Leading Economic Indicators Explained

By: InvestorGuide Staff, dated January 25th, 2013

IN YOUR ACTIVITIES SECTION:

1) Title this assignment: "Leading Economic Indicators Summary Activity"
2) Read this article packet.
3) For each section:
    a. Write a 1-2 sentence summary of the main ideas of each section.
    b. Copy down the ONE sentence from each section that you think is the most important or most describes the main idea. Explain why you chose this sentence.
4) Choose which economic indicator you think is the most important and which economic indicator you think is least important. Write 1-2 paragraphs explaining why you chose these indicators.

Economic indicators are among the most closely watched pieces of news in the investment world. Practically every week there is some announcement that affects investors' predictions about the future of the economy. Leading indicators are those which are believed to change in advance of changes in the economy, giving you 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, but these are of minimal use as predictive tools.) In addition, the Fed watches many of these indicators as it decides what to do about interest rates. For these reasons, these indicators are important to investors. Below we have summarized some of the major indicators and how you can keep tabs on the latest data.

Gross Domestic Product (GDP)

The most important indicator is the GDP report. Basically, the GDP is the widest measure of the state of the economy. The figure is released at 8:30 am EST on the last day of each quarter and reflects the previous quarter. The GDP is the aggregated monetary value of all the goods and services produced by the entire economy during the quarter (with the exception of international activity).

The key number to look for is the growth rate of GDP. Generally, the U.S. economy grows at around 2.5-3% per year and deviations from this range can have a significant impact. Growth above this level is often thought to be unsustainable and a precursor to high inflation, and the Fed usually responds by trying to slow down the "overheated" economy. Growth below this range (and especially negative growth) means that the economy is running slowly, which can lead to increased unemployment and lower spending.

It is worth noting that each initial GDP report will be revised twice before the final figure is settled upon: the "advance" report is followed by the "preliminary" report about a month later and a final report a month after that. Significant revisions to the advance number can cause additional ripples through the markets. The GDP numbers are reported in two forms: current dollar and constant dollar.

- Current dollar GDP is calculated using today's dollars and makes comparisons between time periods difficult because of the effects of inflation.
- Constant dollar GDP solves this problem by converting the current information into some standard era dollar, such as 1997 dollars. This process factors out the effects of inflation and allows easy comparisons between periods.

Don't confuse Gross Domestic Product with Gross National Product (GNP). GDP includes only goods and services produced within the geographic boundaries of the U.S., regardless of the producer's nationality. GNP doesn't include goods and

services produced by foreign producers, but does include goods and services produced by U.S. firms operating in foreign countries. For example, if a U.S. firm was operating a chain of stores in France, the goods and services produced by those stores would not be included in the GDP, but would be included in the GNP. As the global economy grows, the difference in GDP and GNP is falling for developed countries like the U.S. But for smaller, developing countries, the difference can be substantial. For the latest report, visit the Bureau of Economic Analysis website.

Consumer Price Index (CPI)

The CPI is the most widely used measure of inflation. The report is released at 8:30 am EST around the 15th of each month and reflects the previous month's data. The CPI measures the change in the cost of a bundle of consumer goods and services. The bundle includes about 200 types of goods and thousands of actual products, ranging from foods and energy to expensive consumer goods.

The prices are measured by taking a sample of prices at different stores. In addition to the overall CPI number, it is important to also look at the "core rate." The core rate excludes volatile goods like food and energy and gives a closer measure of real inflation. Most reports of the CPI numbers will include both the overall and the core numbers.

The CPI is also important because it is used to adjust the annual changes to Social Security payments. There has been much debate about how well the CPI measures inflation, and some feel that it is an imperfect way to track rising prices. To see the latest report, visit the Bureau of Labor Statistics.

The Producer Price Index (PPI)

As mentioned above, the PPI is one of the two most important ways to measure inflation (along with the CPI). The PPI is released at 8:30 am EST during the second full week of each month and reflects the previous month's data. The index measures the price of goods at the wholesale level. So, while the CPI tracks the cost paid by consumers for goods, the PPI tracks how much the producers are receiving for the goods.

There are three types of goods measured by the PPI: crude, intermediate, and finished.

- Crude goods are raw materials used in production of something else,
- Intermediate goods are components of a larger product, and
- Finished goods are what is actually sold to a reseller.

The finished goods data are the most closely watched because they are the best measure of what consumers will actually have to pay. The latest report can be found at the Bureau of Labor Statistics.

Employment Indicators

The major employment announcement occurs on the first Friday of every month at 8:30 am EST. This announcement includes the unemployment rate (the percentage of the work force that is unemployed), the number of new jobs created, the average hours worked per week, and average hourly earnings. Note: the work force is not the entire population; it is a subset of people that meet certain criteria. The unemployment picture is a key gauge of the health of the economy while the average hourly earnings figure impacts inflation. In addition to this monthly report, there is also a weekly report on initial jobless claims-the number of people filing for unemployment benefits for the first time. Though far less important than the monthly report, these numbers help to take the pulse of the job market. For the latest monthly report, visit the Bureau of Labor Statistics.

Retail Sales Index

The Retail Sales Index measures goods sold within the retail industry, from huge chains to small local stores, by taking a sampling of a set of retail stores across the country. Released at 8:30 am EST around the 12th of the month, the report reflects data from the previous month. This report will be the "advance" report, which can be revised fairly significantly after the final numbers are crunched. Many analysts choose to look at the figures "ex-auto", which means excluding the volatile

car sales figure. It is thought that this number is a better measure of across-the-board purchasing trends. The report does not include money spent on services, so it represents less than half of total consumption during the month. However, even with these limitations, the figures are closely watched as an indicator of the state of the economy. For the latest report, visit the U.S. Census Bureau.

NAPM

The National Association of Purchasing Management index (NAPM) measures conditions in the manufacturing sector. It is released on the first business day of the month at 10 am EST and reflects the previous month's data. According to the association, a reading over 50% indicates that manufacturing is growing, while a reading below 50% means it is shrinking. In addition to providing an excellent picture of the state of manufacturing (the data is only 1 day old) the NAPM is also thought to be an early indicator of inflationary pressures. You can find the latest report by visiting the NAPM.

Consumer Confidence Index

Consumer confidence is considered a crucial part of the economic picture. Released on the last Tuesday of the month at 10 am EST, the report measures how confident consumers feel about the state of the economy and their spending power. The idea is that the more confident people feel about the stability of their incomes, the more likely they are to make purchases. The Consumer Confidence Report uses about 5,000 households as a sample population and even 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 or power a recovery. For the latest release, visit the Conference Board Company.

Durable Goods Orders

The durable goods orders report measures how much people are spending on long-term purchases (products that are expected to last more than three years). The report is made at 8:30 am EST around the 26th of each month and is thought to provide insight into the future for the manufacturing industry. The reports are broken down by industry, which helps to eliminate the effects of single volatile industries like defense spending. Investors are concerned with the overall picture and the markets are moved by general trends across most industries. Visit the U.S. Census Bureau for the latest report.

Employment Cost Index (ECI)

The ECI is another important measure of inflation. Released at 8:30 am EST on the last Thursday of January, April, July, and November, 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. For the latest report, visit the Bureau of Labor Statistics website.

The Productivity Report

The productivity report measures how much output is created by a unit of labor. Released at 8:30 am EST around the 7th of the second month of each quarter, the data reflects the activity during the previous quarter. This indicator has been of secondary importance until relatively recently because Fed Chairman Alan Greenspan has been very interested in productivity growth. 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 heightened inflation resulting. For the latest data, visit the Bureau of Labor Statistics.