Key Leading Indicators

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover key leading indicators, focusing on how economists use data to study the economy.

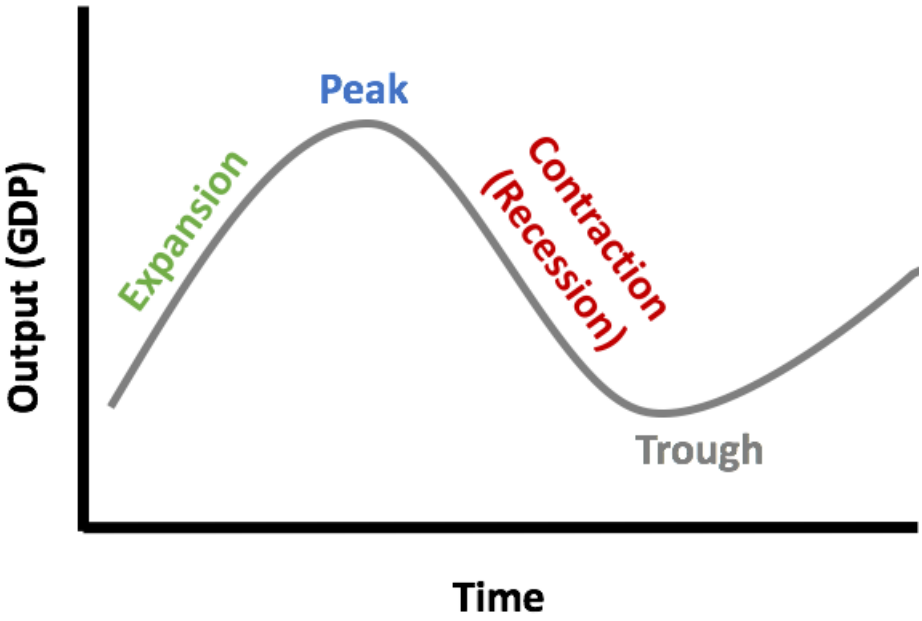
Our discussion breaks down as follows:

1. Business Cycle
2. Leading Indicators
3. Unemployment Insurance Claims
4. Building Permits
5. Stock Market Performance

1. Business Cycle

Here is a business cycle. The rate of growth in the economy, which is measured by GDP or output, is on the y-axis, and time is on the x-axis.

You can see that it is normal for the economy to go through periods of growth and contraction.



Notice the period of expansion leading into a peak, followed by a contraction, where GDP or output falls. After the period of contraction, we hit a trough, and the whole cycle starts over again.

If the contraction lasts six months or longer, most economists agree that we are in a recession.

Most people are concerned about things like the unemployment rate and inflation in the economy.

Economists use many different kinds of data to help them do the following:

- Predict where the economy is headed
- Explain what has just occurred in the economy
- Look at what is currently happening in the economy

For the purposes of this tutorial, we will focus on what is going to happen soon, or where is the economy headed.

2. Leading Indicators

Economists study economic indicators, which provide an overall view of the economy at any given point in time.

The three different categories of indicators are:

- Leading
- Lagging
- Coincident

Today we are discussing **leading indicators**, which are trends, patterns, or situations that assist in forecasting the economy.

The question to be answered here is, "Where is the economy headed?"

It is the leading indicators that give us an idea of where the economy might be headed in the short run.

EXAMPLE Some examples of leading indicators are unemployment insurance claims, building permits, and stock or equity market performance, which we will discuss in further detail.

TERM TO KNOW

Leading Indicators
Trends, patterns or situations that assist in forecasting the economy

3. Unemployment Insurance Claims

When people lose their job from no fault of their own, they are entitled to collect unemployment insurance.

The Department of Labor releases a report each week which details state-by-state jobless claims and then compiles them.

HINT

Keep in mind that these are only people who have filed a claim. This measure does not necessarily measure everybody who is unemployed, because not everyone who is unemployed is filing a claim to collect unemployment.

The Department of Labor gives these week to week reports, which can be volatile because of the short timeframe.

Therefore, generally speaking, what we see on the news or released in newspapers is reported as weekly jobless claims, which takes a four week average, because it is less volatile than week to week.

So, how might consumers and firms might respond when they hear that unemployment claims have risen this week?

Well, if consumers hear that a lot more people are filing unemployment claims, they may have less confidence spending money, fearing that they will lose their job next.

They might forego planning that vacation or save any extra money in their paycheck versus spending it.

This is why this is a leading indicator, because it can actually cause the economy to go down from there.

Firms can respond in the same way. They may see that people are losing their jobs and assume that people will not have money to spend.

Therefore, they may scale back on production.

Now, this is a very macroeconomic way of looking at things, if we are looking at the overall number of people in the economy filing for unemployment.

However, it can be applied to microeconomics, because sometimes certain industries and markets experience different unemployment rates than others.

EXAMPLE For example, if there is an industry with a lot of structural unemployment due to technological changes in that field, it can cause a very high unemployment rate in one industry compared to the others.

