Reading 'The Tea Leaves'

August is a great month to find a hammock on a hot, lazy summer afternoon and reflect on life while enjoying a large pitcher of iced tea. If you are taking the opportunity to do this, your thoughts may wander into territory where you are trying to forecast what is going to happen to the economy and the markets. As you are forming your opinion and seeking to support your theory with details, now may be a good time to recall some of your Economics 101 definitions of leading and lagging economic indicators.

What is the difference between Leading Economic Indicators and Lagging Economic Indicators? Leading indicators are predictive in nature but can be a bit squishy as to their reliability. Lagging indicators are the result of economic activity, are more reliable datapoints, and function as a look in your rear-view mirror as confirmation of where you have been.

To further put these into perspective, let's say you have a friend who has decided to "get into shape" and you see them at your health club. The types of exercises they are doing as well as the number of sets of exercises they are doing for each of these could be considered leading indicators. If your friend seems to be on a disciplined regimen and appears to really be working hard you might expect that they would soon see solid results. After several months they are measured and weighed at your health club and there is virtually no change. These components are lagging indicators and hold a hard, cold truth.

In an effort to understand what has happened, you compliment your friend on consistently coming to the gym and tell them not to get discouraged. Your friend thanks you and shares that they knew their metabolism definitely had picked up over the past few months as they seemed constantly hungry and were eating more pizza, French fries, and drinking more malts than they had ever consumed before. You are reminded that leading indicators are directional and may not tell the whole story.

WHAT ARE A FEW ECONOMIC INDICATORS I SHOULD WATCH?

Our economy is diverse and complex and as a result the number of economic indicators that you could attempt to track can be overwhelming. Economists typically categorize indicators as leading, lagging, or coincident. We've already defined leading and lagging indicators. Coincident indicators are analyzed and used as they occur. Your speedometer on your car could be considered a coincident indicator as it tells you your exact speed at that moment. From an investor's perspective, here are a few basic indicators that are worth paying attention to:

- Gross Domestic Product (GDP): GDP is the total market value of all the finished goods and services produced in a specific time and is a coincident indicator. It is one of the core measurements of economic health.
- Consumer Sentiment: Consumer spending is responsible for over 70% of our nation's economy and the Consumer Confidence Index (CCI) is one of the primary measurements of this. Consider this a leading indicator.
- Inflation: Probably the best-known measure of inflation is the Consumer Price Index (CPI). Keeping inflation growing steadily but not too fast or too slow is one of the core goals of the Fed. Consider this a lagging indicator.
- Employment: The labor market is an important indicator of the health of our economy with the unemployment rate being one of the most reliable lagging indicators.
- Fixed Income Yields: Bond yields are considered leading indicators of the stock market. It's a good idea to pay attention to the variance between short-term, mid-term, and long maturity fixed income instruments which is known as the yield curve. Normally the longer the maturity, the higher the interest rate. When this curve bends the other way, or inverts, it is often signaling an upcoming economic recession.

When I was a boy growing up on the family farm, I used to love to reference the Farmer's Almanac in hopes of being able to predict the weather. "With a publishing history dating back to 1818, how could they be wrong?", I used to think. Trying to predict the economy and the financial markets may seem just as difficult as trying to forecast the weather. Hopefully you'll find the tools referenced above to be helpful in your quest!

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