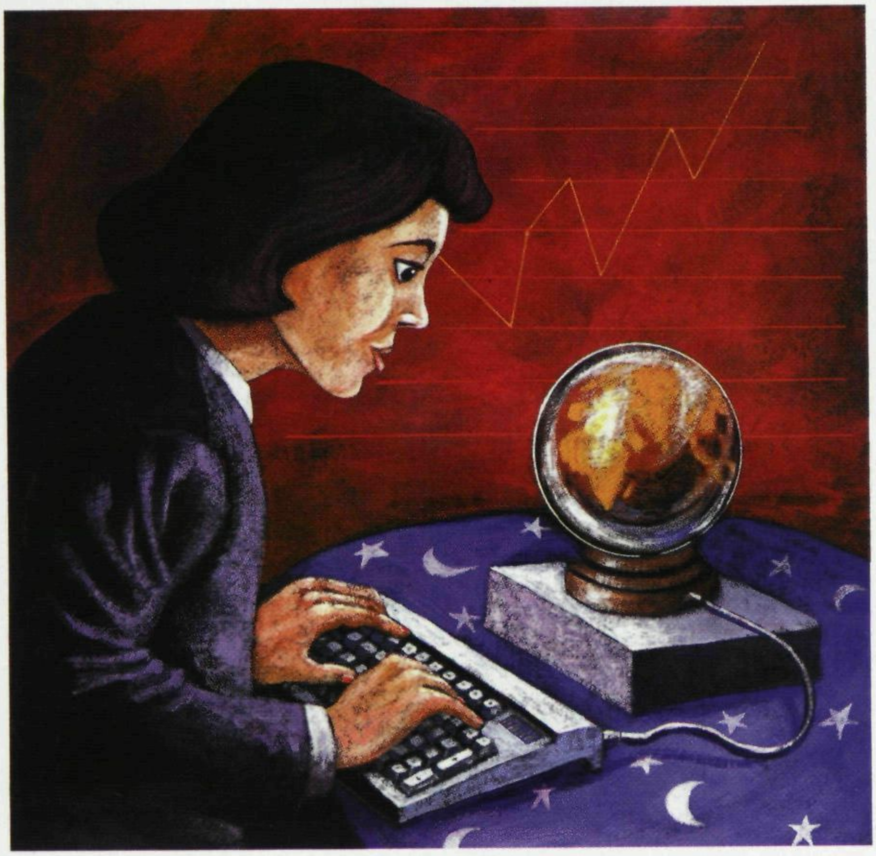
Read the Economy

Forecasting economic growth (or lack thereof) is always tricky. Understanding how the major economic indicators work can help improve your chances. By David A. Twibell



"So, where do you think the economy is headed?" It's a common question from worried clients these days. Many fear the housing market may finally be toppling, while others are concerned that a potential economic slowdown could torpedo the stock market. Rational or not, the specter of an impending recession is terrifying to many clients who are just beginning to recover from losses sustained during the early 2000s.

Helping clients read the economic tea leaves and anticipate a potential slowdown is notoriously tricky business. After all, legions of professional economists with access to highly sophisticated data have been trying to do this for decades, often with precious little success. In fact, President Harry S. Truman once quipped that he'd love to find a "one-armed economist," just so he wouldn't have to continuously hear about what's on the other hand.

If you are brave enough to delve into the uncertain world of economic forecasting, though, you should start by understanding the different types of economic data available and the clues that data provides about where the economy is headed. Economic statistics come in a dizzying array of shapes and sizes. But these statistics can usually be broken down into three main categories—lagging, coincident and leading.

LAGGING AND COINCIDENT INDICATORS

Lagging and coincident indicators—such as gross domestic product, payrolls and retail sales—paint a picture of where the economy currently stands. Unfortunately, if your goal is to figure out where the economy is heading in the future, they aren't much help. Indeed, once the economy's direction becomes clear using coincident and lagging data, the overall economic trend is usually well underway or even shifting in an entirely new direction.

LEADING INDICATORS

Instead, economists generally look at leading economic indicators to decipher where the economy is headed. These indicators are important because they tend to move in advance of the overall economy. Like the proverbial canary in the coal mine, they often turn down before the overall economy starts to cool and turn up in advance of an overall economic expansion.

