

INVESTMENT FOCUS

TOP DOWN INSIGHTS...BOTTOM LINE RESULTS

Should Investors Trust Economic Data?

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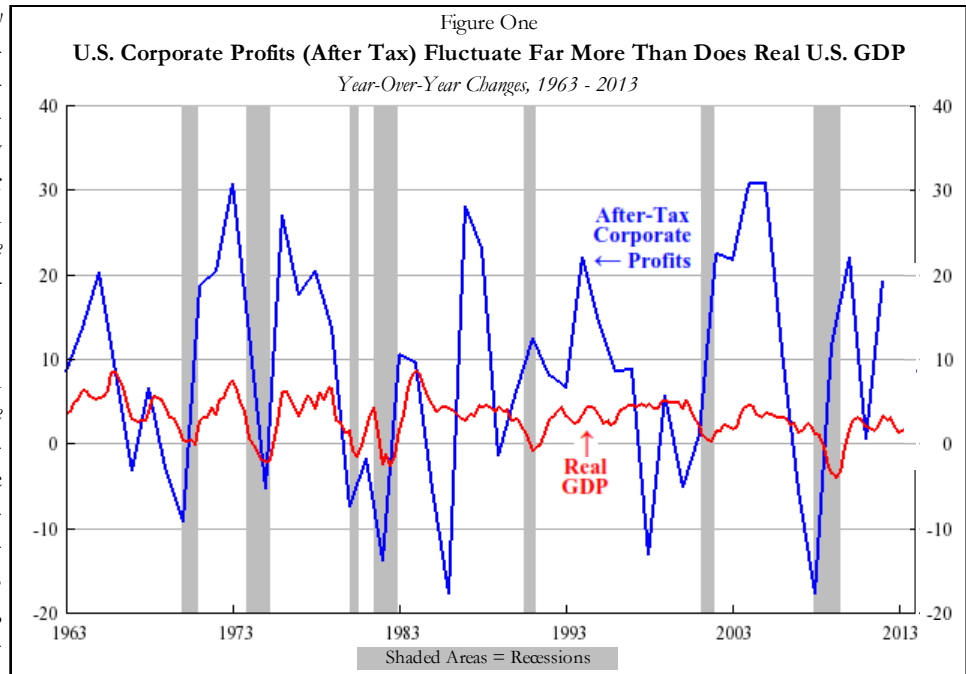
An example of our occasional *negative research*: showing what does *not* matter in forecasting future portfolio returns and can be safely ignored.

Besides having a correct *theory* (or “model”) of how economies and markets work, a credible forecasting system must incorporate accurate and timely *inputs* for the model; this is similar to the principle that a well-baked good requires both a correct *recipe* (model) and high-quality *ingredients*.

IFI’s model of economic and market activity is a *supply-side* model,¹ focusing on saving, investment, production, and the actions of businesses and investors; this is contrast to more conventional *demand-side* models which focus on jobs, sentiment, consumer spending, and the actions of households and govern-

ments. In our model *markets are made by the producers*, not by consumers (whether the private or public sector). In order to consume one must first produce; production is primary, consumption secondary; one is causal, the other consequential. For inputs we use only the best of ingredients: market prices, in which are embedded forecasts derived from the rational expectations of money-motivated buyers and sellers. Prices are forward-looking and not revised after the fact.

A further basic truth is that market activity and prices tend to *foreshadow* what eventually will occur in the economy, as captured in historical accounting-economic data. Thus *portfolio asset returns tend to precede moves in economic data*. Thus for yet another reason, investors should be wary of relying too much on economic data. Dubious



indeed is the investment strategy which ignores inter-market pricing patterns while awaiting release of yet another stream of mind-numbing, often meaningless economic data that are backward-looking and subsequently revised. Such data have almost no bearing on portfolios.

Most of our research is devoted to documenting and explaining the inter-market pricing patterns which can help guide the portfolio optimization and asset allocation decisions of professional investors. Yet we realize that many economists and investors spend a good deal of time and analytical effort parsing the reams of economic-accounting data released each day by government, industry groups, and companies. If the goal of economists and investors is to plan ahead and try to anticipate shifts in portfolio returns, then much of the time, energy, and

¹ See “Saysian Economics,” *The Capitalist Advisor*, December 31, 2003 (Part I) and January 5, 2004 (Part II). Saysian economics is the economics of Jean Baptiste Say (1767-1832), the first real “supply-side” political economist, and it stands in sharp contrast to Keynesian (or demand-side) economics. The latter is not the simple recognition that economic activity entails both supply and demand, but the claim that *consumption* – the using up of goods – spurs production.

