What Do The Numbers Really Mean? Uncovering the Secrets of Economic Indicators

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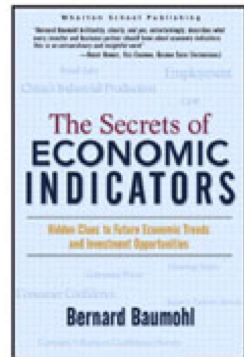

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An economic drama is playing out as you read this, one whose next act is about to unfold. It began quietly enough on Thursday, Jan. 6, when the U.S. Department of Labor issued its weekly report on first-time unemployment-insurance claims. It found that 364,000 workers filed initial claims for unemployment benefits for the week ending Jan. 1 -- 43,000 more than during the previous week. The stock market rose slightly that day.

Events took a different turn the next day, Jan. 7, when the U.S. Department of Labor issued its job-creation report for December. That report revealed that the U.S. economy added 157,000 jobs during the last month of 2004. That was a big enough number to suggest the economy was continuing to grow at a decent pace, but it was lower than many economists had expected. The stock market fell slightly that day.

The two were typical encounters in the complex and continual interplay between economic indicators and the financial markets.

Another key turn in this drama is due on January 13, when the Bureau of the Census will report its first rough estimate of retail sales during December. No doubt that report also will prompt close scrutiny by investors, company managers and economists. After those numbers are released, Knowledge@Wharton will provide an update on how it all plays out with help from Bernard Baumohl, author of *The Secrets of Economic Indicators*, published by Wharton School Publishing.

An array of government agencies and private groups compiles and regularly issues economic indicators. Jobs, consumer spending, consumer confidence, factory orders, business inventories, home sales, foreign trade, inflation, Federal Reserve Bank surveys. The list seemingly is endless.

But why should anyone other than Alan Greenspan care about economic indicators? "Because these are vital barometers that tell us what the economy is up to and, more importantly, in what direction it is likely to go in the future," Baumohl says. He characterizes them as essential knowledge for investors worried about their portfolios, company chief executives trying to make business decisions they can justify to shareholders, and workers just trying to gauge the health of their industry.

Baumohl, a former *Time* magazine economics reporter, now is director of the Economic Outlook Group, a Princeton consulting firm that assesses global economic trends and risks. "You don't need an advanced degree in economics and you don't need to be a statistical geek to understand the numbers. They are surprisingly intuitive in most cases," he says.

So why did the markets react the way they did following the jobs reports? Just what kind of investor reaction will the retail sales report elicit? Just what indicators are essential to track? Baumohl spoke to *Know Knowledge@Wharton* about these questions:

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Jobs Reports

The backdrop to the two reports exerted a stronger influence on the markets than the jobs numbers by themselves. The job data came on the heels of the release by the Federal Reserve of the minutes of its policy-making Federal Open Market Committee's Dec. 14 meeting. The minutes showed the members worrying about accelerating inflation.

The minutes "created a cloud" over the stock market for the rest of the week, Baumohl says. Investors feared that the Fed was signaling a faster pace of interest-rate increases than it has maintained in recent months. Higher interest rates could slow sales and hurt corporate profits. That's bad for shareholders. The bond market, on the other hand, reacted fairly favorably, Baumohl notes. It perceived the Fed to be signaling greater vigilance against inflation.

Against this backdrop, the weekly numbers for initial unemployment insurance claims appeared to allay the stock market's fears. The number of layoffs - 364,000 - was substantially higher than in the previous week. That created the impression, Baumohl says, that "maybe the economy is not growing as rapidly as we originally thought," and maybe, therefore, the Fed would not move so aggressively to raise interest rates. Caught between two indicators seemingly at odds with each other, the market seemed to tread water, rising just slightly.

"The rule of thumb with initial claims is that if the number falls below 350,000, it's a sign that the economy is going well and hiring workers. If it is above 400,000, it is a sign that the economy is in trouble, probably laying off workers and in danger of falling into recession," Baumohl says. The number for the week ending Jan. 1 sent an unclear signal.

The next day, investors had to contend with another uncertain signal. The report that 157,000 jobs were created in December came in on the low side of the range of expectations, Baumohl says. Still, anything above 150,000 new jobs suggests that the economy is growing. The market seemed to tread water again, though it gave up some gains that day amid lingering fears of interest-rate increases.

Retail Report

"Now we get to retail sales. The backdrop is that people are still being hired. That is good for the economy, because the more people work, the more household incomes grow. That income is used eventually to increase spending. An important aspect of the jobs report that people should watch closely is the amount of increase in income that workers are getting. The average hourly earnings and average weekly earnings are both in the jobs report.

"What those numbers revealed, not just for December but for several months, is that the incomes of workers have been trailing inflation. That can suppress spending down the road. People are seeing deterioration in their purchasing power.

"The retail sales report is one of the top 10 economic indicators. When it comes to finding out how healthy the economy is and where it is going over the next six to 12 months, economists, investors and CEO's all focus on the outlook for consumer spending. The reason is that consumer spending makes up 70% of all economic activity. If consumer spending is growing at a good pace, then company revenues are growing, the stock market is rising and household wealth is rising. If consumers are not in a shopping mood, it can have grave consequences for the economy. Profits may shrink and stock prices fall.

