CHAPTER 1

The Lock-Up

Shortly after dawn on most weekday mornings, a strange ritual takes place in Washington D.C. Two dozen select men and women leave their homes, grab their newspapers, and rush off to spend part of the day under virtual house arrest. Yes, house arrest—as in incarceration. Precisely where they go to be confined can vary day to day. It could be in a dilapidated government building one morning and a high-tech office complex the next. Regardless of the location, what occurs in all these places is always the same. They enter a strict, prison-like setting where contact with the outside world is cut off.

One Friday morning, this same group climbs a long set of steps to the side entrance of a sleek, white-stone building on 3rd Avenue and C Street in the heart of the nation's capital. Armed guards greet them at the entrance for a security check; from this point on, everyone has to wear their ID tags at all times. The visitors proceed across a lobby, down a quiet narrow corridor, eventually stopping in front of a locked, heavy wooden door. A government official awaits them and quickly opens the door to reveal a drab, windowless, L-shaped room 40 feet long and some 10 feet across. It is empty except for two dozen plain-looking orange and chrome chairs, each resting alongside a row of narrow cubicle-like desks. A digital clock that rests high on the wall breaks time down to seconds. It is 7:30:15 a.m., and already 12 people have found their way into the "lock-up" room. More are expected within the next 15 minutes. All who enter dutifully sign their names on a special sheet.

Despite its austere appearance, there is an atmosphere of calm in the room, at least for now. Some visitors talk excitedly about the previous night's televised basketball game. Others are either chatting on cell phones or checking their Palm Pilots for messages. A few keep to themselves by catching up on the morning paper or downing a quick muffin and coffee. Everyone in the room, however, makes a point of always knowing the time, with some people eyeing the digital clock so frequently that their actions may be mistaken for nervous tics.

As the time approaches 8 a.m., there is a palpable change in mood. Gone now are the sounds of light conversation; these sounds are replaced by the din of laptops firing up. Everyone appears to be focused on what is about to occur.

At 7:55 a.m. sharp, a government official walks in and picks up a wall phone to call the Naval Observatory, home to the Vice President of the United States. It is also the location of the ultra-accurate atomic clock. She listens intently for a few seconds and then abruptly hangs up without saying a word. The individual then inserts a key into a lock on the wall, which allows her to adjust the digital clock to the precise second. With the correct time now set, the official then turns around to make a terse announcement.

"Please turn off all cell phones and Palm Pilots, and disconnect laptops from your telephone lines."

To make sure everyone complies, the official walks across the room and eyes each desk. Meanwhile a second federal employee arrives carrying copies of a highly sensitive government report. Each one is placed facedown on an empty desk.

Then it begins.

At precisely 8 a.m., the door to the lock-up room clicks shut. From this point on, all those inside are out of touch with the rest of the world. No one is permitted to leave. No calls or messages can come into or out of the room. Security is tight. A guard stands by outside, ready to use force if anyone attempts to sneak out.

What secret is the government protecting? Is the CIA about to begin a classified briefing on intelligence activities? Are Congressional investigators huddling to hear the newest terrorist threat? No. All these precautions are taken for one reason. The government is about to release numbers. Statistics. More precisely, economic statistics. The visitors in the room are business reporters representing news organizations from around the world, and this morning they're working out of the Department of Labor's secure press room.

Why such tight secrecy? Because in the next few seconds, these journalists will be the first to lay their eyes on one of the country's most sensitive economic measures—the monthly report on employment conditions. It can shed fresh light on whether the U.S. economy is growing or facing a slowdown. Did the number of Americans who have jobs rise or fall in the latest month? Have hourly wages gone up or did they drop? Did people work more hours or less? These statistics might not seem particularly earthshaking to most Americans, but they can and do whip the global stock, bond, and currency markets into a frenzy. For individual investors and professional money managers, the information in the jobs report can mean the difference between having a winning or losing portfolio. It also explains the need for the security measures. Individuals getting such hot figures ahead of time can make a quick bundle of money because they know something of which no one else in the financial markets is yet aware. To prevent such abuses, the government guards these and dozens of other key economic indicators as tightly as a military base. It also implements a carefully controlled procedure to disseminate sensitive economic news.

