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USING ECONOMIC INDICATORS

to **Improve  
Investment  
Analysis**

THIRD EDITION

Evelina M. Tainer

# Using Economic Indicators to Improve Investment Analysis

*Third Edition*

EVELINA M. TAINER



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# Preface

**T**he ivory tower view that you cannot bring economic theory to the real world is simply untrue. You—consumers, investors, even government policymakers—*can* apply economic principles, events, and conditions to your daily life, moneymaking ventures, and policy initiatives respectively. Nevertheless, economic indicators reported by public and private agencies are sometimes misread. Relevant indicators are overlooked, while less useful ones get too much attention. As a result, you do not get a clear picture of the current economic environment and what it means for the future. That is why I wrote this book, which began as a pamphlet more than 20 years ago.

Successful trading and speculating, profitable investing, proper policymaking, and effective buying require a thorough grasp of the available data. This includes a healthy dose of skepticism for the information in published reports and a constant eye for aberrations in the established trend. This book explains the relevant details of economic indicators reported by public and private agencies. By the end, you will be able to determine whether the reported data are reliable at face value or need deeper analysis before assessing their role in the current economic environment.

The goal of this book is not to transform you into a full-time economist, but to apprise you of the factors and statistical series that economists monitor in assessing current economic conditions. The reported economic series will have the same meaning whether you are making investment decisions for your household or for your firm. However, the strategy that bond traders take in following the economic statistics is likely to be different from the strategy followed by manufacturing executives or by consumers in their financial investments. In all cases, investors (bond traders, manufacturers, or consumers) or government policymakers must understand the reported economic indicator to make rational decisions.

I have written this book in plain English—not economic or business jargon that is understood by a select few. Economic statistics are described in nontechnical terms—but this is also done by familiarizing you with the language used by financial market participants so that, for example, individual investors can have a better understanding of the relationship between economic indicators and financial markets. While changing interest

rates and foreign exchange rates have an impact on economic activity, it is also true that economic indicators cause stock prices, interest rates, and the foreign exchange value of the dollar to rise and fall. Consumers and investors who are not intimately involved with the financial markets can find it difficult to understand that strong economic growth is bad for the bond market. (Something “good,” such as a drop in the unemployment rate, actually causes interest rates to rise.) I will explain why.

Financial market participants, who anticipate fiscal and monetary policy changes that ultimately affect interest rates, stock prices, and the dollar exchange rate, need to know how to dissect the indicators and search for anomalies. If these economic indicators are misinterpreted, then their market reaction will be wrong and their best guess on future Federal Reserve policy will also be incorrect. For example, perceiving a strong economy, because nonfarm payroll employment posted a large gain, would lead to rising interest rates. This, however, would actually hurt the economy if activity were anemic and the rise in payrolls was due to one or more special factors such as auto workers returning to work after a protracted labor dispute. Policymakers could also misinterpret the economic figures if they did not pay attention to the occasional quirks in the data and policy decisions would be based on incorrect information about the current and future state of the economy. For instance, a healthy employment scenario might cause the Federal Reserve to worry about inflationary pressures and induce unwarranted tightening measures. Rest assured that policymakers and economists at the Federal Reserve do closely scrutinize each economic indicator and are aware of the potential quirks.

Government policymakers in Congress as well as bureaucrats at federal agencies, and state and local government agencies should also have a healthy understanding of current economic conditions. They, too, can misinterpret economic figures when they do not pay attention to quirks in the data that, in turn, lead to bad decision making. State and local government leaders need to understand the interest rate environment because municipalities need to borrow money and issue tax-exempt securities.

The proper interpretation of economic news is not just limited to the players in the financial market and policymakers. Business students who study economics still do not see the connection between economic theory and the real world from their courses. Journalists, too, need to understand economic information before imparting it to the general public (who often only rely on the media for the information that they use to make their economic decisions).

This book serves three functions for its audience. It describes economic indicators and the nuances associated with them and it explains market reactions to those consumers, investors, government officials, and the like

who are not directly participating in the financial markets. It also shows individual investors that they can use economic indicators to their advantage in making long-term strategic investment decisions.