"The retail sales report - due tomorrow, Jan. 13 - comes out about two weeks after the month on which it reports. Retail sales account for about a third of all consumer spending ... [taking into account] spending at department stores, auto dealers, gas stations and restaurants, but not spending on insurance, air travel, movies and haircuts."

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But retail sales are a good "quick and dirty assessment" of consumers' mood. The initial report is based on a sample of 5,000 retailers around the country, about half of whom respond to the survey. A more comprehensive assessment of consumer behavior comes out weeks later in the form of the Commerce Department's personal income and spending report.

The retail sales report gets a lot of attention and can be a market mover because it is the first such report. "Timeliness and approximation of data is considered of more value to investors who want to move in and out of the markets quickly than a dated indicator that may be more comprehensive. Investors like to react immediately to the news."

But investors must take the time to dissect that number also. The retail-sales picture can be warped by a surge in gasoline prices, for instance. So the report breaks out gasoline sales, showing what retail sales were, excluding gasoline. "Gasoline prices have fallen in recent weeks, but still are higher than they were a year ago. Higher gasoline prices are like a tax on consumers. They deprive them of money they could spend on other things," Baumohl notes.

"Another thing that ought to be considered when the retail sales number comes out is that it is often overly influenced by purchases of automobiles and auto parts. A quarter of all retail purchases involve motor vehicles and related products. So, many investors and economists subtract that number, too, from total retail sales."

Holiday Retail Sales

By the time the retail-sales numbers come out, investors already have a good picture of how the crucial November-December holiday season went, as retailers individually report their performance. "So far, it appears we had decent holiday sales. As a result of heavy discounting, consumers bought a lot, but in dollar terms it won't be that big an increase. The increase in holiday sales may be 3% over the same period the previous year, which is about same rate as inflation.

"Because of discounting, margins were much slimmer than these stores wanted. But the stores were worried that consumers would not buy much unless products were heavily discounted. In fact, Thanksgiving sales at department stores slowed markedly, and this made many of the major chain stores nervous. Wal-Mart turned out to be one of the first to notice that and it immediately slashed prices. Other stores then jumped on the bandwagon and as a result attracted customers back and that saved the holiday season from being a major disappointment.

"So now we look forward to the retail sales number and we need to ask a couple of important questions: Are consumers financially healthy enough to continue spending, and spending in a way that will allow the economy to grow?

"Evidence is growing that the economy in fact may be slowing a bit. Some expect anemic expenditures by customers in the next two to three months. Household income has not fully kept pace with inflation. For a year, people have been spending at a rate greater than what they have been earning, and that can't continue indefinitely. Consumers appear to be deeper in debt, and there are some fresh concerns that with the household savings rate at close to zero, they really don't have any emergency funds set up to help pay for all these bills. Finally, in a climate of rising interest rates, debt payments on car loans, equity loans and variable mortgages are going to be more expensive, too.

"When you combine all these stresses on household finances, there is a growing expectation that consumer spending will slow in the next two to three months so consumers can improve their household balance sheets. December really may be the last decent month for a while for consumer spending," Baumohl notes.

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Top Indicators

Which indicators are the most important to track? Says Baumohl: "If you are mainly a stock investor, keep an eye on indicators that tell you something about corporate sales and profits. These will have an impact on stock prices. They include the employment numbers. Personal spending and retail sales numbers are important as well. Among the very best predictors of consumer spending would be sales of new and existing homes. The logic is that when you buy a new home, you also buy furniture and appliances and cars.

"Investors should also monitor international economic indicators. Trade accounts for 25% of the U.S. economy. Most of the S&P 500 companies rely on foreign sales for revenues and profits. About two out of 10 workers in the U.S. are linked to international trade," he says. Among the foreign indicators worth noting are two business-confidence surveys - Germany's IFO Business Survey and Japan's Tankan Survey - and China's Industrial Production survey, which measures monthly changes in that country's industrial output.

"If you are a senior citizen and likely to be more interested in what might happen to bonds, look for indicators that offer clues about the outlook for inflation and interest rates. Once again, the monthly employment report is the key number. When more people are working, there is more spending and a faster growing economy and that raises concerns that inflation is coming down the road. That is bad news for the bond market, because when the economy overheats, interest rates go up, and that depresses bond prices.

"This would be especially the case if the economy already is operating at a fast pace. A strong employment report may not worry the bond market when the economy is just coming out of a recession. But we are well into the business cycle now and a strong employment report at this stage can agitate the bond market."

The other indicators to watch would be the consumer and producer price indexes, which measure inflation and are compiled by the Department of Labor, and a survey of manufacturing activity compiled by the Institute for Supply Management based on a monthly survey of purchasing managers. Released on the first business day after the reporting month, "it is the first piece of news on the economy out of the gate every month and the most influential statistic released by the private sector."

