



## Is the return to economic growth imminent? Interpreting the signs of stabilization

In the past few weeks, the most recent economic and financial news has focused on signs of stabilization in the economy and financial markets. Consumer and business confidence is rising, the pace of layoffs is easing, the real estate market seems to be looking for stable ground, etc. The end result: confidence is gaining traction in financial markets and the main stock indexes have posted significant gains since the start of the year.

The stock market rebound can also be attributed to the easing of financial tensions (graph 1) and the fact that concerns regarding the U.S. financial sector have all but disappeared. The main institutions now appear to have sufficient capital to weather this storm.

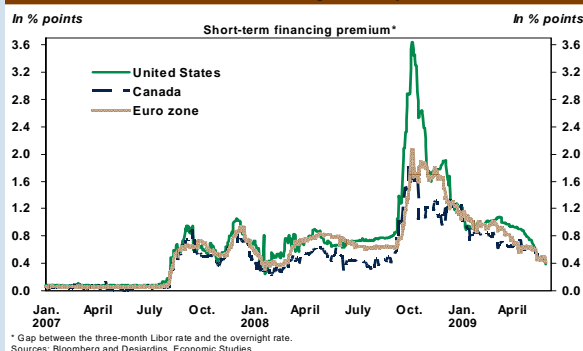
This situation is in sharp contrast with the climate that reigned a little more than two months ago, when few people seemed to believe in the stimulus efforts enacted by governments and the monetary authorities. This change in mood has spread to other major financial variables, like commodity prices. At the forefront, oil prices have doubled since their low point in December 2008. Exchange rates are also experiencing abrupt changes in direction. The context characterized by a stronger U.S. dollar propped up by demand for safe-haven securities is slowly fading away.

No one will win a Nobel Prize for claiming that a recession is always followed by a return to economic growth. The most difficult part is predicting when this return will take place and its magnitude. While many indicators can be used to attempt to answer this question, we have to focus on the most relevant ones and understand the signals they are sending us.

In this *Economic Viewpoint*, we will identify and analyze several indicators for the U.S. and Canada and the latter's two main provinces, Ontario and Québec. And while some signs point to stabilization in the economy and a possible recovery, nothing can really be taken for granted yet.

On a more positive note, we should see more encouraging signs in the months ahead, suggesting ongoing stabilization in our economy and that we are slowly but surely heading toward an economic recovery.

**Graph 1 – Funding gaps, which mirrored financial tensions, have eased significantly**



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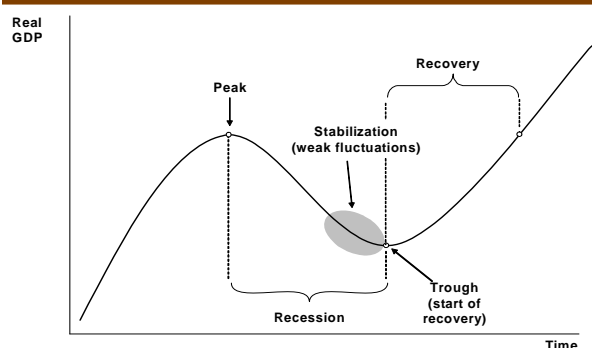
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**STABILIZATION AND RECOVERY ARE TWO DIFFERENT THINGS**

First things first, we must avoid systematically relating any «stabilization» with an “economic recovery.” While these concepts may be similar, there are major differences between the two. If we refer to the tracking of an economic cycle (graph 2), the stabilization period we are referring to moves in line with the phase of the cycle where the drop in real GDP loses steam, spreading out towards a zero-rate decline. As for the economic recovery, it corresponds instead to the period in the cycle where the economy starts to show sustainable growth. This period begins once the recession hits its lowest point. In short, the economy stabilizes just before the recovery takes hold.

**Graph 2 – Stabilization and recovery: two different concepts**



Sources: Conference Board of Canada and Desjardins, Economic Studies

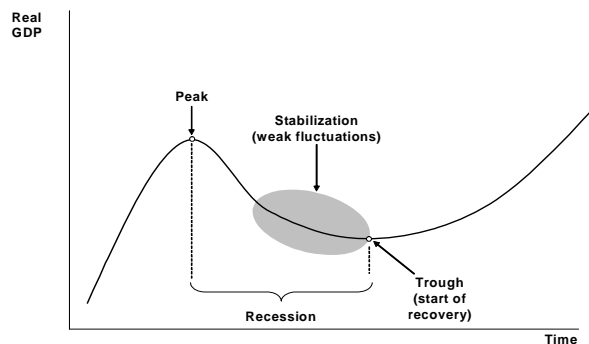
When the recovery is V-shaped, i.e. when the economy starts to show rapid growth after a steep drop in real GDP, enthusiasm from stabilization signs runs naturally high because everyone believes that a recovery is imminent. However, the recovery could end up being U-shaped, meaning that after a sharp decline in the real GDP, the stabilization phase could draw itself out before any recovery really takes hold (graph 3). Growth rates during the recovery also tend to lesser levels than we usually see during a V-shaped recovery. In fact, this is the economic scenario we expect to take hold.

During periods of economic stabilization, employment falls less quickly, but losses continue to accumulate; confidence is bumped up, but consumption doesn't necessarily follow suit. A spike in any given indicator should not always be seen as an upturn in economic growth. We have to be careful when deciphering the true meanings of changes in these indicators.

