

CHAPTER 2

A Beginner's Guide: Understanding the Lingo

INTRODUCTION

Every field of study has its own jargon, an assortment of words or phrases with which one has to grow familiar to understand the subject. Economic indicators are no different. You will regularly come across certain terms and expressions when dealing with measures of economic performance. No need to worry, though. The language of economic indicators is fairly straightforward if you give it a chance. In many cases their meaning and significance are surprisingly obvious. So let's proceed with some of the most common concepts you'll encounter when reading about these indicators.

ANNUAL RATES

You're cruising down the highway at 65 miles per hour. Whether your destination is actually 65 miles away is not important. What counts is what your speedometer tells you: If you keep up this driving pace for a full hour, you will travel about 65 miles.

The term "miles per hour" is used to measure relative speed. A similar relationship exists with economic indicators. A common way to compare how fast the economy is growing is to measure changes in activity in the form of annual rates. For instance, the government might report that autos were selling at a 14 million vehicle annual rate the previous month. That doesn't mean automakers sold 14 million cars and trucks the month before; it's how many will be sold if last month's pace were maintained for each of the next 12 months. Why do it this way? The reason is experts find it easier to look at performance on a yearly basis.

The methodology used to annualize a figure is simple enough: To turn a monthly level into an annual rate, simply multiply it by 12. If you have two months of data that you want to annualize, multiply it by 6. If it's a quarterly change—which is how the GDP is reported—multiply the three-month change in activity by 4. Thus, whenever you see an economic indicator reported in an annual rate, it is telling you what will happen if that pace were sustained for a full 12 months.

BUSINESS CYCLE

Like human nature, the economy has its ups and downs. At times the economy can grow robustly, with household income rising, consumers happily spending, and companies hiring and expanding their business. However, there also are periods when the economy looks tired, with growth barely perceptible. There's less consumer shopping and little, if any, new business investment under way. In the most extreme case, the economy actually shrinks, which is what happens in a recession. Over time, however, recessions give way to a fresh round of economic activity. These swings, from good times to awful times and then eventually back to good times again, are roughly what we mean by a *business cycle*.

Why does the economy have such cycles? Why not have steady, continuous, non-stop growth? After all, that should make everyone happy.

The reason the economy is condemned to undergo business cycles is because it's only natural. An open economy is essentially a reflection of human behavior with millions of people making decisions every day. What should they buy? How much can they spend? Is it time to invest in stocks? Corporate leaders face different issues. Is it time to hire workers? Rebuild inventories? Buy another company?

Occasionally consumers and businesses make mistakes that can have broader economic consequences. Households might have borrowed so much that they're having difficulty servicing their debt. Banks could see their profits slip as loan defaults rise. Retailers might miscalculate by loading up their stockrooms with new goods just when consumers are cutting back on spending. If the mistakes are grave enough and widespread, they can lead to an economic downturn with people being laid off. Fortunately, the government has several tools at its disposal to revive growth again, such as lower interest rates, tax cuts, and greater federal spending.

The *business cycle* itself has five phases. The *first* phase refers to the highest point of output the economy achieves just before it gets into trouble and turns down. After the peak comes phase *two*, which is the recession itself, a painful process whereby the economy actually shrinks. It saps the wealth and confidence of households and causes all sorts of financial distress for business. Such economic contractions can last six months or as long as several years. The *third* phase is reached when the economy finally hits bottom, a point known as the recession trough. The *fourth* occurs after the economy stops shrinking and resumes its growth path, or recovery. Finally, when the level of economic activity (or output) pushes past the previous high point, the business cycle marks the *fifth* and last phase, often referred to as the expansion.

Because a recession is an integral part of the business cycle, it's important to define just what we mean by that term. Many economists and journalists declare a recession when there are two back-to-back quarters of negative GDP growth. Those quarters equal six consecutive months where the economy is shrinking. However, that is a rough, finger-in-the-wind assessment. The real task of determining when a recession begins and ends is

left to a select group of academic economists working under the National Bureau of Economic Research (NBER), a non-governmental and nonpartisan think tank based in Massachusetts. They make the call on whether the economy has turned down or up by evaluating several key economic indicators, such as job growth, personal income, industrial production, as well as the quarterly GDP figures.

According to the NBER, there have been 32 business cycles in the U.S. since 1854, with the average recession lasting 17 months. Since World War II, there have been 10 business cycles with recessions averaging only 10 months long—which means the economy is now achieving longer periods of growth before getting into trouble. Just why the economy has been experiencing fewer recessions lately is a topic of debate among economists, though most attribute it to improved economic policymaking in Washington combined with a more versatile business sector.

