Economic Indicators – A Beginner's Guide

October 1, 2012

Introduction

One of the main functions of the futures market is price discovery. Buyers and sellers come on one platform and the price that both of them agree to, is considered to be the right price of the commodity. It is assumed here that both buyers and sellers are aware of the demand and supply fundamentals and try to get the best price for themselves. Now there is a third participant in the market and that is the investor / speculator. Investor is an outsider and may or may not be aware of the fundamentals. Hence over a period of time markets have evolved tools to bring more transparency to the process of price discovery. These tools are also meant to stop manipulators from cornering the market. Over a period of time number of regulating agencies and some private agencies have established themselves as independent authorities that surveys the markets on the ground and releases, it from time to time for the benefit of the market participants.

On a day to day basis there is gamut of economic data releases from various nations. These are indicators of an economy and they impact global equity, currency and commodity markets.

Economic indicators can be classified into three categories according to their usual timing in relation to the business cycle viz. leading indicators, coincident indicator and lagging indicators.

Leading Indicators

Leading indicators, as the name suggests, are indicators that usually change before the economy as a whole changes. As a result they are useful as short-term predictors of the economy. Examples of leading indicators are Consumer Confidence index, manufacturing Survey, building permits, etc.

Coincident Indicators

Coincident economic indicators are the one that change around the same time as the economy does, thereby providing information about the current state of the economy. Examples of Coincident indicator are GDP, Industrial Production, Non-Farm Payrolls data, etc.

Lagging Indicator

Lagging indicators are indicators that usually change after the economy as a whole does. Unemployment rate is a lagging indicator as employment tends to increase two or three quarters after an upturn in the general economy.

In this edition of Knowledge Series we have explained few economic indicators that have a major impact on Industrial Metals and commodities on a whole.

Gross Domestic Product - GDP

The gross domestic product (GDP) is one of the primary indicators used to gauge the health of a country's economy. It represents the total market value of all goods and services produced in a country over a specific time period. In simple terms it is the national income of any country.

GDP is a Coincident Indicator and is usually expressed in percentage and as a comparison to the previous quarter or year. For the investors higher growth of national income means opportunity to get a better return on their investments. For example, if the year-to-year GDP is up 3%, this is thought to mean that the economy has grown by 3% over the last year.

Data release

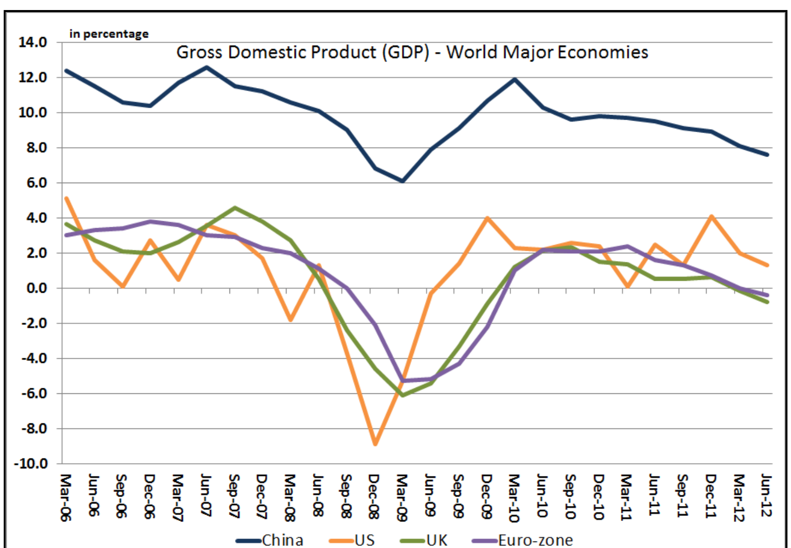
US, UK and Europe release GDP figures for the quarter. There are 3 versions of GDP released a month apart - Advance, Preliminary, and Final. The numbers released generally depicts quarterly growth. The Advance release is the earliest and thus tends to have the most impact. Meanwhile China and India release the data every quarter but on an annualized basis.

Importance

Since GDP signifies the health of an economy, higher number lends support to industrial metals as it signals robust demand. Meanwhile negative growth in GDP means contraction in growth and is negative for industrial Metals.

