JARGON ALERT

Leading Indicators

BY RENEE COURTOIS

Forecasting economic activity is critical to policymaking, though at times it is so fraught with uncertainty that many consider it an art rather than a science. Fortunately, forecasts can be aided by certain economic data that tend to react before the economy as a whole starts to move in a new direction. Such data are called leading economic indicators because they reflect economic agents acting in response to expectations about the future direction of economic activity.

Consider the stock market, for example. Financial market participants are generally quite good at gathering information about the likely future course of the economy. A rise in stock prices, therefore, may signal that investors anticipate a coming surge in demand. Similarly, a stock market decline could signal that many firms' prospects are diminished due to a coming contraction or continued sluggishness.

Other financial market variables also hold predictive value. The difference between short-term and long-term interest rates for bonds, called the "yield curve" slope, has proven to be an insightful economic indicator. When the slope is negative, long-term bond rates are lower than those for short-term debt instruments, which implies that investors expect interest rates to fall in the future as they would during a recession. The slope of the yield curve has turned negative about a year before each of the last seven recessions. Of course, not all financial market moves are clearly and unambiguously related to fundamentals, so the signals sent by asset prices and interest rates sometimes can be "noisy."

Economists also can gain perspective on the economy's prospects by tapping into businesses and individuals on the ground. Home builders, for example, must obtain a permit before building — and they are unlikely to do so unless they think consumers are confident enough in their jobs and other economic prospects to make the large purchase of a home. Therefore, the number of new building permits authorized, as measured and released by the Census Bureau, is a strong indicator of coming construction activity. Home construction, in turn, typically precedes other types of economic activity, including consumer spending on housing-related goods such as furniture and other home furnishings.

To get an overall sense of what message these and other leading economic indicators are providing, a research organization called the Conference Board compiles them into an index of Leading Economic Indicators (LEI). The Conference Board took over this duty from the Bureau of Economic Analysis in 1995, though the index of leading indicators can be traced back to the late 1930s when Wesley Mitchell and Arthur Burns (who would later become Fed chairman) compiled these data for the National Bureau of Economic Research.

Each of the above indicators is included in the LEI, along with several other forward-looking series such as new manufacturers' orders, initial claims for unemployment insurance, a broad measure of the money supply, hours worked by manufacturing workers, and the speed with which industrial companies receive deliveries from suppliers. Also included in the LEI is the Index of Consumer Expectations, a monthly survey conducted by the University of Michigan. Consumers who feel confident about the economy's prospects may be more willing and likely to spend, which helps turn that optimism into economic reality.

Each data series included in the LEI is chosen for its consistent relationship with the business cycle, demonstrated over many years. The data also must be timely, relatively void of erratic movements from period to period, and economically significant. When push comes to shove, no data series matches each of those criteria exactly, but the 10 of them included in the LEI arguably come closest.

Since the LEI compiles data series that have already been released, it doesn't provide much new information to markets. But since any single data series may have uncharacteristic blips from period to period, the LEI provides a more reliable picture of the overall trend. If one or two components of the LEI rise sharply, it could be due to unique or even temporary factors taking place in those markets. But if the LEI as a whole rises persistently, investors and policymakers may take notice. Taken together, the LEI composite can help reveal and identify turning points in the business cycle better than any one series can do alone. The LEI has historically led downturns by eight to 20 months, and recoveries by one to 10 months, according to the Conference Board.

Nonetheless, it's important to remember that "the economy" is simply a collection of the actions of millions of individuals and businesses interacting with each other, so there are a great many indicators to watch to know how the economy is performing. No one indicator or index will hold the same importance in every business cycle, and no single economic indicator will ever tell the whole story about economic activity, including the state of the current recovery. **RF**

ILLUSTRATION: TIMOTHY COOK