CONSENSUS SURVEYS

You're all set to go out for a leisurely walk. Weather forecasters have predicted sunny skies and warm temperatures, so you head out in shorts and leave the sweater at home. Ten minutes later a heavy thunderstorm erupts, followed by colder air. You quickly scramble back for a change of clothing, all the while cursing the forecasters. How could they have gotten it so wrong?

Money managers encounter similar experiences, except that instead of weather, they tend to rely on surveys that feature forecasts from experts on what an upcoming economic indicator will report. If the actual economic news falls in line with expectations, there is generally little market reaction to the news because investors already anticipated it. By getting it right, those forecasters demonstrated that they have a good grasp on what the economy is up to. However, had the news about the economy turned out to be radically different from what private experts predicted, money managers would have rushed in to readjust their investment positions. These abrupt moves can potentially shake up the value of stocks, bonds, and currencies. Why such violent market reactions? Any major departure from expectation means something is going on in the economy for which the experts failed to account. Naturally this brings fresh uncertainty about current and future economic conditions. The bigger the gap between consensus expectations and reality, the larger the backlash in the financial markets.

Who puts out these consensus surveys, and how are they done? Many financial wire service organizations, such as Bloomberg, Dow Jones, Reuters, and Market News International, produce their own consensus surveys by polling economists for their predictions on key upcoming economic indicators. These indicators include consumer prices, producer prices, industrial production, retail sales, capacity utilization, and others. The methodology used is fairly simple: The responses of individual business economists are basically averaged out, and that becomes the consensus forecast.

MOVING AVERAGE

There's great temptation to jump to a conclusion about the economy's health from just one month's data, but that's not a wise practice. Economic numbers can be faulty, inaccurate, or at the very least, misleading because of unusual events such as a major labor strike or severe weather conditions. Such situations can diminish the reliability of an economic indicator in the short term, so it's important to use caution when extrapolating information from just a single month's data.

To get a truer sense of the underlying trend in the economy, it's far better to rely on a moving average of economic numbers. Simply put, a *moving average* is a computation in constant motion because it always averages data for the most recent fixed number of months. As a result, the average changes with the introduction of each new monthly report. For example, let's say consumer price inflation shot up 1% in the most recent month. Obviously a rise of that magnitude could raise lots of red flags. However, before anyone panics, it's far more prudent to consider inflation's actual trend by looking at its *moving average* over the past three or six months. To do this, simply add up the inflation changes over the last three or six months and divide by the total number of months you considered. When the next set of inflation figures are released a month later, recalculate the *moving average* by including the new figure in the equation and discarding the oldest monthly data so that you are always averaging the latest three- or six-month periods. The virtue of moving averages is that they smooth out random fluctuations and make long-term trends clearer. One disadvantage of a moving average is that it's a lagging indicator. Averages are slower to respond when there's a genuine change in the economy's direction.

NOMINAL DOLLARS VERSUS REAL DOLLARS (ALSO KNOWN AS CURRENT DOLLARS VERSUS CONSTANT DOLLARS)

Anything measured in dollars can be looked at in two ways. Nominal dollars (also referred to as current dollars) represents the actual amount of money spent or earned over a period of time. You'll see stories mentioning how American factory workers received total pay hikes of \$500 million, or a 5% increase, in the last 12 months. Or perhaps you read that company A reported income from sales of sweaters climbed to \$220 million that year, up from \$200 million the year before, or a jump of 10%. These figures are based in nominal dollars.

However, nominal (or current) dollars gives you only part of the story. What's missing is how inflation can distort such numbers. Let's go back to the example of the earnings of factory workers. They might have seen their pay jump by 5% in nominal terms, but before anyone celebrates, someone should ask this question: "What if the price of goods and services (i.e., inflation) rose by 4% during that same period?" In that case, the wages of these workers rose by a less-than-impressive 1% in real (or constant) dollars. In other words, the actual increase in purchasing power these workers gained from their pay hike was far smaller than 5%.

Let's now look at company A. It noted that sales revenue jumped by 10%. However, that doesn't necessarily mean it sold 10% more sweaters. In fact, the firm ended up selling the same number of sweaters both years. The only reason it received more money in the second year is because the company raised the price of sweaters by 10%. Thus, the increase in real (constant) dollar sales was actually zero!