**CONFIDENCE INDEXES AND BUSINESS ACTIVITY**

The most difficult indicators to interpret may very well be those that measure confidence and business activity. Not only do we have to rely on the direction they are heading in, we

**Graph 3 – U-shaped recovery: stabilization phase could linger a long time before any meaningful recovery takes hold**



Sources: Conference Board of Canada and Desjardins, Economic Studies

also have to trust where they are at any given moment. For example, in the United States, as long as the ISM manufacturing index hovers at around 40, the economy should remain in recession. An uptick in this index could signal some form of stabilization, with a recovery still far off into the future. Another example: even if confidence improves, it could remain relatively weak from a historical standpoint and continue to weigh negatively on consumption. The level reached may be in line with a stabilization since the decline in consumption is increasingly less steep, but it is still incompatible with a rapid return to economic growth in the short term.

**THE STOCK MARKETS**

The stock markets are often heralded as harbingers when it comes to predicting the turning points in cycles of economic activity. In fact, with the exception of the recession in 2001, the U.S. stock market successfully predicted the end of recessions three to six months in advance (table 1).

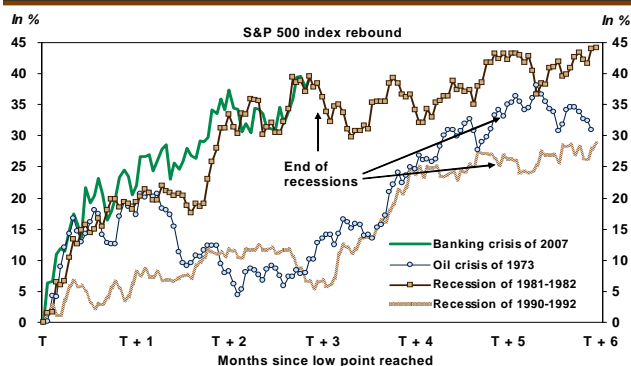
**Table 1 – The stock market usually hits its low point three to six months before the economic recovery**

	Stock market trough	Trough in economic cycle	No. of months in advance
United States	May 1970	November 1970	6 months
	October 1974	March 1975	5 months
	March 1980	July 1980	4 months
	August 1982	November 1982	3 months
	October 1990	March 1991	5 months
	October 2002	November 2001	-11 months*
Canada	July 1982	November 1982	4 months
	October 1990	March 1992	17 months

\* Financial scandals and the uncertainty surrounding the war have not allowed the stock market to anticipate the end of the 2001 recession in the United States.  
Sources: Datastream and Desjardins, Economic Studies

Several stock indexes have posted sizable gains since they reached their low points in March 2009. In the United States, the rebound is strangely similar to the one that followed in the wake of the 1981-82 recession (graph 4). The economic

**Graph 4 – Current stock market rebound in United States is similar to that of the 1981-1982 recession**

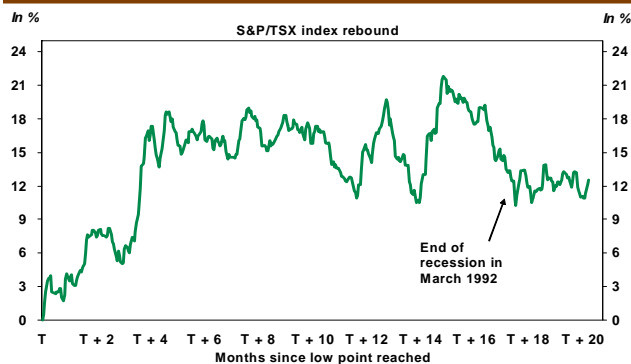


Sources: Datastream and Desjardins, Economic Studies

recovery started to take hold a mere three months after the stock market hit its trough, and the rebound was sustained: real GDP in the U.S. shot up by 7.7% in the first 12 months that followed the end of the recession.

Nothing should be taken for granted in this case, however. During the recession that followed the 1973 oil crisis, the stock market almost fell back to its low point after recovering about 20% in a little more than one month, a false start indeed. The real rebound took place only a few months later, and we could very well witness a repeat of this scenario. An even more vivid example took place in Canada during the 1990-92 recession, when the stock market hit its low point 17 months before the economic recovery took hold (graph 5).

**Graph 5 – Canadian stock market rebound of the 1991-1992 recession had been particularly early**



Sources: Datastream and Desjardins, Economic Studies

The stock market's steep decline and the circumstances that drove the markets to that level also have an impact on the recovery. When concerns and pessimism swell to inflated levels, the markets indexes can tumble quickly and sharply. As such, the rebound that follows an abnormally low slump is simply a readjustment, and does not necessarily signal an economic recovery. It bears mentioning that in last March, several people believed we were on the verge of an economic

depression and many expressed doubt that the financial institutions that were in trouble would come out of this crisis intact. The risks of nationalization appeared quite high for them, in fact. A few months down the road, the markets moved away from this possibility, which partly explains the rebound. The stock market therefore has to post higher gains in order to signal a convincing economic recovery.

### LEADING INDICATORS

Leading indicators are specifically designed to predict movements in economic activity, especially the turning points. When analyzing these indicators, we must focus on their reliability and what makes them fluctuate. In fact, a leading indicator is made up of several variables and sometimes only some of these can ensure that the indicator signals a turning point. If there are misgivings in these variables, then the overall indicator becomes more questionable as well.

The Organisation for Economic Co-operation and Development (OECD) compute leading indicators for different geographical regions across the globe. The latest data for April showed that many regions may very soon reach their low points in this crisis (see box at next page). Note that the turning points highlighted by OECD leading indicators are based on movements in total industrial output. The results, however, can vary from those obtained if the turning points are based on movements of total economic activity, which reduces the reliability of the signals.

