Chapter 1

Introducing Economic Indicators

In This Chapter

- Defining economic indicators
- Looking at what the indicators tell you about the economy
- Figuring out how to track and use indicators to meet your needs

Everyone has a financial interest in the economy. Although you may not think about it every day, your country's economic system has a direct impact on your financial well-being. After all, the economy is made up of you, me, and all the people who buy products and services; the companies that create those products and services and deliver them to their consumers; the factories and equipment used to make the products; the facilities needed to offer the services; and of course, the government.

So you see, everyone has an economic role to play. Whether you're a business leader, an employee, an investor, or a consumer, your actions affect the economy and the economy affects you and your finances.

If you're thinking, "Wow, I should really start paying attention to the economy," you've come to the right place! Economic indicators can help you measure the performance and health of the economy and forecast its future. As a bonus, economic indicators can even help you improve your investment returns, your business plans, and your financial health. This chapter serves as a jumping board into the pool of economic indicators. Here I give you a basic overview of the topic so you can navigate your way through the rest of this book.

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Understanding What Economic Indicators Are

Can you picture NASA's Mission Control Center? Today it's all flat-panel displays and subdued lighting, but it used to be a system of big industrial panels with blinking lights, gauges, levers, dials, push buttons, and at least one bright-red phone. Each one of those lights and gauges displayed some tiny piece of information that was crucial to whatever mission NASA was working on at the time.

The economy is a bit like NASA's Mission Control Center. Each economic indicator is a metaphorical dial, light, or gauge that provides information about some part of the economy. One dial shows how many people are working, and another shows how many are unemployed. One gauge shows how many cars were manufactured last month, and another tells how high interest rates have grown. These metaphorical dials and gauges show you what's happening in the economy right now.

Although no single Mission Control Center exists for the economy, you can use a collection of economic indicators to see what's happening economically. And although you can't push a button and make the economy change course (at least not by yourself), you and your fellow citizens do have some say about the economy through the purchasing, employment, and other business decisions you make on a daily basis.

When you decide to buy a car or not buy a car, start a business, hire new workers, or even take a new job, you have an effect on the economy. When a lot of people make the same decision and push the same economic buttons, noticeable changes happen in the economy.

Economic indicators show you what's happening in the economy. Most indicators examine and report only a tiny slice of the economy, but several of them provide information about the whole economy in one report. By using a combination of both types of indicators, you can tell where the economy has been and where it's headed.

The following sections provide a bit more insight into how to read economic indicators and what they can tell you about the economy.

Reading the economy through economic indicators

The economy isn't complicated, but the experts who spend their days studying it have devised their own private jargon to describe it. Unfortunately,

their terminology often obscures the economy's simplicity. But the economy doesn't have to be confusing. You can use economic indicators to help you read what's happening in the economy.

Several types of economic indicators exist. Some record one kind of data, like the number of people filing for unemployment insurance, and then tabulate and publish the results. Others survey consumers to see how they're feeling about their financial health. Still others massage the data they collect, using complex mathematical formulas, to try and create easy-to-interpret numerical indexes that represent (or *indicate*) the level of things like inflation and consumer confidence.

These different indicators are often categorized by their ability to forecast. *Leading indicators* turn up or down before the economy, so they're generally considered to be good forecasting tools. *Coincident indicators* are useful for identifying the economy's current health, and *lagging indicators* tell where the economy has been.

Find out more about economic jargon as it relates to indicators in Chapter 2. There you also find a brief refresher on the math you need to understand to correctly interpret some economic indicators. It's not high-level math, so don't worry if math isn't your strongest subject.

Cycling through economic ups and downs

You can use economic indicators to give you a clear picture of what direction the economy has gone and where it's going. Economic indicators demonstrate when the economy expands, like during economic growth, and when it falls, like in a recession.