<u>8:00:00</u> The instant the door is shut, reporters dive in to grab the latest release on employment conditions, which up to now had been facedown. They have just 30 minutes to read, digest, and write their stories on how the job market changed during the previous month. Most of the journalists arrived that morning with the expectation that the

employment release would carry dismal economic news, with the number of people without jobs rising—a troubling sign the economy was weakening. At least that was the opinion of most professional forecasters whom these reporters consulted just days earlier.

But on this particular morning, the employment report stuns everyone. Those in the lock-up room read with amazement that companies actually hired workers in far greater numbers than anyone expected. Moreover, other figures inside the report appear to corroborate signs the economy is doing quite well. Wages are rising and factory overtime is increasing. Far from slowing, the latest evidence indicates the economy is actually picking up steam. It is astounding news of which the rest of the world is yet unaware.

As the digital clock continues its silent countdown, reporters working on the story suddenly face some urgent questions. What's really happening in the economy? Why were so many "experts" caught off guard? What does this mean for future inflation and interest rates? How might the stock, bond, and currency markets react to the news?

Though the latest jobs report was unexpected, these journalists are not completely unprepared. As is their routine, a day or two earlier they showered private economists with questions that covered a variety of hypothetical employment scenarios. What does it mean if the job market worsens? What if it actually improves? Now the reporters are frantically searching through their interview notes to help them file their stories.

8:28:00 A Labor Department worker in the lock-up room notifies television reporters that they can now leave under escort to prepare for their live 8:30 broadcast of the jobs report.

For the remaining journalists in the room, there is just a brief warning: "Two minutes left!" By now, most have pieced together their initial version of the story—the headline, the opening sentences, key numbers, and the implications for the economy. All that's left are some last-minute fact checking and a word tweak here and there.

8:29:00 "One minute. You can open your telephone lines—BUT DO NOT TRANSMIT!"

The level of tension is not just high in the lock-up room, for at that moment, money managers and traders in New York, Chicago, Tokyo, Hong Kong, London, Paris, and Frankfurt are riveted to their computer screens, anxiously waiting for the release of the crucial jobs report. It's a stomach-churning time for them because investment decisions that involve hundreds of billions of dollars will be made the instant the latest employment news flashes across their monitors. Why such worldwide interest in how jobs fare in America? For one, many foreign investors own U.S. stocks and bonds, and their values can rise or fall based on what the job report says. Second, the international economy is now so tightly interconnected that a weak or strong jobs report in the U.S. can directly impact business activity in other countries. If joblessness in America climbs, consumers will likely purchase fewer cars from Germany, wine from France, and clothing from Indonesia. In contrast, a jump in employment means households will have more income to spend on imports, and this can stimulate foreign economies.

8:29:30 "Thirty seconds!" The fingers of reporters hover over their computer's Send button, ready to dispatch the latest employment news to the world. On-air reporters are also prepared to deliver the news live.

8:29:50 An official counts the final seconds out loud.

"Ten . . . nine . . . eight . . . seven . . . six . . . five . . . four . . . three . . . two . . . one!"

8:30:00 "Transmit!" Reporters simultaneously hit the Send buttons on their keyboards. In seconds, electronic news carriers, including Bloomberg, AP, Reuters, and Japan's Kyodo News, release their stories. Television and cable news stations, such as CNBC, Bloomberg TV, CNN, and MSNBC broadcast the report live. A second or two later, computer screens around the globe carry the first surprising words: "Jobs unexpectedly rose the previous month, with the unemployment rate falling instead of rising!"

For journalists in the lock-up room, the stress-filled half-hour grind is over, and they are now free to leave. But the work has just begun for those in the investment community.

