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## UNDERSTANDING ECONOMIC INDICATORS

Economic indicators are either narrowly defined or broad-based measures of economic conditions or activities. Many of them have a significant impact on the financial markets since they provide part of the picture of the economy. Leading indicators are those believed to change in advance of changes in the economy, giving one a preview of what is going to happen before the change actually occurs. There are also coincident indicators, which change about the same time as the overall economy, and lagging indicators, which change after the overall economy. From a predictive perspective, leading indicators are much more useful. In addition, the Fed watches many of the leading indicators as it decides what to do about interest rates. For these reasons, leading indicators are important pieces of information to the financial markets. Below is a summarization of major leading indicators, what they mean to the bond (or fixed income) market, and how one may keep track of the latest release. The fixed income market is relevant to credit unions because it dictates the overall level of interest rates, which influences credit unions' loan rates, investments yields, and dividend rates going forward.

### **Gross Domestic Product (GDP)**

The most important indicator is the GDP report. GDP measures the total output in the United States (Excluding U.S. citizens working abroad while including foreign nationals working in the U.S.). The main components of GDP are consumer spending; investment by businesses in new equipment, facilities, and inventories; spending by federal, state, and local governments; and net exports (exports minus imports). Estimates of GDP are made quarterly, and the rate of growth or contraction is expressed as an annual figure.

GDP growth is generally regarded as good news because it signifies more jobs, higher income, and more opportunities for businesses to earn profits. However, the market will be concerned about the overall level of GDP growth because if the economy is growing too rapidly, it can lead to high inflation. So, the key to the interpretation of the GDP report is to find out whether the GDP data is above or below *expectations*. If growth is stronger than expected, people will be fearful of rising inflation which results in higher interest rates and lower bond prices. By contrast, bonds will rally on weaker than expected GDP figures and on expectations the Fed may cut short-term rates.

- **Source:** Bureau of Economic Analysis, U.S. Department of Commerce
- **Release Time:** Third or fourth week of the month at 8:30 EST for the prior quarter, with subsequent revisions released in the second and third months of the quarter.
- **Raw Data Available at:** <http://www.bea.gov/>

### **Inflation**

Inflation is one of the biggest enemies of the economy. Moderate inflation (when prices rise slowly) can be natural during times of economic growth. But, high inflation can cause major problems because it erodes the value of investors' holdings, fixed income assets in particular.

Essentially, an increase in the cost of goods and services decreases the purchasing power of the interest payments on bonds. Inflation is simply the increase in price for the same “basket” of goods over time. The two widely followed inflation indicators are CPI (Consumer Price Index) and PPI (Producer Price Index).

### **CPI: Consumer Price Index**

The Consumer Price Index is a measure of the price level of a fixed basket of goods and services such as food, housing, transportation, healthcare, and clothing, among others, purchased by consumers. The CPI is often used to calculate cost of living adjustments (COLA) for government programs and it is the basis of COLAs for many labor agreements as well. CPI can be further broken down into core CPI, which excludes volatile items such as food and energy. CPI is reported monthly and the figure is highly anticipated in the financial markets. Therefore, the market is sensitive to unexpected changes in the CPI.

- **Source:** Bureau of Labor statistics, U.S. Department of Labor
- **Release Time:** 8:30 EST, about the 13th of each month for the prior month.
- **Raw Data Available At:** <http://stats.bls.gov/news.release/cpi.toc.htm>

### **PPI: Producer Price Index**

The Producer Price Index measures prices of goods at the wholesale level. There are three broad subcategories within PPI: crude, intermediate, and finished. The market tracks the finished goods index most closely, as it represents prices distributors and retailers pay, and ultimately impacts retail prices. The market also focuses on the core rate, which excludes the more volatile food and energy prices. The month-over-month changes to the index are reported without further revision. However, small adjustments may be made based on annual revisions for seasonal adjustment factors. Since the increase in costs to distributors and retailers is not always passed on to consumers, the PPI is more indicative of long-term inflation. Rising PPI will be negative news for the bond market.

- **Source:** Bureau of Labor statistics, U.S. Department of Labor
- **Release Time:** Around the 11th of each month at 8:30 EST for the prior month.
- **Raw Data Available At:** <http://stats.bls.gov/news.release/ppi.toc.htm>

One might assume that there is a close relationship between the PPI and the CPI. But, in fact, the relationship is somewhat complex because the PPI does not include services that account for more than half of the CPI. In the short term, PPI and CPI figures may look very different, but over six to nine months the correlation gets much stronger.

