



June 2010

### Is the Double-Dip Coming Soon?

Fears of a double-dip recession have multiplied in recent weeks. The weak employment report was only the latest signal that the U.S. economy may be softening again. According to the employment report released by Labor Department on last Friday, the non-farm payroll employment increased by 431,000 jobs in May. While the increase in jobs marked the fastest pace of job growth since March of 2000, the increase was primarily due to the addition of 411,000 temporary employees to work on Census 2010. At the same time, the labor department said that the private sectors added only 41,000 jobs in May, after adding 218,000 jobs in April. The modest increase marked the weakest pace of private sector job growth since January.

Federal Reserve board chairman Ben Bernanke was interviewed by ABC News reporter on Jun 7. He said he didn't think the U.S. economy would slip back into a recession, saying that consumer spending and business investment seem strong enough to keep the economy growing, albeit at a relatively subdued rate. On the other hand, some economists think a double dip is even less likely than it was earlier this year. David Wyss, chief economist with Standard & Poor's, said that the odds of a double –dip actually have shrunk to 20% from 25% earlier this year.

A double-dip recession describes a period of time in which the economy goes into recession, briefly rebounds, and then dips back into recession again. U.S. experienced this type of recession in early 80s. It is sometimes referred to W-shaped recession. So, is the double-dip coming soon? According to the Treasury Spread Model and the Leading Economic Indicator released by Conference Board, the answer is NO.

#### Treasury Spread Mode Shows almost No Chance of Recession

Since the 1980s, an extensive literature has developed in support of the yield curve as a reliable predictor of recessions and future economic activity more generally. Indeed, studies have linked the slope of the yield curve to subsequent changes in GDP, consumption, industrial production, and investment<sup>a</sup>.

The measures of the yield curve most frequently employed are based on differences between interest rates on Treasury securities of contrasting maturities, for instance, 10 years minus 3 months. The measures of real activity for which predictive power has been found include GNP and GDP growth, growth in consumption, investment and industrial production, and economic recessions as dated by the National Bureau of Economic Research (NBER).

The specific accuracy of these predictions depends on the particular measures employed, as well as on the estimation and prediction periods. However, the results are generally statistically significant and compare favorably with other variables employed as leading indicators. The yield curve has predicted essentially every U.S. recession since 1950 with only one "false" signal, which preceded the credit crunch and slowdown in production in 1967<sup>b</sup>.

The New York Federal Reserve recently updated its "Probability of U.S. Recession Predicted by Treasury Spread" with treasury yield data through May 2010, and the Fed's recession probability forecast through May 2011. The model uses the spread between the yields on 10-year Treasury notes (3.42% in May) and 3-month Treasury bills (0.16% in May) to calculate the probability of a U.S. recession up to 12 months ahead.

It shows that the recession probability peaked during the October 2007 to April 2008 period at around 35-40%, and has been declining since then in almost every month. For May 2010, the recession probability is only 0.17%.

According to the Treasury Spread model, the recession ended sometime in middle of 2009, and the chances of a double-dip recession through May of 2011 are essentially zero. Some people may criticize that the indicator is now heavily manipulated by the Fed through their intervention and stimulus policies, how about the forecast of leading economic indicator?

## No Warning Signal from the Leading Economic Indicator

The index of leading indicators, released by Conference Board every month, is designed to predict turning points in the economy, such as recession and recoveries. The index incorporates the data from 10 economic releases that traditionally have peaked or bottomed ahead of the business cycle, including:

1) average weekly hours, manufacturing, 2) average weekly initial claims for unemployment insurance, 3) manufacturers' new orders, consumer goods and materials, 4) index of supplier deliveries – vendor performance, 5) manufacturers' new orders, nondefense capital goods, 6) building permits, new private housing units, 7) stock prices, S&P 500, 8) money supply, M2, 9) interest rate spread, 10-year Treasury bonds less federal funds & 10) index of consumer expectations. Each of the 10 components is averaged, and a standardization factor is applied to equalize volatility.

Historical analysis shows that a negative growth rate over a six-month period of the leading index and declines in at least half of the components (i.e. the six-month diffusion index falling below 50 percent) is a reasonable criteria for a recession warning. However, this situation has not yet happened based on the latest data.

In conclusion, we do not see any chance of double-dip recession that will come shortly.

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a. The Yield Curve as a leading Indicator: Some Practical Issues – *Arturo Estrella and Mary R. Trubin*

b. Federal Reserve Bank of New York

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