Three key economic indicators to gauge stock market direction

If you are active or working in capital markets, there is a high probability that when you bump into a relative or a friend they would ask you the most clichéd question “markets kya lagta hai?” (meaning “what do you think about the market’s direction - up or down?”). There are multiple factors that can determine the market’s direction. From corporate earnings, economic data, important events (domestic as well as international), and geopolitical developments, to investor sentiment, many factors can influence the general trend of the market in the short term. But, economic factors have the biggest influence on the long-term direction of the stock market.

The economy moves in a cycle with phases of expansion and contraction commonly referred to as boom and bust cycles. The length of the boom and bust cycles vary from time to time. Economic indicators help you to develop a framework to determine which phase of the economic cycle are you currently in and where are you headed?

Economic indicators are nothing but statistics about various aspects of the economy’s health, which when analysed can give you some sense about the direction of the economy and its impact on the stock market. There are various economic indicators such as GDP, industrial production, interest rates, inflation, fiscal deficit, trade deficit and many more, which need to be interpreted correctly to forecast broad economic trends and their implications on the market.

However, there are three indicators that can be tracked more frequently and used to gauge the direction of the stock market, which are as follows:

1. Inflation – data released every month
2. Interest rates – data released daily
3. PMI (Purchasing Managers Index) – data released every month

Let us understand each of these in more detail.

Inflation – Inflation data shows the increase in the prices of essential goods and services. It is an important measure for the stock market, as it determines how much value of the investment is being depleted due to loss of purchasing power. For example, if the rate of return on an investment is 5% and the inflation is 3%, then the real rate of return is just 2%. In order to receive a higher real rate of return, the same has to be much higher than the prevailing rate of inflation. The actual impact of inflation on stocks comes from its influence on corporate earnings. Low inflation keeps corporates' costs down and increases profits while high inflation can reduce profits. High inflation can be managed if the company can pass on the higher input costs and control overall operational cost. However, a prolonged rise in inflation can overheat the economy, leading to lower spending and reduction in the value of the currency. In order to contain inflation, the central bank intervenes and increases interest rates in order to bring inflation within acceptable levels.

Interest rates – When the central bank keeps its lending rates low, banks pass on the benefit to companies and individuals by cutting their own lending rates. This leads to increased earnings and improved spending power. On the other hand, if the interest rates are increased by the central bank, lending rates by the banks to the companies and individuals rise proportionately, leading to lower profits and reduced spending power, which ultimately affects the stock market.

PMI – PMI is a measure of economic growth. It takes into account the production level, new orders, supplier deliveries, stock of purchases and employment level of all the companies. A PMI number above 50 indicates that the economy is on a firm footing and doing well. If this number goes below 42, it indicates a recessionary scenario and affects corporate earnings estimates, which ultimately lead to a fall in the stock market.

There are many more economic indicators which one needs to analyse before arriving at a precise judgment on the long-term direction of the stock market. If you like to know where to find these details and know what these economic indicators mean, and how to interpret them, then register for one of our free “Power Money Workshops” and join our investing education program “Stock Investor” to polish your investing skills.