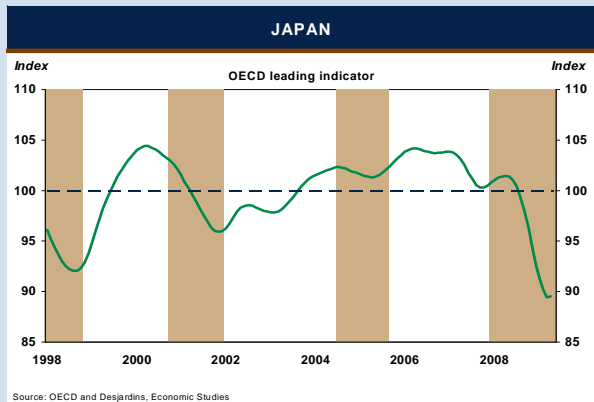
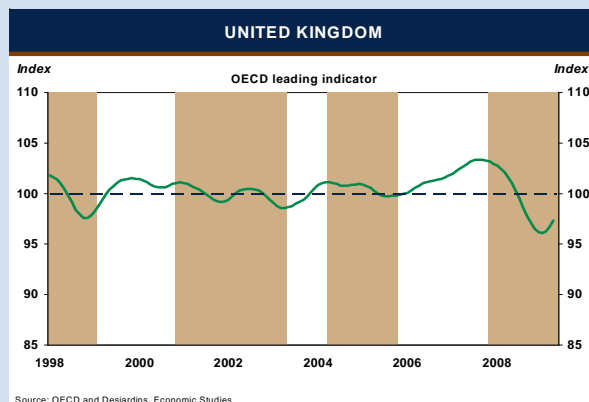
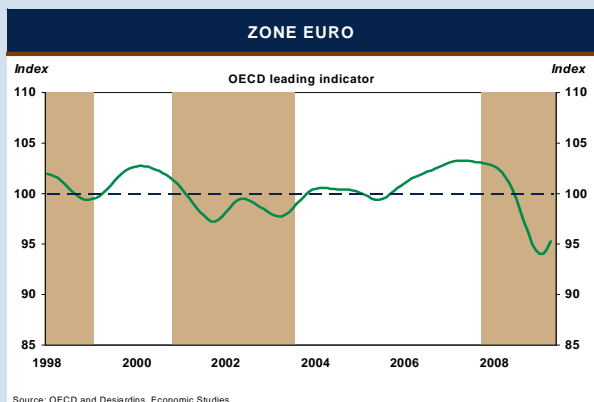
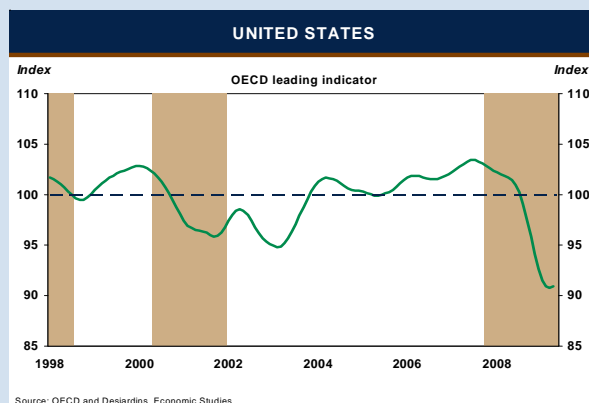
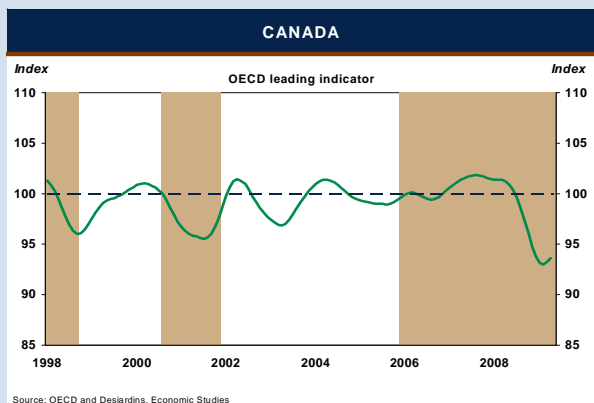
### OTHER VARIABLES

Other relevant variables also merit analysis to predict turning points in economic activity. For example, housing starts usually show gains a few months before the end of a recession. Shifts in inventories can also provide clues. Businesses usually bump up their inventories when they anticipate a recovery. The slope in the yield curve is effective in predicting the start of a recession about 9 to 12 months before it finally strikes, but the signal is harder to decode for recoveries. Lastly, an increase in the number of hours worked, or a drop in jobless claims is the job market's way of signalling an economic recovery.

To provide a snapshot of the most recent signs of stabilization and economic recovery, the following sections spotlight changes in certain variables and selected leading indicators in the United States, Canada, Ontario and Québec.

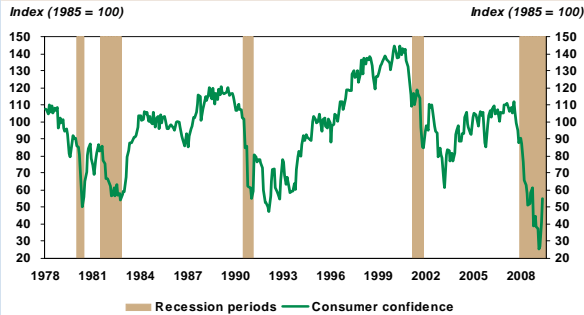
**Box**  
**OECD leading indicators**

These indicators signal turning points in economic activity approximately six months in advance, and their accuracy varies from one country to another. The shaded areas represent the growth cycle's slowdown phases (measured by peaks and troughs) based on one selected variable: total industrial production. The economy usually enters a recovery a few months after this indicator starts moving up again.



