

Market Analysis, Research & Education

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U.S. Economic Update: Improving But Still Fragile

Leading Indicators Point to Recovery

As we discussed in a recent report [See MARE article, *The Road Map to Recovery: Leading Economic Indicators*], keeping an eye on leading economic indicators—those that identify emerging trends—is one of the most useful ways for investors to gauge the direction of the U.S. economy.

Leading Indicators Confirm Improving Trend

Our May report showed that leading economic indicators as a group appeared to be changing direction during the spring of 2009. New data over the past two months has confirmed this trend. For example, five of the 10 components of the Conference Board's Leading Economic Index (LEI) were moving in a more positive direction on a trailing six-month basis at the end of June, up from three in April and just two in March (see Exhibit 1, page 2). On a month-over-month basis, 70% of the LEI's components were rising in June from the prior month.ⁱ As we noted in our previous report, the stage in which these indicators move from all falling to all rising is typically the period that precedes an economic recovery.

Many of the newly positive leading indicators reflect broadly improved sentiment. The U.S. stock

market has rallied more than 35% from its March 9 low point, representing a recovery in investor enthusiasm after a savage bear market.ⁱⁱ Consumer expectations have improved, bouncing upward after hitting multi-decade lows. Vendor performance, a measure of how quickly business suppliers deliver components of production to manufacturers, turned positive, in a reflection that inventory draw-downs may give way to new industrial production.

Traditional leading indicators of credit market conditions, including the steepness of the yield curve and expansion of the money supply, have remained in positive territory. The key difference during the past three months is that these two traditional leading indicators have been joined by coincident credit indicators, such as falling corporate bond spreads and rising bond issuance, demonstrating that credit markets have improved substantially from the crisis conditions of late 2008.

Taken together, the steady improvement in recent months in many leading U.S. economic indicators has continued to support the notion that the economy is firmly in a stabilizing trend and that the worst of the economic recession is in the past.

KEY TAKEAWAYS

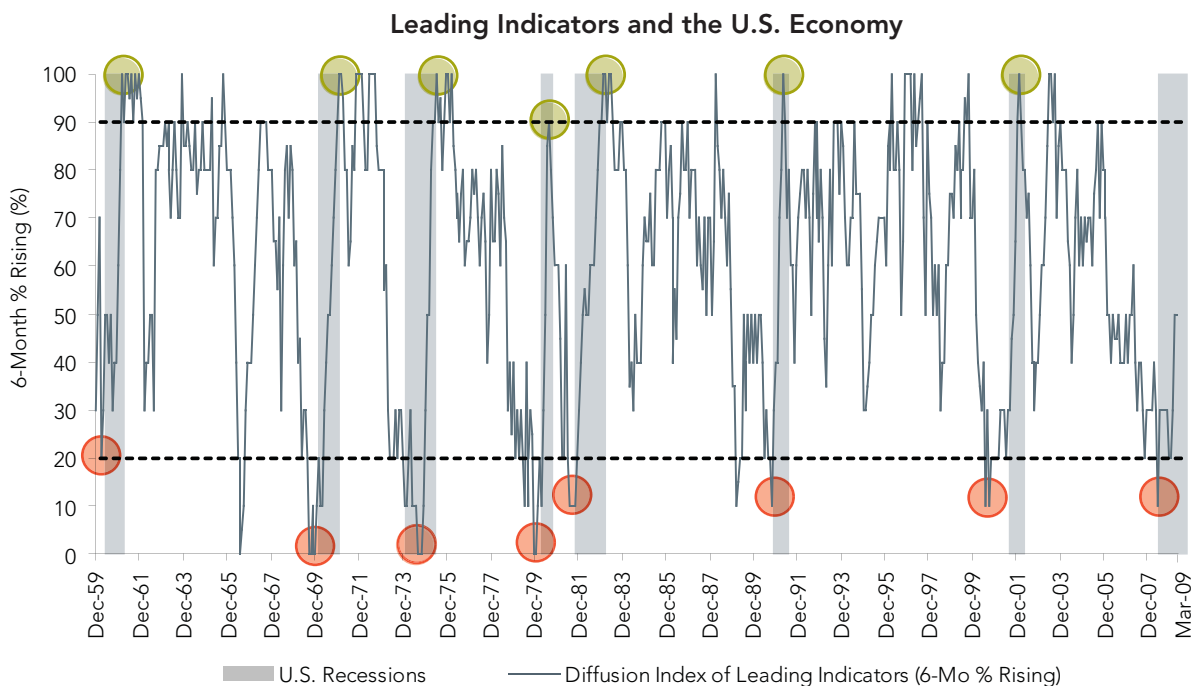
- Recent leading economic data have confirmed the trend that began in the spring—the U.S. economy is moving toward recovery.
- However, mixed data, particularly in the employment markets, provide considerable uncertainty about the timing, sustainability and magnitude of the potential recovery.
- Nevertheless, a recessionary economy that is improving but not yet in full recovery has historically provided a positive backdrop for the prices of stocks and other riskier asset categories.

