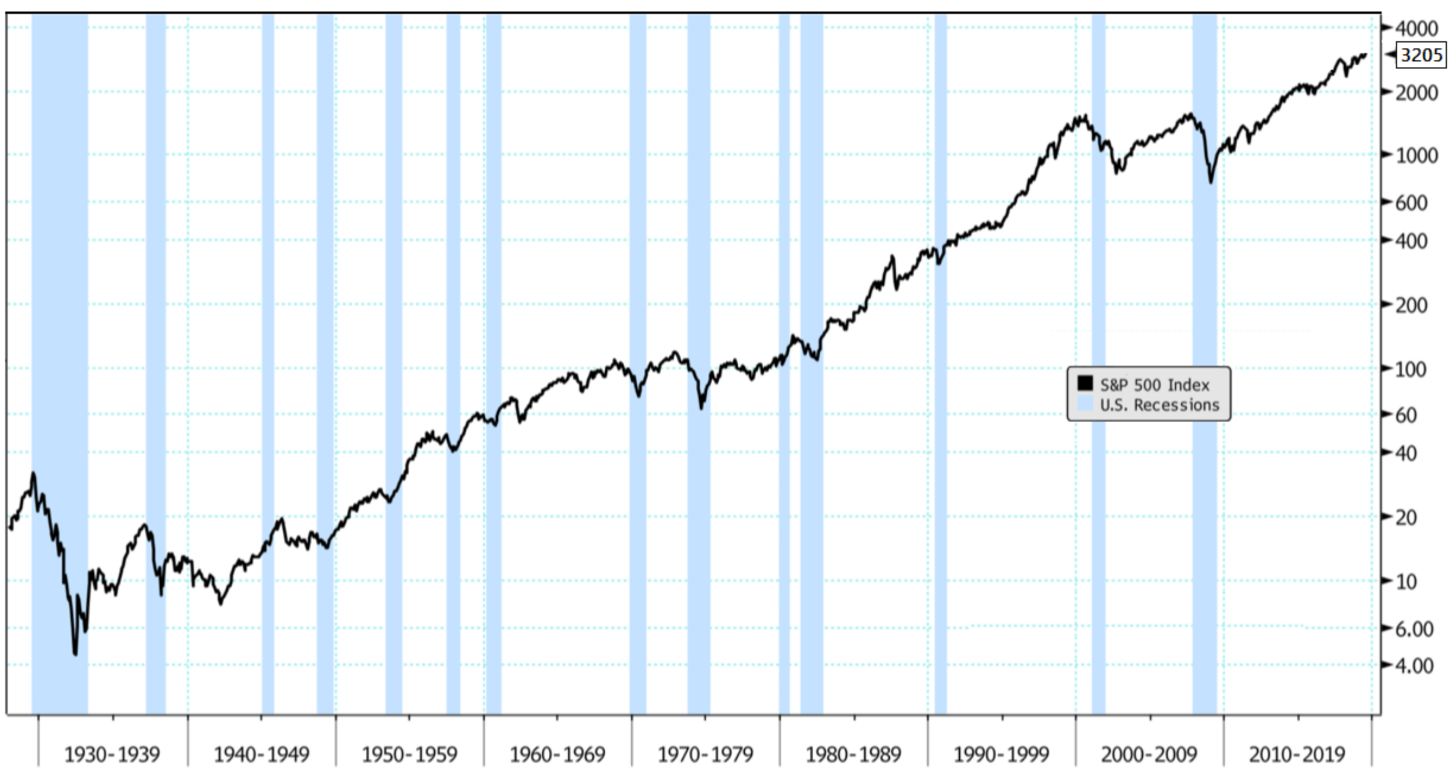
Chart of the Month

December 2019

Why is the Business Cycle Important?

S&P 500 and U.S. Recessions



Source: © Merk Investments, Bloomberg

The health of the economy and the stock market are, not surprisingly, interrelated. Stocks perform well during expansions and poorly during recessions. Since 1927, the S&P 500 has averaged a monthly return of +0.9% during expansions and -0.7% during recessions.

While the returns are somewhat offsetting on a monthly basis, the good news is that the economy has been expanding more than 80% of the time and receding less than 20% during this period. The compound annual growth rate has been approximately 6% without dividends and 10% with dividends over the past century (inclusive of expansions and recessions). Adjusted for inflation, the CAGR has been roughly 3% and 7%, respectively.

Due to the high correlation between the direction of the economy and stocks, it is important to monitor the incoming economic data on a regular basis. However, investing is not as simple as being in the market when the economy is growing and being out of the market when the economy is contracting because, as you can see in the graph above, the S&P 500 tends to peak prior to recessions and trough in the midst of recessions. It is further complicated by the fact that the beginning and ending of recessions are generally not made official until well after their start and stop dates.

