The severe drop in equity prices has raised concerns of recession risks in the US. While financial market corrections typically follow economic downturns, they do sometimes precede them. A review of today’s key economic variables suggests to us that the economic growth cycle remains on track. However, continued financial market disorder would pose a risk to the expansion at some point.

Core Elements in Business Cycle

Business cycles are rarely alike, and their growth impulses and recessionary causes differ over time. Even so, the recurring pattern of economic cycles more or less ensures that the cyclicality (i.e., growth and recession) of each business cycle will be apparent in a number of economic indicators. Importantly, some indicators have proven to be more useful than others. In fact, our research has found that three leading economic indicators—the Institute for Supply Management (ISM) new orders index, building permits and jobless claims—stand out for their consistency in successfully highlighting inflection points in the business cycle.

Equity prices have also offered valuable insight, but a number of substantial equity market corrections broadcast false signals as well. In our assessment, the current equity market setback is a long overdue correction: It’s a necessary readjustment from the Fed’s highly accommodative monetary policy that included the unconventional asset purchase program and culminated with equity prices racing far ahead of the economic cycle. However, the current equity market correction may have longer legs and be more disruptive to the economy than we currently think.

Business Cycle Key Economic Indicators

The ISM composite index of new orders captures underlying trends in the manufacturing sector and has been a reliable leading indicator of transition periods in the business cycle. In fact, this new orders index has recently been added to The Conference Board’s index of leading economic indicators.

The composite new orders index is a diffusion index: both the level and the change in the level are important. At 51.5 in January, the new orders index suggests continued moderate growth (Display 1). Beyond the numbers, it is also constructive to see the responses from a wide range of industries—such as primary metals, plastic, chemicals, computers and electronic products, and transportation—all indicating that new business trends in January were very encouraging.

If the recession risk were relatively high, the new orders index would already have been well below the all-important 50.0

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threshold for several months, and the eventual drop would be roughly 10 points below January’s level.

**Building Permits**
The US Census Bureau series on building permits captures new construction activity for both single and multifamily housing. The building permits series has always been part of the index of leading economic indicators, because it captures the ups and downs of one of the most important cyclically sensitive sectors (i.e., the residential construction market).

History shows that building permits tend to decline long before the economy does, and lead time could be one year or longer. In the fourth quarter of 2015, the level of building permits reached its second highest level since 2007 (Display 2, previous page). So the signal from this all-important leading indicator is still one of moderate growth.

The consensus among housing analysts is that building permits and overall housing starts should rise 6% to 7% in 2016. That would provide a powerful lift to economic growth.

**Jobless Claims**
Weekly jobless claims offer early insight into the changing dynamics of labor market conditions. Historically, a large sustained rise in jobless claims indicates that the layoff pace is starting to rise and that other labor market opportunities are not sufficient in scale—or are disappearing as well.

Jobless claims remain relatively low, and have been below the 300,000 per week threshold for nearly a year (Display 3). Weekly claims would have to rise above 350,000 and stay at that elevated level for an extended period (at least three months) to signal a significant change in labor conditions.

Although press reports of layoffs have increased in recent weeks, one has to put them in the context of job opportunities. In December, for example, the number of job openings rose 261,000 to 5.61 million, the second highest on record. The high number of job openings should make it somewhat easy for the recently displaced workers to find new employment.

As impressive as the numbers of job openings appear on paper, it will be important to monitor these figures going forward: companies may pull back or cancel hiring plans if they see or anticipate a material change in business prospects.

**Equity Prices**
Significant declines in equity prices have often been a precursor to negative economic outcomes. But those market declines have a record of predicting false outcomes as well. History shows that substantial and sustained declines (15% to 20% over a 12-month period) have been associated with recessionary outcomes. But there have also been substantial declines of 15% to 20% over six-month timespans (1988 and 2002) when no economic fallout occurred (Display 4).

Household ownership in the equity market is fairly narrow. According to the 2013 Survey of Consumer Finances conducted by the Federal Reserve, 31.6% of households owned stocks through multiple accounts (directly or indirectly). Furthermore, most of the household holdings of equities are owned by the top 10% of income groups. In comparison, ownership of residential real estate is much broader. According to the US Census Bureau, 63.7% of households owned homes in 2015.

**2016 Is Not 2008**
When asset cycles unwind abruptly, it can trigger nonlinear or outsize adjustments in the economy.

However, it’s important to point out that 2016 is not 2008. Notably, in 2008, both home values and equity prices tanked. And what made that economic situation even worse was that a record number of households had “tapped the till,” or borrowed against the higher housing values. So the plunge in house values left many households with less wealth and even higher debt loads.

Today’s real estate values are not as inflated as those in 2008, and house prices are rising roughly 5%, on average, across the nation. More importantly, the percentage of household income that is being used or absorbed for the full costs of servicing total financial obligations (principal and interest payments, lease payments, etc.) stands at about 15% today—near the lows of the past 35 years—compared to a record high of 18% in 2007.

All of this suggests that the wealth and cash positions and psychological outlook of the average household will not be jarred anywhere near as badly as happened in 2008. And while there might be some temporary pullback on consumer spending from high-end consumers, we expect the impact to be short lived and relatively small, unless the equity spiral continues downward.
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