Index of Leading Economic Indicators. Perhaps the best-known leading economic indicator is the aptly named Index of Leading Economic Indicators (LEI). Published each month by The Conference Board, a New York-based private research group, the LEI is really a compilation of 10 different component statistics, each of which has a separate weighting within the index. The largest LEI components are M2 money supply, the interest-rate spread between the 10-year Treasury note and the federal funds rate and the average hourly manufacturing workweek. Together these statistics account for over 80% of the total LEI.

Experts differ on the usefulness of the LEI. For example, in his book,

Leading the Way

Here is a summary of some of the more popular leading indicators and where to find them.

Indicator	What it tells us	Where to find it	Frequency
Gross Domestic Product	Growth in the overall U.S. economy	www.bea.doc.gov/bea/dn/home/gdp.htm	Quarterly
Durable Goods Orders	Future manufacturing activity	www.census.gov/indicator/www/m3/adv	Monthly
Factory Orders	Manufacturing orders and sales	www.census.gov/indicator/www/m3/prel/index.htm	Monthly
Business Inventories	Domestic business sales and inventories	www.census.gov/mtis/www/mtis.html	Monthly
Industrial Production	Domestic industry output and available capacity	www.federalreserve.gov/releases/g17/current	Monthly
ISM Manufacturing Survey	Leading indicator of manufacturing strength	www.ism.ws/ismreport/index.cfm	Monthly
Index of Leading Economic Indicators	Leading indicator of future economic strength	www.globalindicators.org/us/latestreleases	Monthly
New Housing Starts and Building Permits	New housing construction and permits	www.census.gov/const/www/newresconstindex.html	Monthly
Existing Home Sales	Sales of previously owned single-family homes	www.realtor.org/research.nsf/pages/ehsdata	Monthly
New Home Sales	Sales of new single-family homes	www.census.gov/newhomesales	Monthly
Federal Reserve Beige Book	Domestic economic strength	www.federalreserve.gov/frbindex.htm	Twice/Quarter
Current Account Balance	International trade	www.bea.doc.gov/bea/rels.htm	Quarterly
Consumer Price Index	Price inflation in retail goods and services	www.bls.gov/cpi/	Monthly
Producer Price Index	Inflation in prices paid by businesses	www.bls.gov/ppi	Monthly
Employment Cost Index	Domestic labor costs	www.stats.bls.gov	Quarterly
Productivity and Costs	Changes in worker efficiency	www.bls.gov/lpc	Quarterly

The Secrets of Economic Indicators, former *Time* magazine senior economics reporter Bernard Baumohl suggests that the LEI "has done a fairly respectable job of signaling peaks and troughs of [the] economy some three to nine months down the road."

Other economists are less complimentary about the indicator. "The LEI's track record at predicting economic slowdowns is abysmal," says Michael Englund, PhD, principal director and chief economist for Action Economics in Boulder, Colo., and former chief market economist for Standard & Poor's. "In most situations, you would be better off tossing darts than relying on the LEI to help you gauge where the economy is headed."

Through the first half of this year, the LEI declined by 0.7%, although it is still well above the levels it reached last summer. It has now fallen for four out of the last six months—which could be cause for concern. While the debate over the usefulness of the LEI is definitely far from over, it is worth noting that it has failed to predict any of the past three recessions correctly.

The housing market. The housing market is another good barometer of future economic activity. According to research by Merrill Lynch Chief Economist David Rosenberg, new home sales have registered double-digit declines eight times over the past three decades. In all but one case, the economy slowed by an average of three percentage points within 12 months. In six of the eight instances, the slowdown in housing sales was followed by a recession within 15 months.

Another housing statistic that has proven useful in anticipating economic slowdowns is the number of building permits issued for new residential construction. Permits tend to increase during the early phase of an economic expansion and then decline sharply several months before a slowdown or recession. As a matter of fact, every recession since the 1950s was presaged by a sharp decline in residential construction permits, except the most recent recession we experienced in 2001. "New residential construction permits are a very good leading indicator of future economic growth," Englund notes.

Currently, neither data set bodes well for the economy's fate. Both housing starts and new permits have fallen precipitously since the start of the year. In fact, the pace of new home sales is now down 21.6% from year-ago levels, with every region of the United States showing double-digit percentage declines compared with last year. Permits are also down by nearly 21% compared to year-ago levels.

