A Summary of Economic Indicators

Many traders design and run trading systems that only use technical indicators. However, fundamental factors are the main reasons that financial markets move. Ron Schelling takes a look at some of the most important economic indicators and reports.

In this article, I would like to look at a number of major U.S. fundamental market indicators and discuss which are important to the daily movements of the major financial markets.

What is an Economic Indicator?

An economic indicator (or business indicator) is a statistic about the economy. Economic indicators allow analysis of economic performance. They also allow analysts to make predictions of the future performance of an economy. Economic indicators include various indices, earnings reports and economic summaries. Examples of economic indicators include unemployment, housing starts, Consumer Price Index (a measure for inflation), industrial production, stock market prices and money supply and changes in money supply.

Leading Indicators

Leading indicators are used by traders to predict imminent changes in a market. Since leading indicators by their definition change before a market changes, traders consider them important as guidelines for investing wisely to take advantage of price events before they occur.

In some cases, leading indicators are useful mainly as a guideline for potential change in a market, rather than assured change.

For example, information about employment records, building permit applications and prominent changes in the executive lineup of a corporation can reflect coming changes in the production level of the corresponding asset, or in the buying or selling pressure on that asset. However, this kind of leading indicator should be used as a guideline to investment rather than as a prediction of future events.

In other cases, leading indicators can actually change the behavior of a market.

A number of leading indicators – including unemployment insurance claims, the amount of money in the economy and increases in the production workweek – are watched by the Federal Reserve in order to determine whether changes in interest rates are needed. As a result, some traders watch these leading indicators carefully and if enough leading indicators seem to point to the fact that the Federal Reserve is preparing to change interest rates, traders can take the appropriate actions.

Lagging Indicators

Lagging indicators are indicators that usually change after the economy as a whole does. Typically, the lag for a lagging indicator is a few quarters of a year. The unemployment rate is a lagging indicator. Employment tends to increase two or three quarters after an upturn in the general economy.

In a performance measuring system, profits earned by a business would be considered a lagging indicator as it reflects a historical performance; similarly, improved customer satisfaction is the result of initiatives taken in the past. There are many more economic indicators that could be discussed, but we will stay with the most basic indicators useful in our daily trading in this article.

The Beige Book

The Beige Book, more formally called the *Summary of Commentary on Current Economic Conditions*, is a summary of economic conditions around the United States compiled for the members of the Federal Reserve Board.

Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its District through reports from Bank and Branch directors and interviews with key businessmen, economists, market experts and other sources. This information is summarized in *The Beige Book* by District and sector. This allows outsiders to know what the Federal Reserve governors are looking at as they prepare for their upcoming Federal Open Market Committee meeting.

If *The Beige Book* indicates inflationary pressure, the Federal Reserve may raise interest rates, which is dollar bullish.

If *The Beige Book* portrays recessionary conditions, the Federal Reserve may lower interest rates, which is dollar bearish.

Business Inventories

Business inventories report total U.S. business sales and inventories or total current-dollar sales and inventories for the manufacturing, wholesale, and retail sectors of the economy. Traders look at how retail inventory numbers influence interest rates.

If inventories are rising at a faster pace than sales, it typically indicates that the economy is slowing down, which means lower interest rates. Lower interest rates are dollar bearish. It is considered dollar bullish if both sales and inventories are rising at the retail, wholesale and manufacturing level.

Consumer Price Index

The Consumer Price Index or CPI is an index measuring the change in price of a representative basket of goods and services. This basket includes such items as food, energy, housing, clothing, transportation, medical care, entertainment and education. It is also known as the "Cost-of-Living Index."

The CPI measures inflation (a sustained rise in prices in an economy) as experienced by consumers in their day-to-day living expenses. The increase in the CPI is what most people think of as the "inflation rate."

It is used by retailers to predict future price increases, by employers to calculate salaries and by the government to determine cost-of-living increases in Social Security benefits.

Signs of inflation mean the central bank has to increase interest rates. The most widely used indicator of inflation is the Consumer Price Index. If CPI is increasing, it gives a central bank such as the Federal Reserve the necessary supportive data to increase rates. Higher interest rates are bullish for the currency.

"In a performance measuring system, profits earned by a business would be considered a lagging indicator as it reflects a historical performance..."

Durable Goods Orders

Durable goods orders are a key indicator of future manufacturing activity. This government index measures the dollar volume of orders, shipments and unfilled orders of durable goods. Durable goods are new or used items generally with a normal life expectancy of three years or more.

This indicator measures demand for U.S. manufactured durable goods, from domestic and foreign sources. When the index increases, it suggests demand is strengthening, which will probably result in increaing production and employment. A falling durable goods index suggests the opposite.

Housing Starts and Building Permits

Housing starts and building permits are indictors that show the way the building market is moving. When housing starts and building permits are used to compare the market, the following are considerations.

1. When housing starts are up, the bond market is down, stock market is up and the dollar sees very little impact.
2. When the housing starts are down, the bond market is likely up, the stock market is down and the dollar has little to no impact.

Existing Home Sales measures the monthly sales of previously-owned single-family houses. *The New Home Sales* report offers data on new homes sold, expressed in thousands of homes and broken down by geographic region of the country.

Non-Farm Payroll Employment

Non-Farm Payroll Employment is an estimate of the number of payroll jobs at all non-farm business establishments and government agencies. Information is also provided on the unemployment rate, average number of hours worked per week and average hourly and weekly earnings. Non-Farm Payroll numbers are included in the monthly Employment Situation report.

Growth of employment and hours worked provides important information about the current and likely future pace of overall economic growth. Trends in average hourly earnings provide information about supply and demand conditions in labor markets, which may provide signals about the overall level of resource utilization in the economy.

Producer Price Index

The Producer Price Index, or PPI, is a monthly report released by the Bureau of Labor and Statistics detailing the purchase price of various consumer goods. The report is released in the second week of every month and includes data on the previous month (April's report includes data on March).

Retail Sales

Retail Sales is an estimate of the total sales of goods by all retail establishments in the United States (sales of services are not included) for the month prior to the release of the report.

Data is presented in nominal, or current dollars, meaning they are not adjusted for inflation. However, the data is adjusted for seasonal, holiday and trading-day differences between the months of the year.

Traders consider the *Retail Sales* report one of the most useful of the economic indicators, with a wide range of applications for various asset markets.

Trade Balance

Trade balance measures the ratio of exports to imports for a given country's economy.

If exports are higher than imports (a trade surplus), the trade balance will be positive.

If imports are higher than exports (a trade deficit), the trade balance will be negative. **FJ**

– Ron Schelling is an independent trader in The Netherlands with over 25 years experience trading Forex and futures. He can be reached at www.2hedge.com