At the Chicago Board of Trade (CBOT), where U.S. Treasury bonds and notes are traded, news of the strong job growth sparks pandemonium. Bond traders were so sure they would see a deterioration in the job market that many had bet millions on such an outcome. These traders bought bonds for clients *prior to* the government's release on unemployment and expected to earn a quick bundle of money based on the following strategy: If the number of people employed fell, it would drag down consumer spending. That, in turn, would slow the economy, reduce inflation pressures, and cause bond prices to turn up and interest rates to fall, thereby guaranteeing traders an easy profit.

The strategy was sound, but they bet on the wrong horse. Instead of laying off workers, companies were substantially adding to their workforce. The economy was not slowing, but demonstrating remarkable strength, and those bond traders who hoped to make a fast buck for their customers now face losing lots of money. With *more* people getting jobs, household income increases, and that leads to greater spending and borrowing. The presence of a more robust economy heightens concerns of future inflation and rising interest rates. The result: Bond prices begin tumbling and interest rates start climbing. In order to cut their losses, hundreds of floor traders at the CBOT are now screaming, jumping up and down, flailing hand signals in a desperate attempt to rid themselves of bonds whose values are fast eroding.

Stock investors are also dazed by the news and jump into action. A drop in unemployment is bullish for the economy. More consumer spending translates into higher business sales and fatter corporate profits, which can lift share prices. However, because the New York Stock Exchange, the world's largest marketplace for equities, doesn't start trading for another hour (9:30 a.m.), money managers rush to buy stock index futures on the Chicago Mercantile Exchange (CME), where S&P 500 and NASDAQ contracts are traded electronically virtually 24 hours a day, five days a week. Action here occurs at lightning speed, with orders being executed in just 3/10 of a second—faster than the blink of an eye. The enthusiasm of traders in the pre-market hours is a harbinger of things to come. By noon that day, stocks across the board reach their highest prices in months.

At the same time, the New York Mercantile Exchange explodes into action. Commodity specialists in the cavernous trading room are also caught off guard by the jobs report and are now gesturing wildly and barking out orders to *buy* oil and gasoline contracts on the expectation that a resilient economy will drive up demand for fuel in the future. After all, as business activity accelerates, factories operate longer hours and use more electricity. Business and leisure travel should pick up as well. Airlines will use greater amounts of fuel. The positive jobs report will encourage more shopping and weekend getaway trips, resulting in greater gasoline consumption. Thus, moments after the Labor Department releases the news on jobs, the futures prices of gasoline, heating oil, and other types of fuel shoot up.

Meanwhile, in currency markets across Asia and Europe, news of the rebound in U.S. jobs makes the dollar a more attractive currency to own. Foreign investors are always keen on placing their money wherever they can earn a better payoff in the global marketplace. This morning, with U.S. interest rates and stocks both heading higher, owning American securities makes the most sense. Foreigners proceed to load up on U.S. equities and bonds, causing the dollar to climb in value against other currencies.

Back in Washington, hours earlier an emissary from the Labor Department delivered an advance copy of the employment release in a sealed package to the President's top economic adviser. White House officials now huddle to discuss ways to spin the positive jobs report for political gain. How should the president comment on it? Does the employment news require a change in public policy? How can it be used to support the administration's economic plan? What impact might it have on the federal budget?

Unquestionably the single most important institution to evaluate the crucial employment report is the Federal Reserve. Economists there also see the release before it goes public. They begin to scrutinize the data to detect any stress or imbalance in the labor market that could destabilize the economy. Fed experts ponder whether the unemployment rate is falling so fast that it will drive wages higher and fire up inflation pressures. As they pore over the jobs statistics, a secret but informal discussion commences inside the Fed on whether a change in interest rate policy is needed.

