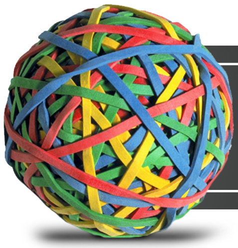

WEALTHMANAGEMENT APRIL 2014

LIST OF MAJOR LEADING & LAGGING ECONOMIC INDICATORS

Most economists talk about where the economy is headed – it's what they do. Paying attention to economic indicators can give you an idea of where the economy is headed so portfolios ca be positioned to take advantage of asset classes that have a history or performing better in the various market cycles.

There are two types of indicators you need to be aware of:

- Leading indicators often change prior to large economic adjustments and, as such, can be used to predict future trends.
- Lagging indicators, however, reflect the economy's historical performance and changes to these are only identifiable after an economic trend or pattern has already been established.

LEADING INDICATORS

Stock Market

Though the stock market is not the most important indicator, it's the most well-known and widely followed leading indicator. Because stock prices are based in part on what companies are expected to earn, the market can indicate the economy's direction if earnings estimates are accurate.

For example, a strong market may suggest that earnings estimates are up and therefore that the overall economy is preparing to thrive. Conversely, a down market may indicate that company earnings are expected to decrease and that the economy is headed toward a recession.

Manufacturing Activity

Manufacturing activity is another leading indicator of the state of the economy. This influences the GDP (gross domestic product) strongly; an increase in which suggests more demand for consumer goods and, in turn, a healthy economy. Since workers are required to manufacture new goods, increases in manufacturing activity also boost employment and possibly wages as well.

Increases in manufacturing activity can also be misleading. Sometimes the goods produced do not make it to the end consumer. They may sit in wholesale or retailer inventory for a while, which increases the cost of holding the assets. Therefore, when looking at manufacturing data, it is also important to look at retail sales data. If both are on the rise, it indicates there is heightened demand for consumer goods.

Inventory Levels

High inventory levels can reflect two very different things: either that demand for inventory is expected to increase or that there is a current lack of demand.

Case #1, businesses purposely bulk up inventory to prepare for increased consumption in the coming months. If consumer activity increases as expected, businesses with high inventory can meet the demand and thereby increase their profit. Both are good things for the economy.

Case #2, high inventories reflect that company supplies exceed demand. Not only does this cost companies money, but it indicates that retail sales and consumer confidence are both down, which further suggests that tough times are ahead.

Retail sales

Retail sales are particularly important metrics and function hand in hand with inventory levels and manufacturing activity. Most importantly, strong retail sales directly increase GDP, which also strengthens the home currency. When sales improve, companies can hire more employees to sell and manufacture more product, which in turn puts more money back in the pockets of consumers.

One downside to this metric, though, is that it doesn't account for how people pay for their purchases. For example, if consumers go into debt to acquire goods, it could signal an impending recession if the debt becomes too steep to pay back. In general, an increase in retail sales indicates an improving economy.

Building Permits

Building permits offer foresight into future real estate supply levels. A high volume indicates the construction industry will be active, which forecasts more jobs and, again, an increase in GDP.

But just like with inventory levels, if more houses are built than consumers are willing to buy, it takes away from the builder's bottom line. To compensate, housing prices are likely to decline, which, in turn, devalues the entire real estate market and not just "new" homes.

Building Permits

A decline in housing prices can suggest that supply exceeds demand that existing prices are unaffordable, and/or that housing prices are inflated and need to correct as a result of a housing bubble.

In any scenario, declines in housing have a negative impact on the economy for several key reasons:

- They decrease homeowner wealth.
- They reduce the number of construction jobs needed to build new homes, which thereby increases unemployment.
- They reduce property taxes, which limits government resources.
- Homeowners are less able to refinance or sell their homes, which may force them into foreclosure.

When you look at housing data, look at two things: changes in housing values and changes in sales.
When sales decline, it generally indicates that values will also drop.

Level of New Business Startups

The number of new businesses entering the economy is another indicator of economic health. In fact, some have claimed that small businesses hire more employees than larger corporations and, thereby, contribute more to addressing unemployment.

Small businesses can contribute significantly to GDP, and they introduce innovative ideas and products that stimulate growth. Therefore, increases in small businesses are an extremely important indicator of the economic well-being of any capitalist nation.

Unlike leading indicators, lagging indicators shift after the economy changes. Although they do not typically tell us where the economy is headed, they indicate how the economy changes over time and can help identify long-term trends.

Changes in the Gross Domestic Product (GDP)

GDP is typically considered by economists to be the most important measure of the economy's current health. When GDP increases, it's a sign the economy is strong. In fact, businesses will adjust their expenditures on inventory, payroll, and other investments based on GDP output.

GDP is not a flawless indicator. Like the stock market, GDP can be misleading because of programs such as quantitative easing and excessive government spending.

As a lagging indicator, some question the true value of the GDP metric. After all, it simply tells us what has already happened, not what is going to happen. GDP is a key determinant as to whether or not the United States is entering a recession. The rule of thumb is that when the GDP drops for more than two quarters, a recession is at hand.

