FOCUS ON THE ECONOMY

Reading the Tea Leaves

by Hugh F. Kelly, CRE

One of my high school English teachers gave our class what many considered an insulting assignment. We were to report on a text called *How to Read a Book*, by Charles Van Doren. With all the confidence of presumptuous teenagers, we objected that we already read dozens of books a year. Besides, how could we read a book called *How to Read a Book* if we didn't already know how to read a book? It appeared, though, that our teacher had been down this road with other classes before us, and the assignment stood. I'm glad it did, because I learned a lot from one of the great humanities scholars the U.S has produced.

This early learning experience comes to mind because the sudden deceleration of the economy has prompted most real estate professionals to look even more closely at the economic news during the fall and winter of 2000 - 2001. Nearly every day, the Federal Government produces an economic indicator that is released, with an instant commentary across the media and the Internet, to be followed inexorably by a graph and capsule interpretation in the next day's *Wall Street Journal*. It all seems so normal and natural, so transparent and straightforward, that the direction of the economy should be pretty easy to puzzle out. So why does it seem that the only certainty about economic predictions is that they will be wrong in the details even more than the seven-day forecast for local weather?

Some of the problem stems from the understandable emphasis on the "new" in the news. It is change that captures our attention, and so reporting stresses volatility over constancy. My favorite example of this is the graphic published each day that shows the minute-by-minute change in the Dow Jones Industrial Average. This is a splendid collection of mostly meaningless detail. The one useful thought that it conjures up is a healthy skepticism that the stock market actually provides a rational measurement of future profit expectations. The fundamental outlook for earnings simply doesn't wobble with anything like the skittishness of the Dow, or any of the other market indexes for that matter.

To take a more common example of a data series watched intensely by economic commentators, consider the numbers on Factory Orders as displayed on the front page of the *Journal* last December 6th. This was presented in a graph showing the month-to-month percentage change in new orders for manufactured goods for the most recent 12 months. Seven months were up, with the best months showing slightly more than 4% growth, and five months were down, with one month dropping 8%. What are we to conclude? From the graph as published, really not very much. Certainly there would be more useful information if some kind of moving average of the data were calculated to indicate a trend, or even some comparison of the amount of factory orders as

they have fluctuated on a year-over-year basis. Such comparisons take a lot of the drama out of the statistics, but provide a better perspective on where we are actually heading.

Then there are data series that look like they are going down when they are really going up. For example, the Federal Reserve released the Industrial Production figures on December 18th. This information was usefully converted to year-to-year percentage change (which you can tell if you read the fine print in the axis scale), and shows that between August and November the trend had been downward, and fairly steeply so. Back in the summer, industrial production was growing more than 6% annually, and by November it was - oh my! - under 5%. What was the problem? Nothing more than a graph whose entire y-axis range went from a low of 2% to a high of 8%, thus exaggerating any small change in the data. But, even more obfuscatory, the entire picture of downward movement is actually one of continued growth, albeit at varying rates. But, in any event, isn't the deceleration a worrisome sign? Maybe, or maybe not. After all, from January 1998 to January 1999, this same measure dropped from 7% growth to just about 3% - and then the overall economy grew a robust 4.7% for all of 1999, and as much as 8.3% in the final quarter of that year.

Readers who look at the Industrial Production figures as an indicator of future trends might be surprised to find that the production index is considered a coincident, rather than a leading indicator of economic direction. Other such data series, that tend to move simultaneously with GDP trends, are nonagricultural employment, personal income, and sales in the manufacturing and trade (wholesale and retail) sectors. The Index of Leading Indicators, the predictive index, is composed of 10 variables, and it is worth knowing what these are. Two of the variables relate to labor conditions: the average weekly hours worked in manufacturing jobs, and the number of initial unemployment claims. Three variables cover the world of finance: the S&P 500 Index, the monetary aggregate M2, and the interest rate spread between the Fed Funds rate and the 10-year Treasury rate. Two factors indirectly measure consumption elements: housing permit activity, and the Index of Consumer Expectations. The final three components look at production trends: new manufacturing orders for consumer goods, new orders for non-defense capital goods, and the speed of vendor deliveries to businesses.

The most intriguing feature I see in reviewing the leading indicator components is that, individually, not one of them stands out as a dependable litmus test for the economic future. Of the 10 series, I would say that housing permits offer the most consistently accurate read on a potential recession, followed by the interest rate spread measure. Neither is by any means infallible, though. In 1966 - 1967, for instance, housing permits dropped from about 1.5 million to less than 1 million, but the long expansion of the Sixties continued and permits recovered to their prior level in 1968 and stayed high until the recession of 1973 - 1974. And the end of the Reagan-era briefly saw a negative yield curve in 1988, as did the Clinton-era expansion in 1998, though the economy continued to grow for at least two years thereafter in each case.

It is the combination of the 10 variables that has the best predictive power. This was true when the indicator approach was first developed by the National Bureau of Economic Research in the 1930, and remains true in its present incarnation as maintained by The Conference Board. Even so, the index has been known to trigger false alarms, slipping into negative (recession-alert) territory in 1966, 1984, 1993, and 1995 without an economic contraction subsequently emerging. This may in fact be a success story for the Index, since it serves as a danger signal of weakening conditions and thus alerts businesses, consumers, and Fed officials that changes in behavior are called for if a downturn is to be averted.

That interaction between new information and the adaptations it prompts among economic actors is, of course, what makes economic forecasting a considerable challenge. "If you must forecast," John Kenneth Galbraith said, "forecast frequently." Nevertheless, it is fairly amazing how loudly some economists and CEOs have been professing their surprise about the slowdown that began in 2000's fourth quarter. They remind me of Captain Louis in *Casablanca*, who professed to be shocked, *shocked* to learn that there was gambling occurring in Rick's establishment. If our managers and pundits were truly unprepared for deceleration, what exactly did they think the regimen of interest rate increases in 1999 and early 2000 were designed to do?

The Fed, meanwhile, appears at least to be consistent in its long-term management policies,

directed toward moderate, sustainable domestic growth, with very low inflation in the U.S. and a reduction of volatility in worldwide economic trends. As Alan Greenspan knows very well, no single number serves as the weathercock. Those looking for simple indicators in the day's statistical releases share something of the attitude my class had back in high school, when we thought we couldn't benefit from reading Van Doren, despite the fact that we had barely scratched the surface of world literature, science, and the humanities. The fact is that economic statistics require perspective and considerable breadth of vision before they yield their secrets.

Greenspan himself offered some succinct advice in a speech to the National Association of Business Economists in October 1998. He said, "For those of you who want to get an objective view of what is going on in the world, it's probably wise to put your newspapers in your In Box and leave them there for a week, and then you can read them." That's one way of saying, "Don't get caught up in the hype, and don't rely just on today's headlines." Investors in long-lived assets like real estate, and the Counselors who assist them, will find that good advice indeed. RE125

ABOUT OUR FEATURED COLUMNIST

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