SIGNS IN THE UNITED STATES

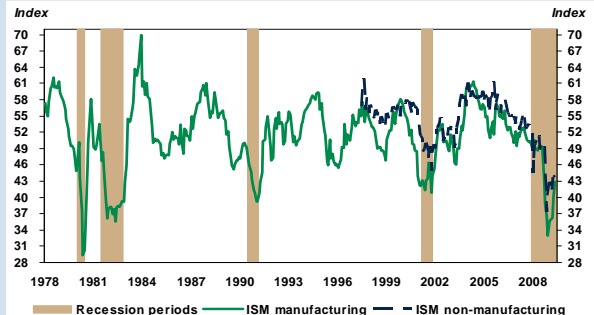
United States - Conference Board consumer confidence



Sources: Conference Board and Desjardins, Economic Studies

The decline in household confidence during this recession truly reflects the scope of the difficulties being faced. While it's been rising for three months now, the level of confidence still signals a decline in real consumption. However, the pace of the decline will moderate. The most recent reading of the confidence index—54.9—is close to levels signaling the end of a recession. The average level of this index at the end of the recessions in 1980, 1981-82 and 1990-91 was 56.6.

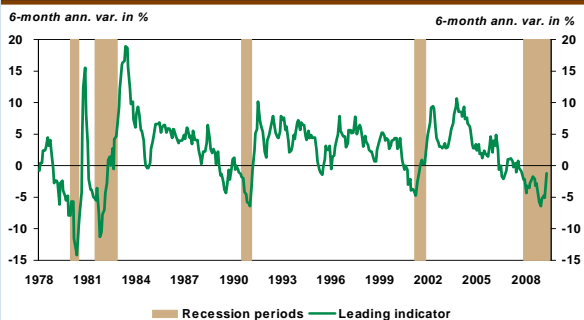
United States - ISM indices



Sources: Institute for Supply Management and Desjardins, Economic Studies

Since last winter, both the ISM manufacturing and non-manufacturing indexes have shown notable advances. They remain under the 50-mark, however, which point to an increase in activity. The 50-mark level is not a required condition for the recession to be nearing its end. The average of the ISM manufacturing index just prior to the last three recoveries was 39.9, and it is currently at 42.8. The troubles in the automobile sector and the anticipated decline in production could limit any new advances in this index.

United States - Conference Board leading indicator



Sources: Conference Board and Desjardins, Economic Studies

The leading indicator is a combination of 10 variables and several of them are analyzed in this document. Recently, it showed an increase for one month only, in April, but the pace of previous declines was easing up slowly, pointing to stabilization in the economy. As such, the six-month change in this indicator has improved, moving from a low of -6.4% in December to -1.2% in April. This indicator would have to move into positive territory in the near term to raise hopes for an end to the current recession.

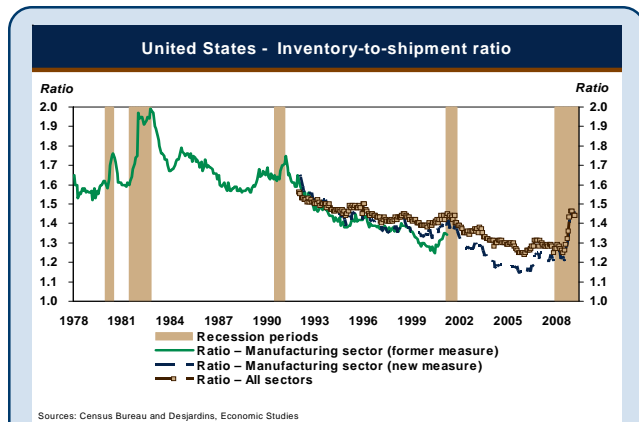
United States - Initial unemployment claims



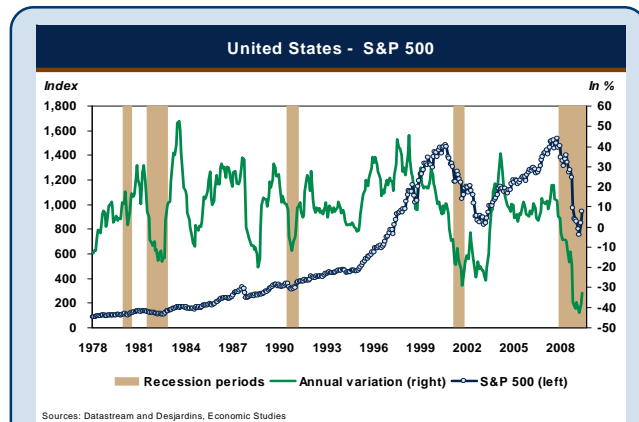
Sources: Office of Workforce Security and Desjardins, Economic Studies

Weekly jobless claims reached a level during this cycle not seen since October 1982. The recent peak was reached at the end of March 2008. Peaks are usually reached towards the end of a recession, which is obviously a good sign. However, the scope of new jobless claims and mounting job losses (not including the troubled automobile sector, again) could end up clouding the signal.

