Markets Are Believing Fed But Ignoring Leading Indicators

The Fed has been successful in altering market expectations of future policy actions. No longer are the futures markets fully discounting interest rate cuts this year. And yearend 2024 fed funds expectations have been lifted over the last month from 2.75% to 3.75%. **There is a lot less easing priced into the forwards than what had previously been the case.** Meanwhile, the FOMC central tendencies show only 100 basis points (bps) in rate cuts next year.

Interestingly, this adjustment has occurred against the backdrop of continued deterioration in GDP growth prospects. **The Index of Leading Economic Indicators fell 0.7% in May, its 14th consecutive decline.** This is the longest span of declines since the 24 months from April 2007 to March 2009. Over the last year, the Index of Leading Indicators is down -7.9%, the lowest reading since September 2009 (-9.8%). Is the Fed making a significant policy mistake?

As illustrated in the chart below, the growth rates in Leading Indicators and real GDP are highly correlated. Seldom does either series move in the opposite direction on the other for any length of time. Both series are trending downward, with Leading Indicators down more substantially than real GDP, which is often the case.

While the depth of the decline in Leading Indicators does not necessarily tell us how big of a drop we will see in real GDP — witness its big decline in 2001 and what turned out to be a mild recession. Despite this, the Index of Leading Indicators has nevertheless been a good predictor of economic inflection points. The series is telling us that we could be nearing one now.

**Whenever the next downturn begins, its depth in part is going to be determined by how aggressively the Fed responds.** Right now, the probability of a policy pivot is low. Chair Powell has repeatedly stated that it is the FOMC’s intention to lift rates another 50 bps from already restrictive levels. If so, this would be happening against the backdrop of a worsening in Leading Indicators.

The upshot is that while the timing of recession may have been pushed out, its depth could be much deeper because of Fed hawkishness. If this is the case, then ultimately the Fed will cut rates much more than it anticipates. Consequently, earlier futures market expectations may be proven right.

![Chart showing the correlation between Index of Leading Indicators and GDP](chart.png)

*Source: Conference Board, Haver, SMBC Nikko*
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