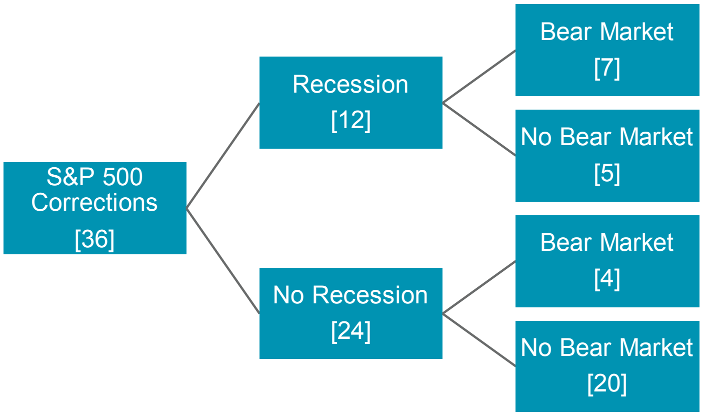
Cycle Watch

April 30, 2018

How does it perform? Nobel Laureate Paul Samuelson joked that the stock market has predicted nine of the last five recessions, meaning that this signal tends to flash red when it shouldn't, at least as a predictor of a downturn. The stock market is known for false positives because stock market corrections—a decline in prices of 10% from the most recent peak—are common. For example, this cycle has seen one of them so far already using S&P 500 daily closing prices. (There were two additional instances of near 10% declines.) A bear market—a sustained drop in stock prices, of 20% or more—is actually a better predictor of a downturn than just a downward movement in stock prices alone, but it's still not foolproof. Since WWII, seven of the 12 recessions have coincided with a bear market and it is usually not until well into a recession that it is known whether it is a bear market or not. However, all 12 recessions coincided with falling stock prices, and typically those price declines have been sustained in advance of the downturn. Year-over-year declines in the stock prices has typically led recessions by one to two quarters.

What is it telling us now? Recent stock price volatility is probably telling us a lot more about investors' reactions to earnings reports and their appetite for unpredictable policy than anything about the business cycle. Investors are also getting the first glimpse into how the tax cuts are impacting this year's operations and profits. So far in 2018, the S&P 500 has seen two near-corrections: on February 8 and on April 2. Thus, the VIX—a measure of stock price volatility inferred from options prices on the S&P 500—has hit some high points this year (particularly in February, when it exceeded 35). But it has since fallen back below its historical average. At Friday's close, the VIX was 15.4, below the average since 1990 of 19.3. This index tends to spike in tandem with large movements in stock prices, making its predictive capabilities as lackluster as the stock market's. And while reported price-to-earnings ratios are high by historical standards—the S&P 500 reported P/E ratio for 17Q4, the latest actual data point available, was 24.3, well above the average since 1945 of 17.7—they are expected to be below that average by the end of 2018. Market estimates of future price-to-earnings ratios imply that corporate earnings will not disappoint.

Leading Indicators: Stock Market
Stock market corrections since WWII



Source: Goldman Sachs

Witnessing the Longest Cycle Ever

Current estimates of the probability of a recession within the next 12 months are between 0-25%. A majority of forecasters have predictions between 10-15%. Tailwinds from fiscal stimulus and the revival of emerging markets as a global growth engine bode well for the economy in the near-term. Popular leading indicators are not flashing red. It's more like light orange. The yield curve has the potential to compress further or sit comfortably where it is for some time. Looking at other leading indicators—including confidence, the labor market and manufacturing orders—there is little reason to think that the end of the expansion is in sight.

Footenote: *The NBER is the arbiter of U.S. business cycles and uses a broad array of indicators to determine when the economy peaks and when it reaches a trough. Although it is commonly believed that two consecutive quarters of negative real GDP growth signal a recession, the NBER rejects that claim. For example, the Great Recession began in December 2007 and lasted through June 2009. During that period, real GDP declined in the first, third and fourth quarters of 2008 and in the first quarter of 2009. However real GDI declined for all six quarters. NBER states on its website that puts "considerable" weight on real GDP, but also uses data on real income, total employment, industrial production, and real wholesale-retail sales in its determination of business cycle dates. It is usually not until well after a peak or trough occurs that NBER announces its determination.*