Income and Wages

If the economy is operating efficiently, earnings should increase regularly to keep up with the average cost of living. When incomes decline, however, it is a sign that employers are either cutting pay rates, laying workers off, or reducing their hours. Declining incomes can also reflect an environment where investments are not performing as well.

Incomes are broken down by different demographics, such as gender, age, ethnicity, and level of education, and these demographics give insight into how wages change for various groups. This is important because a trend affecting a few outliers may suggest an income problem for the entire country, rather than just the groups it effects.

Unemployment Rate

The unemployment rate is very important and measures the number of people looking for work as a percentage of the total labor force. In a healthy economy, the unemployment rate will be anywhere from 3% to 5%.

When unemployment rates are high, however, consumers have less money to spend, which negatively affects retail stores, GDP, housing markets, and stocks, to name a few. Government debt can also increase via stimulus spending and assistance programs, such as unemployment benefits and food stamps.

Consumer Price Index (Inflation)

The consumer price index (CPI) reflects the increased cost of living, or inflation. The CPI is calculated by measuring the costs of essential goods and services, including vehicles, medical care, professional services, shelter, clothing, transportation, and electronics. Inflation is then determined by the average increased cost of the total basket of goods over a period of time.

A high rate of inflation may erode the value of the dollar more quickly than the average consumer's income can compensate. This, thereby, decreases consumer purchasing power, and the average standard of living declines. Moreover, inflation can affect other factors, such as job growth, and can lead to decreases in the employment rate and GDP.

However, inflation is not entirely a bad thing, especially if it is in line with changes in the average consumer's income. Some key benefits to moderate levels of inflation include:

- It encourages spending and investing, which can help grow an economy. Otherwise, the value of money held in cash would be simply corroded by inflation.
- It keeps interest rates at a moderately high level, which encourages people to invest their money and provide loans to small businesses and entrepreneurs.
- It's not deflation, which can lead to an economic depression.

Deflation is a condition in which the cost of living decreases. Although this sounds like a good thing, it is an indicator that the economy is in very poor shape. Deflation occurs when consumers decide to cut back on spending and is often caused by a reduction in the supply of money. This forces retailers to lower their prices to meet a lower demand. But as retailers lower their prices, their profits contract considerably. Since they don't have as much money to pay their employees, creditors, and suppliers, they have to cut wages, lay off employees, or default on their loans.

Currency Strength

A strong currency increases a country's purchasing and selling power with other nations. The country with the stronger currency can sell its products overseas at higher foreign prices and import products more cheaply.

However, there are advantages to having a weak dollar as well. When the dollar is weak, the United States can draw in more tourists and encourage other countries to buy U.S. goods. In fact, as the dollar drops, the demand for American products increases.

Interest Rates

I nterest rates are another important lagging indicator of economic growth. They represent the cost of borrowing money and are based around the federal funds rate, which represents the rate at which money is lent from one bank to another and is determined by the Federal Open Market Committee (FOMC). These rates change as a result of economic and market events.

When the federal funds rate increases, banks and other lenders have to pay higher interest rates to obtain money. They, in turn, lend money to borrowers at higher rates to compensate, which thereby makes borrowers more reluctant to take out loans. This discourages businesses from expanding and consumers from taking on debt. As a result, GDP growth becomes stagnant.

Rates that are too low can lead to an increased demand for money and raise the likelihood of inflation. Current interest rates are thus indicative of the economy's current condition and can further suggest where it might be headed as well.

Corporate Profits

Strong corporate profits are correlated with a rise in GDP because they reflect an increase in sales and therefore encourage job growth. They also increase stock market performance as investors look for places to invest income. That said, growth in profits does not always reflect a healthy economy.

For example, in the recession that began in 2008, companies enjoyed increased profits largely as a result of excessive outsourcing and downsizing (including major job cuts). Since both activities took jobs out of the economy, this indicator falsely suggested a strong economy.

Balance of Trade

The balance of trade is the net difference between the value of exports and imports and shows whether there is a trade surplus (more money coming into the country) or a trade deficit (more money going out of the country).

Trade surpluses are generally desirable, but if the trade surplus is too high, a country may not be taking full advantage of the opportunity to purchase other countries' products.

Trade deficits, however, can lead to significant domestic debt. Over the long term, a trade deficit can result in a devaluation of the local currency as foreign debt increases.

Value of Commodity Substitutes to U.S. Dollar

Gold and silver are often viewed as substitutes to the U.S. dollar. When the economy suffers or the value of the U.S. dollar declines, these commodities increase in price because more people buy them as a measure of protection. They are viewed to have inherent value that does not decline.

Because metals are priced in U.S. dollars, any deterioration or projected decline in the value of the dollar must logically lead to an increase in the price of the metal. Precious metal prices can act as a reflection of consumer sentiment towards the U.S. dollar and its future. For example, consider the record-high price of gold at $1,900 an ounce in 2011 as the value of the U.S. dollar deteriorated.

Final Word

To accurately characterize the state of the economy, you must rely on the analysis of others without a particular agenda. Keep in mind that most economic indicators work best in conjunction with other indicators. At WT Wealth Management we feel that analyzing economic data allows us to make better decisions regarding portfolio design and construction.

Disclosure

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