It has been a hectic morning for investors, policymakers, and reporters. But what about the vast majority of Americans? How did they respond to the turn of events in the employment report? Did they drop everything at 8:30 a.m. and rush off with paper and pen to the nearest television or radio to take notes on how the economy changed the month before? Not likely. In sharp contrast to all the frenetic activity in world financial markets, most households were preoccupied with carrying out the routines of daily life—getting ready for work, sending kids off to school, or doing some early shopping before the crowds show up at the supermarkets. Let's face it—the data released on jobs is just too remote and abstract to be of much interest to them. However, that doesn't mean the employment news will not affect them; everyone in the country will in some manner be touched by what transpired in the financial markets after the jobs report went public.

It makes no difference whether one is a business owner, a retiree, a housewife, an employee, a homeowner, or a renter. All will eventually feel the fallout from the news that came from the Labor Department's press room that morning. That fallout will produce a mixture of both favorable and unfavorable developments.

What might the benefits be? Clearly, rising employment is positive for the economy. The more American workers earn, the more they have to spend on goods and services. As long as there's no danger of the economy's expanding so fast that it threatens higher inflation, everyone gains from rising employment. Furthermore, the government spends less on unemployment benefits, which eases the strain on the federal budget. Now for the bad news. You'll recall that when the government released its surprisingly strong jobs report, it spooked bond traders into selling Treasury securities, which quickly drove up interest rates. With the cost of credit going up, banks and other lenders have little choice but to raise their rates on home mortgages and car loans. Even existing homeowners holding variable-rate mortgages now have to dig deeper into their pockets to make higher monthly payments. There's more bad news. Remember how commodity investors at the New York Mercantile Exchange reacted by bidding up the price of oil and other kinds of fuel? That will shortly spill in the retail sector, which means drivers will end up paying extra for gas and homeowners will shell out more for heating oil. Plane travel becomes more expensive too as airlines boost fares to offset the higher cost of aviation fuel.

Now let's return to positive consequences. In foreign exchange markets, the dollar's value jumped in response to the jobs news. A stronger U.S. currency is good for American consumers because it lowers the price of imports such as foreign-made cars, home electronics, and perfumes. That, in turn, puts pressure on U.S. firms to keep their own prices down, all of which helps contain U.S. inflation. Americans traveling overseas also can purchase more with each dollar. However, here's the flip side to a muscular greenback: If your job depends on selling products in foreign markets, you could be in trouble. A strong dollar makes U.S.-made goods more expensive in other countries, and foreign buyers might want to look elsewhere for better deals.

U.S. Economic Indicators

It may be hard to believe all this action and reaction can be triggered by just a *single* statistic. If you multiply that by more than 50 economic indicators that are released every week, month, or quarter, you begin to understand why the stock, bond, and currency markets are in a perpetual state of motion. Among the other influential economic indicators that can rattle financial markets are consumer prices, industrial production, retail sales, and new home construction. It is precisely because these indicators can so easily sway the value of investments that the government takes extraordinary steps to control the flow of sensitive economic information.

That wasn't always the case. Thirty years ago, barely any guidelines applied to the release of economic reports. A lock-up room was a term reserved for prisons, not press rooms. The lack of strict ground rules on the publication of these influential statistics created the perfect climate for abuse. Politicians tried to control the release of economic news to score points with voters. When President Nixon heard the Commerce Department was about to go public with an upbeat figure on housing starts, he pressed the agency to time the release for maximum political effect. On those occasions when economic figures turned out to be a liability, Nixon sought to hold up the report until such time he believed its release would get little notice.

Even Wall Street firms realized that big money could be made off the economic numbers given the lax supervision of their release. Some brokerages went so far as to dish out large amounts of money to reporters who were willing to leak economic news to the firm's traders before writing about it. Anyone who got an advance peek at the economic statistics stood to gain millions in a matter of minutes by knowing which stocks and bonds to trade. Eventually this blatant manipulation of the economic indicators led a furious Senator William Proxmire to schedule Congressional hearings in the 1970s on how these reports are released. Later that decade, the government set up a strict calendar that included rigid rules on how economic data would be distributed. Today, nearly every major economic indicator is released under tight lock-up conditions, which has enhanced the integrity of how the public gets such sensitive information. Trading based on inside information of economic indicators is now virtually unheard of.