Not Out of the Woods Yet

Although the economy may have rebounded from its worst level, there is much uncertainty about the timing, sustainability and magnitude of any potential recovery. Some leading indicators have shown only modest improvement after falling to dramatically low levels, while others have yet to demonstrate any sustained progress.

For example, the issuance of permits to build new homes, a leading indicator of home construction activity, has stopped falling but remains near its lowest level on record.ⁱⁱⁱ In addition, manufacturing data continues to paint a mixed picture. Though

EXHIBIT 1: During the past few months, there has been a steady increase in the number of leading economic indicators in the Conference Board's LEI Diffusion Index that have begun rising (now 50% have turned more favorable), an indication that the economy is stabilizing and potentially moving toward a recovery. Historically, when 90% or more of all 10 leading indicators are rising in a positive direction, the U.S. typically has emerged from recession (green circles).



Series is centered by the Conference Board in the middle of the six-month span it measures. March 2009 end point includes all data through June 2009. U.S. recessions defined by the National Bureau of Economic Research. Source: The Conference Board, Haver Analytics, FMRCo (MARE) as of 6/30/09.

vendor delivery times appear to reflect that inventories have fallen to levels that will require new production to meet upcoming orders, new orders for both capital and consumer goods have remained lackluster. An inventory cycle that stabilizes manufacturing levels would be a major improvement from the plunging industrial production numbers in late 2008, but there is nothing in the data at this point that demonstrates a definitive rise in end demand that is necessary for a full industrial recovery.

Spotlight on labor market

Perhaps the economic sector that best illustrates this general trend of improvement but continued weakness is the employment market. The domestic labor market, with its influence over wages and incomes, is critical to the American consumer's ability to spend. Lagging indicators of employment have drawn considerable attention from investors, and likely have contributed to stock market weakness in recent weeks. This includes the June monthly payroll report

that showed job losses rising more than expected and the unemployment rate spiking to a 26-year high of 9.5%.^{iv} Unemployment is widely expected to continue rising above 10% well into 2010, casting doubt on the prospects for a consumer-led recovery.

Leading indicators of the job market paint a more mixed picture. On the one hand, initial unemployment claims (a proxy for layoffs) have been trending downward for nearly three months after peaking at an all-time record in early April. The declining trend in new claims is positive news, as it demonstrates that employer cost-cutting efforts are slowing. The next step in the labor market cycle would be for employers to fully utilize their existing work force—by increasing the number of hours worked by employees—before they eventually expand payrolls, thus reducing levels of aggregate unemployment. However, the average manufacturing workweek (another leading indicator) was still declining as of June, in a sign that the labor markets remain under

considerable stress (see Exhibit 2, below). A continued (and larger) drop in jobless claims alongside stabilization in weekly hours would be a significant sign that an economic recovery is gaining traction.

