One way to determine if a recession is coming soon is to build a model estimated from the historical data. If you do that, you may not like the answer. Many models say that a recession in the next 12 months is a virtual certainty.

For example, take a look at the data on building permits for private housing illustrated below, with the U.S. recessions shaded.

Ten mountains of homes have been built since 1954. The most recent permit peak of 2.2 million homes occurred about a year ago in August 2005. We are now skiing down a very steep slope, falling to 1.5 million units in October 2006. That kind of decline preceded seven of the last eight recessions, 2001 being the exception, which was a “business downturn” not a “consumer downturn.” There were only two sharp declines in building permits that did not lead into a recession. In the language of statistics, skiing down a mountain of permits predicts a recession well with only one false negative and two false positives. The false negative, labeled “FN” in the figure, was the 2001 recession that was not predicted because there was no decline in permits preceding it.

What explains the false positives? One decline in permits (#3) started in January 1966: that time, weakness in housing was offset by spending by the Department of Defense for the Vietnam War. There was also a relatively mild housing problem (#8) that started in October 1985 in the middle of the Reagan expansion but it did not lead into a recession. The life of that expansion was extended by a decline in oil prices, good export growth because of a depreciated value of the dollar and a monetary stimulus as well. This picture offers an unpleasant choice:
a recession soon, or a huge ramp-up in spending on the war on terror, or some major good fortune.

Any model built on housing starts is sure to say a recession is coming soon. But, the curmudgeon jokes: “Economists are like artists. They tend to fall in love with their models.” With considerably less pleasure, I would add.

Better to treat the model as a helpful companion, not an all-wise Delphic love-object. After all, accurate forecasting comes first from understanding that some things repeat and others do not, and second from recognizing that the line between the two is constantly changing. Models don’t have access to that bit of wisdom, since they are necessarily built on the assumption that everything in them only repeats. Electronic computers mindlessly project the past into the future. The organic computer that sits on your shoulders doesn’t suffer from that psychological rigidity. Your brain is capable of a broad range of free-spirited thinking ranging from the insightful to the merely wishful.

Thus, when your mind tells you that your model is going astray, listen carefully. Eliminate the wishful thinking and all that remains are the insights.

My view, announced in December 2005, is that this time will be different. This time the problems in housing will stay in housing. So far, I am feeling very smug. But this keeps me up at night.

In this column, first the models, and then the mind. The models say that a recession is coming soon. The mind says otherwise.

THE MODELS: PROBIT RECESSION ALARMS

The ten components of the Conference Board Index of Leading Indicators are natural places to begin to make a model to predict the next recession.

Table 1 reports these ten components. To be evocative, I have sorted them into groups: labor market, housing market, financial markets, manufacturing order books, and man-on-the-street predictions.

That “man-on-the-street” label for the “index of consumer expectations” is intended to be derogatory since, before looking at the data, we should begin with a high state of skepticism regarding the predictive value of survey responses to questions about the future state of the economy. What do they know anyway?

I have estimated thirteen different equations that predict recessions using one of thirteen
different indicators: the ten components of the Conference Board Index, the Purchasing Managers Index, the unemployment rate and the real price of crude oil. Essentially, I ask with this analysis how the year before a recession is different from the other periods. I exclude from the analysis the data during recessions as well as the first two years of expansions. This eliminates the recessions and the recovery periods that have their own special features which are not relevant to decide if a recession is coming soon.

The best single variable for predicting recessions is the interest rate spread, followed by claims for unemployment and building permits. Consumer confidence is about in the middle of the pack, better than expected.

The models that rely on history suggest that the extreme problems in housing currently being corrected will almost surely infect the rest of the economy, but that history does not take into account two important facts:

- Manufacturing is not poised to contribute much to job loss.
- Real interest rates are very low and there is no evident credit crunch, now or on the horizon.

These facts make the problem in housing less severe than it would be otherwise, and help to confine the pathology to the directly affected real estate sectors: builders, real estate brokers and real estate bankers.

You can see the manufacturing point in three figures (see next page):

- Outside of manufacturing and construction, there is hardly any job loss, as illustrated in Figure 1.
Figure 1—Payrolls Jobs

Figure 2—Detrended Employment in Manufacturing and Construction
(Manufacturing has one trend before 1983 and another after)

Figure 3—Contributions to Job Loss from Manufacturing and Construction
Year over Year Changes in Employment as a Percentage of Jobs Outside Manufacturing and Construction
• The employment cycles in construction and manufacturing are normally closely coordinated but they disconnected in the 2001 downturn, as shown in Figure 2. While construction is at a peak, manufacturing is at a trough, having never recovered from the last recession.
• There cannot be enough job loss in construction alone to qualify as a real recession. See Figure 3.

The bad news is that we trimmed 3 million jobs from manufacturing in the 2001 recession, but the good news is there aren’t many more to lose. That makes a recession highly unlikely, even though analysis of the historical data suggests otherwise. But that analysis cannot deal with the current disconnect between the construction and manufacturing cycles, because it hasn’t happened before.

CONCLUSION

The models say “recession;” the mind says “no way.”
I’m going with the mind. This time the problems in housing will stay in housing. If you are a builder or a broker, it will feel like a deep depression. The rest of us will hardly notice.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

REFERENCES AND FURTHER READING