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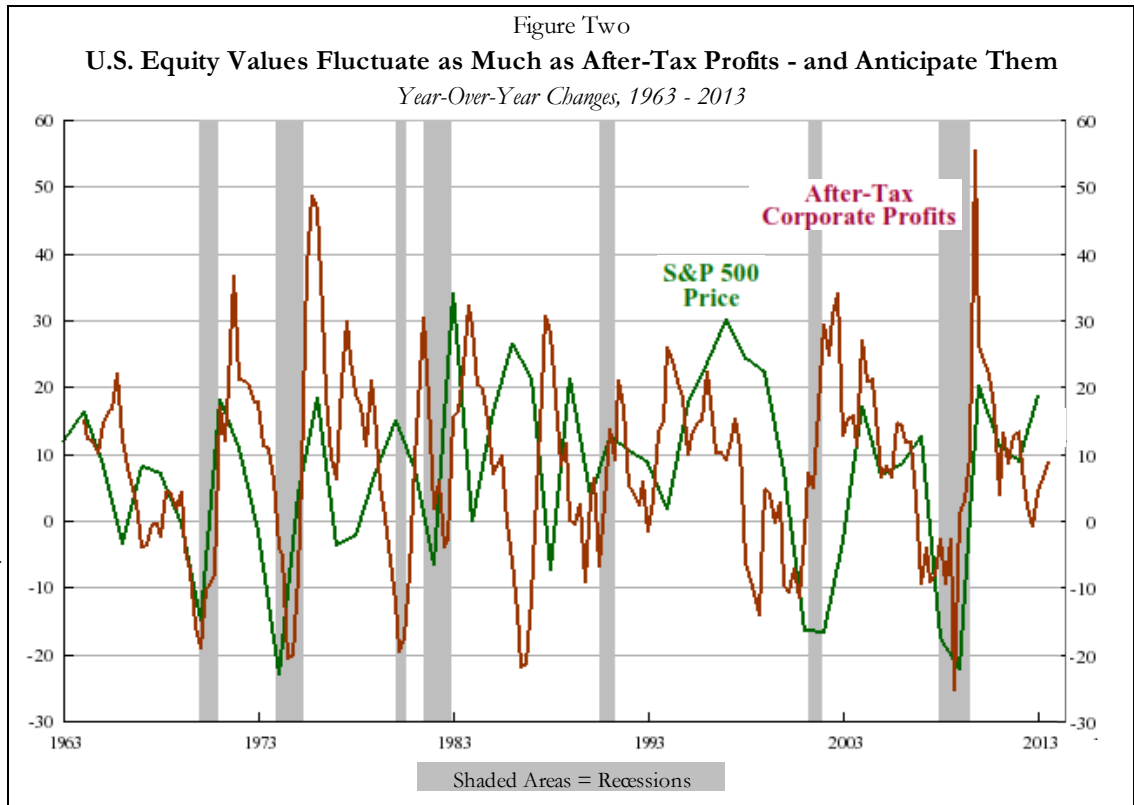
attention paid to such data is wasted. It's simply isn't so that investment returns are predicted by prior moves in economic-accounting data; more often, the data lag. Indeed, most investment returns are registered *prior* to movements in the economic and accounting-based data.

In a recent report we showed (in cases of post-recession economic recoveries)² that even if you were to rely solely on economic-accounting data for your investment strategy, you're

at least better off consulting the much less-publicized *supply-side* (production and profit-oriented) data than rely on the more popular and widely-cited *demand-side* (consumption oriented) data. Nevertheless, you should be skeptical about the practical value of all such data.