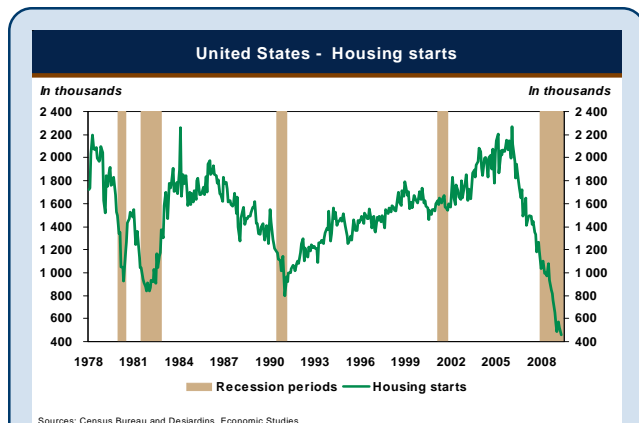
SIGNS IN THE UNITED STATES (suite)



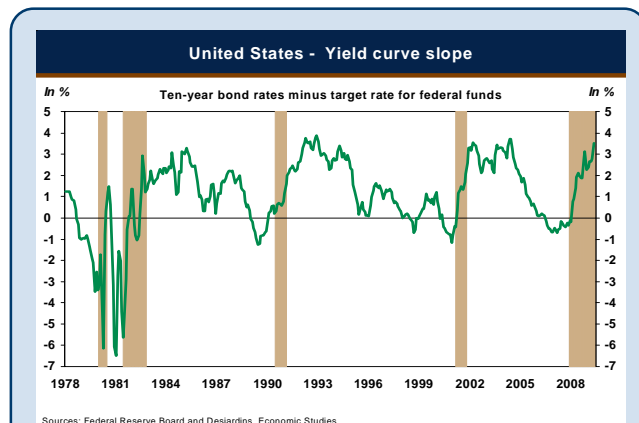
The downward adjustments made by business in terms of demand are behind the decline in production that characterizes a recession. When demand plunges, the inventory-to-shipment ratio rises. The ratio has risen from 1.25 to 1.46 during this recession, the highest level since 1996. With the exception of the 2001 recession, this variable usually peaks towards the end of a recession. It remains unclear whether a peak has been reached in this current cycle.



The stock market usually rises three to six months before a recession ends, except for the 2001 recession. The annual change in the S&P 500 is also a good signal, moving into positive territory before the end of the recession in 1980, 1981-82 and 1990-91. If the index hit its trough in March 2009, the annual change is still very low, however, at -35%. We need a much more substantial increase to hope for a clear message that the end of the recession is near, especially since there's a risk the market may correct again.



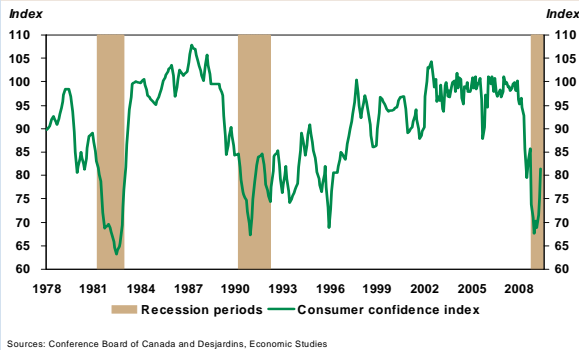
The downfall of housing starts since the peak in 2006 has been phenomenal: 80%. Real estate is one of the first sectors that usually see growth during a recession, as it reacts quite keenly to interest rate cuts. The problems in this sector run so deep, it is hard to imagine any rebound in construction in the short term, and we have yet to determine whether a genuine trough has been reached since the lowest level in this cycle was recorded in April 2009 with 458,000 units breaking ground.



Spread between 10-year federal bond and federal fund rates is about 350 basis points which is more than average near the end of previous recessions. Extremely weak key interest rates and rising bond rates in connection with the exploding public debt are providing strong support to this spread. In addition, tightened credit conditions and the fragile state of the financial sector are no doubt limiting the stimulus effects low key rates can have on the economy.

SIGNS IN CANADA

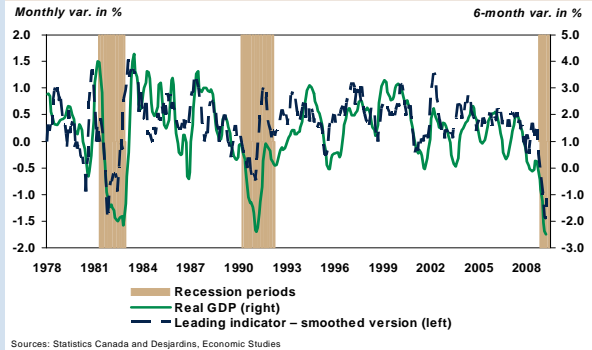
Canada – Consumer confidence



Sources: Conference Board of Canada and Desjardins, Economic Studies

After dropping sharply since the end of 2007, the consumer confidence index has rebounded these past few months, signalling that the economy has entered a stabilization phase. And yet it is still at a low level historically, which suggests that the recession will continue for a few more months. This index would have to rise closer to the average levels seen before the recession to signal the end of the contraction in the economy.

