



ECONOMICS 101 – WHAT DO THE LEADING INDICES MEAN?



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As the current economic times unfold, we are bombarded with the jargon, acronyms and analysis of financial data. For many, struggling to keep your business moving forward, a refresher on economic terminology might help crystallize the latest financial news.

One benchmark is the Gross Domestic Product (GDP), which is very similar to the Gross National Product (GNP). What is the difference? Both numbers report on the total amount of goods or services produced by a country. GDP is defined as the value of all goods and services produced inside a country in one year. GNP is the market value of all goods and services produced in one year by labor and property supplied by the nationalized residents of the United States, here or overseas.

According to the World Bank, the GDP of the United States in 2008 was \$14.2 trillion compared to the global GDP of \$60.6 trillion. The United States accounted for 23% of the global GDP, ranking us first. How does that compare to the larger economies of the world? China is third at \$4.3 trillion and Saudi Arabia, even with all of its oil wealth, is 23rd at only \$467 billion dollars of GDP. Here is even brighter news; the GDP for the United States grew 3.5% in the third quarter of 2009.

When unemployment numbers are announced, stock traders hold their breath. Unemployment has one of the most significant influences on the volatility of equity markets. But there is a key concept to remember when evaluating the unemployment news. Unemployment data is a lagging economic indicator. Lagging indicators change only after the economy has changed. So changes in the unemployment rate are a by-product of bad economic times past – not an indication of future market direction.

Currently, New Jersey's unemployment rate is currently is at 9.8% which is equal to the national average. Although New Jersey's unemployment rate rose in September, it follows two consecutive months of decline. New Jersey's average until recently has consistently trended slower than the national average.

Another lagging indicator is the Consumer Price Index (CPI). CPI measures the price change from period-to-period of consumer goods and services purchased by a household. Based on the U.S. Department of Labor, the CPI increased 0.2% in September but remains lower with an annual decrease of 1.3%. The retail and auto industries have offered significant discounts to move goods and services. The decline in the CPI follows the pattern of consumer purchase decisions.

On the flip side, we have leading indicators. These indicators change before the economy changes and represent future trends. Two leading indicator examples are stock prices and consumer spending. The Dow Jones Industrial Average, which is comprised of thirty U.S. industrial companies, closed in 2008 at 8,776. On October 30, 2009 the market index was 9,712 or an increase of 11%. What does this trend reveal?

Many economists have blamed the depressed housing market for the severity of this recession. But just how does it compare to historical trends? Are we looking at numbers equivalent to that of the Great Depression of the 1930s? Hardly, between 1918 and 1949 our country had eight recession periods averaging sixteen months in duration. Between 1983 and 2007 we have had two with an average duration of only eight months. A recession is defined by economists as a decline of GDP for two consecutive quarters.

Two new items are impacting interest rates at historical and global proportions. Traditional borrowing sources for closely-held business owners include equipment loans and mortgages issued by the commercial banking industry. The neighborhood bank lends to its creditors based on the borrowing sources established by the Federal Reserve Bank and its index, the Federal Funds Rate (FFR). The FFR in 2006 was 5.25% and 4.25% in 2007. Today the FFR is at -0.25%. This dramatic decline has allowed financing sources to offer loans at historically low interest rates.

One of the most commonly quoted interest rates is “prime.” The prime rate moves up or down with changes in the interest rate by the Federal Reserve Board. The most widely quoted source of the prime rate is the Wall Street Journal. This index is based on a survey of the interest rates offered by the thirty largest banks to their best customers. When three-quarters of them (twenty-three banks) report a change in their interest rate, the Journal updates the “prime” rate.

A new global benchmark is taking hold quickly. With international barriers being broken by small businesses using the Internet, we see the emergence of the London Inter-Banking Offering Rate (LIBOR). LIBOR operates in the same manner as a commodity market like oil or gold. LIBOR is a free market rate at which contributors lend funds on an unsecured basis to users at interest rates based on volume and demand. Because of its market demand structure, LIBOR is slowly replacing the old American standard of “prime.”

Reacting to these indicators in the context of what is being measured allows the business owner to correctly modify their business model. As a Master Sponsor of the New Jersey Builders Association, Cowan, Guteski & Co., P.A. keeps clients abreast of changes in the key economic indicators. Visit www.cowanguteski.com or contact Bill McNamara, CPA, CCIFP® at 732-349-6880 or bmcnamara@cowanguteski.com to see how we can assist you in reaching your goals.



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