Economic indicators help identify the following pattern of economic expansion and contraction as it happens over and over again:

- At the beginning of an economic recovery, you see an abundance of underutilized production equipment and even some factories that have been idle. A lot of people are looking for work, interest rates are generally low, and the supply of raw materials needed to make new products is high.
- As the economy expands, most people who want a job can find one, factory equipment is put to good use, and idled factories are restarted.
- At some point during the expansion, some raw materials become hard to find. For example, say the lumber used for new-home construction becomes scarce. The price of the lumber goes up as a result, and so do the prices for new homes. As the expansion matures, companies may have a hard time finding the skilled workers they need to continue growing the business. Raw material and labor scarcity leads to rising commodity prices and higher wages.

- Economic growth slows down. The Federal Reserve observes the rising prices and the potential for inflation. It responds by raising interest rates. As a result, credit gets more expensive, and some people have a harder time qualifying for new mortgages or new car loans. Sales of big-ticket items and new-home construction slow down.
- The economy is still growing but perhaps a little more slowly than before. Employers become cautious. If sales slow, employers slow production. Layoffs may not be imminent, but if sales remain soft, job losses are all but inevitable.
- The contraction begins. When the nightly news starts featuring stories about rising prices and higher interest rates, people start to worry. Worried consumers hold off on bigger purchases. Instead of flying to an expensive resort, some vacationers take local vacations. Some consumers delay new car purchases as long as their old ones are running fine.
- The pace of growth may slow so much that the economy actually shrinks. When that happens, businesses are forced to lay off production staff, which causes workers to have less money to spend. Even consumers who are still employed start saving rather than spending.
- As the economy slows, interest rates fall. Prices for things like houses and raw materials also fall. During a recession, the economy takes at least a few months, and sometimes much longer, to find its footing again. But the good thing is it will do so eventually.

Chapter 3 shows the interaction between the stock market, the economic cycle, and the business climate. It also shows the types of indicators that can help investors and business managers plan for the economic future.

Identifying What Indicators Indicate

Though some economic indicators try to report on the big economic picture, most look at only a tiny vignette. For example, one indicator looks at the kind of products people are buying. Another shows if workers are able to find jobs easily. Still others report on current interest rates, the rate of inflation, and the availability of credit for businesses and consumers. This section looks at the specific types of economic conditions that economic indicators measure and report.

Tracking consumer spending

One area economic indicators measure is how much money consumers spend. Consumer purchases drive most of the economy. In fact, if you include the amount the U.S. Government spends on behalf of individuals for healthcare, about 70 percent of all spending is for consumer purchases.

Several types of economic indicators focus on consumer spending. Here's what they measure:

- **How much consumers earn:** Before consumers can spend anything, they have to earn money. Thus, the strength of the job market is a very good indication of the strength of the economy as a whole. As long as the market for jobs is robust, the economy is generally growing. A faltering job market is one of the best signs that an economic peak is near. I discuss which indicators track employment conditions in Chapter 4.
- **How confident consumers feel:** People spend money when they're feeling confident about the future; they hold onto their money when they're concerned about their job or financial situation. The best way to find out how consumers feel about their finances, their jobs, and the economy is to ask them, which is exactly what consumer surveys do. Consumer sentiment is a very good indicator of people's future spending patterns. Turn to Chapter 5 to get the lowdown on consumer economic surveys.
- **How consumers spend their money:** Another way to keep up with the economy is to watch consumers' income and spending patterns. Personal income indicators show you how much money people bring home each month. However, the amount of money consumers have to spend isn't a good determinant of how much they will spend. Sometimes consumers spend more than they make. Other times they choose to spend less than they earn.

  Watching how much consumers actually spend and what they're buying can give you a better overall picture of the economy. For example, if people are feeling uncomfortable about their jobs or if they're worried about the economy, they're probably not going to empty their wallets at the shopping mall. And they're certainly not going to remodel the kitchen or take on a new car loan. Retail sales statistics show you what consumers are actually buying each month and how much they're buying. Turn to Chapter 6 to find out how to keep track of both consumer income and spending.