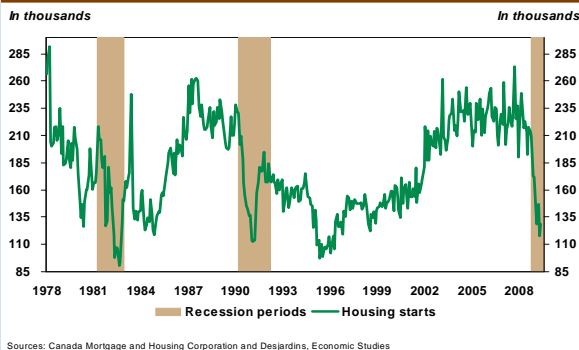
Canada – Leading indicator



Sources: Statistics Canada and Desjardins, Economic Studies

The unsmoothed version of the leading indicator rose by 0.5% last April, the first monthly increase since August 2008. This upturn is largely explained by the rebound in stock market prices and growth of the money supply. The smoothed version of this indicator clearly continued to decline however, but at a slower pace. It usually foretells the end of a recession a few months ahead when it restarts to increase. Stock prices could correct however, nipping any recent improvements in the leading indicator in the bud.

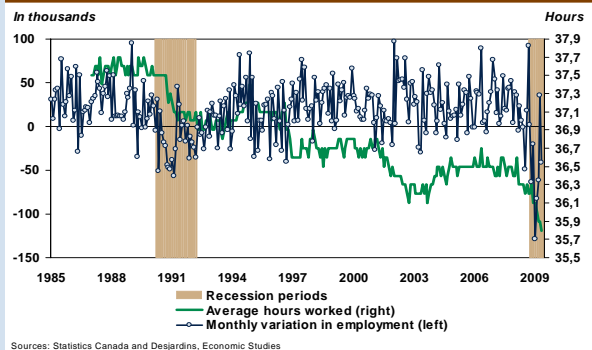
Canada – Housing starts



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

Housing starts are not really showing signs of improvement. In the past few years, several regions across the country had over-invested in this sector, a situation that is being corrected gradually. As seen during previous recessions, we cannot hope for any genuine economic turnaround if residential construction does not stabilize. The decline in prices for new homes and interest rate cuts are improving affordability in the real estate market, which may prove fruitful in the coming quarters.

Canada – Average hours worked per week



Sources: Statistics Canada and Desjardins, Economic Studies

After shedding 356,600 jobs between November 2008 and March 2009, the labour market bounced back in April but then lost 41 800 jobs in May. The same surge was noted during the recession at the start of the 1990s, which did not prevent the downward trend in employment from making an about-face. Given that employment is usually a lagging indicator, early signs usually stem from the average number of hours worked instead. And since the decline in the hours worked has yet to stabilize, this signals that Canada is still grappling with economic difficulties.

**SIGNS IN CANADA** (suite)

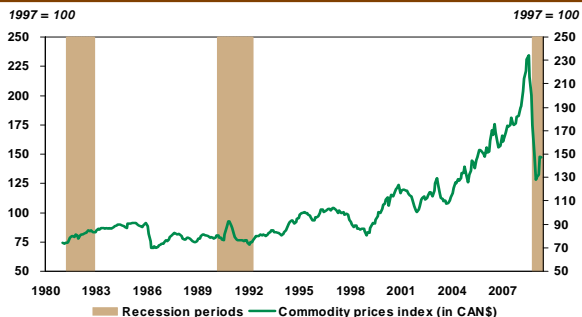
**Canada – Retail sales of durable goods**



Sources: Statistics Canada and Desjardins, Economic Studies

The consumption of discretionary goods and services (that are less essential to the day-to-day lives of households) drops sharply during recessions. For example, retail sales of goods and services fell by 15.4% between January and December 2008. Some improvement has been noted since the start of the year, however. The recent jump in household confidence, slashed interest rates and programs designed to stimulate automobile sales seem to have favoured purchases of durable goods.

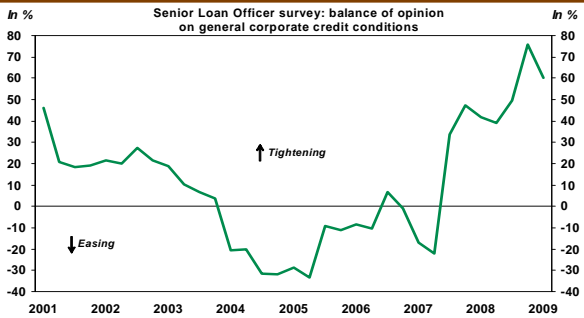
**Canada – Commodity prices**



Sources: Statistics Canada and Desjardins, Economic Studies

Canada's economy was dealt a blow from plunging commodity prices that started falling in mid-2008. Not only did the value of exports decline dramatically, many investment projects were either shelved or cancelled outright. However, most commodity prices have rebounded in the past few months. If this trend continues, Canada's economy could once again benefit from a positive wealth effect, leading us out of this recession that much faster.

**Canada – Business credit conditions**



Sources: Bank of Canada and Desjardins, Economic Studies

Credit conditions continued to tighten, although to a slightly lesser extent than in the previous quarter. This improvement stems essentially from non-pricing lending conditions even though several respondents signalled no changes on this front since the end of 2008. Tightened credit conditions led to a decline in the annual change in the corporate credit portfolio, which fell from 8.1% at the end of 2007 to 3.7% in April 2009.

**Canada – S&P/TSX**

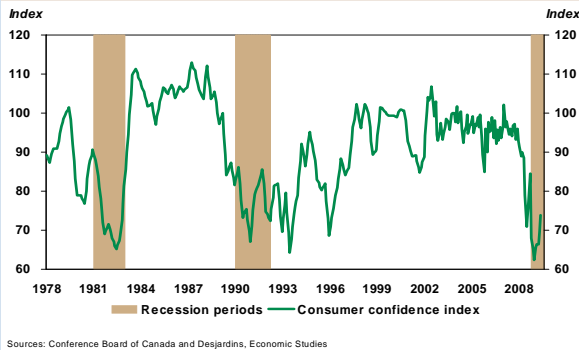


Sources: Datastream and Desjardins, Economic Studies

As we have seen in previous recessions, movements in the stock markets usually run ahead of the economic cycle by a few months. It just so happens that Canada's main stock index, the S&P/TSX, has surged ahead these past few weeks due to improved global economic outlooks and the recent spike in commodity prices. This reversal could signal that an economic recovery could occur in the next few months.