Current Market Condition

In a major sign of economic slowdown across globe, GDP of major economies are trending lower. US, world's largest economy grew at a slower rate of 1.3% in second quarter of 2012 after growing by 2% in first quarter. US economy was in recession in 2008, when the financial crisis engulfed markets, however it started improving from third quarter of 2009. Though the nation's economy continues to grow; the pace has slowed down, when compared to 4.1% in last quarter of 2011.



Source: Bloomberg, KCSL Research

In China, the fastest growing economy, growth has fallen below government's estimate of 8%. After clocking double digit growth until the 2008 financial crisis, GDP growth has fallen to 7.6% in second quarter of 2012. The annual GDP is expected to grow by 8 to 8.2% in 2012 from 9.2% in 2011.Since China is the second largest economy in the world and largest consumer of base metals slowdown in China is expected to have larger impact on metals and commodities in general. The turnaround in prices post 2008 financial crisis was mostly due to positive growth in China. However these times around there are fears that China's slowdown may be more severe than markets anticipate and thus will lead to sharp decline in the prices. The Chinese government on its part is taking measures to boost economic growth in the region but so far the results elude them.

Further Euro Zone is expected to witness double dip recession in 2012. Technically its economy has still not entered recession, as after a stagnant first quarter growth; its GDP contracted 0.5% in second quarter. For a notion to be called in recession it should note contraction in its GDP for two consecutive quarters. Meanwhile UK is officially into the recession after its first two quarter GDP showed contraction. UK first quarter GDP contracted by 0.2% followed by 0.4% contraction in second quarter.

Manufacturing PMI

The Purchasing Managers' Index (PMI) is an indicator produced by Markit Group and the Institute for Supply Management of financial activity reflecting purchasing managers' acquisition of goods and services. The predominant operator and owner of the Purchasing Managers Index (PMI) series outside the US is the Markit Group.

Markit Group and the Institute for Supply Management (ISM) compile The Purchasing Managers' Index (PMI) surveys on a monthly basis by polling businesses that represent the make-up of the respective sector. The surveys cover private sector companies, but not the public sector. Markit Economics collects data from more than 20,000 companies across more than 30 countries every month.

Meanwhile in China, apart from Markit group's HSBC PMI, China Federation of Logistics & Purchasing and National Bureau of Statistics release Official PMI data every month.

Manufacturing PMI is an indicator of the economic health of the manufacturing sector. A PMI of more than 50 represents expansion of the manufacturing sector, compared to the previous month. A reading under 50 represents a contraction, while a reading at 50 indicates no change. Manufacturing PMI is a Leading Indicator of an economy.

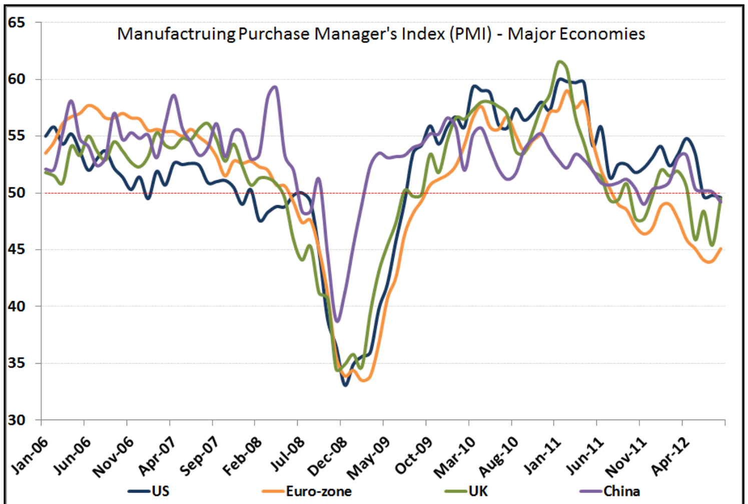
Data Release

Markit releases 2 versions of this report released about a week apart – Flash or Preliminary and Final. The preliminary 'flash' PMI reading is based on around 85% of usual monthly replies.

As a general rule, Flash readings are released during third week of the current month while Final readings are released on the first working day of each month for the previous month.