Nominal dollars simply reflects the present value of goods and services exchanged in the marketplace. However, real dollars tells you the true value of goods and services produced or sold because it strips out the effects of inflation. When economists and investors want to compare the performance of the economy over different time frames, they generally look at both measures—nominal and real. They note the change in the size of the economy in nominal dollars because that points to what individuals, businesses, and the government actually spent. However, to find out if the economy genuinely expanded by producing more in quantity or volume, economists and investors look at the numbers in real-dollar terms.

REVISIONS AND BENCHMARKS

Traders and money managers are always hungry for the very latest piece of economic news. The more timely the information, the more influential it is; and the faster investors can get their hands on it, the quicker they can act.

Therein lies the problem. Government agencies and private groups that supply economic data to the public are under tremendous pressure to get it out quickly, and that's not easy. Every week or month, depending on the economic indicator, statisticians follow a rigid schedule to query sources in the field, collect the raw responses, organize the data, readjust for seasonal factors, perhaps recalculate the numbers to adjust for inflation, and then write some introductory comments about the results before finally releasing it to the public. It's a hurried process where accuracy and completeness take a backseat at times to getting the information out on deadline. For this reason the first release of many economic indicators contains pieces of data that are far from reliable and thus considered preliminary.

Of course, to many investors, it makes little difference whether the initial data is reliable. They'll trade on these numbers anyway because the figures represent the very latest information they can get on the economy. Later, though, as more information is received and after statisticians have had a chance to review their computations, the preliminary figures undergo one or more revisions. Though revisions to earlier data are also read by investors, they generally do not spark much trading because by then the information refers to a time period that has long since passed. Investors usually focus on the future, not the past. Economists, however, take revisions more seriously because the new figures can affect their forecasts of economic activity.

Benchmark changes are different from monthly revisions. The latter is an ongoing effort to make the statistical results more accurate, especially if there was insufficient time to gather all the data. However, benchmark changes come about once a year or so

when the government introduces new seasonal adjustment factors or decides to undertake a formal change in the methodology itself. Benchmark revisions can affect economic data going back five, 10, or even more years to allow for historical comparisons.

SEASONAL ADJUSTMENTS

Before most economic indicators are released, they are calculated to reflect seasonal adjustments. What are seasonal adjustments? The simplest way to answer this question is with an example. It's no surprise that consumers do a lot more shopping during the November/December holiday period than at other times of the year. In addition, when the Christmas shopping season is over, retail sales often slow in January and February. These seasonal shifts in consumer spending patterns are quite common. They're temporary changes that have nothing to do with the business cycle.

Let's look at another example. In the spring when schools close, the number of people getting jobs surges as students enter the workforce to earn money over the summer. By mid-August, the process is reversed and employment drops off as students leave the workforce and return to school. Again, these fluctuations in employment are perfectly normal and are not indicative of a fundamental change in the economy's health. Even industrial production tends to fall in July as automakers shut down plants that month to retool their assembly lines for the new model year. No one should conclude this slow-down in industrial output means that the manufacturing sector is in trouble. These are all routine seasonal shifts that take place in the economy.

How do you differentiate changes that are the result of normal seasonal factors from those that represent a more serious problem in the economy? That's where the seasonal adjustment process comes in. Government experts look at economic data going back five to 10 years to identify recurring trends. These trends are changes in economic activity that have nothing to do with the broader business cycle but that can be explained by short-term external factors (such as summers, winters, and major holidays). After observing such patterns, officials come up with a formula that factors out variations in the economic numbers attributable to seasonal changes. This enables private economists and investors to discern economic events that should be viewed as normal from those that are out of the ordinary.

Seasonal adjustments, however, are far from perfect. You could have abnormal economic data even after seasonal adjustments are considered, and it still doesn't necessarily signal a turning point in the economy. Blizzards, floods, terrorism, labor strikes, and major bankruptcies are all unpredictable shocks that can have an impact on economic output, but their effects are almost always short-lived. Moreover, these incidents are easy

to identify as the cause behind any sharp deviation in business activity. By and large, seasonal adjustments are important to analysts because they can help identify true deviations from the normal course of activity in the economy.

Now that we have reviewed some of the most widely-used terms that accompany economic indicators, we're ready to move on to the next chapters. What are the world's most influential economic indicators, and how do you get the most out of these statistics? How do you locate them? Interpret them? Most important of all, where can you find the clues that can tip you off on how the economy might perform in the future?