This still leaves us with the most important task of all, though. How do you decipher what all these indicators actually tell us about the economy? After all, at least four key economic indicators are released on a weekly basis, 43 every month, and nine each quarter. Do we really need so many measures? Absolutely. The U.S. is the largest and most complex economy in the world. No single indicator can provide a complete picture of what the economy is up to. Nor is there a simple combination of measures that provide a connect-the-dots path to the future. At best, each indicator can give you a snapshot of what conditions are like within a specific sector of the economy at a particular point in time (see Table 1A). Ideally, when you piece all these snapshots together, they should provide a clearer picture of how the economy is faring and offer clues on where it is heading.

Yet even if you took the time to absorb every bit of economic information and monitored each squiggle in the indicators, don't expect to uncover a crystal-ball formula that can single-handedly forecast what consumer spending, inflation, and interest rates will do in the months ahead. That's because there are some important caveats when dealing with economic indicators. First, they often fail to paint a consistent picture of the economy. Different indicators can simultaneously flash conflicting signals on business conditions. One can show the economy improving, while another may point to a clear deterioration. For example, the government might report a drop in the unemployment rate, normally a bullish sign for the economy. However, a different employment survey might show a day or two later that companies are laying off workers in record numbers. You're now presented with two contradictory portraits on labor market conditions, both covering the same time period. Which should you believe?

Table 1A: How Economic Indicators Track the U.S. Economy

The federal government and private groups release dozens of economic reports on a weekly, monthly, or quarterly basis. Each is a barometer that measures activity in a particular segment of the U.S. economy. By following these indicators, one can get the latest reading on the economy's health and valuable clues on where it is heading.

Real GDP and its Components *

Consumption (71%)
Goods (30%)
Services (41%)

Key Indicators

- Retail sales
- Consumer installment credit
- Personal income and spending
- Employment report
- New claims for unemployment insurance
- Consumer confidence and sentiment surveys
- MBA - mortgage refinancings
- Cambridge consumer credit index
- ABC/Money consumer comfort index
- Real earnings
- Auto sales
- Chain store sales

Business Fixed Investments (17%)

Nonresidential (12%)

- Industrial production
- Capacity utilization
- Orders for durable goods
- ISM surveys
- Federal Reserve Bank regional surveys
- Factory orders
- Manufacturers' shipments, inventories, and orders

Residential (5%)

- Housing starts
- New single-family home sales
- Existing home sales
- MBA mortgage applications
- NAHB survey on home building

* Percentages are based on how the economy performed in 2003

Change in business inventories (<1%)

Manufacturing and trade inventories

Government spending (18%)

Construction spending
Federal budget balance report

Net exports (-5%)

International trade
Current account balance

Signs of Price Pressures

Inflation

Consumer price index
Producer price index
Employment cost index
Non-farm productivity
Unit labor costs
Import and export prices
Employer costs for employee compensation

The confusion doesn't stop there. Another complication, one especially maddening to investors and economists, is that people can behave counterintuitively. Just look at two ostensibly related reports: consumer confidence and consumer spending. The first measures the general mood of potential shoppers; if they are upbeat about the economy, it stands to reason they will spend more. If there is widespread gloom and uncertainty about the future, logic would lead you to believe people will curb their spending and save money instead. However, that's not the way it plays out in the real world. There appears to be little relationship between these two measures. During the mild 2001 recession, consumer confidence kept plummeting throughout the year, reaching levels not seen in decades. Yet these same consumers not only refused to cut back on spending that year, they bought homes and cars at a record pace. Obviously, one cannot determine the outlook for consumer spending just by monitoring the psychological state of American households. The inclination to spend is influenced by many factors, including personal income growth, job security, interest rates, and the build-up in wealth from the value of one's home and the ownership of stocks and bonds.

