Assessing Growth Conditions

Ron Madey, CFA®, Chief Investment Officer

September 11, 2015

WEALTHCARE
financial guidance for life

The Anecdotal Evidence

If my recent flight from Philadelphia to Chicago was any indication, economic activity remains fairly strong. For those unfamiliar with the Philadelphia Airport, there are six terminals, A through F, each with their own parking deck. Upon arriving, I was greeted with an unprecedented dilemma: parking decks A, B and C were completely full. This has never happened to me before. Deck D was almost full, but I managed to find an available space on the roof. Of course, my flight was departing from Terminal A, so I had to trek across four terminals, bags in tow, to get to my gate. Like the parking decks, my flight was also full. I had to wedge myself into a middle seat in the back of the plane. The experience would make any traveler long for a little less economic activity.

Of course, this is a narrow experience that could have causes specific to Philadelphia such as the route, the time and date of travel, or it could be a consequence of recent airline mergers. It would be unwise to make investment decisions based on this narrow and unconfirmed anecdotal evidence. There is also the challenge of how one might thoughtfully and prudently adjust their portfolio based on this subjective information. So, what is the alternative?

The GDP Data

Why not just observe the GDP data directly as it is published by the Bureau of Economic Analysis (BEA) to assess growth conditions? The BEA releases three estimates of GDP growth for each quarter. The first estimate of Q2 GDP growth, referred to as the *advanced estimate*, was reported on July 30th, one month after the end of the quarter. The advanced estimate came in at 2.3%. A month later, the *second estimate* for Q2 GDP growth was revised to 3.7%. On September 25th, we will get a *third estimate* revision for Q2 GDP. This means the final, most accurate estimate for Q2 GDP growth is provided three months after the end of the quarter. The third report in September regarding economic activity data for March is incredibly stale and of little use for assessing current growth conditions. It is old news.

The first report was also of little use. Quarterly data is inherently stale, as the information on the first month of the quarter is not reported on for at least three months. The quality of the advanced report is also subject to significant revision. In the case of Q2, the advanced report was revised from 2.3% to 3.7% for the second estimate. The quarterly GDP data may serve social purposes, but by the time it is reported, it is old news, particularly for a forward-looking, sometimes emotional market. So, how do we get a straightforward measure of growth conditions that will help us avoid being drawn into the emotional world of talking heads and the 24/7 financial news cycle?

Other Economic Reports

Financial news outlets and opinion makers have a never-ending supply of economic reports to trot out to express their viewpoints and engage us in their world view. Over the course of a given month, there are over 150 economy— related statistics reported by Bloomberg. These reports include both government and private data, and surveys on performance and expectations of various sectors of the economy. Of course, rarely (if ever) do all point in the same direction, so there is always ample fodder to make a bullish or bearish case – with the most eloquent or heralded opinion makers shaping the crowd mind.

Is there a better way to make sense of all this data? One effort is the Conference Board Leading Economic Index (LEI). It is intended to signal peaks and troughs. LEI has ten components, three of which are market-related (stock prices, credit spreads, yield curve). Using financial market indicators may help forecast the business cycle, but using stock prices to assess economic support for stock prices is just a bit too circular for our purposes. Our goal is to provide a straightforward and objective measure of growth conditions to better understand the economic pressure, both positive and negative, on markets. So while we cannot use the entire LEI composite for this purpose, we can consider using the seven remaining LEI components, as well as some of the 150+ other publicly reported monthly statistics, in crafting a more reliable alternative.

GCONIX: Wealthcare's Growth Conditions Index

The Wealthcare Growth Conditions Index, "GCONIX" for short, is a composite of 20 key economic indicators that have had a tendency to lead or coincide with changes in economic activity. The components of GCONIX are published no less frequently than monthly. It is intended to measure the breadth of economic strength/weakness, not the level of growth. As such, the selected indicators span the major elements of economic activity and actors (e.g. the Federal Reserve) that influence it. Below is a list of the indicators (source in parenthesis):

Business Activity and Production

1. New Orders (National Association of Purchasing Managers Survey)
2. Backlog Orders (NAPM)
3. Business Activity (NAPM)
4. Industrial Production (Federal Reserve)
5. Manufacturers' New Orders (U.S. Census Bureau)
6. Durable Goods New Orders (U.S. Census Bureau)
7. Capital Goods Orders (U.S. Census Bureau)

Consumer/Worker and External Demand

8. Personal Income (Bureau of Economic Analysis)
9. Personal Consumption Expenditures (BEA)
10. Retail Sales (U.S. Census Bureau)
11. Initial Jobless Claims (Department of Labor)
12. Average Work Week (Conference Board)
13. Exports (U.S. Census Bureau)

Housing and Construction

14. Home Builders Market Activity (National Association of Home Builders)
15. Housing Starts (U.S. Census Bureau)
16. Building Permits (U.S. Census Bureau)
17. Construction Spending (Census Bureau)

