THE ECONOMIC OUTLOOK IS PERFECT —OR LOUSY. HOW DO YOU TELL?

Here's a guide to help you wend your way through the maze of conflicting indicators

Data is a four-letter word. Especially among investors, homeowners, and executives cursing the economy's maddening ambiguity.

On the one hand, "the economic news is just about perfect," says Edward E. Yardeni, chief economist at Prudential-Bache Securities Inc. The latest statistics show an economy growing fast enough to keep employment gains healthy but slow enough to prevent inflation from spiraling upward—the so-called soft landing. Industrial output rose a healthy 0.3% in August, and retail sales surged 0.7%. Producer prices fell for the third month in a row.

Yet some indicators are signaling anemic growth at best and recession at worst. The purchasing managers index is at a near-recession level. "Core inflation" is rising: Producer prices, excluding the volatile food and energy components, were up 0.5% in August. Corporate profits are down, interest payments are absorbing 30% of cash flow, and the junk-bond market's troubles are rippling through the economy.

THE BIG PICTURE. No doubt you're confused. But there is a way through the maze of statistics. First, take a look at some broad-brush indexes of economic activity rather than trying to read too much into one particular activity in a given month. That way, the constant up-and-down revisions that often seem to plague the individual measures may be partially diluted by the bigger indicators, and you can get a more accurate view of the general direction of economic growth. Then, a quick tour of a handful of indicators may be in order. Finally, the amateur forecaster should spend the most time reviewing indicators based on the financial markets, which these days, at least, seem to be emitting the most reliable signals for divining the economy's future course.

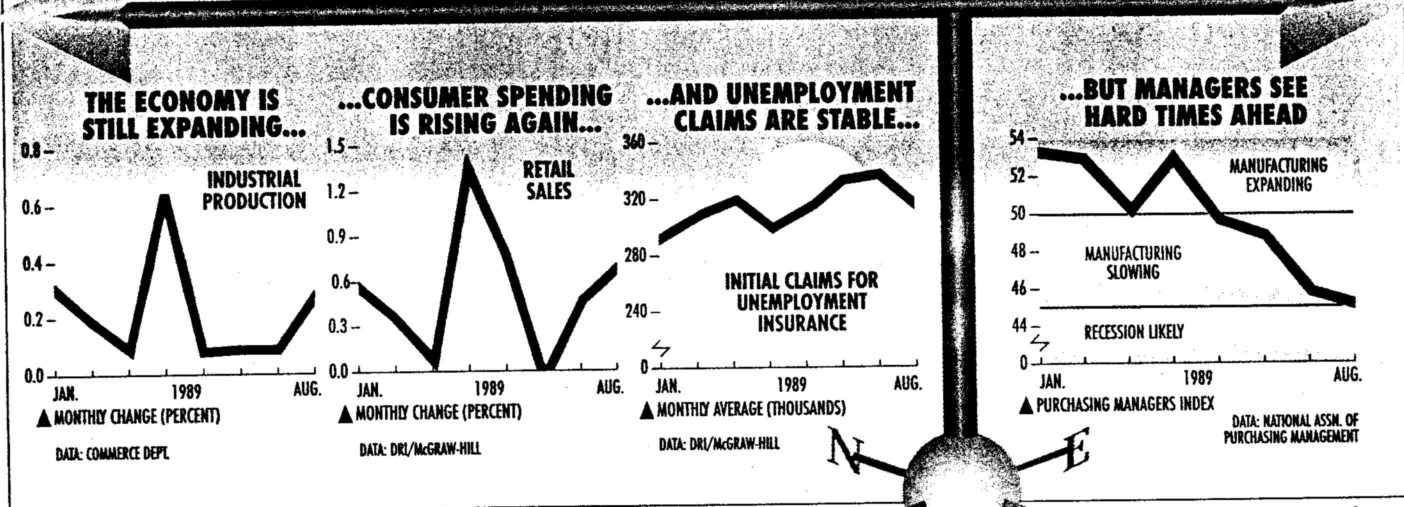
To get your bearings, check which way the wind is blowing by looking at the economic polls. Many economists use the *Blue Chip Consensus*, a monthly survey of 53 economists conducted by Robert J. Eggert in Sedona, Ariz. In September, the group forecast that real, or after-inflation, gross national product will be up 2.8% in 1989. It's worth noting, however, that this consensus, like conventional wisdom, is frequently off the mark. It underestimated growth in four out of the last six years of expansion—a period of 4% average annual growth.

Once you've grasped the consensus, take just a brief look at some of the individual indicators of what's going on in the real economy. The weekly report of initial unemployment claims has a good track record for pinpointing turns in the economy, for instance. The monthly National Association of Purchasing Management's survey is a useful window on manufacturing activity. But other indicators are less reliable. Don't read too much into retail sales. That measure has been revised upward 13 times in the past 16 months.

Then, move quickly from Main Street to Wall Street. The "money economy" captures both the economic fundamentals and the daily psychological mood of investors risking their money in an uncertain world. Today, the markets are signaling lower inflation and modest growth.

Take the so-called yield curve. When the economy is growing, short-term interest rates are often lower than long-term rates, producing an upward-sloping yield curve. One reason is that strong economic growth can fan inflation, so bond investors demand a yield premium to compensate them against eroding purchasing power. But when the Federal Reserve decides to fight inflation, it drives short-term rates up. Long-term yields fall as inflation abates. This creates an inverted yield curve, often a precursor of economic sluggishness and lower inflation.

