LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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SURPRISE, SURPRISE, SURPRISE!

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KEY TAKEAWAYS

Several economic surprise indexes hit multi-year highs in November.

Expectations underestimated the bounceback from Hurricanes Harvey and Irma, giving the surprise indexes a boost.

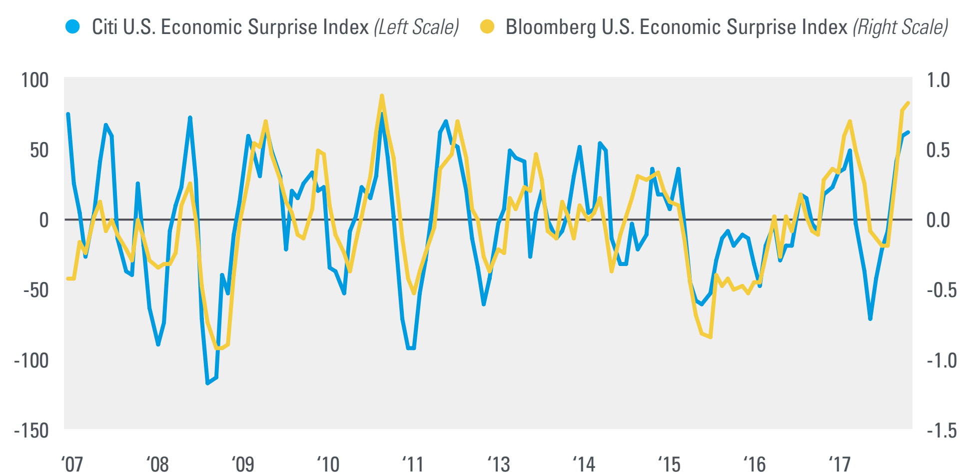
"Soft data" surprises remain stronger than "hard data," but hard data have been picking up.

Jim Nabors, who played the bumbling but lovable Gomer Pyle in *The Andy Griffith Show* and subsequent spinoff *Gomer Pyle, U.S.M.C.*, passed away on November 30. Inspired by a couple of Gomer Pyle's catch phrases, this week we look at some recent strength in economic surprise indexes that hit multi-year highs in November. These new highs might have led Gomer—if he were an economist instead of a filling station attendant and then Marine Corp private—to say, "Surprise, surprise, surprise!"

SHAZAM!

Economic surprises in November into early December may deserve a "Shazam!", Gomer's catchphrase for something dramatically unexpected that happens as if by magic. Two of the most well-known surprise indexes both hit multi-year highs in November, indicating actual data have outpaced expectations at a rate not seen in years. The Citi U.S. Economic Surprise Index rose to its highest level since January 2014 in November and has continued to climb, while Bloomberg's Surprise Index rose to its highest level since March 2011 [Figure 1]. The steady stream of net positive surprises was due to data breaking to the upside, as well as somewhat

1 ECONOMIC SURPRISES INDEXES HAVE HIT MULTI-YEAR HIGHS



Source: LPL Research, Bloomberg, Citigroup 12/08/17

Values above zero indicate economic reports that have, on average, exceeded expectations.

Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

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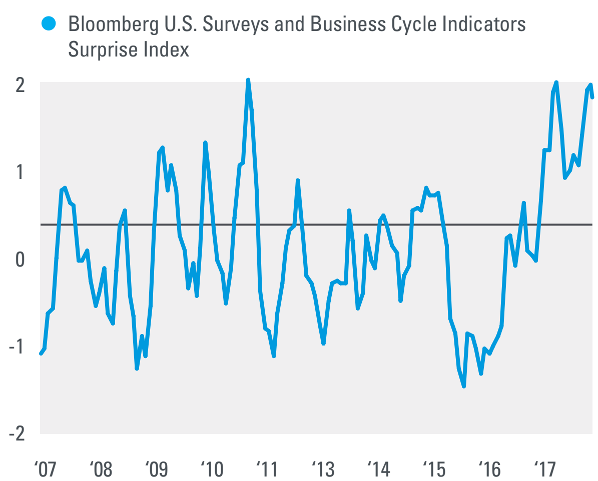
muted expectations due to increased uncertainty about the impact of Hurricanes Harvey and Irma.

The two surprise indexes have a lot of similarities. They both use similar scales, but express them a little differently—multiply Bloomberg's scale by 100 and you get something comparable to Citi's numbers. Both indexes reflect the average positive or negative surprise compared to the spread of forecasts. As a result, when there's a wide range of forecasts (reflecting greater uncertainty), you don't get as much credit for a miss compared to the same miss when forecasts have a narrower range. One key difference: The Bloomberg index's average is longer than Citi's, resulting in a number that's a little less responsive but also a little less subjected to noise.