Each chapter explains the economic indicator, the different market reactions to it whether the fixed income, foreign exchange, and stock markets, and key points to look for in the particular series. Economic indicators are divided by sectors of the economy such as consumer, investment, and inflation. If you are a sophisticated financial market participant, the “Market Reaction” sections may seem simplistic. However, even sophisticated market players will find useful information in the specific indicator section. The “Watch Out!” sections are crucial, too, for pointing out common and uncommon quirks along with potential special factors.

Chapter 1 links economic indicators to the financial markets. It presents a basic description of cycles in the economy and markets that move within the cycles. This chapter also discusses the basics of market psychology and explains how we are all financial market participants in some way.

An overview of the macroeconomic framework is provided in Chapter 2, using the standard national income accounting methodology. It concentrates on GDP (gross domestic product) and explains the income side of the accounts from which corporate profits are derived. It also provides a framework for analyzing the economy. Chapter 3 features a discussion on the consumer sector, a major component of the U.S. economy. It includes the relevant indicators that reflect consumer behavior, which are reported monthly, quarterly, or more frequently. This section compares and contrasts indicators of consumer behavior so that you will recognize which series are more consistently reliable.

The investment sector of the economy is the subject of Chapter 4, which looks at investments in *physical* capital such as machinery or buildings as opposed to *financial* investments that include stocks or bonds. Monthly indicators that represent the investment sector typically fluctuate dramatically from month to month and need to be interpreted cautiously.

Since 1980, the United States has increased its trade with foreign countries and can truly call itself a global player. Chapter 5 investigates this, the foreign sector. You will learn how to make sense of the few available indicators to understand behavior in the foreign exchange market as well as in the domestic bond and equity markets. Chapter 6 considers government spending. Monthly or quarterly indicators are sparse even though the government accounts for one-fifth of gross domestic product. This chapter uncovers some hidden indicators.

Chapter 7 focuses on the familiar one of inflation—and its advantages and disadvantages. This chapter defines inflation and how we measure it. You will also learn that all inflation measures are not identical and that it is

important to distinguish between inflation in the market for goods, services, and labor.

Chapter 8 covers labor market indicators as reported by government statistics agencies and private institutions. The monthly employment situation, usually reported on the first Friday of every month, is the indicator that consistently causes the largest fluctuations in financial markets—including equity and bond markets overseas!

A variety of production measures are the subject of Chapter 9. These statistics, such as the index of industrial production and the ISM manufacturing survey are compiled by government agencies as well as by private organizations such as the Institute for Supply Management.

Chapter 10 gives an overview of the Federal Reserve System and how its monetary policy is implemented. Also included here is a revealing look into the evolution of Fed watching and how to interpret key indicators produced by the Fed such as the monetary aggregates, the *Beige Book*, and the flow of funds.

Chapter 11 looks at the Treasury securities market, the method by which the government borrows money. It also covers the monthly Treasury statement, which reveals the income and expenditures of the federal government. Here you will learn about Treasury International Capital, an indicator published for nearly 30 years but only recently “discovered” by financial markets.

Lastly, how individual investors can use economic indicators to make profitable investment decisions is the focus of Chapter 12. Day trading became popular in the late 1990s and early 2000s as online resources gave individual investors the ability to trade with professionals. Despite the Internet, most individual investors do not have the same resources available to professional investors and would do better by using economic indicators to make long-term investment decisions instead.

One final caveat: Statistical agencies in the public and private sector revise data frequently and sometimes revise their statistical methodologies. Some changes are minor while others are more consequential. To keep track of these changes and their importance, readers should check online at [www.econoday.com](http://www.econoday.com).

Evelina M. Tainer

Tacoma, Washington  
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E.M.T.



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# Cycles, Markets, and Participants

**U**nderstanding the importance of economic indicators to the U.S. economy requires familiarity with the underlying cycles, markets, and participants in those markets—concepts typically included in an introductory macroeconomics course. This chapter briefly describes three kinds of cycles, three distinct markets, and several types of participants, including their sentiments and their actions. The intent here is to simplify a complex subject and relate theoretical constructs to real world economics and finance.