There is also the quandary that comes with abundance. Everyone—from the professional money manager down to the mom dabbling part time in the markets—can be overwhelmed by the statistical minutia out there. How do you discern which indicators are worth watching and which ones to view with skepticism or even ignore? How does an investor employ economic indicators to help choose which stocks and bonds to buy and sell, and when? Which measures should a business forecaster follow to spot coming economic trends? What key indicators should corporate chiefs rely on to help them decide whether to hire new workers or invest in new equipment?

You can find the answers to these questions in subsequent chapters, but clearly some economic indicators are far more telling than others. Generally, the most influential statistics, those most likely to shake up the stock, bond, and currency markets, possess some of the following attributes:

- Accuracy: Certain economic measures are known to be more reliable than others in assessing the economy's health. What determines their accuracy is linked to how the data is compiled. Most economic indicators are based on results of public surveys. Getting a large and representative sample is thus a prerequisite for accuracy. For instance, to measure the change in consumer price inflation, the government's Bureau of Labor Statistics sends out agents and conducts telephone interviews every month to find out how much prices have changed on 80,000 items and services at 23,000 retail outlets around the country. To calculate shifts in consumer confidence, the Conference Board, a business research organization, polls 5,000 households each month.

  Another variable is the proportion of those queried who actually came back with answers. How quickly did they respond? The bigger and faster the response, the better the quality of the data and the smaller the subsequent revisions. If an indicator has a history of suffering large revisions, it generally carries less weight in the financial markets. After all, why should an investor buy stocks or a company hire additional workers when the underlying economic statistic is suspect to begin with?

The monthly *construction spending* report by the Commerce Department is one that gets substantially revised and is thus often ignored by the investment community. In contrast, *housing starts* figures are rarely revised, which is why this indicator is taken far more seriously.

- Timeliness of the indicator: Investors want the most immediate news of the economy that they can get their hands on. The older the data, the more yawns it evokes. The more current it is, the greater the wallop it packs on the markets. Case in point: Investors pay close attention to the *employment situation* report because it comes out barely a week after the month ends. In contrast, there's far less interest in the Federal Reserve's *consumer installment credit* report, whose information is two months old by the time it's released.
- The business cycle stage: There are moments when the release of certain economic indicators is awaited with great anticipation. Yet those *same* indicators barely get noticed at other times. Why do these economic measures jump in and out of the limelight? The answer is that much depends on where the U.S. economy stands in the business cycle. (The business cycle is a recurring pattern in the economy consisting first of growth, followed by weakness and recession, and finally by a resumption of growth again. We'll take a closer look at the business cycle in the next chapter.) During a recession, when there are lots of unemployed workers and idle manufacturing capacity, inflation is less of a concern. Thus, measures such as the consumer price index, which gauges inflation at the retail level, do not have the same impact on the financial markets as they would if the economy were operating at full speed. During recessionary periods, indicators that grab the headlines are *housing starts*, *auto sales*, and the major stock indexes because they often provide the earliest clues that an economic recovery is imminent. Once business activity is in full swing, inflation measures like the CPI take center stage again while the other indicators recede a bit to the background.
- Predictive ability: A few indicators have a reputation of successfully spotting turning points in the economy well in advance. We mentioned how housing and auto sales as well as the stock indexes have such characteristics. However, other less-known measures are harbingers of a change in business activity. One such indicator is the *advance orders for durable goods.* Generally, economic gauges known for being ahead of the curve carry more weight with investors.
- Degree of interest: Depending on whether you're an investor, an economist, a manufacturer, or a banker, some indicators might be of greater interest to you than others. Business leaders, for instance, might focus on *new home sales* and *existing home sales* figures to see whether Americans are in a shopping mood. By monitoring such statistics, companies selling furniture and appliances can decide whether to expand operations, invest in new inventories, or shut down factories.

