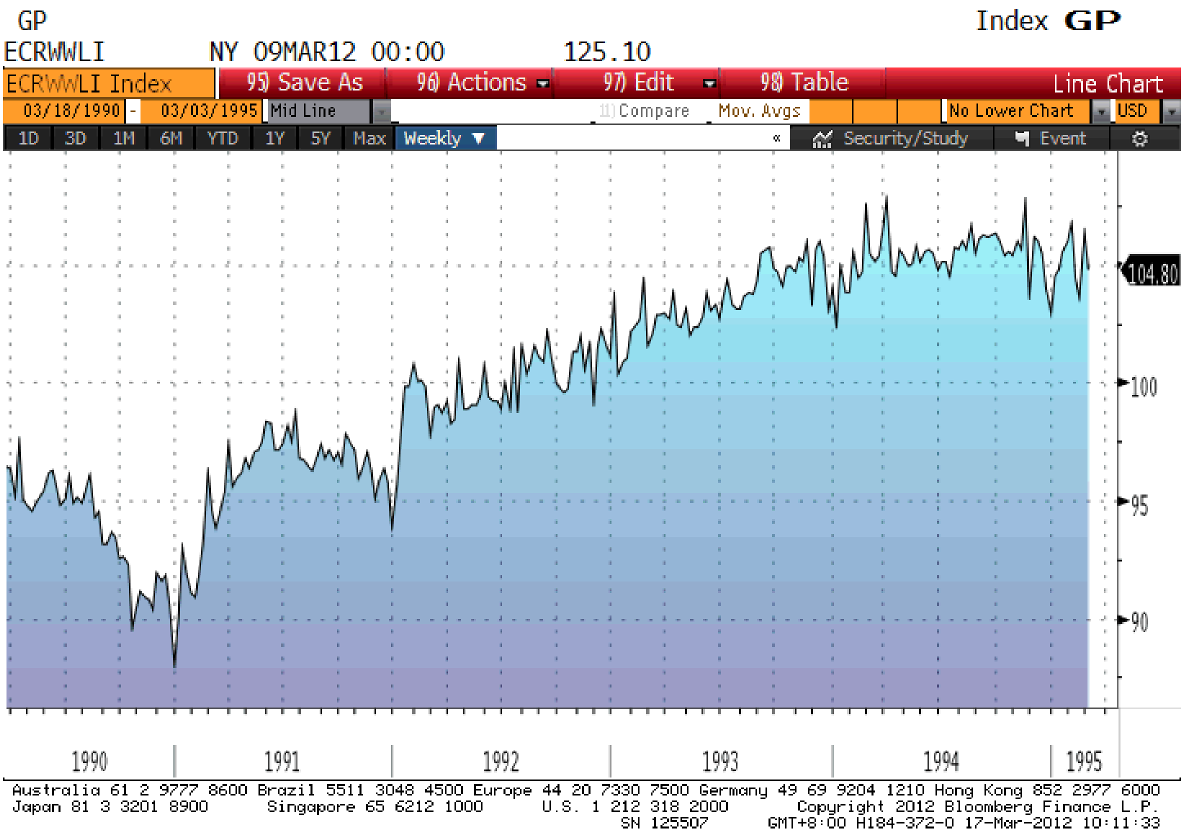
1. The recessions of 1990/91 and 2008/09 are unmistakeable as sharp dips on the ECRWGROW chart. In both instances, the index dipped to -10% or lower. (GOOD)
2. Ditto for the sharp slowdown in 2001. (GOOD)
3. The prolonged period of above 4% growth from 1996-2000 doesn't show up at all on the ECRWGROW as anything special, in terms of the strength of the index. (BAD)
4. The above 4% GDP growth in 2004 does show clearly on the ECRWGROW. (GOOD)
5. However, the two instances of above 4% GDP growth in 1992 and 1994 are absent. (BAD)
6. The ECRWGROW fell to -10% in mid-2010 and mid-2011 but neither was accompanied by a recession or a sharp slowdown. In fact, it suggested a TRIPLE DIP in the US economy, when in fact, there wasn't even a double dip. (BAD)
7. During its history, the ECRWGROW has fallen below zero numerous times but it appears that only when it falls to -10% is there a really meaningful collapse in economic activity. (NEUTRAL)
8. The index doesn't seem to capture positive economic activity very well. It missed nearly all the periods of above trend economic growth while the spike in ECRWGROW in late 2009 was not accompanied by above trend growth. (BAD)

In my opinion, two things stand out about ECRWGROW.

1. A negative ECRWGROW is meaningless. It's only at -10% that one really needs to worry. Even so, -10% doesn't always reflect a sharp downturn.
2. It's better at reflecting weak economic conditions than strong.

What about the absolute indicator, ECRWWLI, from which ECRWGROW is derived?

1. The recessions of 1990/91 and 2008/09 are clearly marked. The ECRWWLI fell more than 10% in 1990/91 and more than 25% in 2008/09. (GOOD)
2. The sharp slowdown in 2001 was also marked by a more than 10% slide in the index. (GOOD)
3. The strong economic growth from 1996-2000 shows up as a relentless rise in the index. (GOOD)
4. Ditto for the growth spurt in 2004. (GOOD)
5. You can only see this from a more detailed chart (below) but the strong GDP growth 1992 does show up first as a spike in early 1992 and a steady uptrend for the rest of the year. There was also a sharp rise in the ECRWWLI in the first quarter of 1994. (GOOD).
6. The rebound of the ECRWWLI in 2009/2010 was sharp and large but it stopped about 7% short of the all time peak in Jun 2007. This suggests that the US economy has not regained it's pre-2008 vigour, which tallies with the GDP growth chart. (GOOD).
7. There were 2 sharp downward spikes in 2Q, 2010 and 3Q, 2011 but the economy never really went into a sharp downturn. But the slope in both instances was negative for less than a quarter and the absolute level never fell below that of early 2003 when GDP growth was around 2%. (SLIGHTLY BAD)



In my opinion, four things stand out about the ECRWWLI

1. It is a far more reliable and consistent gauge of economic conditions than the ECRWGROW.
2. It is a cumulative index. As the economy grows over time, the absolute level of the index rises.
3. It is the direction (or slope) of the ECRWWLI that matters. An upward slope says the economy is expanding, and vice versa. The gradient of the slope is a measure of the rate of change in economic conditions i.e. a steep downward slope is a sign that the economy is crashing.
4. To impact the economy growth data significantly, the slope must be sustained over at least 2 quarter.

Conclusion : Use the ECRWWLI if you are trying to gauge the state of the US economy, and not the YoY version (ECRWGROW).

Footnote : Incidentally, the current slope of the ECRWWLI confirms what we already know – the US economy is expanding steadily but its vigour is a long way(-14%) from the pre-2008 peak. This tells us that the US output gap is still very large and therefore, contrary to the rantings of the anti-QE crowd, wage/CPI inflation is will be nowhere in sight for quite a while more. These conditions should be very positive for US equities…..