

Insights

Piecing Together the Economic Indicator Puzzle

For hundreds of years and using countless theories, academic research has tried to explain why the financial markets go up or down in an attempt to forecast the future. Theories range from those that rely on highly complex mathematical models to simple qualitative theories based on gut feeling. Why don't these theories work consistently? Simply put, there is nothing more valuable than the economic reports released by government agencies.

The financial markets tend to be efficient and trade on a daily basis according to what investors believe fair value is. Fair value is based on today's economic news and expectations of tomorrow's events. When expectations occur as expected (or do not occur), this realisation is what causes markets to change value on a daily basis. Unexpected events — such as wars, famines and hurricanes — can impact economies as well as the markets. This inherent unpredictability poses a difficulty for theoretical models: different academic models for fair value can have very different results once "actual" numbers are inserted. In essence, this is why economic data and world events play a crucial role in determining the fair value of financial markets.

There are many different economic indicators, but some are more significant than others. First, let's look at the basics about economic indicators and then at some of the most meaningful ones:

- Some indicators are lagging while others are leading. Markets tend to be forward looking and, as a result, put more weight on leading indicators.
- Some economic indicators, when publicly released, are estimates that can be revised up or down, up to three months later. This becomes a cause for depreciating the usefulness of indicators that get frequently revised.
- Finally, some indicators over time become less and less useful, due to structural changes in economies, or are more important during different times of an economic cycle.

US Economic Indicators

Change in Non-farm Payrolls — is an eagerly awaited monthly report that can have significant impacts on markets. This leading indicator is very relevant in determining economic growth. A strong report usually leads to a bond market sell-off and an equity rally.

Retail Sales — a closely watched leading indicator giving an insight on the health of consumer spending, a major component of GDP. A strong report leads to higher equity markets, as company bottom lines could improve in the future. The bond market impact can be flat to down, because strong retail sales could improve the pricing power of corporations, leading to inflation.

Consumer Confidence — whilst it has little economic data supporting it, consumer confidence can have a moderate impact on markets, since it is considered a leading indicator and another insight on the health of the consumer. A strong confidence number can lead to mildly higher equities and lower bond prices.

Gross Domestic Product (GDP) — represents the actual economic growth as reported by the government. Contrary to what one might expect, GDP typically has little impact on markets, since it is both lagging and revised several times, due to the first and second reports being estimates. When "actual" GDP is finally reported three months later, the markets are not sensitive to what economic growth was three months prior.

Consumer Price Index (CPI) — is the preferred measure of inflation by the markets. It measures the increases or decreases of consumer prices over time. The CPI ex food and energy is generally what market participants pay attention to, due to its less volatile nature. CPI, unfortunately, suffers from being a lagging indicator, but it impacts the bond markets broadly, as inflation erodes the real value of bonds. Furthermore, a high CPI could motivate the Fed to raise short-term rates. Equities can also be harmed by inflation, as it has the potential to decrease profit margins, especially when inflation is commodity driven.



International Economic Indicators

German IFO Business Survey — is published monthly and assesses the current and future economic environment in Germany. The IFO is significant for European equities, as Germany is the largest contributor to European GDP. When there is a strong IFO release, equities are likely to rally and bonds are likely to sell-off.

Japan's Tankan Survey — is produced by Japan's central bank, published on a quarterly basis, and provides guidance into the Bank of Japan's official thoughts on future monetary policy action. A hawkish stance usually results in both a bond and equity market sell-off.

Brazil Industrial Production — is a closely watched indicator for the Latin American economy, since Brazil represents 40% of South America's GDP and industrial production is 42% of Brazil's economy. A strong report typically leads to both an equity and bond rally, as investors become more comfortable that the government can satisfy its debt obligations.

Unquestionably, economic indicators — along with natural disasters, wars and other world events — impact the financial markets and should be monitored either by the investor directly or by his investment manager in order to determine if an adjustment in asset allocation should be made and how quickly that adjustment is made. Shifting asset allocations frequently, however, can detract from performance. The saying “all good things come to those who wait” is perfectly apt for this situation; it is generally considered a better strategy to set up an asset allocation plan with a long-term outlook. Investors who understand the impact of the economic indicators and unanticipated world events, who can make non-emotional decisions and shift asset allocation without too much frequency are likely to come out on top.

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SG-11/06

SCPB-108-0608-F-E

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