Those in the forecasting business want to know what's ahead for the economy and thus concentrate on a set of measures known as "leading indicators." These include *initial unemployment claims*, *building permits*, the *ISM purchasing managers report*, and the *yield curve*.

Investors in the financial markets also have their favorite indicators; the specific measures they watch depend on what assets are at greatest risk. Those trading stocks focus on indicators that foreshadow changes in consumer and business spending because they can affect future corporate profits and the price of shares (see Table 1B). For bond traders, the looming concern is not company profits but the outlook for inflation and interest rates. Any evidence suggesting that inflation might accelerate can hurt bonds. (See Table 1C for the economic indicators most sensitive to the bond market.) Players in the currency markets look for economic news that can drive the dollar's value up or down. Signs pointing to a robust U.S. economy, for example, normally lure foreigners to invest in this country, especially if the other major economies show comparatively little growth. That lifts the greenback's value against other currencies. (See Table 1D for the measures most likely to move the dollar.)

Table 1B: Economic Indicators Most Sensitive to Stocks

Rank	Indicator	Page
1	Employment Situation Report (Payroll Survey)	25
2	ISM Report—Manufacturing	147
3	Weekly Claims for Unemployment Insurance	38
4	Consumer Prices	245
5	Producer Prices	255
6	Retail Sales	62
7	Consumer Confidence and Sentiment Surveys	86 and 91
8	Advance Report on Durable Goods	116
9	Industrial Production	137
10	GDP	100

Table 1C: Economic Indicators Most Sensitive to Bonds

Rank	Indicator	Page
1	Employment Situation Report (Payroll Survey)	25
2	Consumer Prices	245
3	ISM Report—Manufacturing	147
4	Producer Prices	255
5	Weekly Claims for Unemployment Insurance	38
6	Retail Sales	62
7	Housing Starts	169
8	Chicago Purchasing Managers Report	216
9	Industrial Production/Capacity Utilization	137
10	GDP	100

Table 1D: Indicators That Most Influence the U.S. Dollar's Value

Rank	Indicator	Page
1	Employment Situation Report (Payroll Survey)	25
2	International Trade	223
3	GDP	100
4	Current Account	237
5	Industrial Production/Capacity Utilization	137
6	ISM Report—Manufacturing	147
7	Retail Sales	62
8	Consumer Prices	245
9	Weekly Claims for Unemployment Insurance	38
10	Productivity and Costs	275

International Economic Indicators

Up to now, we've been dealing only with U.S. economic reports. Now let's look at the growing importance of monitoring international economic indicators. During much of the twentieth century, Americans had only a remote interest in following the economic affairs of other nations. Few saw a need to take them more seriously. The U.S., after all, possessed the largest and most self-sufficient economy in the world and, by and large, had been impervious to the ups and downs of foreign economic cycles. If Germany or France or even the emerging countries of Asia suffered an economic downturn, barely anyone in the U.S. would care or even notice.

That's not the case any longer. Though the U.S. economy still reigns supreme, the international economy has undergone vast structural changes in the last three decades. These changes were brought on by a reduction in trade barriers, the modernization of global financial markets, and remarkable advances in telecommunications, the Internet, computer technology, and software. The results have been profound. The world economy now operates in a more tightly integrated fashion.

For the U.S., the implications are huge. Healthy domestic economic performance depends increasingly on how well other nations are doing. Gone forever are the days when this country was immune to financial and political mishaps originating halfway around the world. When OPEC decided to sharply boost oil prices in the mid-to-late 1970s, Americans felt real pain. Indeed, U.S. inflation subsequently exploded, ultimately leading to one of the worst U.S. recessions since the Great Depression. Years later investors took another beating during the Asian financial crises in 1997 when the Dow plummeted by the largest point loss ever on October 27 because investors were worried that problems in Asia would hurt the U.S. economy and corporate earnings. In addition, who would have imagined that a bond default by Russia in 1998—a country with an economy the size of Illinois and Wisconsin combined—would be considered so grave a threat to world financial markets that the Federal Reserve was under pressure to orchestrate a global rescue plan to calm investors worldwide?

