

# WEEKLY ECONOMIC LETTER

July 6, 2001

## AN NBF SUMMER HITS COMPILATION

### Key Points

Top five reasons to cheer up:

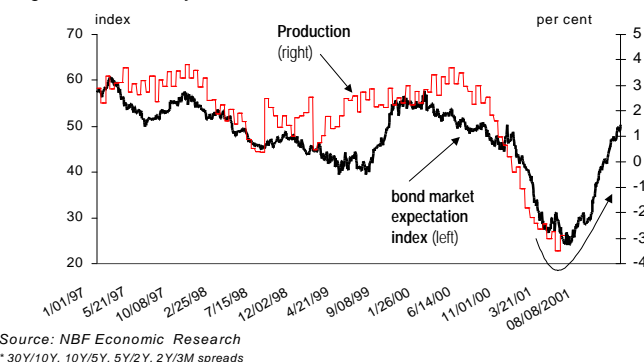
- #1. The clairvoyant bond market foresees an economic rebound.
- #2. Nonfinancial leading indicators are now validating the economic recovery signal from financial leading indicators.
- #3. The wait for Fed efforts to pay off is nearly over.
- #4. Financial market tensions are abating rapidly. Our financial stress indicator is at its lowest in more than four years.
- #5. A Fed tightening is beginning to be priced in for early next year. The futures market is rapidly warming to the V-shaped recovery scenario.

### Still waters

There was very little action on the markets this week. Concerns have temporarily shifted from whether the Fed's efforts will trigger a stock market rebound to whether it's a good day for the beach. So we thought it was time for a little light reading. How about an NBF summer hits compilation?

### (1) Keeping the Faith

U.S. industrial production and bond market expectation derived from all segments of the U.S. yield curve\*



### #1: Keeping the Faith

#### All-American Bond Market Big Band

*The number-one spot is still held by the All-American Bond Market Big Band and its upbeat single "Keeping the Faith." Longtime fans like us have not forgotten this band's big hit of 1999, "Going Down Fast."*

As chart 1 illustrates, the bond market implicitly sees a strong rebound of the U.S. economy later this year. This chart plots the yearly change in industrial production alongside our proprietary bond market expectations index, derived from all segments of the U.S. yield curve (30Y/10Y, 10Y/5Y, 5Y/2Y and 2Y/3M spreads). In short, the clairvoyant bond market foresees an economic rebound.

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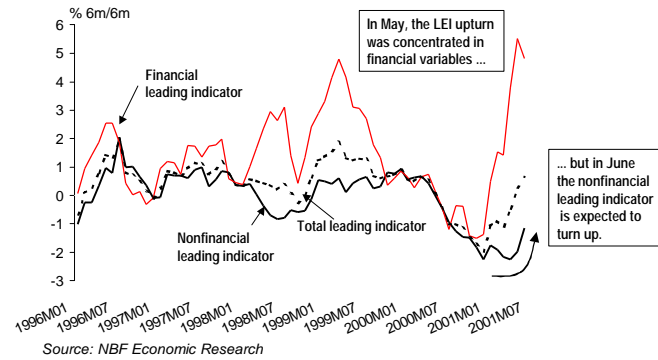
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**#2: Message in a Bottle**  
*Crystal Ball and Tea Leaves (formerly known as LEI)*

Up from third place, the very catchy reggae-flavoured “Message in a Bottle” moves to second in the charts. It’s been a while since we’ve heard from this band. Once considered has-beens, they are back in business and rapidly gaining popularity.

**(2) Message in a Bottle**

Financial and nonfinancial variables of the U.S. leading indicator (LEI)



In Chart 2, the dotted line plots the leading economic indicator (LEI) of the U.S. Conference Board. Two weeks ago we noted the LEI’s accuracy in signalling economic recoveries.<sup>1</sup> However, some have argued that the May signal of recovery was unreliable because it was due solely to upticks in financial components of the LEI. True, few of the nonfinancial components turned up in May.

For June, however, nearly all the nonfinancial LEI components released so far have turned up.<sup>2</sup> Chart 2 illustrates this point by splitting the LEI into financial and nonfinancial components. The strong signal from

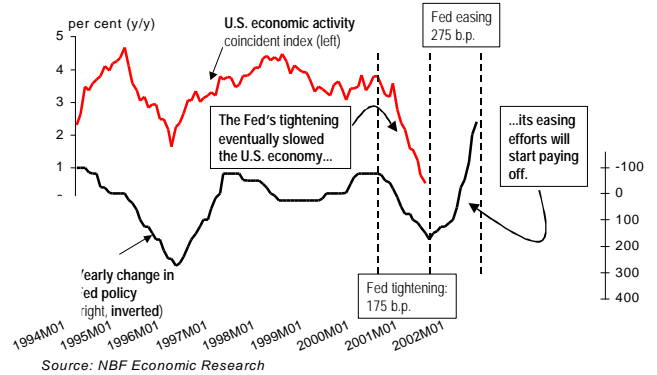
<sup>1</sup> “Lighthouse on the Horizon,” *Weekly Economic Letter*, June 22, 2001.