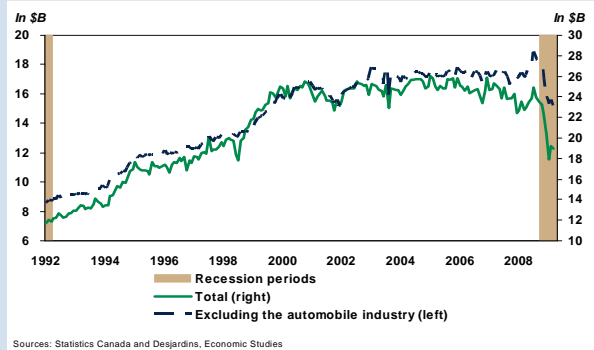
SIGNS IN ONTARIO

Ontario – Consumer confidence



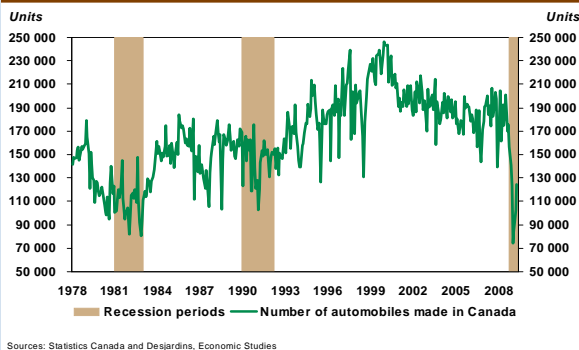
Like elsewhere across the country, the confidence index of Ontario households has posted slight gains in the past few months. Consumer confidence in Ontario has risen by 18% since the low point was reached at the end of 2008. However, since consumer confidence in this province had dwindled further in previous quarters, the climb up will be that much steeper. As such, household confidence in Ontario is still relatively low, suggesting that the recession could last for a few more quarters.

Ontario – Manufacturing sales



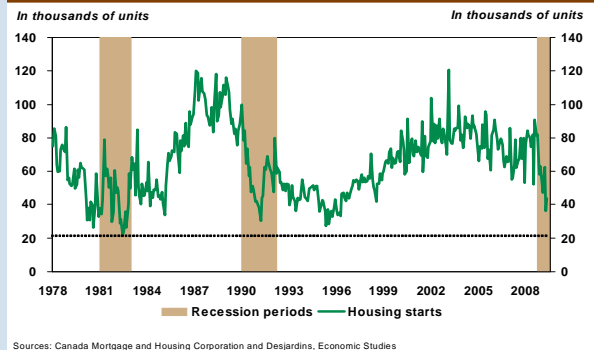
The recent increase in the number of automobiles produced clearly paved the way to a slight uptick in total manufacturer sales in Ontario in the past few months, but the troubles in Ontario's manufacturing sector remain uncompromising and widespread. If we exclude the automobile industry, sales are still down, corroborating the negative effects of the global recession and the jump in the loonie's value seen earlier.

Ontario – Automobile production in Canada



In addition to the cyclical decline in global demand, as was the case in previous recessions, Ontario's automobile industry will have to deal with a major restructuring at North America's big three automakers. The number of new automobiles built has fallen dramatically these past few quarters and the recent improvement wiped out just a tiny portion of the losses sustained. This upturn is fragile, however, since the ongoing restructuring could lead to further closures in the months ahead.

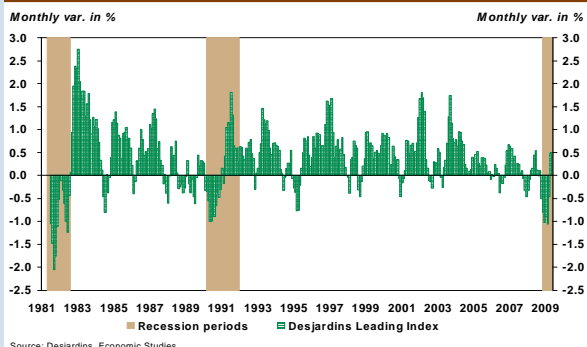
Ontario – Housing starts



The number of residential construction starts has fallen sharply in the past few quarters, with little signs of stabilization on the horizon. At 43,800 units, the number of housing starts is close of its historic low of 22,000 units recorded in June 1982. Ontario is still waiting for residential construction to recover, which signalled the imminent end of economic contractions in previous recessions.

