By Jason Stipp and Robert Johnson, CFA | 8-8-2012

Checking the Recession Signs

How do current inflation, auto sales, initial claims, and other data compare with levels just before the December 2007 recession?

Jason Stipp: I'm Jason Stipp for Morningstar.

With a still-sluggish economy and global woes still on the radar, we're checking in today with Morningstar's Bob Johnson, our director of economic analysis, on some high-level recession indicators and what they're saying today.

Bob, thanks for joining me.

Bob Johnson: Great to be here.

Stipp: There are a few indicators that folks would historically or traditionally look at that would seem to signal a recession; I want to run through some of those today, discuss why they tend to be related to a recession, and also what they're saying today.

Recently we've seen in the news that some folks think we might already be in a recession or we might be close to recession, so I think it's a timely moment to look at some of these indicators.

The first one is initial unemployment claims. Obviously the employment market is something that folks watch a lot. We track the employment data month-to-month, but you look at initial unemployment claims as well, and that could be a good indicator of whether we're going into a recession or not.

Johnson: Yes, [initial unemployment claims] have historically been probably the single best number to indicate that a recession is coming, when those numbers start to tick up.

For example, in the 2007 recession, the one that began in December, the initial claims ... were at their lowest levels of about 300,000 in the middle of the year, and by the end of the year, they had crept all the way up to 353,000-360,000 before really beginning their rapid ascent in the months following that.

And ... right now in 2012, our initial unemployment claims are actually [at] the best level of the recovery. I was kind of surprised; in getting prepared for this video, I looked at the numbers, and we are, on a four-week moving average basis, at the best of this recovery. So that's not terribly indicative of recession.

Stipp: So we know that the recovery in the employment market has been sluggish and we haven't added jobs as fast as we'd like, but people aren’t getting laid off to the extent that would seem to indicate that a recession is imminent.

Johnson: Right. I think people tend to look at the employment numbers and say that's slow, but when you go on to recession, that's when people get scared and they start laying people off. Now we're not adding [jobs] as fast as we like, but there's nobody that seems to be firing anybody. [The] Challenger, Gray [layoff report] is also, I think, pretty close to a record level.

Stipp: A second indicator that is interesting and tied to consumers is auto sales. So there are lots of different ways to look at the consumer and what they are spending on retail, homes, autos, what their confidence is, and they have varying lenses that you can use and varying levels of maybe reliability as far as consumer health. But autos is an interesting one. Why do you look at autos and what does auto sales [data] tell you about the likelihood of a recession?

Johnson: It's been also a pretty good indicator, maybe because it employs a fair number of high-paying jobs, maybe that's part of it. Maybe it's because it is a great indicator of consumer confidence--it's one of my favorite consumer confidence indicators. This time going in, we're maybe down from 14.4-14.5 million in terms of units to maybe 14.1 million in terms of ... a seasonally adjusted annual rate for autos.

So we are off a little, but I would say that when we look back at 2007, for example, we [had been] trending down for well over a year [before the 2007 recession]. We'd been up well over 17 million units at one point and then fallen all the way to 16 million by the time the recession began in December of 2007.

Stipp: So a little softness recently--maybe it's one to keep a very close eye on, maybe a yellow flag--but certainly not the kind of trend that we saw before the last recession in auto sales.

Johnson: Correct.

Stipp: OK. PMI is another one that seems to be get a lot of attention recently, the manufacturing index. What is that one telling you, and why are folks paying such close attention to it right now?

Johnson: Well, it has been historically one of the better indicators of a recession, but it's actually a really good [indicator] at beginnings of recoveries. It is the best one, and a lot of people got faked out and missed the recovery beginning in 2009 because they weren't watching PMI, and I think lot of people [are thinking], I'm not going to miss this one again.

The one thing I will say about the PMI this time around is the pattern looks eerily similar to 2007--before the 2007 recession--and in fact I think the actual PMI number is identical to where it was when we began the [2007] recession.

Stipp: So a kind of a big worry sign, if you're just looking at PMI and you see a number similar to the pre-2007 recession. How are you reading that number now? How worried are you about it?

Johnson: I'm not terribly worried because the PMI has been very good at predicting recessions, but it also predicts more recessions than there really are. In the 1990s, it ... probably went down to 40, I think, four different times, and out of that batch, we only got one decline in GDP.

So I'm not terribly worried, and actually everybody worries about ... whether [the PMI reading] is above or below the 50 number, but if one goes back and does the correlations with the data, usually we don't have negative GDP growth until the index gets all the way down to 42. I don't know if I want to wait all the way until it gets to 42 [before calling a recession] if it's clearly trending there, but I'm not really worried about this one just yet.

And PMI will get [less meaningful] further along in history, since manufacturing is a smaller part of ... our employment market. I'm a little less worried about that number.

Stipp: So PMI, one of those numbers that you want to look at but probably not in isolation, because you get some false positives. If you see PMI trending down and you see some other indicators also suggesting recession, certainly time to sit up and take notice.

Johnson: Absolutely.

Stipp: OK. So also an interesting one that you've talked about before is inflation, which is also tied to interest rates, and you've called inflation a recovery killer before. What is inflation telling you right now and how is that maybe feeding into, or not feeding into, the chances of a recession coming up?

Johnson: Well, we've made some huge improvements ... from a year ago this summer. I think we've gone from almost 4%, very close to 4%, which I view as a critical year-over-year level on inflation, all the way down to something that looks much closer to 2%. So that one is clearly not signaling a recession.

The drought we are having in the Midwest and ... how that may roll through price increases has me just a little bit worried; that's one I'll be watching the closest, because [inflation] has been the biggest killer of recoveries.

Stipp: So one to keep an eye, and especially in the fall given the crop situation that we've had.

Last one, Bob, is the stock market--what the stock market predicts about what's going to happen in the future. What did we see, what was the trend, before the 2007 recession? Let's compare that to what we're seeing recently in the stock market.

Johnson: Well, the stock market peaked out in October 2007 and started rolling over prior to the actual recession date, which turned out to be December [2007].

Stipp: So maybe about a quarter or so of soft performance there ...

Johnson: ... before we [actually entered recession]. Now this year, the stock market is up almost 13% year-to-date. So it's hardly like the stock market is predicting a recession, and it's usually a darn good indicator. Every recession has been preceded by a decline in the stock market. [The stock market] probably figures it out a little bit sooner than the government statisticians do--that's probably why it's a decent indicator. But it tends to [have a] hair-trigger. The joke always used to be amongst economists that the stock markets predicted nine of the last five recessions. I think one has to be careful with that one, but that one is clearly not flashing a warning sign at all right now.

Stipp: Some very interesting indicators to keep an eye on, certainly some to watch very closely given some recent situations, but it sounds like based on these [current data], not an imminent chance of recession in the near future.

Johnson: That's my view of the world, but we've got ones that are a little bit worse [that] I'm going to keep an eye on, like the PMI and like what the drought does to inflation. But in general it looks to me like it's clear sailing.

Stipp: All right. We will depend on you to help us keep an eye on those. Thanks for joining me today.

Johnson: Thank you.

Stipp: For Morningstar, I'm Jason Stipp. Thanks for watching.