Figure One (page 1) offers one obvious demonstration of our basic point. Suppose you're concerned with maximizing risk-adjusted portfolio returns and you wish to discern which variables are most closely associated with swings in equity prices. Consulting our Figure One, and knowing that equity prices, historically, have exhibited big swings, would you be more likely to look to the role played by after-tax corporate profits, or changes in real GDP? Fluctuations in GDP seem as nothing compared to fluctuations in profits, and the latter, not implausibly of course, plausibly relate to swings in equity prices. After all, equity pricing reflects a present valuation assigned to a projected stream of future profits, discounted by an interest rate. Equities are a claim on the dividends that are made possible by profits; they're not a claim on GDP. Far too much analytic attention is paid to GDP.

Figure Two (above) illustrates how, in fact, fluctuations in



after-tax corporate profits tend to be *wider* than fluctuations in equity prices, mostly because the other key determinant of equity prices, the prevailing discount factor (interest rate), also fluctuates. But our broader conclusion remains valid: equity prices and profits *both* fluctuate far more than do relatively inconsequential yet widely-cited, popularly-forecasted measures like GDP.

The balance of this report (pages 3-4) relates patterns in the total returns of four U.S. asset classes – equities, bonds, bills and commodities – to fourteen series of economic-accounting data, for the years 1953-2013.³ We provide correlations for annual data on both a *contemporaneous* basis and with the total return on the relevant investment asset *lagged by one year*. There's not much sense in relying on contemporaneous correlations, even high ones, since time is required to reposition and optimize portfolios. In each table we ranks the economic variables from largest positive correlation down to largest negative correlation. Obviously, the largest correlations in either direction are the only ones worth exploring. Small correlations (10% or less) suggest no relationship—thus a variable to be largely ignored (if relied on in isolation).

² See "Why the U.S. Economic Expansion Isn't Really Sub-Par," *The Capitalist Advisor*, InterMarket Forecasting, Inc., December 6, 2013.

³ For consistency and comparability, we use the same fourteen economic-accounting measures as we used in our prior report: "Why the U.S. Economic Expansion Isn't Really Sub-Par," *The Capitalist Advisor*, InterMarket Forecasting, Inc., December 6, 2013.

Table One

Economic Data and U.S. Equities (S&P 500)

Annual Changes in S&P 500 TR Correlated with Annual Changes in Economic Data
U.S., 1953 - 2013

<u>Economic Data</u>	<u>Contemporaneous</u>	<u>TR on S&P 500 Lagged 1 Yr</u>
Unemployment Rate:	-20%	21%
Corporate Free Cash Flow:	14%	5%
Real Government Spending:	-25%	5%
Corporate Profits After-Tax:	30%	0%
Consumer Sentiment Index:	61%	0%
Price Inflation (CPI):	-18%	-1%
Corporate Dividends:	13%	-18%
Real Personal Disposable Income:	10%	-19%
Real Gross Private Investment:	25%	-20%
Corporate CAPEX:	8%	-21%
Real Consumer Expenditures	41%	-24%
Non-Farm Payrolls:	9%	-24%
Real GDP	31%	-26%
Industrial Production Index:	40%	-32%

Table Two

Economic Data and U.S. Treasury Bonds

Annual Changes in T-Bond TR Correlated with Annual Changes in Economic Data
U.S., 1953 - 2013

<u>Economic Data</u>	<u>Contemporaneous</u>	<u>TR on T-Bonds Lagged 1 Yr</u>
Corporate Profits After-Tax:	-23%	21%
Consumer Sentiment Index:	-15%	17%
Corporate Dividends:	17%	16%
Price Inflation (CPI):	-13%	14%
Real Gross Private Investment:	-19%	12%
Corporate CAPEX:	-22%	10%
Real GDP	-20%	8%
Industrial Production Index:	-26%	7%
Corporate Free Cash Flow:	-16%	6%
Real Government Spending:	-7%	4%
Real Consumer Expenditures	-2%	1%
Non-Farm Payrolls:	-17%	0%
Real Personal Disposable Income:	12%	-2%
Unemployment Rate:	11%	-4%

Table Three

Economic Data and U.S. Treasury Bills

Annual Changes in T-Bill TR Correlated with Annual Changes in Economic Data
U.S., 1953 - 2013

