23BAE707 – Security Analysis & Portfolio Management

Unit 3 – Fundamental Analysis

RECAP

GUESS
WHAT ?

Economic
Analysis

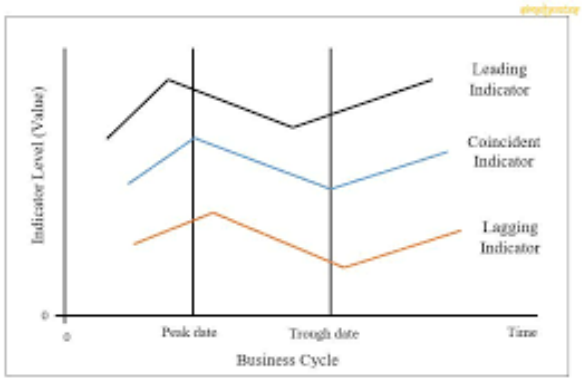
Forecasting techniques
www.educba.com

Economic Analysis: Forecasting Techniques

1. Barometric or Indicator Approach
2. Anticipatory Surveys
3. Diffusion Index
4. Econometric model building
5. Opportunistic model building

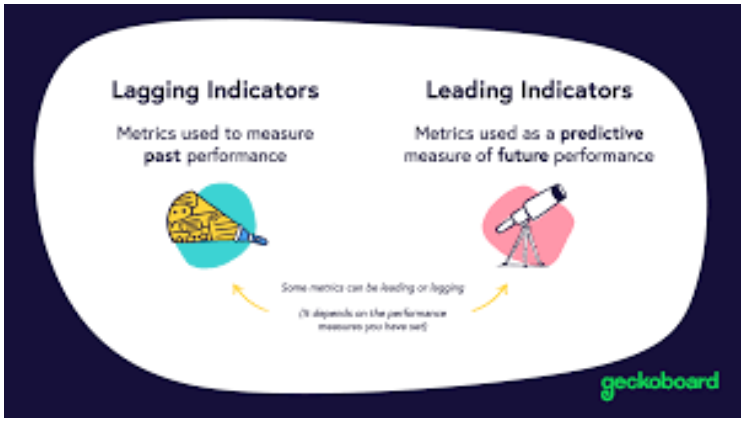
1. Barometric or Indicator Approach

- These indicators are time series data of certain economic variables.
- Classified into
  - ✓ Leading Indicators
  - ✓ Coincidental Indicators
  - ✓ Lagging Indicators



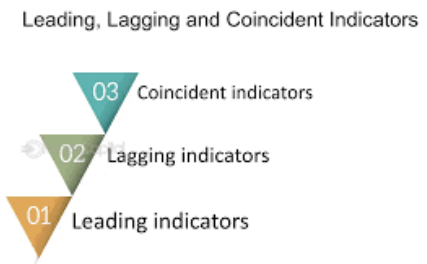
Leading Indicators

- Tells us what to expect in the future
- Some of the leading indexes are
  - Productivity
  - Consumer Spending
  - New Order of Durable
  - Residential Construction – New Building Permits



Coincidental Indicators

- Tells us what is happening in the economy, but do not forecast the future
- Some of the Coincidental indicators are
  - Gross National Product
  - Industrial Production
  - sales recorded by the manufacturing, trading and the retail sectors
  - Interest rates
  - Corporate Profits
  - GDP – aggregate amount of goods and services produced in the national economy.
  - Gap b/w the budgeted GDP and actual GDP attained indicates the present situation.



Lagging Indicators

- Lagging indicators turn after the movement in the coincidental indicators.
- Some of the Lagging indicators are
  - Prime rate
  - Commercial paper rates
  - Inventory sales ratio
  - Retail Sales
  - Average duration of unemployment
  - Consumer Price Index

2.Anticipatory Surveys

- These are the surveys of intentions of people in government , business, trade and industry regarding their construction activities, plant and machinery expenditures, level of inventory, etc.
- Such surveys may also include the future plans of consumers with regard to their spending on durables and non-durables.
- Based on the results of these surveys, the analyst can form his own forecast of the future state of the economy.
- External shocks, such as strikes, political turmoil or government action can cause changes in intentions

3.Diffusion Index

- It is a composite or consensus index.
- The diffusion index consists of leading, coincidental and lagging indicators.
- Has been constructed by National Bureau of Economic Research in USA.
- Complex in nature to calculate and the irregular movements that occur in individual indicators cannot be completely eliminated.
- For example, if there are say 9 leading indicators for forecasting the construction activity and if by plotting we find that say, 6 indices show a rise, then we can calculate that diffusion index is (6/9*100) = 66.7 percent. When the index xceeds 50 percent, we can predict a rise in forecast variable

4. Econometric Model Building

- Makes use of Econometrics, a discipline that applies mathematical and statistical techniques to economic theory.
- Precise relationships between dependent and independent variables are specified in a formal mathematical manner in the form of equations
- The equations are then solved to yield a forecast.
- The analyst not only forecasts the direction but also the magnitude.

Contd.,

- The forecast made through econometric method are much more reliable than those made through any other method.
- For applying econometric technique, the user is to specify in a formal mathematical manner the precise relation between the dependent and independent variable.
- In using econometrics, the forecaster must quantify precisely the relationships and assumptions he is making. This not only gives him direction but also the magnitudes.

5.Opportunistic Model Building

- Also called as GNP model building or Sectoral analysis
- Analyst initially estimates demand in the economy – Based on it he estimates total income or GNP for the forecast period by considering prevailing tax rates, interest rate, rate of inflation, etc
- Also forecasts GNP figure considering government purchase of goods and services, gross private domestic investment, net exports, etc.

Knowledge Check

- The diffusion index consists of _____, _____ and _____indicators.

Thanks...