To make explanations clearer—and to avoid the famous economic apology, “all other factors held constant”—the following definitions focus on one factor at a time. Always remember the difference between the real world, where various effects get tangled together, and the laboratory, where we can isolate and dissect the individual parts. The key points to each are summarized so that you will have the underpinnings of the economic system.

## **THE ECONOMIC BUSINESS CYCLE**

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Practically everyone knows about the economic business cycle. The press may not describe it that way, but people often hear the terms *economic expansion* and *recession*. The economic business cycle is measured from peak to peak, or from trough to trough, and has five phases. The business cycle peak is the highest level reached in economic activity—the last month or quarter of economic data before indicators begin to decline. The first drop in a set of economic indicators suggests that the economy has just entered its first phase: *downturn*, more commonly known as *recession*. The downturn lasts as long as economic indicators continue to decrease. The second

phase of the business cycle is the *trough*. It is the lowest point in the business cycle and the weakest point in any economic series. The peak and trough of the business cycle are generally viewed as a point in time, such as a specific month as seen in Table 1.1. The recession can last for several months (or years in the case of the Great Depression). The average length of the 10 U.S. recessions in the post-World War II period was just over 10 months.

The *recovery* signals the third phase of the business cycle. A recovery is in progress the first month that a set of economic indicators begins to rise. It means that the recession is over. As a participant in the economy, you are unlikely to notice any improvement in business activity in the first few months of recovery. Keep in mind that the first month of recovery is just as bad as the second-to-last month of recession. You are barely one inch above the ground. The early stages of recovery often continue to feel like recession to the unemployed who cannot immediately find jobs and to retailers who have yet to liquidate still unwanted inventories. Typically, after the first few months, the economy gathers some steam, and growth becomes quite robust for about two years.

Economic *expansion* is the fourth phase of the business cycle. One can say that the recovery ends and the expansion begins when the output lost in the recession is recuperated.

The fifth phase of a business cycle occurs when the economy reaches a new *peak*; you do not know you are in the fifth phase until the peak has

**TABLE 1.1** Postwar Business Cycles

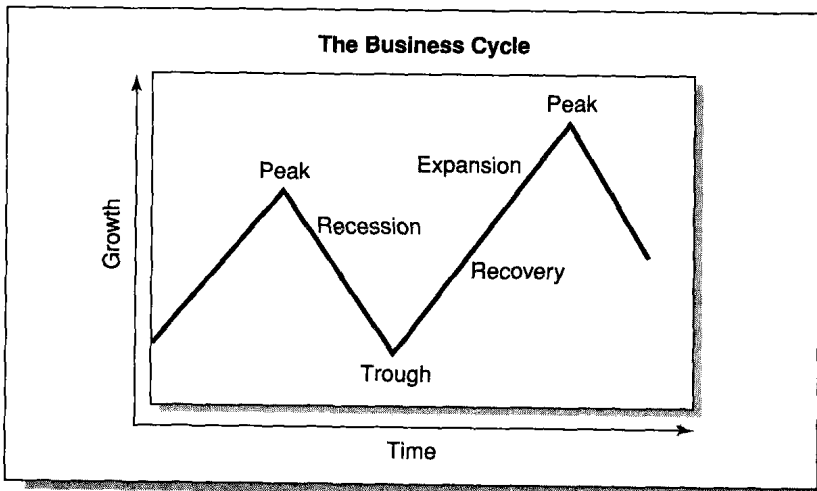
Peak	Trough	Months of Recession	Months of Previous Expansion
Nov 1948	Oct 1949	11	36
Jul 1953	May 1954	10	44
Jul 1957	Apr 1958	9	37
Apr 1960	Feb 1961	10	23
Dec 1969	Nov 1970	11	105
Nov 1973	Mar 1975	16	36
Jan 1980	Jul 1980	6	57
Jul 1981	Nov 1982	16	11
Jul 1990	Mar 1991	8	92
Mar 2001	Nov 2001	8	120

Source: National Bureau of Economic Research.

passed and the economy has already headed for a downturn. Figure 1.1 depicts a stylized version of the economic business cycle, but all economic indicators do not follow this pattern. Figure 1.2 depicts gross domestic product (GDP) and nonfarm payroll employment. GDP hardly declined and recovered quickly, but employment kept falling into the (official) recovery period and recuperated much more slowly.