<sup>2</sup> Rising components in June: initial claims (very modestly), NAPM slower deliveries index (strongly), Michigan consumer expectations index (strongly). Manufacturers’ new orders for consumer and nondefence capital goods are not yet available but the NAPM survey suggests they should also edge up in June. Thus at least five of the seven nonfinancial components of the LEI probably turned up in June. In June, average weekly hours were slightly down.

the financial LEI for May is being validated by the nonfinancial LEI for June.

**(3) Saved by the Fed?**

Coincident index of U.S. economic activity and yearly change in the fed funds rate (inverted, lagged 12 -months)



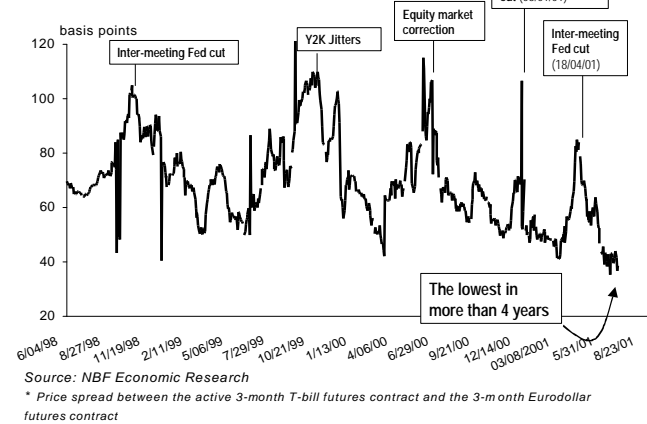
**#3: Ride of the Valkyries**  
*The Federal Reserve Orchestra*

The number-three spot is held by the Federal Reserve Orchestra and its nontraditional but very powerful version of the Wagner classic. In this version, Maestro Greenspan and his orchestra really give it all they’ve got, playing like there was no tomorrow. Some critics even say they’re pushing it too far.

The Fed certainly has a V-shaped recovery in mind. Its cumulative rate cut amounts to a very deep 275 basis points. Chart 3 links the U.S. business cycle (proxied by the U.S. coincident index) and monetary policy. For illustrative purposes we have inverted and lagged changes in the fed funds rate. This is a way of showing that the wait is nearly over – the Fed’s efforts will soon start paying off.

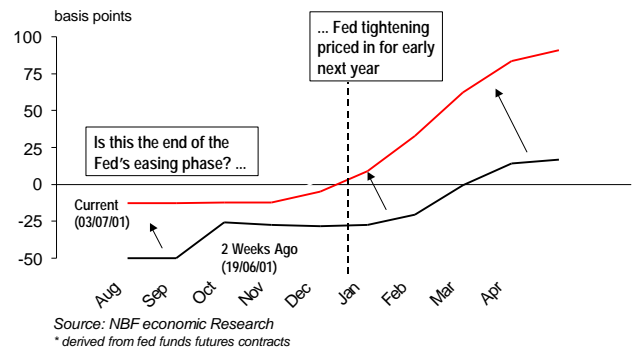
**(4) Good Vibrations**

*TED spreads\* (U.S. financial stress indicator)*



**(5) Flip Flop Fly**

*U.S. expectation curve\*: current configuration vs. two weeks ago*



**#4: Good Vibrations**  
*The Ted Spread Boys*

*A refreshing pop hit by the Ted Spread Boys now ranks number 4. It is good to see that this group also has a lighter side. We had become accustomed to more lugubrious titles from this underground duo.*

The Ted spread is a reliable financial stress indicator. In periods of heightened financial market tension it widens significantly, as happened in January and April. On both occasions, the Fed eased between meetings. The good news is that, since the April inter-meeting Fed cut, the Ted spread has been narrowing steadily and is currently the lowest in more than four years. Rapidly abating financial market tensions are consistent with an improving economic outlook. The environment is slowly but surely turning market-friendlier.

**#5: Flip Flop Fly**  
*Fed Funds Futures Club*

*The number-five spot is held by the Fed Funds Futures Club and their foot-stomping live version of “Flip Flop Fly.” Two weeks ago an official release wasn’t even planned – now the single is rapidly climbing the charts.*

Two weeks ago, the futures market was expecting the Fed to remain in easing mode for quite a while. Expectations have shifted rapidly after the Fed’s June FOMC meeting and the latest string of more upbeat economic reports. Chart 5 plots the Fed expectation curve, showing the amount of easing (or tightening) priced in over the coming months. As it indicates, the futures market is still undecided about the short run – it rates the odds of another quarter-point cut sometime between August and yearend at about 50%. This is quite a contrast with half a month ago. What’s more, a Fed tightening is beginning to be priced in for early next year. The futures market is clearly warming fast to the V-shaped recovery scenario.

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