With the foregoing in mind, two of our favorite predictive measures are the U.S. Leading Economic Indicators Index (LEI) and the shape of the yield curve, both of which we have covered in our Charts of the Month in 2017, 2018, and 2019. As shown below, the LEI is near its all-time high and the year-over-year rate of change remains positive, pointing to the likelihood of continued growth over the foreseeable future.

While the 10-year minus the 3-month yield curve was inverted for most of the summer, it has steepened since October, a sign that the bond market is less concerned about an impending recession than it was several months ago. The 10-year minus the 3-*year* yield curve (bottom graph), which has gone negative prior to every recession during the past 50 years, has yet to invert, also suggesting an economic downturn in the near term is unlikely.

In addition, the economy added 266,000 jobs in November and the unemployment rate ticked down to 3.5%, the lowest level in the past half century. While the labor force participation rate is hovering at a multi-year high, there is still some slack in the labor market, indicating that employment gains can continue without undue wage pressures.

Although consumer confidence has been trending sideways of late, the two major indexes are just below their highs for this cycle. Notably, these gauges have always been in decline prior to the onset of the last half-dozen recessions.

As we highlighted in our Chart of the Month in October, the housing sector is strong with building permits and starts recently hitting 12-year highs. Bank lending standards are supportive of economic activity and high-yield spreads in the corporate bond market are not pointing to any warning signs.

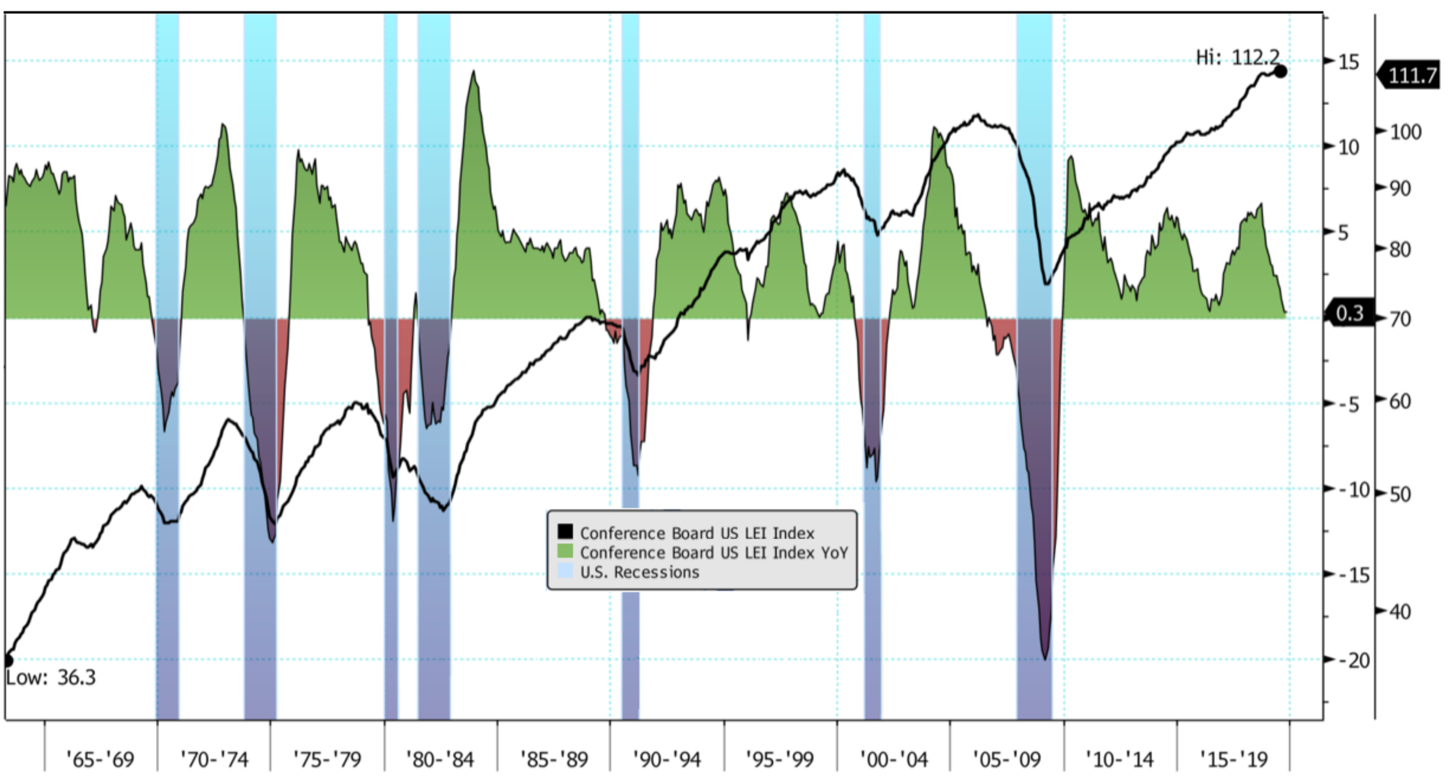
Furthermore, the Commerce Department reported this morning that the Gross Domestic Product (GDP) increased at a 2.1% annualized rate in the third quarter. GDP has advanced 2.4% for the first nine months of the year, a moderate and (hopefully) sustainable pace.