<u>Economic Data</u>	<u>Contemporaneous</u>	<u>TR on T-Bills Lagged 1 Yr</u>
Price Inflation (CPI):	71%	75%
Non-Farm Payrolls:	10%	35%
Corporate CAPEX:	4%	23%
Corporate Dividends:	11%	20%
Real GDP	-7%	15%
Real Government Spending:	20%	11%
Real Consumer Expenditures	-6%	11%
Real Gross Private Investment:	-12%	9%
Industrial Production Index:	-19%	8%
Corporate Free Cash Flow:	-5%	5%
Real Personal Disposable Income:	-3%	0%
Consumer Sentiment Index:	-13%	-1%
Corporate Profits After-Tax:	-19%	-8%
Unemployment Rate:	13%	-14%

Table Four

Economic Data and Commodities

Annual Changes in CRB TR Correlated with Annual Changes in Economic Data
U.S., 1953 - 2013

<u>Economic Data</u>	<u>Contemporaneous</u>	<u>TR on CRB Lagged 1 Yr</u>
Corporate Free Cash Flow:	3%	24%
Real Personal Disposable Income:	-18%	17%
Corporate CAPEX:	17%	16%
Non-Farm Payrolls:	14%	16%
Corporate Profits After-Tax:	11%	14%
Price Inflation (CPI):	55%	12%
Real GDP	6%	12%
Real Consumer Expenditures	-6%	7%
Real Gross Private Investment:	8%	7%
Industrial Production Index:	10%	6%
Corporate Dividends:	12%	-3%
Unemployment Rate:	-3%	-4%
Real Government Spending:	-13%	-6%
Consumer Sentiment Index:	-18%	-12%

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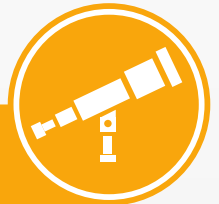


Investment Focus

the factors
driving
each asset
class

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IFI's investment advice flows directly from its regression-based proprietary models, which are based on a careful scrutiny of long-term market data and historical patterns. Markets are inter-connected such that price changes have forecasting power. IFI identifies the quantitative links and distinct causal patterns of market history and uses these to signal portfolio outcomes. IFI's service and forecasts address the five major asset classes – currencies, commodities, stocks, bonds and bills – as well as sub-classes, including: large-cap vs. small-cap stocks, value stocks vs. growth stocks, stocks by sector, government bonds vs. corporate bonds, credit spreads and shifts in the yield curve. IFI's time horizon is six and twelve months ahead. Clients receive the following four reports each month by e-mail (an interactive, web-based archive is also available):

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Methodologically, IFI's research emphasizes the incentives and disincentives faced by producers, savers and investors and how these effect investments – the essence of classical or “supply-side” economics, in contrast to the flawed themes and track records of Keynesian economics. IFI views markets as global, inter-connected, and often politicized, so it also provides a rational framework for understanding and predicting how policies (monetary, fiscal, regulatory) will influence investment performance. IFI has no vested interest in rising or falling markets or in any particular investment styles. It offers clients an independent, objective source of investment research, forecasts and advice, in contrast to the bias often exhibited in brokerage firm material and salesmanship. Since its founding in 2000 IFI has delivered an average, across the board forecasting success rate of 65% and has outperformed its peers (Wall Street strategists) 61% of the time.



Richard M. Salsman, Ph.D., CFA®

Richard Salsman is founder, president and chief market strategist. Prior to IFI he was senior economist at H.C. Wainwright Economics, Inc. (1993-1999) and from 1981 to 1992 a banker and capital markets specialist at the Bank of New York and Citibank. Mr. Salsman has authored numerous articles and is an expert in market history, economics, forecasting, and investment strategy. His work has appeared in *The Wall Street Journal*, *Investor's Business Daily*, *Barron's*, *Forbes*, *National Post* (Canada) and *The Economist*. In addition, he has authored three books—*Gold and Liberty* (1995), *Breaking the Banks: Central Banking Problems and Free Banking Solutions* (1990), *The Political Economy of Public Debt: Three Centuries of Theory and Evidence* (2017)—plus many chapters in edited books. Salsman speaks regularly at conferences, investment gatherings and universities. He earned his B.A. in Law and Economics from Bowdoin College (1981), his M.B.A. in Economics from the Stern School of Business at NYU (1988), and his Ph.D. from Duke University in Political Economy (2012). In 1993 he earned the designation of Chartered Financial Analyst (CFA) from the Association for Investment Management and Research.

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