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Economic and market indicators help predict the markets

People often call us and ask what economic data they should be looking at to formulate an opinion on which way the markets are heading or which sectors to be investing in.

This is a very broad subject. Many of you, who have either gone to business school or are avid investors or perhaps like to watch the commentaries on BNN or CNBC, may have heard of economic indicators.

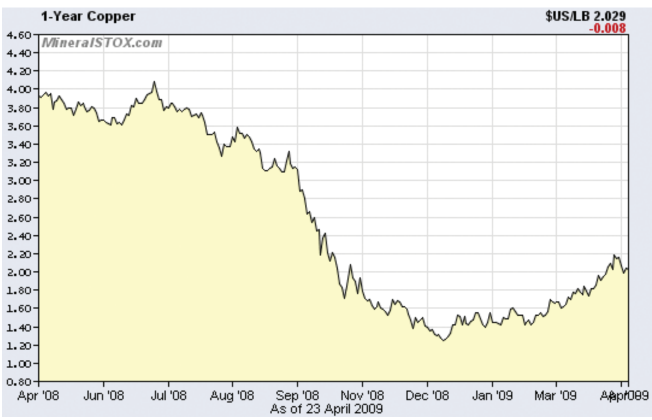
An economic indicator (or business indicator) is a statistic about the economy. Economic indicators allow analysis of economic performance and predictions of possible future performance. These indicators include various indices, earnings reports, and economic summaries, such as unemployment, housing starts, Consumer Price Index (a measure for inflation), industrial production, bankruptcies, Gross Domestic Product, broadband Internet penetration, retail sales, stock market prices and money supply changes.

Economic indicators fall into three categories: leading, lagging and coincident.

Some common leading indicators (those that predict the market) are: average number of initial applications for unemployment insurance, the number of manufacturers' new orders for consumer goods and materials, speed of delivery of new merchandise to vendors from suppliers, amount of new orders for capital goods unrelated to defense, amount of new building permits for residential buildings, the S&P 500 stock index, and inflation-adjusted money supply (M2).

The most talked about lagging indicators (those that react to the market) are: the average duration of unemployment (inverted), the value of outstanding commercial and industrial loans, the change in the Consumer Price Index for services, the change in labour cost per unit of output, the ratio of manufacturing and trade inventories to sales, the ratio of consumer credit outstanding to personal income, and the average prime rate charged by banks.

Coincident indicators are those which change at approximately the same time and in the same direction as the whole economy, thereby providing information about the current state of the economy. Personal income, GDP, industrial production and retail sales are coincident indicators. A coincident index may be used to identify, after the fact, the dates of peaks and troughs in the business cycle.



Other economic and market indicators to look at are the Baltic Dry Index (BDI) and also the Transports Sector Index (NQ: TRAN). Both are an important gauge of economic activity. The BDI measures bulk shipping. If shipping activity is weak, then the odds are the economy is still struggling. When these indexes start to shoot higher, it is most likely a positive sign. Both have seen some bullish activity in about the last 30 days with a steady uptrend and, most recently, some healthy consolidation. This pattern typically likes to breakout to the upside. But, as always, be nimble and buy on weakness and sell on strength.

Another one we like to use is the semiconductor index (SOX) and the semiconductor ETF from Proshares (USD). As exports of the product increase or decrease, it signals strength or weakness in consumer demand and, therefore, economic strength. Semiconductor exports in the U.S. alone nose-dived 50.3% to $945.78 million last December from $1.904 billion the same month in 2007.

We regard copper in the same way and think that a rise in base metals signals that economic growth could be making a comeback. The red metal has a great record of predicting both upturns and downturns in the economy. For example, the housing sector is a big user of copper and, as construction and housing starts to slow down, copper will devalue as demand for the metal diminishes. In an economic upturn, the reverse happens.

Steel will also act in a similar way as it is directly tied to economic activity such as the making of vehicles, a product people buy when they have money and the economy is strong and an item they sell or choose not to buy in hard economic times. Over capacity and supply exceeding demand in copper and steel points to deflation and economic downturn.

Some investment professionals prefer these commodity indicators to raw economic data, as these metals moved downwards long before the data signaled weakness in the global economy.

This makes perfect sense, as these metals are used for the construction of physical objects that are often used in infrastructure and other global growth sectors. The metals are argued to be better leading indicators, while raw data (such as unemployment figures) are often better lagging indicators.

In any case, as a prudent investor, one should always use a combination of indicators combined with specific fundamental information regarding the particular company or stock you want to buy or sell.

Readers, if you want more information on economic and stock market indicators, as well as specific stocks related to each, and how to read them, do not hesitate to contact us. ■

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