The yield curve. Historically, the slope of the yield curve—traditionally the spread between 90-day Treasury bills and 10-year Treasury notes—has also been a good leading indicator. As it turns out, an inverted yield curve has correctly predicted almost every U.S. recession since 1950.

Normally, yields of 10-year Treasury notes outpace those of 90-day Treasury bills by roughly 182 basis points. This upward-sloping yield curve is generally viewed as a bullish sign, since it means market participants believe strong economic growth will likely prompt the Federal Reserve to raise interest rates sometime in the future. On rare occasions, the normal relationship between long- and short-term yields becomes unhinged, resulting in an inverted yield curve. This is usually viewed as a harbinger of economic weakness, since it reflects the belief that the economy is slowing, which may spur future interest-rate cuts by the Fed.

According to research by Federal Reserve economists Arturo Estrella and Frederic Mishkin, the yield curve is the single most reliable barometer of future economic weakness—outperforming more than 30 other widely followed leading economic indicators. This sentiment is shared by many other economists. "An inverted yield curve is about as good an indicator of possible future economic trouble as you can get," notes Scott Brown, senior economist for Raymond James & Associates in St. Petersburg, Fla.

At the end of August, the yield curve was inverted by roughly 45 basis points. According to Estrella and Mishkin's research, an inversion of this magnitude signals a coming recession at least 40% of the time.

Manufacturing surveys. Manufacturing surveys such as the Institute for Supply Management (ISM) Manufacturing Survey, the Chicago Purchasing Managers Index and the Philly Fed Index attempt to gauge future manufacturing activity by canvassing corporate purchasing agents. While most of these indexes measure purchasing manager activity in certain regions, the ISM survey is unique in that it polls over 300 purchasing managers in 20 different industries across the United States.

As with its regional cousins, the ISM survey is a diffusion index. Consequently, it tells us more about the breadth of strength in the manufacturing sector than it does about the magnitude of that strength. It is designed so that readings above 50 indicate manufacturing-sector growth, while readings below 50 indicate declining manufacturing activity.

While the absolute level of the ISM survey has not proven to be a very good leading indicator of approaching economic trouble, peaks and troughs in the series have been fairly reliable in gauging the direction in which the economy is headed. For example, the ISM survey registered steep declines immediately prior to every recession over the past 50 years. "The ISM numbers tend to turn early, which makes them worth watching if you are trying to determine where the economy is headed," says Action Economics' Englund.

When viewed in isolation, any single indicator may prove to be confusing and unreliable. Look at them together to paint a clearer picture of the economy.

Durable goods orders. Economists also point to orders for durable goods like aircraft, cars and appliances as important gauges of overall economy growth. This indicator measures the dollar volume of orders, shipments and unfilled orders of goods whose intended life span is three years or more. Rising orders generally lead to increased manufacturing and employment activity, while decreases in orders lead to inventory buildups and a decline in manufacturing.

While it is true that every recession that's occurred for the past several decades has been preceded at some point by a large drop in factory orders, the monthly data is so volatile it often gives false signals. For example, swings in defense-related items and large commercial aircraft orders can significantly skew the sum total of durable goods orders even though the overall economic picture remains unchanged. Consequently, while declining durable goods orders may provide you with some warning of a future economic slowdown, the inconsistency of the monthly data makes this indicator less useful than many other leading indicators.

COMPOSITE PICTURE

While all of the above indicators are important, they are only a fraction of the economic data available to would-be economic forecasters. In fact, there are so many indicators, some often pointing in totally different directions, that many professional economists suggest laymen stick to looking at composite indicators like those released by the National Bureau of Economic Research (NBER) for clues about how the economy is doing.

"Composite indicators are not necessarily perfect, but they do provide a general overview of where the economy is heading," says Boyce Watkins, PhD, assistant professor of finance at Syracuse University's Whitman School of Management. "More important, they are often accompanied by commentary and analysis to help noneconomists put the data in proper perspective."

Even those of us who insist on sorting through the voluminous economic data on our own should be mindful of the vagaries inherent in relying on any one indicator. When viewed in isolation, these indicators often prove to be confusing and unreliable. It is only when viewed in conjunction with other data that it's possible to paint a somewhat reliable picture of the overall economy. FP

David A. Twibell, JD, is president of Wealth Management at Colorado Capital Bank, where he directs the bank's investment management and financial planning practice. He can be reached at (303) 814-5545 or via email at dtwibell@coloradocapitalbank.com.

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