Looking at the big picture

The most direct way to evaluate the economy's health is to look at the whole thing and then compare its current condition to the last quarter or the last year. That's exactly what the Gross Domestic Product (GDP) report does. It reports the total value of everything businesses produce and the earnings of both businesses and consumers.

The GDP report distills economic data from a wide variety of sources, including other economic indicators, into a single report. In fact, it tries to distill the entirety of the economy into a single number. Then it shows the underlying economic details in extensive data tables to explain how the GDP was determined. Unfortunately, this important report is only available quarterly.

But when it does come out, it's an excellent indicator for showing the economy's current health. You find everything you need to interpret and use the GDP report in Chapter 7.

For another big-picture look at the U.S. economy, follow the actions and pronouncements from the U.S. Federal Reserve. The Fed (that's what those in the know call it) manages the money supply for the United States. Part of its responsibility is to keep inflation from getting out of control. The Fed's reports and actions are very good indications of the economy's current and future condition. Chapter 8 shows you how to keep a close eye on the Fed.

Eyeing manufacturing

Consumer products fall into two broad categories: the things people use or consume every day and the things that are supposed to last for a number of years. In economic jargon, these categories are called *consumer staples* and *consumer durables,* respectively, and you can use economic indicators to keep tabs on both of them.

- **Consumer staples:** Also called *nondurable goods,* they include things like food, beverages, toothpaste, medicine, bath soap, paper towels, and cosmetics. Although these purchases make up the largest percentage of consumer product spending, they don't tell you much about the economy.
- **Consumer durable goods:** These products include kitchen appliances, laptop computers, home entertainment systems, and even automobiles. These products are rarely urgent purchases. People don't really need a new refrigerator as long as the old one is still working, which is why durable goods purchases are considered discretionary. Durable goods purchases show how freely consumers are making discretionary purchases.

When you look at the economy from the point of view of the durable-goods manufacturers, you get an entirely different perspective than from the consumer's perspective. Are orders for cars and refrigerators going up, or are inventories growing? Are the factories having problems getting enough raw materials to keep the factories busy, or is the supply chain meeting requirements?

You can watch toothpaste inventories all you want, but the real action is in durable goods. Chapter 9 shows you how to track current sales orders, inventories, and the raw material supply chain for durable goods manufacturing.

Another way to stay up on manufacturing is to ask manufacturers. Business people love to talk about business, which is why business surveys are so

compelling. They give you an insiders' view of the business world. Surveys of manufacturing industries are the most economically sensitive, although you can also find surveys for service industries. If you want to know what's really happening in the world of business, go to Chapter 10, where you find out how to find and interpret the premiere business survey results.

Counting up the number of bought, sold, and newly built homes

You find another excellent indicator of the economy's health right in your own neighborhood. Have you tried to sell your house lately? Did you have to chase away the buyers, or did your home sit on the market for months or longer?

Even if you're not personally in the market to buy or sell a home, housing indicators tell a great deal about the economy's health. Are new homes being built? If so, how many? Are houses selling quickly, or do buyers have the upper hand?

Housing indicators are very sensitive to the economy's health. If the economy is doing really well, the housing market is often strong, too. In a healthy home-building market, home builders can keep a large team of skilled tradesmen and laborers employed and the factories of home-building suppliers busy. More to the point, a healthy market for new homes means that consumers are willing to make very large, long-term financial commitments. You can build on your knowledge of the local and national housing markets and stay up-to-date with housing indicators in Chapter 11.

Monitoring inflation

Some indicators also track inflation. The economy almost always has a little inflation, which is a good thing. A little inflation is like an economic fertilizer that keeps the economy growing. However, in this case, the economy is like a houseplant. Too much fertilizer is unhealthy for houseplants, and too much inflation is unhealthy for the economy.

Inflation makes the money you earn worth less and the prices you pay go up for no good reason. In other words, you see price increases that aren't caused by changes in consumer purchasing habits or the availability of products. High inflation is the number-one concern of bond investors because it erodes the value of a bond's interest payments. As inflation creeps higher, the bond's value falls. Chapter 12 covers the most useful inflation indicators.

