REMEMBERING LEADING, LAGGING AND COINCIDENT

by Steve Brown

Despite all the technological advancements, people still use the yellow sticky to remember things or leave notes for others. We wonder if the Fed left a note for the market to watch the data last Friday. Each month on the first Friday, the financial markets are literally hanging onto the edge of their seats waiting for the jobs report and Friday's poor showing was no exception. We call the unemployment rate "the headline rate" because it shows up in every news publication and is widely used as a high level gauge of the state of the economy. The unemployment rate is also one of the benchmarks the Fed has said it will use to determine when policy tightening might occur (see the grid at the bottom of this publication). It is certainly an important number, but does it make sense to use it to determine how the economy is doing now? We thought it would be fun to go back to the lessons of Economics 101 and think about what measures of the economy really do indicate where we are vs. where we have been and which ones point to where we might be going.

Economists divide the plethora of statistics flowing around the markets every day into three major categories - leading, lagging and coincident indicators. Leading indicators signal future trends and include things like building permits, home sales, business startups, manufacturing and inventories. Coincident indicators are events that occur at the same time as conditions they signify and include things like personal income, industrial production and trade sales. Lagging indicators typically change after the economy as a whole has already moved. These are historical reports and represent outcomes that are results of other factors. They include statistics like profits earned and the headline unemployment rate. This is because employment typically increases two to three quarters after the economy has already begun to turn higher, so it lags increases in other economic indicators by a significant period of time.

You might be wondering then, why the Fed would use the unemployment rate as the trigger to determine the appropriate time to begin tightening monetary policy. The lag in this statistic behind real improvement in the economy should mean that reaching this benchmark would be an indication of a real trend, not just a momentary blip in employment. In that context, it probably makes a lot of sense for the Fed to use a lagging indicator like the unemployment rate as a trigger for policy tightening. The other benchmark the Fed has indicated it will rely upon is inflation and that is also a lagging indicator. Prices of goods and services typically don't rise until there has been a significant increase in demand for some time. This creates the classic scenario of too many dollars chasing too few goods, so prices begin to rise to balance supply and demand.

Some pundits have questioned, however, whether it makes sense to use a volatile measure like inflation because it can move wildly, simply due to swings in energy prices. To compensate for that, consumer and producer inflation are measured at the core level, where the most volatile sectors have been removed. The problem here is that higher fuel prices can quickly percolate into prices overall, so that isn't perfect either. Perhaps the Fed announced this group of indicators so people have something to track and because it is seeking a reliable gauge that the economy is expanding in a sustainable manner. That is exactly what the Fed is seeking, so it makes sense.

In the end, using the unemployment rate to answer whether people feel better or worse might not make sense, but it has shown over time to be a useful indicator of long-term trends. People also don't need a yellow sticky note to remember that.

BANK NEWS

Closure (5 YTD)

Regulators closed Gold Canyon Bank ($45mm, AZ) and sold it to First Scottsdale Bank ($80mm, AZ). First Scottsdale gets 2 branches, assumed all deposits and entered into a P&A agreement with the FDIC.

M&A

Investors Bancorp ($12.7B, NJ) will buy the holding company of GCF Bank ($310mm, NJ) for an undisclosed sum.

Yield Pressure

Turmoil in Europe, the Bank of Japan saying they planned to pump $1.4T into their own economy to jumpstart it and very poor US employment data combined to drive investor fear of a growing global slowdown. As such, US Treasury yields slid to their lowest level in a year last week.

Settlement Approved

A federal judge has approved Bank of America's $2.4B settlement to resolve investor litigation due to the bank's acquisition of Merrill Lynch.

TBTF Tax

A bipartisan group of Senators has drafted legislation that would require banks with assets above $400B (too big to fail) to hold 5 percentage points more capital as an additional surcharge for their inherent risk to the government (beyond the 10% already required). It will be interesting to see how this plays out.

Currency Risk

Online currency Bitcoin (used online by merchants and customers) is a virtual currency that has more than $1B of digital currency in circulation. It allows online users and merchants to exchange credits for goods and services through computers and smartphones. The currency was hacked and attackers reportedly destabilized it enough so prices crashed and then came back in buying back on the cheap (only to sell again). Last week FINCEN said the virtual currency must be treated just like a foreign currency.

Fewer Banks

Fed research finds the number of commercial bank charters outstanding has declined by more than 50% since 1985.

Failures

From 2006 through 2012, 468 banks & thrifts failed.