Monthly Blog

PM's Perspectives

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Leading indicators are the key for equity investment.

Many institutions publish a variety of economic indicators, and each person values different indicators. Legislators care about unemployment rates and stock price indices to grasp voter sentiment while economists pay attention to indicators which are incorporated in the gross domestic product (GDP). Then which indicator should equity investors focus on?

I place emphasis on the leading economic indicators, because the stock market moves ahead of the economy and only the leading indicators can help me in looking for promising areas and industries.

Leading indicators anticipate economic movements a few months down the road. For example, new job openings is a leading indicator. Companies usually advertise job openings to recruit people, so we can expect an increase in employment when the number of new openings increase. The ratio of job offers to applicants and the unemployment rate are also well-known as employment economic indicators, but stock markets price in these indicators before they turn up or decline. It is because the former is a coincident indicator while the latter is a lagging one. Given the fact that stock markets look further ahead than coincident/lagging indicators, leading indicators including new job openings are more useful for equity investors.

Eleven components of composite index (CI) of leading indicators and their concept

	Name	Area	Concept (Condition)	Concept (Result)
L1	Index of Inventory Ratio of Final Demand Goods	Inventory	If the inventory decreases,	production will increase in the future.
L2	Index of Inventory Ratio of Industrial Production Goods	Inventory	If the inventory decreases,	production will increase in the future.
L3	New Job Openings (excluding new graduates)	Employment	If new openings increase,	employment will increase in the future.
L4	Machinery Orders (Manufacturing)	Capital Investment	If orders increase,	capital investments will increase in the future.
L5	Floor Space of Newly Built Houses	Housing	If the housing starts increase,	housing investments will increase in the future.
L6	Consumer Confidence Index	Consumption	If the sentiment improves,	consumption will increase in the future.
L7	Nikkei Commodity Price Index (42 basic materials)	Commodity	If commodity prices go up,	the economy will improve in the future.
L8	Money Stock (M2, year-on-year)	Financials	If cash-flow situations improve,	the economy will improve in the future.
L9	TOPIX	Performance	If stock prices advance,	corporate earnings will increase in the future.
L10	Investment Climate Ratio (Manufacturing)	Capital Investment	If the investment climate improves,	capital investments will increase in the future.
L11	Small-Medium Enterprises (SMEs) Sales Prospect DI	Earnings	If the sentiment improves,	corporate earnings will increase in the future.

Source: SMDAM, based on data compiled by the Cabinet Office

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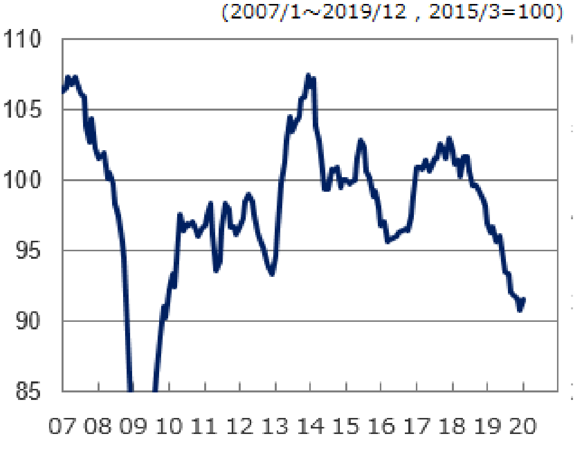
We can cite the Composite Index (CI) of leading indicators as a typical leading indicator. This is an index of eleven leading indicators which shows the size of economic fluctuations. We can vaguely forecast the course of the economy by looking at the CI. We can also take a cue on which industry to improve by examining its breakdown.

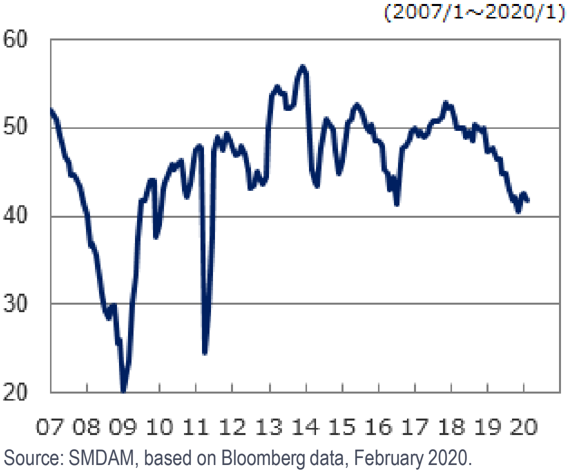
However, the CI doesn't cover enough businesses in the non-manufacturing sector including cutting-edge IT and new services as it requires a long period to verify whether each indicator really moves ahead of the economy. Therefore, we have to find leading indicators in each industry by ourselves; for example, new orders and overtime hours for the staffing service industry or a status of flight/room booking for the inbound industry.

Diffusion index of composite leading indicators



Source: SMDAM, based on Bloomberg data, February 2020.

Economy Watchers Survey (average of current conditions and expected).



Source: SMDAM, based on Bloomberg data, February 2020.

The Economy Watchers Survey is also a useful leading indicator. The survey is based on responses to a questionnaire from about 2,000 people engaged in jobs in various industries and has been considered as a candidate component of the CI of leading indicators by the government. The survey runs from the 25th of every month to the end of the month and is announced around the 10th of the next month. So we can promptly gain an accurate grasp of the economy. In addition, comments in the survey sometimes provide new information unexpectedly ahead of the public disclosure, for example, they were the first to show the impact of the new pneumonia in China, on which we heard a series of news reports in the latter half of January. They expressed concerns over not only the impact of decreasing Chinese tourists on retailers, hotels and travel agencies but also a delay in construction work, which might have anticipated a shortage of anti-dust masks.

I used to keep an eye on Tankan, a short-term economic survey of enterprises in Japan conducted by the Bank of Japan (BoJ) due to strong interest among market participants. However the Large Manufacturing index in Tankan is not personally so useful despite the highest degree of attention, as the index doesn't show sufficient signs of economic movements in advance.

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Note: Daiwa SB Investments Ltd. (DSBI) merged with Sumitomo Mitsui Asset Management Company, Limited (SMAM) on 1 April 2019.

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