Indicators for CEOs

"Corporate chief executives must look at a slightly different set of indicators than investors do in making business decisions," says Baumohl. "They have to know when to make investments in plant and equipment, when to expand, when to raise capital, when to hire workers. Their main goal is to know what the economy will do a year in the future. A factory is not going to come on line tomorrow. They want to be certain the economy will remain healthy before they start hiring workers."

Two vanguard indicators for business executives would be housing starts and permits for future construction, both compiled by the Census Bureau. "The logic here is that if companies are constructing new homes, it is based on the belief that people will be buying the homes and that mortgage rates will be low enough for the buyers. Housing is a massive umbrella industry. Many other industries are linked to it," he says.

Baumohl notes that in 2004, "there appears to have been a record number of new- and existing-home sales. Home prices also have risen at a faster pace than the inflation rate. Now interest rates are likely to go up a bit in 2005 and that is going to make mortgage rates rise as well. When you combine higher mortgage rates with higher home prices, home purchases probably are going to be less affordable in 2005. Add in lackluster job growth, and home sales are likely to flag a bit this year."

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Update:

On Thursday Jan. 13, a day after Knowledge@Wharton was published, two economic indicators were announced: the retail sales numbers for Dec. 2004 as well as the number for first-time jobless claims during the week ending Jan. 8. Retail sales rose more than expected (by 1.2% from November and 8.7% from a year ago), but so did the initial jobless claims (to 367,000, for the week ending Jan. 8). Knowledge@Wharton asked Bernard Baumohl what these numbers might mean for investors.

Knowledge@Wharton: Stock prices fell, but bond prices rose. What was going on?

Baumohl: It was a tough day for the stock market. Investors had to digest lots of news, and they concluded it was a net negative for future corporate profits and economic growth. Their biggest concern was that the price of oil rose for the third straight day and now stands at its highest level in six weeks.

As the price of crude reached $48 a barrel in futures trading in New York, it stirred fears that we might soon see a return to the mid-$50s high of October. Worries over the election in Iraq, more sabotage by insurgents in that country, OPEC's decision to cut production, and new forecasts of a colder winter in the Northeast all led to a spike in oil prices.

The prospect of rising energy prices raises business costs even as it crimps future consumer spending. If Americans have to pay more for gasoline and heating oil, there's less money available to pay for discretionary items such as clothing, movies, restaurants, vacations and books. Thus, not only do companies face higher production expenses, but they may see revenues drop off, too, as consumers spend a larger share of their money on energy.

This double whammy – lower corporate profits and lower consumer expenditures – can slow economic activity in the coming months. This is bullish for traders in the bond market since such a scenario means there is less inflation to worry about.

The bond market was further encouraged by the unexpected jump in filings for unemployment insurance. The report (for the week ending Jan. 8) showed that claims for jobless benefits leaped by 10,000 to 367,000, and that came after claims soared by 36,000 during the week ending Jan. 1. (The numbers relating to the week ending Jan. 1 are slightly different from those originally reported because they have been revised.)

These numbers suggest that companies are still very apprehensive about hiring new workers. If this trend continues it will further curb consumer spending. As a result, traders bid bond prices higher, causing yields to fall."

Knowledge@Wharton: So did retailers have a strong holiday season? Or, as you suggested earlier, does the increase in sales during December hide thin margins because of all the discounting?

Baumohl: Retail sales jumped by 1.2% in December, the biggest increase in three months. Pretty impressive, you might think, especially since November sales rose by a barely noticeable 0.1%. But the stores really have little reason to boast. If you look past the headline number, it becomes apparent that shoppers actually were quite stingy in December. They opened their wallets only at the opportunity to pick up some genuine bargains.

This time the big bargains were found in the auto sector. After weak car and light-truck sales in November, the big automakers boosted incentives in December to get shoppers into showrooms. The strategy worked and triggered a year-end surge in auto sales, with purchases of cars and light truck

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climbing to an 18.4 million unit annual rate, the fastest in three years!

Since motor vehicle sales typically represent about a quarter of all retail sales, it's no surprise this helped push up total retail sales by 1.2% for the month. However, if you take out auto sales from total spending, then retail sales rose by a much more modest 0.3%. And the only reason retailers saw even that amount was because oil prices fell in December and so drivers spent 2% less filling up their cars with gas. That freed up more than $100 billion, which could be used to buy other items.

All that discounting by retailers will cut profit margins, and this is another reason why stock investors were in a lousy mood on Thursday."

Knowledge@Wharton: Finally, are you sticking with your earlier analysis that December likely will be the last good month for retail sales for a few months?

Baumohl: Yes. What sustains consumer spending and retail sales, above all, is household income. For income to grow at a healthy clip, the economy has to generate more jobs. The employment report for December and Thursday's figures on initial weekly claims for unemployment are not encouraging. I continue to believe that households will come under increasing financial stress in the first half of 2005. Consumer debt levels are high and interest rates are rising. Savings rates are close to zero. As a result, retail sales will suffer. It's going to take more aggressive price cutting and sales by stores to keep Americans in a shopping mood during the next several months.

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