### **Employment Indicators**

The employment report is actually two reports - the household survey and the establishment survey. The household survey is a survey of roughly 60,000 households that produces the unemployment rate. The establishment survey is a survey of 375,000 businesses that produces the non-farm payrolls, average workweek (also known as hours worked), and average hourly

earnings figures, to name a few. Both reports measure employment levels, just from different angles.

The unemployment rate is the percentage of the work force that is actively looking for jobs, but cannot find work. It is important to note that the work force here is not the entire population; it is a subset of people that meet certain criteria.

While the unemployment picture is a key gauge of the health of the economy, the market focuses more on the results of the establishment survey. Total payrolls are broken down by sectors (manufacturing, mining, construction, services, and government). The market follows each component closely for the trends in different sectors of the economy. However, the manufacturing sector is watched the most closely as it often leads the business cycle. The establishment report also includes breakdowns of average workweek, overtime, and average hourly earnings. The average workweek is important for two reasons. First, it is a critical determinant of other indicators such as industrial production and personal income. Second, it is considered a useful indicator of labor market conditions. A rising workweek early in the business cycle may be the first indication that employers are preparing to boost their payrolls, while late in the cycle a rising workweek may indicate that employers are having difficulty finding qualified applicants for open positions. Average earnings are closely followed as an indicator of potential inflation. Like the price of any good or service, the price of labor reacts to an overly accommodative monetary policy. If the price of labor is rising sharply, it may be an indication that too much money is chasing too few goods, or in this case, employees.

As far as the impact on the bond market, bonds tend to sell off on high levels of job creation because high job creation can cause inflation and subsequently higher interest rates.

- **Source:** Bureau of Labor Statistics, U.S. Department of Labor.
- **Release Time:** First Friday of the month at 8:30 EST for the prior month.
- **Raw Data Available At:** <http://stats.bls.gov/news.release/empsit.toc.htm>

## **Initial Jobless Claims**

In addition to the monthly employment report, there is also a weekly report on initial jobless claims--the number of people filing for unemployment benefits for the first time. Increases in claims potentially signals slowing job growth. But, on a week-over-week basis, the claims can be volatile and therefore misleading. Some analysts prefer a four-week moving average for any indication of underlying trends and regard a sustained change in claims of 30K as material. Still, initial jobless claims help to take the pulse of the job market. The bond market reacts favorably to high numbers of new claims as it may lead the Fed to cut interest rates in an attempt to stimulate the economy.

- **Source:** The Employment and Training Administration of the Department of Labor.
- **Release Time:** 8:30 EST each Thursday (data for week ended prior Saturday).
- **Raw Data Available At:** <http://www.dol.gov/opa/media/press/eta/main.htm>

## **Retail Sales Index**

The Retail Sales Index measures goods sold within the retail industry, from huge chains to small local stores, by sampling a set of retail stores across the country. This report will be the "advance" report, which can be revised significantly after the final numbers are compiled. The report does not include money spent on services, so it represents less than half of total consumption during the month. But, even with these limitations, the changes in retail sales are closely watched as an indicator of the state of the economy. Many analysts choose to look at the retail sales excluding automobiles, released at about the same time, which is less volatile for across-the-board purchasing trends. Stronger than expected retail sales figures are bad news for bonds because they are often associated with inflation concerns.

- **Source:** The Census Bureau of the Department of Commerce.
- **Release Time:** 8:30 EST around the 13th of the month (data for one month prior).
- **Raw Data Available At:** <http://www.census.gov/svsd/www/advtable.html>

## **ISM: Institute for Supply Management**

The ISM report is a national survey of purchasing managers from over 400 companies in 20 industries throughout the 50 states which covers indicators such as new orders, production, employment, inventories, delivery times, prices, export orders, and import orders.

The total index is calculated based on a weighted average of the following five sub-indexes, with weights in parentheses: new orders (30%), production (25%), employment (20%), deliveries (15%), and inventories (10%). It measures conditions in the manufacturing sector. A reading over 50% indicates that the manufacturing sector is expanding relative to the prior month, while a reading below 50% implies it is contracting.

