

Baird Investor Education

The Relationship Between the Economy and the Financial Markets

If you are an investor in the bond or stock market, your investments are affected by the state of the economy. Changes in the economy have a large impact on interest rates and inflation, which both directly affect the stock and bond markets. Over the past several years, interest rates have been low, historically speaking, which means that individuals who have invested their money in bank savings accounts or money market funds probably have not added significant wealth to their nest eggs. In general, investors need to take on some risk in their portfolios to pursue growth. This means placing a greater emphasis on longer-term securities, which tend to offer higher returns.

Investors are often better equipped to plan their investment strategies if they are able to understand some basic economic principles.

The Vocabulary of the Economy

Gross domestic product (GDP) is a measure in dollar value of the economy's total production of goods and services. Comparing the current GDP with previous periods indicates the economy's rate of growth (or lack of it). An increasing GDP indicates that the economy is expanding and corporate profits are generally strong. On the other hand, slower economic growth typically

slows corporate profits, which in turn impacts inventories. With slower sales, companies experience a buildup in inventories, which means that they will slow down their production to adjust for this buildup. However, the state of the economy is far more complex than the mere correlation of two variables. To better assess the state of the economy, many measures—the inflation rate, unemployment rate, national income, international trade, and manufacturing capacity, among others—need to be considered.

Inflation distorts the accuracy of this measurement of growth, so there is a measure of the real growth of an economy's output, referred to as "real" GDP. Real GDP is adjusted for price-level changes and measures each period's growth in goods and services using prices that prevailed in a selected base year. A comparison of real GDP figures with those of prior periods provides a more accurate measurement of the real rate of growth. Gross domestic product is therefore a measure of the economic health of a country. In the U.S., inflation has been low recently and has not significantly detracted from real GDP.

A more narrowly focused measure of a nation's output is industrial production, which measures manufacturing output. The manufacturing sector generally leads the economy's short-term swings.

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The **unemployment rate** is the percentage of the nation's labor force that is out of work, and it is another indicator of the economy's strength (or lack of it). A growing economy and a low unemployment rate in combination have traditionally fueled inflation. Concern arises when rates for labor rise faster than productivity gains. This is why the bond and stock markets pay so much attention to the utterances of the Federal Reserve Chairman's speech to Congress about interest rates. When there is even a shadow of inflation on the horizon, the Federal Reserve will raise short-term interest rates.

The other side of the coin is a high unemployment rate. Governments become concerned when the unemployment rate rises above a certain level (about 7%), and they will try to stimulate the economy (through fiscal and monetary policies) to reduce the unemployment rate. These actions may also stimulate inflation.

In the early 1980s, the U.S. experienced high rates of both unemployment and inflation. The government dealt with the inflation first by pursuing restrictive economic policies. This sent the economy into a recession and the unemployment rate increased further. In 1992, the U.S. experienced low inflation but high unemployment. The government's approach was to stimulate the economy by lowering interest rates (through the Federal Reserve Bank).

Inflation is defined as the rate at which the prices for goods and services rise in an economy. Inflation often characterizes a growing economy, in which the demand for goods and services outstrips production, in turn leading to rising prices. In other words, there is too much money chasing too few goods and services.

The **Consumer Price Index (CPI)** is one measure of inflation. It is calculated monthly by the Bureau of Labor Statistics. The Bureau monitors the changes in prices of items (such as food, clothing, housing, transportation, medical care, entertainment) in the CPI.

It is a gauge of the level of inflation and is more meaningful when it is compared to the CPIs of previous periods.

Some economists believe that the CPI fuels inflation, similar to a cat chasing its tail. Social Security payments and many cost-of-living increases in employment contracts are tied to increases in the CPI. The CPI may, in fact, exacerbate the level of inflation.

When the level of inflation is high (relative to previous periods), governments will pursue restrictive economic policies to try and reduce it.

The **Producer Price Index (PPI)** is announced monthly and monitors the costs of raw materials used to produce products. The PPI may be a better predictor of inflation than the CPI, because when prices of raw materials increase, there is a time lag before consumers experience these price increases.

Another key indicator is the Commodity Research Bureau's **commodity price index**, which measures prices of raw materials. When this index rises significantly over a six-month period, it is a warning that inflation is on the horizon.

The **Leading Inflation Index**, developed by Columbia University's Center for Business Cycle Research, is an index that anticipates cyclical turns in consumer price inflation. When it moves up with commodity prices, it is a clear signal that inflation is ahead. When an economy is in recovery, the **manufacturing capacity utilization rate** becomes a key indicator to watch. This indicator measures how much of the economy's factory potential is being used. Economists worry about inflation when the nation's factory capacity rises above 82.5%. For example, when a recovery is robust and the economy is growing rapidly, with interest rates remaining low, there will be a decline in unemployment, which will give rise to increasing wage pressures and increasing prices of goods.

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Inflation has a detrimental effect on both the bond and stock markets as well as on the economy. When the level of inflation increases, real GDP falls (in 1980 in the U.S.). Similarly, when inflation declines, real GDP increases (in 1983 in the U.S.). This inverse relationship may not always hold up, as evidenced by the economy in the mid 1990s. Despite lower levels of inflation, real GDP showed insignificant growth, which translated into the economy taking a long time to move out of recession.

Housing starts are released monthly and show the strength in housing production. An increase in housing starts relative to previous months indicates optimism about the economy as more people are buying homes. Thus, strength in housing starts shows consumer confidence in the economy.

Economists have designed an index of **leading indicators** to forecast economic activity. This index includes data series ranging from stock prices, new building permits, and average work week to changes in business and consumer debt. By analyzing this monthly index, economists hope to be able to forecast economic turns and be able to give advance warning of a turn in the stock market, which can impact the bond markets. In reality, however, when the leading indicators forecast an economic turn, the stock market has already reacted to the change.

Reviewing these basic economic principles can help you understand how the performance of your portfolio depends on many external factors, as well as how the individual investments are selected and managed.