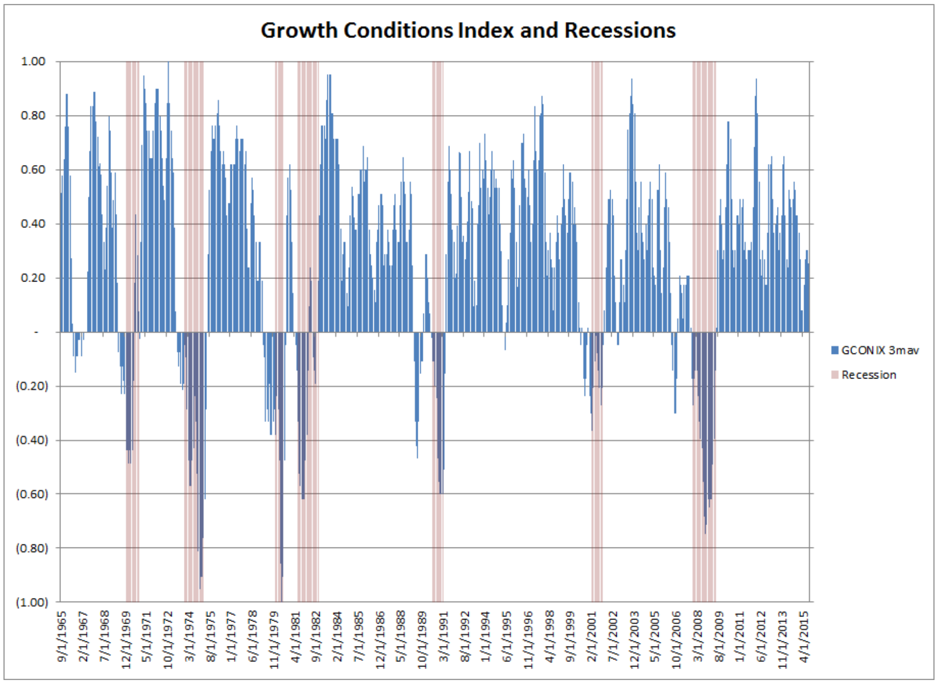
Monetary and Fiscal Stimulus

18. Government Debt (U.S. Treasury)
19. M2 Money Supply (Federal Reserve)
20. The Monetary Base (Federal Reserve)

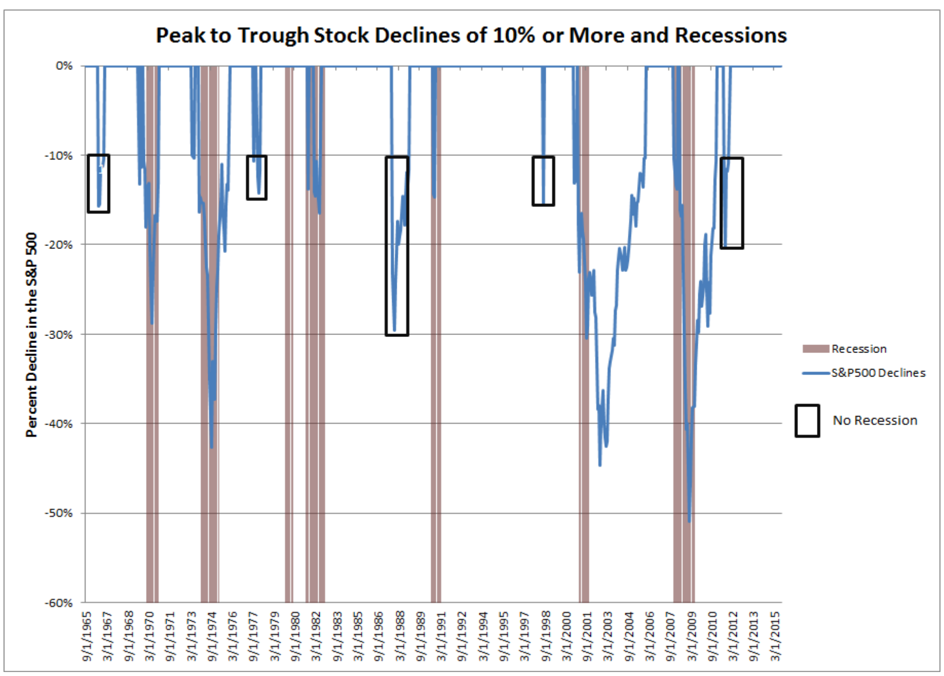
The business activity indicators focus on orders as they lead production activity. Likewise, Housing and Construction have downstream impacts on economic activity – buy a new home and you also buy appliances, employ construction workers, painters, etc. The Consumer/Worker indicators assess the state of this important component of the economy. Consumer Spending represents about two-thirds of GDP. Jobless Claims and the average work week tend to lead consumer spending. The Monetary and Fiscal indicators provide a measure of policy support for economic activity.

Of note, there is no financial market data used in GCONIX. The raw Index can range from 100% positive to 100% negative based on whether each component of the Index is rising or falling in real terms. Data is smoothed to reduce noise. If 10 of the GCONIX components are rising and 10 are falling, the Index has a reading of zero, which is a neutral reading meaning neither positive nor negative net growth conditions.

As you can see from the following chart, GCONIX is effective at identifying recessions. In each of the past seven recessions, a reading of minus 0.2 or less led and/or coincided with the recession. Minus 0.2 on the Index means that 12 of the component indicators were falling and 8 were rising. In two cases there were early signals that were minus 0.2 or less where the signal was early, then reversed, then captured the recession. Not a bad track record.



By contrast, based on stock market declines of 10% or more, the market has forecasted five recessions that did not come to pass. So, while the recent declines in U.S. stocks are disconcerting, they do not necessarily portend an imminent recession, particularly given the continued positive reading of GCONIX. As growth conditions evolve, GCONIX will continue to provide us an objective measure of economic pressures impacting markets.



Data sources include Bloomberg, MPI Stylus and Wealthcare.

WEALTHCARE
financial guidance for life

2100 EAST CARY STREET, SUITE 200 | RICHMOND, VA 23223 | 804.644.4711

WEALTHCARECAPITAL.COM