Weekly Economic Commentary

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Disappointing GDP, but No Early Warnings of Recession on Horizon

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Highlights

We do not think the weather-related economic weakness in the first quarter was the start of another recession or even a slowdown in growth.

The statistical evidence of the LEI indicates that the risk of recession in the next 12 months is small at about 4%, but not zero.

On June 25, 2014, the Bureau of Economic Analysis of the U.S. Department of Commerce released revised figures on economic growth for the first quarter of 2014, as measured by gross domestic product (GDP). The GDP data are closely watched, as GDP is the broadest measure of the nation's economic output. The pace of GDP growth is a critical driver of corporate earnings, which, in turn, are the key driver of stock market performance.

The GDP data revealed the economy contracted at an annualized 2.9% pace in the first quarter, just the second time that the economy contracted during a quarter since the end of the Great Recession in mid-2009. Could the first quarter GDP report be a harbinger of another wrenching recession? We do not think the weather-related economic weakness is the start of another recession or even a sign of a growth slowdown over the rest of the year. We continue to expect that economic growth will rebound and expand 3% in all of 2014.* In fact, the return to a more normal weather pattern nationwide has already led to a sharp snapback in economic activity. The U.S. economic data released thus far for April, May, and June 2014 suggest that economic growth will accelerate in the second quarter to well above the economy's long-term average growth rate after a weather-induced slowdown in growth in the first quarter of 2014.

While first quarter GDP was both unusual and disappointing, it does not change our view on the economy. Second quarter GDP is due out in late July. With that release, the GDP data (including the first quarter of 2014) will be revised back as far as 1999 to incorporate new data, methodological and definitional changes, and updated seasonal factors. This annual revision to GDP happens every year in late July.

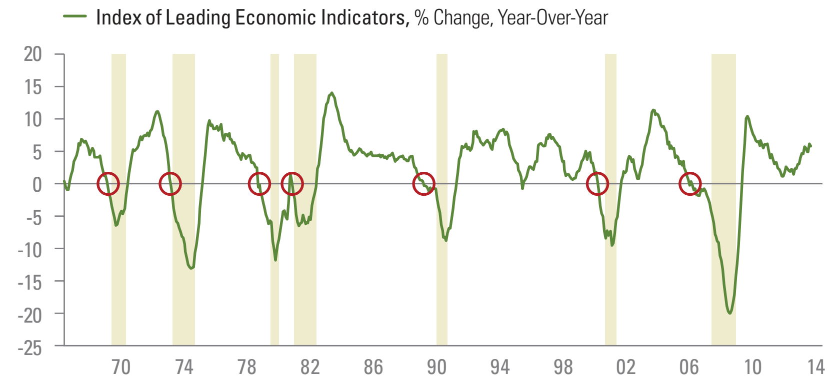
LEI Reveals No Red Flags

Importantly, many of the other indicators that can provide an early warning of recession are not signaling a downturn in the economy. The Index of Leading Economic Indicators (LEI)—compiled by the Conference Board, a private sector think tank—is comprised of 10 primarily fundamental economic indicators and is designed to predict the future path of the economy, with

*As noted in the *Outlook 2014 The Investor's Almanac*, LPL Financial Research expects GDP to accelerate from the 2% pace of recent years to 3% in 2014. Since 2011, government spending subtracted about 0.5% each year from GDP growth. Government spending should be less of a drag on growth which would result in +1% increase for 2014.

a lead time of between 6 and 12 months. When the year-over-year rate of change in the LEI turns negative and begins to fall, a recession has historically followed by anywhere from zero to 14 months [Figure 1].

1 LEI Provides Early Warning of Recession



Source: LPL Financial Research, Federal Reserve 06/06/14

The year-over-year increase in the LEI in April 2014 was 5.9%. Since 1960, the year-over-year increase in the LEI has been at least 5.9% in 211 of 652 months. Not surprisingly, the U.S. economy was not in recession in any of those 211 months. Thus, it is highly unlikely that the economy is in a recession today, despite the below zero reading on real GDP in the first quarter of 2014. Looking out 12 months after the LEI was up 5.9% or more, the economy was in recession in just 9 of the 211 months, or 4% of the time.

On balance then, we would agree with the statistical evidence of the LEI that the risk of recession in the next 12 months is small at about 4%, but not zero. The LEI suggests the U.S. economy is in the middle of the cycle that began in mid-2009. ■

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