The fly in the ointment is the manufacturing sector. Similar to the 2014-15 period, it is currently in contraction after rebounding in 2016-18. Any further deterioration could serve to offset the strength in the consumer-dominated economy, which is roughly 70% of the total. The recent passage of the USMCA and "phase one" of the U.S.-China trade agreement could serve to aid the industrial and agricultural industries going forward.

Conclusion: While the uncertainty surrounding the election clouds the prospects beyond 2020, our outlook for the business cycle remains positive over the next 6-to-12 months.

U.S. Leading Economic Indicators Index

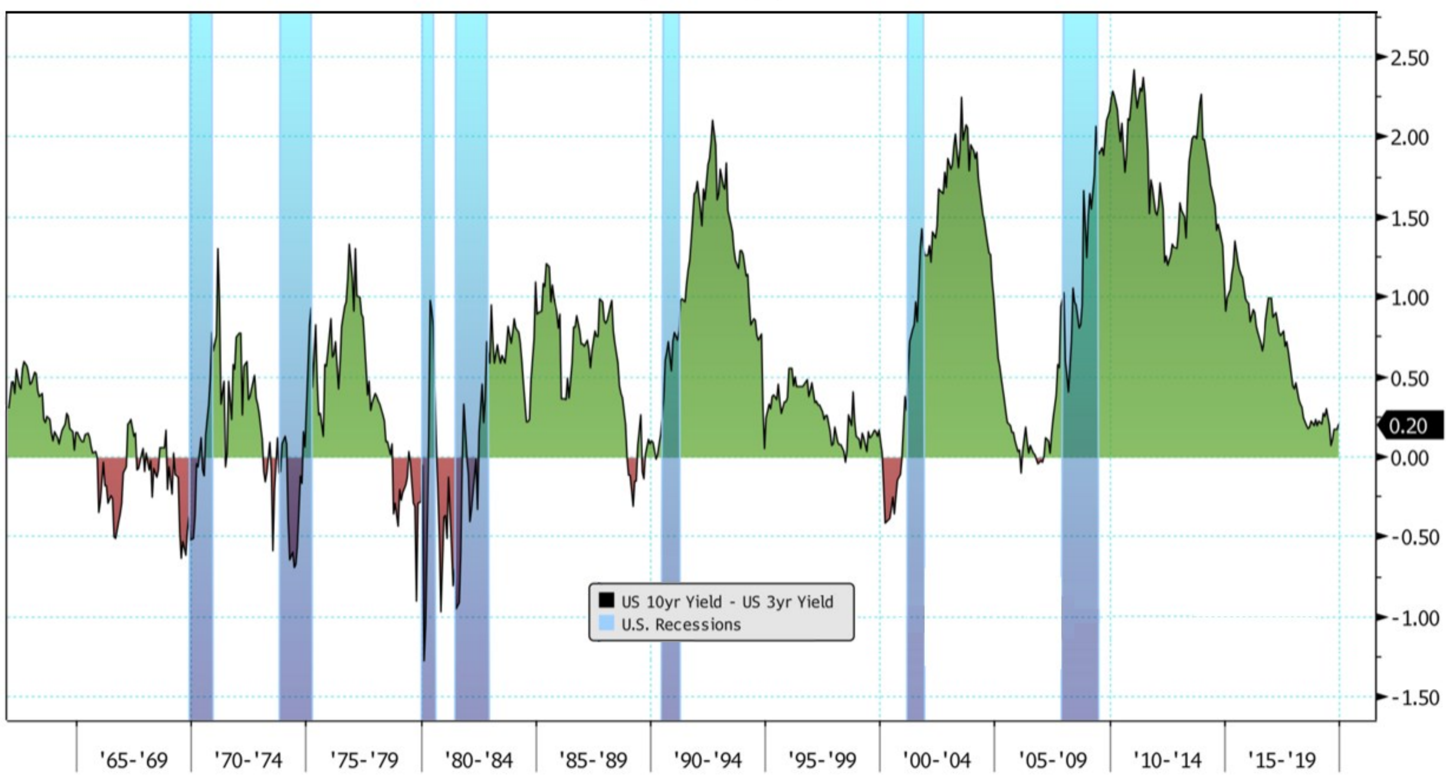
LEI Index and YoY Rate of Change



Source: © Merk Investments, Bloomberg

U.S. Yield Curve Steepness

(10yr yield – 3yr yield)



Source: © Merk Investments, Bloomberg

Lederer & Associates
Investment Counsel
5305 East 2nd Street, Suite 201, Long Beach, California 90803
Tel: (562) 434-5305 ▲ Fax: (562) 434-5306
www.lederer-associates.com