Importance

PMI is a very important sentiment reading, not only for manufacturing, but also the economy as a whole. The magic number for the PMI is 50. A reading of 50 or higher generally indicates that the industry is expanding. If manufacturing is expanding, the general economy should be doing likewise. As such, it is considered a good indicator of future GDP levels.



Source: Bloomberg, KCSL Research

Current Scenario

Manufacturing PMI of major economies saw a sharp contraction during financial crisis of 2008. The indexes improved in late 2009 and were expanding through first half of 2011 however the trend has reversed since. As of August 2012, PMI of US, UK, China and Europe have fallen below the 50 level mark signaling contraction.

Industrial Production - IP

Industrial production is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining, and utilities.

Industrial production is a coincident indicator. The data is expressed in percentage terms as a comparison to the previous month or year, shedding light on short-term rates of change and business cycle growth, respectively. If the month on month figure is up 1.5% in August, this means that the industrial production has grown by 1.5% in August as compared to July. But in India we usually talk about y-o-y growth i.e. if the Industrial Production rose by 1.5% in July 2012 its over July 2011 figure.

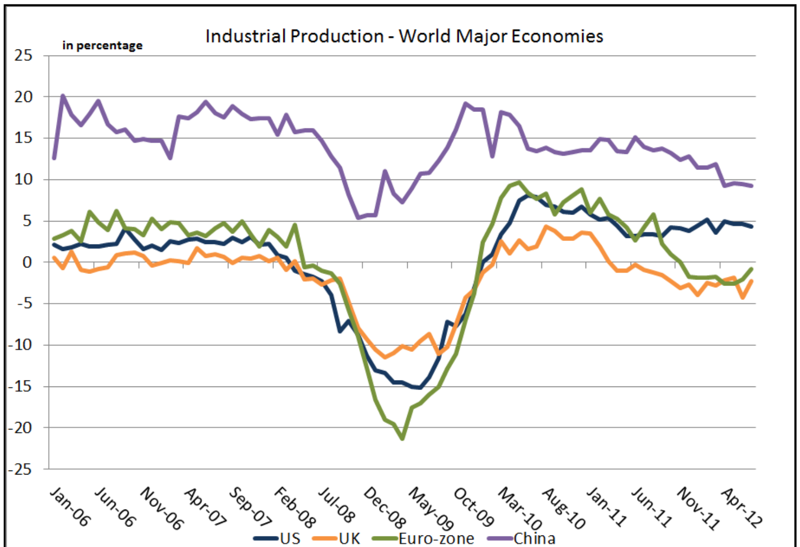
Data Release

Industrial Production data is released by the respective government on a monthly basis. US release the data around 16 days after the month ends while China 9 days after the month ends. Other nations like Euro Zone release 45 days after the month ends while UK and India almost 40 days after the month ends.

Importance

Industrial sector is part of GDP and therefore the data acts as an important tool for forecasting future GDP and economic performance of the nation. Since base metals are majorly used in industrial sector, higher IP number signals robust demand for metals thus lending support to the prices. Meanwhile negative reading of IP means contraction in growth and is negative for industrial metals.

Current Scenario



Source: Bloomberg, KCSL Research

Industrial Production has seen sharp downfall in China, where according to the latest data production grew at a slower pace of 8.9% in August after notching double digit growth until March 2012.

In US production continues to grow albeit at a slower rate while in UK and Euro Zone it has shown negative growth. Recent reading of June 2012 from Euro Zone showed industrial production dropped by 2.3% while in UK its fell by 0.8%

Housing Data

Construction accounts for 25% of total copper consumption in the world and therefore robust housing sector signals good demand for metals.

Various data releases can help us determine health of a housing sector in a nation. However no other nation except US releases this data. In US there are series of Housing data releases every month which portrays health of housing sector in world’s largest economy. Some of the major data releases are Building Permits and Housing Starts

Housing Starts are a measure of the number of residential units on which construction is begun each month. A start in construction is defined as the beginning of excavation of the foundation for the building and is comprised primarily of residential housing.

Building permits are permits taken out in order to allow excavation of ground for building. Permits lead starts, but permits are not required in all regions of the country, and the level of permits therefore tends to be less than the level of starts over time.