Measuring productivity

Businesses can improve profitability in a couple of ways. They can cut material costs, or they can improve productivity. Cutting costs works but only up to a point. If the manufacturer cuts costs so deeply that doing so harms the product's quality, then the increased profitability will be very short-lived.

The better long-term approach is to improve productivity. If businesses can get more production and more product from the same number of employees, they're basically tapping into free money. They get more product to sell, and the per-product costs fall.

As long as the machinery or employee training needed for productivity improvements costs less than the value of the productivity gains, it's an easy investment for any business to make. As long as businesses give their employees the tools to produce more and then fairly compensate them for the productivity improvements, everyone is happy.

Productivity improvements are as important to the economy as they are to the individual business that's making them. Growing productivity means that the economy can generate more product and profit from the same number of employees. Productivity improvements generally raise the standard of living for everyone and are a good indication of a healthy, growing economy. Chapter 13 explains how different indicators measure productivity and how you can use them.

Looking at loans and commodity purchases

Almost everyone borrows money. Consumers use personal credit to purchase goods and services and longer-term credit to buy durable goods. Of course, most homeowners also borrow money to buy their homes.

Businesses borrow money, too. They use short-term loans to finance things like inventories and accounts receivables, and they use longer-term loans to buy production machinery and finance construction or purchases of factories and office facilities.

The interest rates that consumers and businesses pay for short-term loans rise and fall with the economy. Rates generally rise during economic expansion and fall during a recession.

One important indicator of the economy's health measures the difference between short-term and long-term interest rates. Short-term rates are normally lower than long-term rates, but when short-term rates get close to long-term rates, you can usually assume the economy is in poor health. Sometimes short-term rates actually rise above long-term rates, and when that happens, you'll usually see a recession in the near future. To find out more about business finances and interest rates, see Chapter 14.

Sometimes businesses use credit to buy raw materials, like oil, corn, wheat, lumber, and even silver and gold, that they need to produce consumer and business products. The markets call these types of raw materials *commodities.* You can tell a lot about the economy by watching commodity prices; see Chapter 15 for details.

Following worldwide economies

The United States is one of the world's largest exporters, but it imports a lot more products from overseas than it exports, which is why the United States has a trade deficit. While exports are a clear boost to the U.S. economy, imports aren't. Check out Chapter 16 to find out how to track foreign trade and trade deficits.

Though the United States may be the largest economy in the world (at least for the moment), many other countries have large and important economies, too. Not all these countries use the same accepted methodologies for reporting and data gathering as the United States, but you can find enough similarities between them and the U.S. methods that you can use the tools identified in this book to evaluate the economic indicators from other countries. Plus, many of these countries publish their reports in English. Travel on over to Chapter 17 to see several examples of first-class economic indicators from foreign lands.

Some countries are still trying to establish their economic reputations. These economies are growing rapidly, but they don't always provide the same level of economic information that you find in the United States. Countries like China, India, and Brazil have very large, growing economies, but some of their economic reports are hard to interpret. The good news is that their economic reports are improving, and some are even published in English. For the intrepid traveler, these emerging economies offer plenty of investment opportunities, so get your travel documents in order and head to Chapter 18, where you find a map for keeping up with these emerging markets.

Knowing How to Start Following Economic Indicators

As an investor, I use economic indicators to develop my strategic investment plan. They help me evaluate the risk level in the economy and identify where opportunities may exist. (As a stock trader, I use a few additional tools to make specific buy-and-sell decisions. They're not a secret. See the latest edition of *Trading For Dummies*, the book I coauthored with Lita Epstein, for an in-depth review of my buy-and-sell methodology; it's published by John Wiley & Sons, Inc.)

