What is a Leading Indicator?

Definitions, Examples, & Use Cases

Key Definitions

A **leading indicator** is a measurable economic factor or set of data that tends to change before the overall economy. The underlying premise behind leading indicators is that certain economic variables tend to change in advance of broader shifts in the economy. When analyzed collectively, these changes provide a comprehensive picture of the future economic landscape and may help forecast economic activity.

The remaining two types of economic indicators are coincident and lagging indicators. **Coincident indicators** move concurrently with the overall economy, providing real-time insight into the current state of economic activity. In contrast, **lagging indicators** change after the economy has already experienced a shift.

Examples of Leading Indicators

- **Building Permits** – A building permit is a formal authorization issued by a local government that allows a builder to start construction. This permit is required to ensure the proposed project complies with local building codes, zoning regulations, and other applicable laws. An increase in building permits reflects an increase in the level of planned construction activity, while a decrease foreshadows a potential decline in construction activity.
- **Weekly Jobless Claims** – Initial jobless claims provide a real-time snapshot of the number of people who have recently lost their jobs and are seeking unemployment benefits. A decline in initial claims often precedes improvements in employment figures and overall economic growth. In contrast, rising claims can signal softening labor demand and may foreshadow a rise in unemployment and slowdown in economic activity.
- **Bank Lending Standards** – Lending standards are a leading indicator for overall economic activity because they reflect the ease with which businesses and consumers can access credit. Tighter lending standards make financing more expensive and difficult to obtain, which can restrict growth by limiting the funds available for investment, expansion, and consumption. In contrast, looser lending standards can stimulate economic activity by facilitating borrowing and encouraging spending, ultimately contributing to overall economic expansion.
- **Purchasing Managers' Index (PMI)** – The PMI is a survey that reflects the sentiment of purchasing managers in the manufacturing sector and provides insight into production levels, new orders, and employment trends. A rising PMI indicates the manufacturing sector is expanding, signaling future economic growth. In contrast, a falling PMI indicates the manufacturing sector is contracting, signaling slower economic growth.

Use Cases

Leading indicators hold particular significance for investors and traders because they offer valuable insight into the direction of economic trends and enable more informed decision-making. By identifying emerging patterns in advance of broader shifts in the economy, investors can anticipate potential shifts and construct portfolios to either capitalize on opportunities or minimize risk exposure.

For instance, if leading indicators forecast an economic upturn, traders may choose to invest in cyclical stocks that are more likely to benefit from the expansion. Conversely, if the indicators predict a downturn, investors may seek refuge in defensive assets that are less sensitive to economic fluctuations. This ability to anticipate and act upon changing economic conditions can give investors and traders a competitive advantage, improve risk-adjusted returns, and help navigate market uncertainties with greater confidence.