Conclusion: Positive Trend, But More Progress Needed

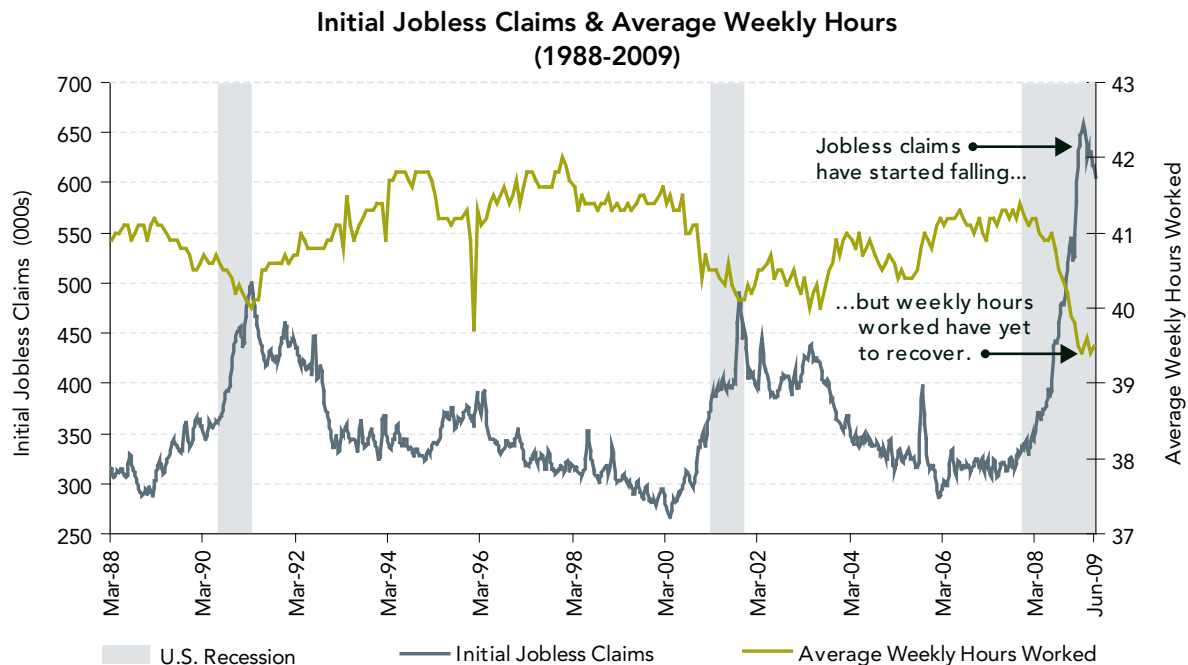
The movement of more leading indicators in an upward direction is a positive sign pointing toward an economic recovery on the horizon. However, many of the indicators that have turned positive, such as consumer expectations and stock market prices, represent improvements in sentiment as opposed to tangible economic activity. Several leading indicators that more closely measure actual activity, in areas such as employment or manufacturing, have yet to definitely turn upward. For the economy to move into a full-fledged recovery, the improving trend in leading indicators will need to deepen and broaden in the coming months. Given the level of trauma in the labor markets, employment indica-

tors are likely to provide important clues about the timing and strength of an economic recovery.

Investment Implications

Stock markets typically anticipate economic recoveries by looking several months ahead, and the major stock market rally during the second quarter of this year was in large part due to the improvement in expectations for the U.S. economy. With leading economic indicators largely confirming that the worst of the recession is in the past, the stock market's momentum pause in recent weeks may indicate a perception that investors are now looking for more—namely, concrete signs of recovery. So far, these signals have remained elusive. However, investors may do well to keep in mind that a recessionary economy that is improving but not yet in full recovery has historically provided a positive backdrop for the prices of stocks and other riskier asset categories [See previous MARE article, *How Will the Bear Market End?*]. ■

EXHIBIT 2: While the pace of weekly jobless claims has declined some in recent weeks, companies have yet to increase the number of hours worked by employees, which typically occurs in a recovering economy.



Average weekly hours worked - manufacturing, seasonally adjusted. Initial unemployment insurance claims, 4-week moving average, seasonally adjusted. Source: Department of Labor, Bureau of Labor Statistics, Haver Analytics, FMRCo (MARE) as of 7/4/09.

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Past performance is no guarantee of future results.

[i] Source: The Conference Board, Haver Analytics, FMRCo (MARE) as of 6/30/09.

[ii] Stock performance represented by the S&P 500 Index. Source: FMRCo (MARE) as of 7/14/09.

[iii] May private housing units authorized by permits were 518,000 on a seasonally-adjusted annualized rate, up from a record low 498,000 on a seasonally-adjusted annualized rate in April. Records begin in January 1960. Source: Census Bureau, Haver Analytics, FMRCo (MARE) as of 5/31/09.

[iv] Source: Bureau of Labor Statistics, Haver Analytics, FMRCo (MARE) as of 6/30/09.

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