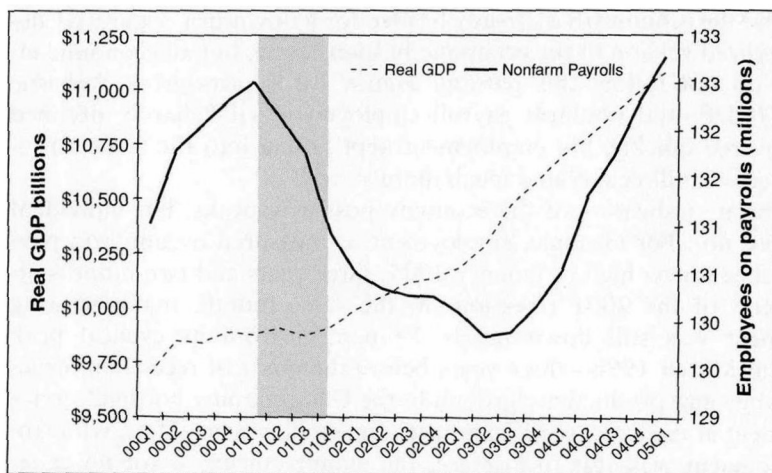
Aggregate indicators of the economy post new peaks, but individual series need not. For example, employment as measured by nonfarm payrolls reached a new high in January 2005, three years and two months after the end of the 2001 recession. In the same month, manufacturing employment was still down nearly 19 percent from its cyclical peak reached in March 1998—three years before the onset of recession. Structural change and productivity growth in the U.S. economy boosted service employment at the expense of manufacturing employment. Thus, while total employment was able to increase, the manufacturing sector never recovered the workers it had lost during this period. The all-time peak in factory payrolls was recorded in June 1979.

The National Bureau of Economic Research (NBER), the official arbiter of business cycles, includes several prominent economists on its Business Cycle Dating Committee who analyze many factors before pinpointing the exact date a recession began or ended. With respect to the 2001 recession, the NBER announced on November 26, 2001 that the business cycle had peaked March 2001, eight months earlier. It was not until July 17,



**FIGURE 1.1** The Business Cycle: This is the classic example of an economic business cycle. The real world, however, does not move in a straight line.





**FIGURE 1.2** Gross Domestic Product and Employment: This is an example of a recent business cycle. Real GDP peaked in the first quarter of 2001 and reached its trough in the third quarter. It surpassed the previous peak in the fourth quarter of that same year, revealing a short and shallow recession. Contrast this to nonfarm payrolls, which peaked in February 2001, bottomed out two years later in May 2003, and did not attain the previous peak until January 2005.

*Source:* Bureau of Economic Analysis, Bureau of Labor Statistics, and Haver Analytics.

2003 that the NBER Business Cycle Dating Committee announced November 2001 as the end of the recession, even though many economists—including Federal Reserve Chairman Alan Greenspan—conjectured that the recovery actually began in early 2002 when several economic indicators started to turn around.<sup>1</sup>

The timing of the 2001 recession was a bit sensitive because no one wanted to credit the September 11 terrorist attacks with having triggered a recession. As it turns out, the recession had indeed begun before the attacks on the World Trade Center and the Pentagon.

Although the NBER economists analyze several economic sectors and economic series, many economists use the rule of thumb that a recession requires at least two consecutive quarters of decline in real gross domestic product. (GDP is the most encompassing measure of production of goods and services.) Real—that is, inflation-adjusted—GDP fell in the third quarter of 2000 as well as the first and third quarters of 2001, but it was positive in the fourth quarter of 2000 and the second quarter of 2001. The