The type of investing I do requires that I check my investments frequently. In fact, I check my investments every day, sometimes a little more frequently, and I evaluate my strategy every week. My weekly checklist looks like this:

- **Evaluate the current economic situation.** Have there been any major changes in the economic situation? Which economic reports have surprised investors? Do I need to adjust my strategy or risk outlook?
- **Evaluate the current condition of the stock market.** I analyze stock sectors and the technical condition of the market.
- **Evaluate my current investment positions.** Have the fundamentals of any of my companies changed? Are any of my existing positions likely to change their technical condition during the next week?
- **Evaluate alternative investment candidates.** See whether I'd like to own any stocks other than the ones currently in my portfolio.
- **Decide how and when to implement any portfolio changes.** Make my plans for how and when to buy or sell.

If any of this is Greek to you, you really need to read *Trading For Dummies*. If it sounds like I'm promoting my other book a bit too much, I'm only doing so to help you understand how I use economic indicators. From my perspective, economic indicators are risk-analysis tools. I use them to identify the current state of the market and to predict whether that condition is likely to change. After all, if the current condition is likely to change, I need to change my investment positions.

The following sections help you get started with using economic indicators to meet your investment and business planning needs. They explain how to analyze the economic indicators you choose to follow and how to stay up-to-date with them so you don't miss anything important.

Analyzing the data

Keeping track of different economic indicators doesn't mean you have to quit your full-time job. You just need to know how to analyze and decipher the data and then put what you learn to use. Becoming an economic analyst takes a little practice, but you don't have to spend every minute of every day looking at economic reports to understand what's happening in the economy. I certainly don't.

I spend between 30 and 60 minutes each week on this part of my investment plan. You may need a little more time, but you may also be able to get by with less, at least after you get a feel for the analysis process.

At the beginning, following all the economic indicators that you think are important to your business or investment strategy may seem overwhelming, so start small. Select ten indicators to follow. If ten prove to be unworkable, start with two or three. Pick the two or three indicators that you think will be most beneficial to your business or to your investing portfolio (see Chapter 19 for details). Then add to your list as you become comfortable with the reports and what they're telling you.

I recommend that you keep records of the indicators you choose and your thoughts as you read them. Track your analysis over time. Record which indicator caused you to make a specific decision. Identify which predictions and decisions you get right and which ones you get wrong. In either case, try to figure out why you were right or wrong and write it down.

After you've tracked your analysis for a little while, you'll really get the hang of it. You'll find that your analysis is at least as good as the talking heads on TV. And because you've selected specific indicators to suit your business or investment, your analysis will likely be even better than theirs!

Soon you'll find that the news reports simply provide too little information to be useful for your analysis efforts. Then you'll be well on your way to making your own reliable economic forecasts.

Tracking economic indicator release dates

Keeping up with economic indicators is fairly easy. Several prominent websites post release dates for the economic reports coming out during the current week (these dates are collectively called the *economic calendar*), and some of them even include summaries of the indicators after their release. Check out these sites for details:

- **Bloomberg:** www.bloomberg.com/markets/economic-calendar/
- **MarketWatch:** www.marketwatch.com/economy-politics/calendars/economic
- **Briefing.com:** www.briefing.com/Investor/Public/Calendars/EconomicCalendar.htm

When you're first starting out, you may want to rely on one or two of these calendars to keep track of the indicators you've chosen to follow. However, I've been doing this long enough that I really don't have to use these calendar tools that often. The release dates for the main indicators I follow have become second nature to me. Besides, you can request to have most indicators sent to you by e-mail.

Keeping track of the economic indicators published by the U.S. Government is especially simple. Here are the two primary sources for government indicators:

- **Economics and Statistics Administration:** You can sign up to receive e-mail reports from the Census Bureau and the Bureau of Economic Analysis (BEA), including the GDP report, the New Residential Construction report, the Personal Income and Outlays report, and others. Just go to www.economicindicators.gov.
- **Bureau of Labor Statistics News Service**: You can sign up for e-mail alerts regarding indicators like the CPI, PPI, Employment Situation report, and more. Just go to www.bls.gov/bls/list.htm.

Additional sources for e-mail reports are available. Most of the publicly available reports allow you to sign up for automatic e-mails whenever the report is released.