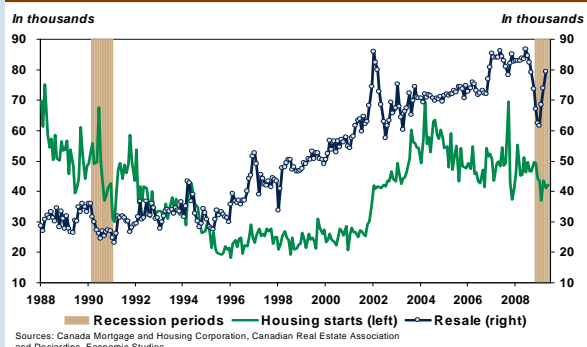
SIGNS IN QUÉBEC

Québec – Desjardins Leading Index



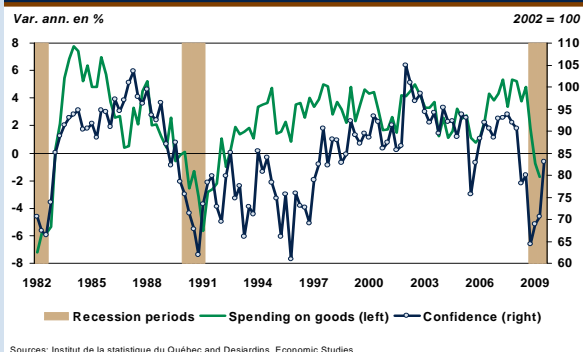
The Desjardins Leading Index (DLI) was finally put right in April, posting a monthly gain of 0.5%. While this increase is certainly an encouraging sign, it is still too timid to unequivocally herald the end of the recession in Québec. It is still too early to forecast that the economy will reach a turning point in the next three to six months. If other increases are posted this summer, the true recovery may very well take hold at the turning of the year. For the moment, the DLI's revival signals that the worst of the economy's deterioration is now behind us.

Québec – Housing starts



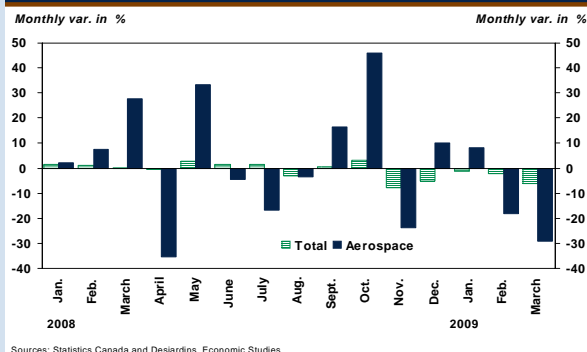
Housing starts show poor signs of improvement, which does not suggest that an economic recovery is just around the corner. While the decline is less steep than in other regions across the country, construction continues to fall. Sales of existing homes spike recently after they sag last fall. And while Québec has skirted the price declines that have taken hold in the rest of Canada and in the U.S., further drops in the number of homes sold would quickly translate into declining home prices.

Québec – Consumer confidence



The jump in confidence levels is surely the most promising sign of a possible economic recovery. The mood in households continued to improve in April, reaching its highest level since September 2008. The brutal crash in stock prices in October 2008 saw confidence levels tumble close to low points last seen in the 1990s. The index is currently slightly below its historic average of 85, a level that has to be reached before we see any growth in consumer spending, an essential ingredient to end the recession.

Québec – Manufacturing sales



Manufacturing sales suffered a fifth consecutive decline in March (-6.1%). Lower sales in the aerospace sector (-29.0%) fuelled this decline. Layoffs will continue to mount in this sector, which does not raise hopes for any near-term improvement. And while a turnaround in the manufacturing sector is not essential to an overall economic recovery, the recent drop cannot be seen as a sign of an upswing.

**CAREFUL : DOWNWARD RISKS STILL EXIST!**

In light of our analyses, we can't deny that some signs have started to emerge that point to stabilization, if not to an imminent economic recovery. It also bears noting that the most recent data available go back, in most cases, to the month of March or April. Assuming that certain signs emerge usually three to six months before the economic recovery, this would see the recovery take hold sometime towards next fall. The data to be released shortly should confirm an imminent upturn.

In the United States, several indicators show encouraging signs that we are settling into a stabilization phase, but other indicators will remain unstable in the short term. This is the case for the ISM manufacturing index, which could see a new decline should an abrupt restructuring take place at General Motors. The yield curve slope is very steep, but it partially reflects the weak impact of the monetary policy, which requires a key rate of close to 0%, and the increase in bond rates associated with investors' concerns about excessive public debt. We do not dismiss the possibility of a short-term market correction either. The increase would in fact have to be more convincing to frankly state that a recovery is imminent. With regard to the real estate market, nothing points to any quick turnaround. And since this variable usually takes the lead in cycles of economic activity, this could mean the recovery will be slower without its contribution.

In Canada, several signs are pointing to a recovery. However, these signs say nothing of when this recovery will take off: maybe in three months, or perhaps nine. Even if we can claim that the worst is behind us, the recession will most probably drag on until the fall.

Ontario is the most hard-hit Canadian province due to the size of its automobile industry. The restructuring of U.S. automakers will not take place overnight and the after-effects will be felt for quite some time. Ontario will, without a doubt, be one of the last provinces to recover from this recession.

In Québec, despite improvements in household confidence, several economic indicators continue to point downwards, especially those that reflect manufacturing sales. The upturn in the DLI in April, however, provides another pale glimmer of hope. But we need to see this indicator bump up further before we can confirm any recovery by the end of the year.

Overall, these indicators are evolving in line with our scenario that calls for a U-shaped recovery in fall. In the meantime, the economy will continue to contract, but at an increasingly slower pace. That said, we must not underestimate the downward risks, which remain substantial. These risks tend to pile up during recessions when negative spill-over effects start to ripple through the economy. The first job losses often pave

the way for even more job cuts and some restructuring, especially in the automobile sector, are far from over. In fact, other risk sectors could, in the end, sink under the weight of falling demand for their products or services, as is the case for air carriers.

On a more positive note, we should see more encouraging signs in the months ahead, suggesting ongoing stabilization in our economy and that we are slowly but surely heading toward an economic recovery.

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