Indeed, a study by Campbell R. Harvey of Duke University argues that the changing shape of the yield curve



LAUREL DAUNIS

is a powerful leading economic indicator. Today, the yield curve is almost flat, and according to Harvey's calculations that means the economy will be slowing to a 1.7% rate from now to the third quarter of 1990. Long-term bond yields, he says, must fall a full percentage point below the three-month Treasury bill rate, producing a sharply inverted yield curve, to flash recession.

Also signaling slow growth and tame inflation are commodity prices. While the government's monthly inflation gauges reflect the past, commodity prices are a favored indicator of inflation's future course because they show the extent to which demand is pushing prices up in the early stages of production. Right now, the Commodity Research Bureau's futures index, down almost 11% since last December, has remained fairly stable in recent weeks.

WHO TO WATCH. The money supply, too, is gaining adherents as a financial indicator, after having fallen into disfavor. The strong links between money-supply growth and economic performance were sundered by financial deregulation during the early 1980s. By now, though, the structural changes have been largely absorbed. And as the expansion ages, the role of the money supply is becoming more critical.

Too much money chasing too few goods yields inflation; too little money available to buy too many goods yields not only disinflation but also recession. So a careful look at the monetary aggregates is once again prudent. Money growth has been penurious since 1986, with the broadly defined M2 measure up a scant 3.5% this year, and some worry that tight money will translate into slow economic growth. "The longer money growth remains slow, the higher the odds that it will have an impact on the economy," says economist Edward S. Hyman Jr. of C. J. Lawrence, Morgan Grenfell Inc.

With the yield curve, commodity prices, and the money supply giving some of the most reliable signals around, it's advisable to watch the people who are watching these numbers. More and more, Federal Reserve governors and district bank presidents are checking the markets for clues, and how they react will make the difference between slow growth and no growth.

The nation's past six recessions came about when the Fed fought the inflation dragon head on—and ended up slaying the economy as well. So far, the Greenspan Fed has engaged only gingerly—but effectively—in preemptive action. Until and unless it has to engage in full-scale battle, the short-term outlook for the soft landing looks good.

On the other hand...

By Christopher Farrell in New York

FOUR SEERS NAME THE NUMBERS THEY LIKE

■ Edward S. Hyman Jr., *vice-chairman, C. J. Lawrence, Morgan Grenfell Inc.*

Hyman's weekly reports, with pithy insights scrawled alongside each chart, have drawn a huge following. Recently, Hyman began trying to put his insights to work making money, running a fixed-income mutual fund. "I'm long on bonds, with the economy slowing, and yields coming down." He sees 1% growth, 3.5% inflation, and 7% bond yields in 1990.

'I'm long on bonds with the economy slowing, and yields coming down'

HYMAN

One of his favorite indicators, because of its timeliness and comprehensiveness, is the weekly measure of initial unemployment-insurance claims. In addition, Hyman solicits information each week from contacts at department stores and other companies to get a sense of their business. Finally, he watches commodity prices closely, not only for inflation signals but also to gauge demand. Today's numbers, buttressed by an analysis of low money-supply growth, declining credit demands, and flat to inverted yield curves around the world, lead Hyman to forecast a slower period of economic growth.

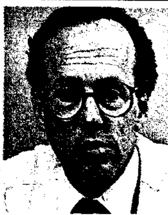
■ Stephen S. Roach, *senior economist, Morgan Stanley & Co.*

Roach is widely admired for his reasoned studies of major economic trends, such as his dispassionate look at leverage and the role of the computer in the service economy.

He's no slouch as a forecaster, either. "It's clear that the economy is reaccelerating," says Roach, who expects 3% real GNP growth in the second half of this year. He's focusing on the consumer, watching the momentum in retail sales and real disposable income. But with "core inflation"—excluding food and energy costs—running above 1988's rate, he says that the Federal Reserve will be forced to clamp down to fight inflation.

'It's clear that the economy is reaccelerating'

ROACH



■ Edward E. Yardeni, *senior vice president, Prudential-Bache Securities Inc.*

Yardeni is an optimist. He began a recent report with this sentence: "'End-of-cycle' and 'twin deficit' preoccupations have distracted many investors from seeing and appreciating the big, global picture—which is extraordinarily bullish for stocks, bonds, and humans!"

So it isn't surprising that Yardeni sees 3% real growth and inflation of 3.5% over the next year—and long-term Treasuries yielding 5% by 1993. The U. S., he believes, is in a long-run disinflation trend. "If you threw me in a prison cell with no windows and only one data series to pick, I'd pick the Commodity Research Bureau's industrial spot prices," he says.

'The global picture is extraordinarily bullish for stocks, bonds, and humans'

YARDENI

■ Samuel D. Kahan, *chief financial economist, Kleinwort Benson Government Securities Inc.*

Chicago-based Kahan has a healthy respect for the financial markets as economic indicators. He watches the tilt of the yield curve carefully, and compares the level of short-term interest rates with the inflation rate. These days, he sees a 2% to 2.5% pace of GNP growth. But that growth will be uneven. "The economy's current expansion has been characterized by the phenomenon that problems have been contained without spreading into other sectors," says Kahan. He expects more "rolling recessions" to hit one region or sector without knocking the economy into a recession.

'Problems have been contained without spreading into other sectors'

KAHAN

By Christopher Farrell in New York

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