Both building permits and housing starts are Leading Indicators. Both are shown as a percentage change from the prior month and year-over-year period. In addition, absolute figures are mentioned and both sets are divided geographically into four regions - Northeast, Midwest, South and West. This helps to reflect the vast differences in real estate markets in different areas of the country. On the national aggregates, the data is segmented between single-family and multiple-unit housing, and all information is presented with and without seasonal adjustment.

Data Release

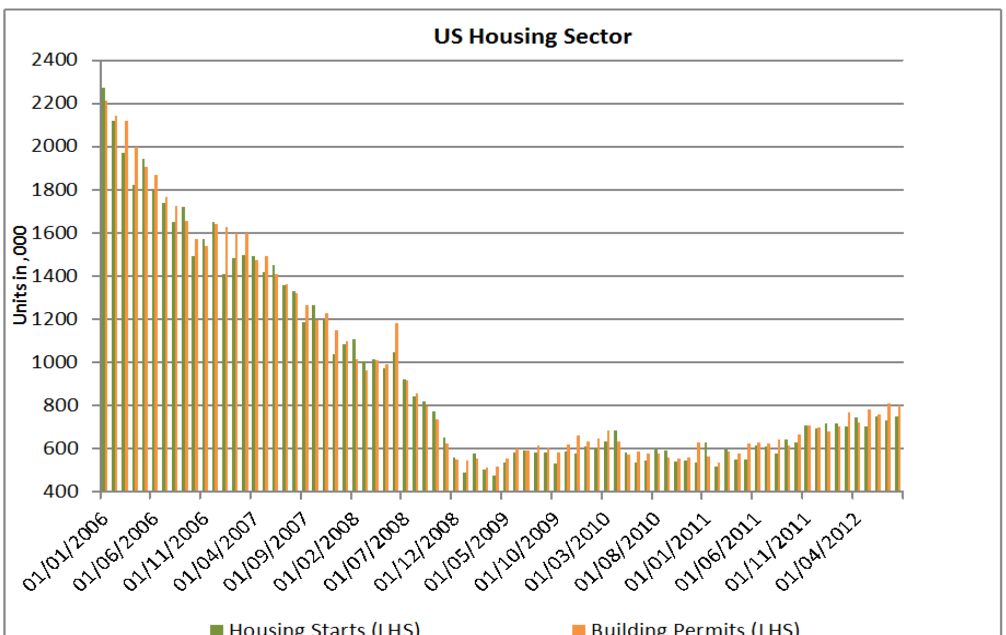
The US Census Bureau jointly with the US Department of Housing and Urban Development (HUD) releases this data. Both the data are released on the same day which is usually about 17 days after the month ends.

Importance

Its gives an idea of how the housing sector in US is performing and also gives hints about health of the economy. Higher number signifies robustness in housing sector which in turn means good demand for metals in construction sector, thus lending support to the prices.

Current Scenario

In US, housing sector is one of the weakest links hindering the current economic recovery. Department of Commerce in US releases Housing Starts and building Permits data on monthly basis which act as a leading indicator of housing sector in the nation.



Source: Bloomberg, KCSL Research

Housing Starts which states the number of new residential buildings that began construction during the previous month has seen a sharp drop from 2, 273,000 units in Jan 2006 to 478,000 in April 2009; and currently stand at 750,000 units as of August 2012. Also Building Permits, a proxy for future construction, fell to 801,000 units in August 2012 from high of 2,263,000 units in September 2005, but has recovered from 513,000 units in March 2009.

Labour data

One of the major sectors that signify health of an economy is the labour market. Countries across globe aim to have near zero unemployment or joblessness. This is because when people are unemployed, they, their families, and the country as a whole, all lose. Workers and their families lose wages, and the country loses the goods or services that could have been produced. In addition, the purchasing power of these workers is lost, which can lead to unemployment for yet other workers.

There are various indicators that signal health of a labour sector in the nation. US releases three major data related to labour sector viz. Initial Jobless Claims, Non-Farm Payrolls and Unemployment Rate.

Initial Jobless Claims

Initial Jobless Claims Report is a weekly release, by US Department of Labour that, shows the number of first-time filings for state jobless claims nationwide. Since the data is release every week it tends to have a limited impact on financial markets. Initial Jobless claims data is a Coincident Indicator.