Just how dependent have American companies become on other nations for profits and job creation? The numbers speak for themselves. Nearly half the earnings of S&P 500 firms come from business generated outside the U.S. More than 22 million American workers—nearly two in 10 jobs—are linked to foreign trade. One out of every four dollars generated in the U.S. economy is based on trade. What this all boils down to is that foreign economic indicators should be followed with the same regularity, interest, and scrutiny as the domestic indicators. If foreign economies do well, U.S. firms are in a better position to sell more exports, earn more money, and keep millions of American workers employed. By closely monitoring the international indicators, U.S. companies can seek out new foreign markets or decide whether to expand (or shut down) facilities overseas. American investors can diversify their portfolios more smartly by identifying and purchasing those foreign stocks and bonds that might offer a lucrative return.

Another important reason to monitor the performance of other major economies is that it helps us check the mood of foreign investors. As long as *they* view the U.S. as a safe and attractive place to invest, capital from abroad will continue to flow into this country, and that is vital for the well-being of the U.S. economy. Foreign investors play an indispensable role in financing U.S. economic growth by lending this country an average of nearly $2 billion a day—money that goes into buying stocks, bonds, and other American assets. Why does the U.S. need to borrow such huge sums from other nations? Because consumers and the federal government together spend so much on cars, computers, military hardware, and health care (to name just a few items) that there's little domestic savings left over. Yet savings is the lifeblood that keeps an economy healthy. It's used to finance productive investments, such as building efficient factories and funding the research and development of new and better products. Without adequate savings, the U.S. would be incapable of showing healthy long-term growth.

To make up for the shortfall in domestic savings, the U.S. has to lure the surplus savings of other countries. In addition, while all that foreign capital entering the U.S. has kept the economy humming, serious risks come with being so dependent on overseas creditors. America's total foreign debt has skyrocketed in the last decade from $50 billion to a staggering $1.5 trillion—the most of any nation in the world. In the process, foreigners have acquired an ever-increasing share of U.S. assets; they own 40% of all U.S. Treasury issues, 24% of American corporate bonds, and about 15% of all equities. Should the mood of those investors turn sour on the U.S. market—something that can occur if there is poor expectation of investment returns here as compared with other countries—it could spark a sell-off of American stocks and bonds by foreigners.

For all these reasons international economic indicators have lately taken on a more prominent role in the formulation of investment and business strategies. However, as with U.S. economic data, literally hundreds of foreign economic measures are released every month. With so much information being thrown at investors and business executives each day, how does one know which one of these statistics are worthy of consideration? There is no one simple answer to this question. American companies and investors have different interests and risk exposures in the global economy.

In this book, three factors are considered in determining the most influential international economic indicators. First, after the U.S., which are the largest economies in the world? Second, how liquid are the markets in those countries? That is, how easy is it to buy and sell securities on their exchanges? Third, who are the important trading partners of the U.S.? By trade, we're talking about the exchange of goods (such as the sale of trucks, pharmaceuticals, and computers) *and* the exchange of services (such as insurance, consulting, transportation, and entertainment). The service sector is especially important because it includes the all-important category of investment flows. (See Table 1E for a list of the "must-watch" international economic indicators.)

Table 1E: "Top Ten" International Economic Indicators

Rank	Indicator	Page
1	German Industrial Production	298
2	German IFO Business Survey	300
3	German Consumer Price Index	302
4	Japan Tankan Survey	306
5	Japan Industrial Production	312
6	France Monthly Business Survey (INSEE)	317
7	Eurozone/Global Purchasing Managers Index	320
8	OECD Composite Leading Indicators (CLI)	326
9	China Industrial Production	329
10	Brazil Industrial Production	334