Do the surprise indexes have any meaning for asset prices? Since current economic consensus typically points to a continuation of the current state of the economy, and therefore acts as a coincident or even a lagging indicator, economic surprises signal something has happened that has not been absorbed by expectations. Markets react to new information and the "newness" of the information is part of what the indexes are measuring. There will also be short stretches where misses are just randomly too high or too low; but when the average of surprises moves meaningfully higher or lower, it usually means something more is going on. Historically, an above-average level of economic surprises has been associated with greater odds of market strength and vice versa. But while this relationship has held true on average, it has not been particularly strong in the long term.

2 ECONOMIC SURPRISES HAVE BEEN STRONGER FOR SOFT DATA



Source: LPL Research, Bloomberg 12/08/17

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That's just "golly" for most of us, but for Gomer, who used it when struck with a sense of awe, it would get dragged out with a Mayberry drawl. While the strength of the surprise index is certainly a positive sign that expectations have been too low relative to overall economic activity, we should not be too easily overawed by the current stretch of surprises. First, these kinds of moving averages get measured relative to expectations, and where those expectations are matter too. For example, the Citi index reached a multi-year low back in June of this year that hadn't been seen since 2011. Equity markets, however, were unmoved by the stretch of negative surprises. Also, things certainly didn't feel like 2011, when a U.S. debt downgrade and concerns that the European Union might break under the weight of government debt led to the S&P 500 Index tumbling almost 20%. Back in 2011, expectations were already fairly low and the economy still failed to keep up with them. In the period leading up to June 2017, expectations were elevated and uncertainty was lower, giving smaller misses a larger impact but potentially less meaning.

Second, during the recent upswing, some of the surprise has been due to difficulty gauging the impact Hurricanes Harvey and Irma would have on the economic data, initially to the downside due to the disruptive impact of the storms, then to the upside as the impacted areas began to rebuild and recover and disrupted transportation networks came back online. It's also been noteworthy that much of the strength in the rebound has been in "soft data"—surveys and business cycle indicators—rather than "hard data," numbers that directly reflect economic activity [Figure 2].

Soft data include reports like consumer confidence data and the Institute for Supply Management's Purchasing Managers' Indexes. The most recent value for Bloomberg's Surveys and Business Cycle Indicators Surprise Index, at 1.82, is nearly double the most recent value of the overall surprise index, at 0.81. The hard data have been getting better, but the numbers have generally been more in line with expectations. Soft data can still be important: Many reports reflect underlying economic activity and even when they simply reflect mood or perception, optimism is a force that can help drive the economy. But ultimately, soft data need to be confirmed by hard data to be meaningful.

CONCLUSION

Recent multi-year highs in economic surprise indexes help support the overall picture of an economy growing faster than the 2.2% average we have seen for much of the current expansion. With gross domestic product (GDP) growth for the first three quarters of the year in the books, overall GDP growth for 2017 is tracking near 2.5%, and the upside surprises signal at least a similar run rate headed into early 2018.

As discussed in our *Outlook 2018: Return of the Business Cycle*, we expect the U.S. economy to continue to expand at about 2.5% in 2018, supported by improved business spending, better global growth, and business-friendly fiscal policy. We have had strong stretches of economic growth before within the current expansion. In the second and third quarters of 2014, when oil prices were just starting to decline, the economy had grown at an annualized rate of 4.6% and 5.2%, respectively, with the lesson that when it comes to the economy, expect the unexpected. An estimate of 2.5% growth in 2018 is a reasonable baseline to start with, but keep an eye on the surprise indexes to see if we're getting potential upside (or downside) surprises. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

DEFINITIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg Economic Surprise Index shows the degree to which economic analysts under or over-estimate the trends in the business cycle. The surprise element is defined as the percentage difference between analysts forecasts and the published value of a large number of economic data releases of regularly reported weekly and monthly economic data releases (smoothed over a six-month period with more weight given to recent releases). The forecasts are surveyed and displayed on the Bloomberg economic release calendar.

The Bloomberg U.S. Economic Surveys & Business Cycle Indicators Surprise Index only looks at surprises from surveys and business cycle indicators, such as consumer sentiment and purchasing managers' indexes. The surprise element is defined as the percentage difference between analysts forecasts and the published value of a large number of economic data releases of regularly reported weekly and monthly economic data releases (smoothed over a six-month period with more weight given to recent releases). The forecasts are surveyed and displayed on the Bloomberg economic release calendar.

The Citigroup U.S. Economic Surprise Index is an objective and quantitative measure of economic news. It is defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The index is calculated daily in a rolling three-month window.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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