Non-Farm Payrolls Data

Non-Farm Payrolls data is a number that states the number of jobs added or lost in the economy over the last month, not including jobs relating to the farming industry. Even Non-Farm Payrolls data is a Coincident Indicator

Unemployment Rate

Unemployment Rate is the percentage of the total labor force that is unemployed but actively seeking employment and willing to work. It is calculated as a percentage by dividing the number of unemployed individuals by all individuals currently in the labor force. It is one of the most closely watched statistics because a rising rate is seen as a sign of weakening economy while a falling rate indicates a growing economy. However it is a Lagging Indicator.

Unemployment rate, unlike Jobless claims and Non-Farm Payrolls data is released by other nations also.

Data Release

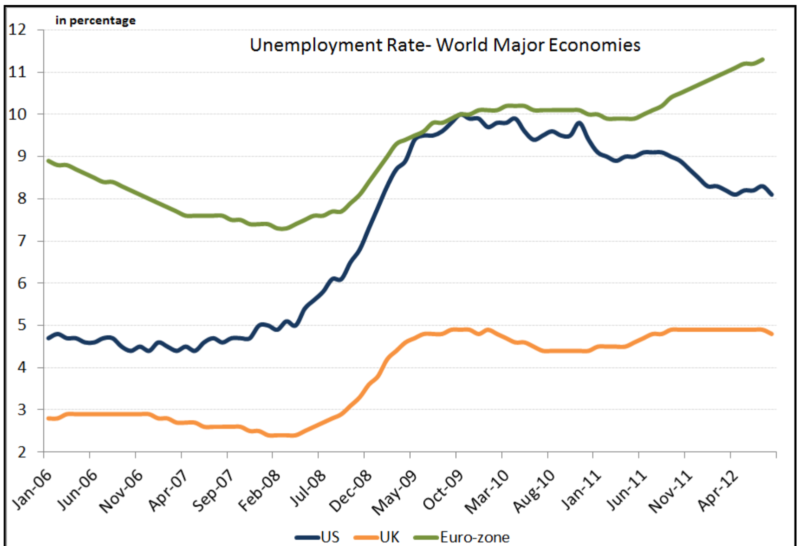
Initial Jobless claims are released every Thursday of the week by US Department of Labour while Non-Farm Payrolls data is released on First Friday of month.

Unemployment rate in US is released along with Non-Farm Payrolls data i.e. on first Friday of every month. While Euro Zone and UK releases this data on a monthly basis 30 days and 45 days after the month ends respectively.

Importance

Labour data given an indication of overall health of the economy. Rising jobless claims or unemployment rate indicates weakness in labour sector and thus weakness in economy. While rising Non-Farm payrolls data indicate new hiring in the nation which is sign of good health of the economy.

Current Scenario



Source: Bloomberg, KCSL Research

Labour market is one of the worst hit sectors of 2008 recession. Almost all the developed nations are struggling with higher unemployment rate, making the recovery process painfully slow. Though the labour market has no direct impact on base metals; higher unemployment lessens consumer spending thus hurting demand for metals.

In US, the nation that enjoyed sub 5% unemployment rate pre 2008, currently fights stubbornly high unemployment rate. Even though unemployment rate in the nation has witnessed a drop it is not as per the government's liking. The current (August) jobless rate is 8.1 % as against 9.1% in same month last year.

Meanwhile in Euro Zone unemployment stood at euro era high of 11.3% in July. Unemployment in Euro zone has been rising steadily fuelling further worries over recession in the region.

In UK, unemployment rate fell to 4.8% in August after remaining steady at 4.9% for past eleven months, and was the highest level since 1997.

Conclusion

There is plethora of economic data released every month, but not all have equal impact across asset class. Indicators explained above are economic releases that will have major impact on industrial metals prices and commodities in general.

Also market tends to react on data much before the actual data releases in anticipation. We have various agencies like Bloomberg and Reuters that conduct survey's and poll to estimate what the data reading is going to be like. If the forecast tends to signal improvement in economy we witness that the market rises in anticipation. If the actual data released is not in line with market estimates we may see sharp decline in the prices and vice versa.

The economic releases may have different impact on different commodities as even fundamentals of each commodity play an important role. Nevertheless studying data releases along with other price moving factors helps one take an informed decision on whether to be in buy or sell side of the market.

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