The ISM is one of the first comprehensive economic releases of the month, typically preceding the employment report. This index was first introduced in 1931, and has the longest track record. Over the years, the ISM has been one of the better predictors of the business cycle. It provides an excellent picture of the state of manufacturing. In addition, the ISM is viewed as an early indicator of inflationary pressures. A high ISM typically has negative impacts on bond prices.

- **Source:** The Institute for Supply Management.
- **Release Time:** 10:00 EST on the first business day of the month (data for one month prior).
- **Raw Data Available At:** <http://www.ism.ws/>

## **Durable Goods Orders**

The durable goods orders report measures how much people are spending on long-term purchases (products expected to last more than three years). Changes in orders from month-to-month are considered a leading indicator for manufacturing activity. The report is broken down by industry, which helps minimize the distortion by huge increases in aircraft and defense orders. Still, investors are more concerned with the overall picture of the manufacturing and the

general trends across most industries. As expected, strong durable goods orders are not good news for bonds due to inflation fears.

- **Source:** The Census Bureau of the Department of Commerce.
- **Release Time:** 8:30 EST around the 26th of the month (data for month prior).
- **Raw Data Available At:** <http://www.census.gov/ftp/pub/indicator/www/m3/index.htm>

## **Consumer Confidence Index**

Consumer confidence is considered a crucial part of the economic picture. The report measures how confident consumers are about the state of the economy and is an early read on consumer spending power. The idea is that the more confident people are about the stability of their income, the more likely they are to make purchases. The Consumer Confidence Report uses about 5,000 households as a sample population and measures the number of help wanted ads in newspapers to gain a sense of the state of the labor market. Many analysts believe that high consumer confidence can cure a lot of what ails an economy. When most data points to a slumping economy, high consumer confidence and consistent spending may help soften the blow of a recession or strengthen a recovery. The index is currently slightly over 100 (108 in May 2007). Typically, only changes of at least five points should be considered significant while most small changes in the index are just noise. The report can occasionally be helpful in predicting sudden shifts in consumption patterns. As far as the impact on the bond market, strong consumer confidence may lead to higher interest rates and lower bond prices.

- **Source:** The Conference Board.
- **Release Time:** 10:00 EST on the last Tuesday of the month (data for current month).
- **Raw Data Available At:** <http://www.conference-board.org/economics/consumer.cfm>

## **Employment Cost Index (ECI)**

The ECI is another important measure of inflation. The ECI measures the cost of labor including wages, benefits, and bonuses. The reason the ECI is thought to be an indicator of inflation is that as wages increase, the added cost is often passed to consumers shortly thereafter in the form of higher prices (inflation). In combination with the productivity report (see below), the ECI can reveal whether the increased cost of labor is justified or not. A high ECI is negative for bond prices.

- **Source:** U.S. Department of Labor, Bureau of Labor Statistics
- **Release Time:** 8:30 EST on the last Thursday of January, April, July and November for the prior quarter
- **Raw Data Available At:** <http://stats.bls.gov/news.release/eci.toc.htm>

## **The Productivity Report**

The productivity report measures how much output is created by a unit of labor. Many economists believe that productivity growth allows the economy to grow at unusually high rates without causing inflation. If productivity is growing, employment costs can increase without causing heightened inflation. Nonetheless, the GDP data released prior to the productivity data

provide a clear indication of the direction of the productivity revision. Since growing productivity can prevent inflation, it is viewed as good news for the bond market.

- **Source:** The Bureau of Labor Statistics of the Department of Labor
- **Release Time:** 8:30 EST around the 7th of the second month of the quarter (data for quarter prior), with subsequent revisions released in third month of the quarter.
- **Raw Data Available At:** <http://stats.bls.gov/news.release/prod2.toc.htm>

Having economic data that is relevant and timely is useful and sometimes critical when making business/investment decisions. However, in the real business world, decisions are often made before all information is available. Financial markets are a dynamic environment with many forces at work. There may not be sufficient explanations of every market change until long after all is said and done. Paying too much attention to daily news and commentary about the economy can be dangerous as one may lose focus of the more important long-term plan. A good strategy to cope with the ups and downs of business cycles is to always know the risks, have a long-term view, and stick with a plan. Remember, the day-to-day overreactions have the tendency to work themselves out over time as market valuation adjusts to fundamental business and economic realities.

**Sources of information:**

1. The Secrets of Economic Indicators, Bernard Baumohl, Wharton School Publishing, 2004
2. [www.investorwords.com](http://www.investorwords.com)
3. [www.briefing.com](http://www.briefing.com)