Microeconomists might look at how a certain market will be impacted by increasing or shrinking unemployment, or how certain individuals could be impacted by structural unemployment.

4. Building Permits

The second leading indicator to discuss are building permits.

The government also collects data on the number of permits for new private housing units.

Almost all residential buildings in our country are built in places that require a permit to be issued in order to build it.

Every month, our government surveys 9,000 selected permit issuing places to see the number of new private housing units being developed.

So, how can this help us determine anything?

Well, when these rise, it suggests that people are confident in the future because they are making a large purchase--a home. To make such a large purchase indicates that people are fairly confident in the stability of their job and in the future of the economy.

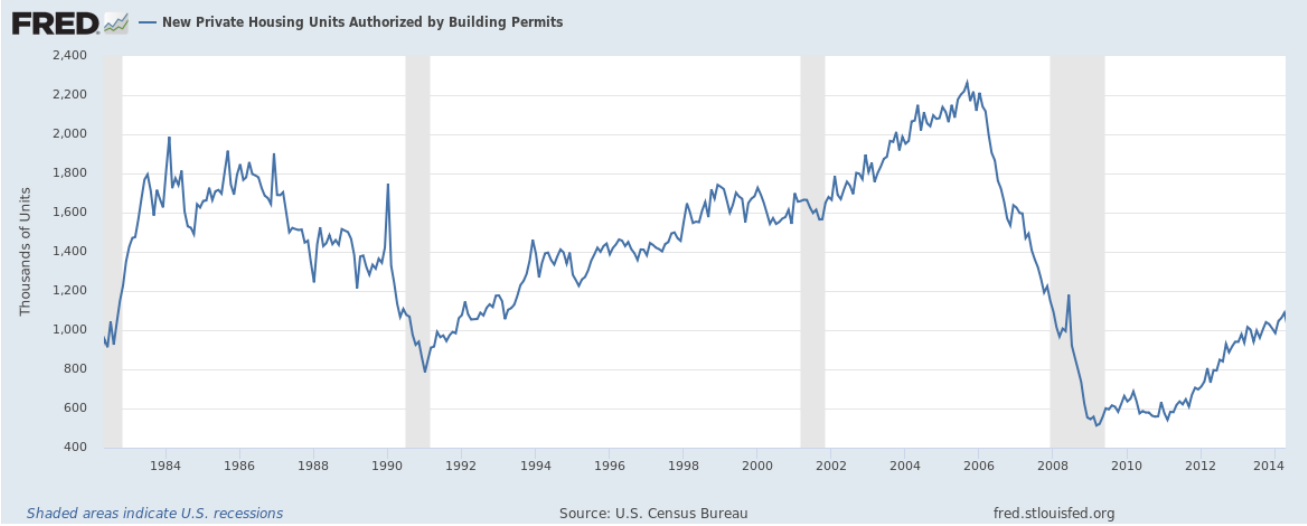
The housing market affects many other markets. When you buy a new house, you need a lot of things for that house. You need to employ a lot of workers in different industries to finish a house and it could even impact the furniture or appliance market, because people need those things when they buy or build a new house.

Microeconomists might study the impact of these individual markets and expect future growth in those markets as these building permits rise.

They may also look at how future economic growth might impact certain individuals.

Here is a graph of building permits from 1960.

Any area shaded in gray reflects a recession in our country. Typically, you can see that right after building permits started to fall, we entered a recession.



When building permits begin to rise, we come out of the recession.

5. Stock Market Performance

The last leading indicator is stock or equity market performance.

Performance in the stock market tends to predict where our economy is headed.

As the stock market begins to improve, it is usually an indication that we are on an upswing. If it starts to taper off, it can be an indication that we are headed for a contraction.

This is because changes in stock prices reflect investors' expectations for the future.

Instead of measuring every company in the stock market, which would be time consuming and an overload of information, the most common index used is called the S&P 500, which stands for Standard & Poor's.

The S&P 500 reflects 500 major companies that represent an overall picture of the stock market.

It includes companies across all industries, including utilities or telecom services, energy, information technology, financial, health care, etc.

If it is a major company and meets certain criteria, it can be included in the S&P 500.

Therefore, when individuals hear on the news that the S&P is up, they are more confident about the economy and tend to make more purchases in the short term.

Anytime the stock market falls, people are fearful of spending money right now, so it does tend to predict where the economy is headed.

A microeconomist might use this information to show where or how a certain kind of firm is generating revenue.

Here you can see a graph of the S&P 500 Stock Price Index, with the gray areas shaded here represent recessions.

You can see that right after the stock market falls, we enter a recession, and after it begins to rise again, the economy tend to improve.

SUMMARY

We began today's lesson by reviewing the **business cycle** and discussing how economists use data to study the economy overall and individual markets. We learned that **leading indicators** give us an idea of where the economy is headed. The three leading indicators discussed today were **unemployment claims**, **building permits**, and **stock market performance**.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Leading Indicators
Trends, patterns or situations that assist in forecasting the economy.