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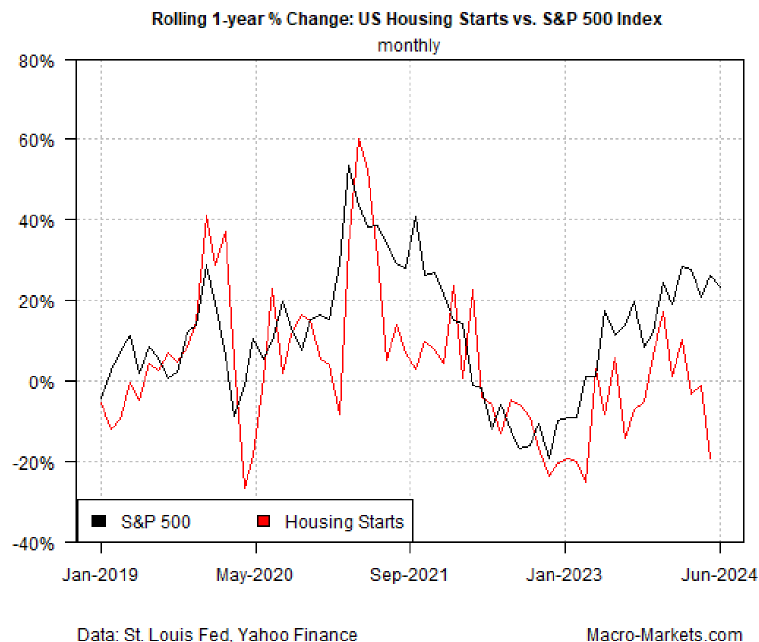
Does housing still drive the economy? If so, economic headwinds are strengthening. So, why is the S&P 500 Index rallying? AI-based optimism appears to be the explanation.

Key Points:

- *The US housing market's influence on the S&P 500 Index appears to be fading*
- *Optimism about artificial intelligence (AI) is driving the biggest names in the S&P 500*
- *AI-driven optimism has had lesser effects on small-capitalization stocks*

A widely-read research paper from 2007 advised that "Housing IS the Business Cycle." Ed Leamer's choice for a title was well-founded, given the historical record at that point. "Of the components of GDP, residential investment offers by far the best early warning sign of an oncoming recession," wrote the UCLA economist. "Since World War II we have had eight recessions preceded by substantial problems in housing and consumer durables."



Fast forward to 2024 and the housing component for estimating business-cycle risk is looking a bit shaky. Or so it appears through the lens of the US stock market.

Consider the relatively tight correlation between US housing starts and the S&P 500 Index, based on rolling one-year changes (chart at right). In recent years, the ebb and flow of residential housing construction closely tracked changes in residential construction – and for good reason. Quite a lot of economic activity is linked with new housing. From the purchases of furniture and landscaping services to the formation of families and all that entails for consumer spending, suffice to say that the aggregate effect of new home purchases tends to stimulate growth. Not surprisingly, softer housing activity is a headwind for the economy, and the stock market tends to pick up on such changes.

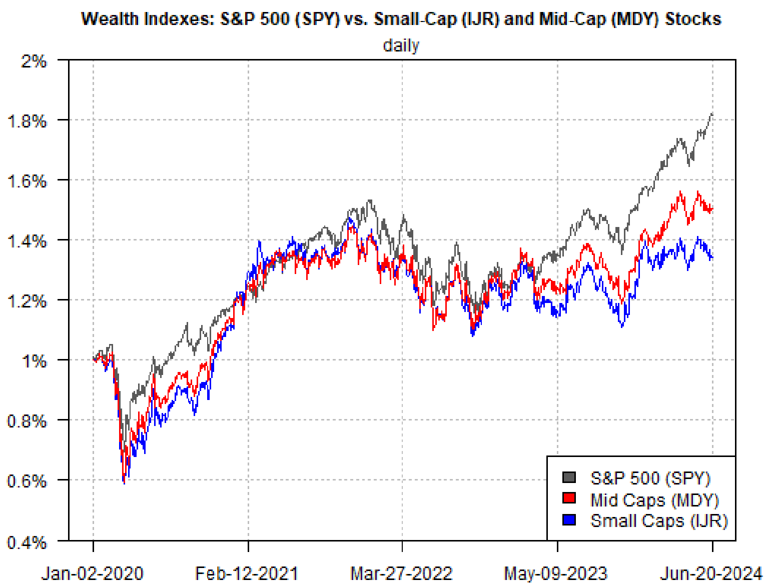
The question is whether the linkage has changed? Notably, the S&P 500 in recent months has continued to rally despite the sharp slide in housing starts. In May, new residential construction activity fell to the lowest level in four years. If

that's a warning sign for the economy, you wouldn't know it by watching the S&P, which is trading just slightly below an all-time high (as of June 21).

Does the market see a rosier economic outlook than implied by the real estate sector? Perhaps, but another explanation offers an alternative view. Note that the S&P 500, a market capitalization-weighted index, is dominated by the biggest holdings. The top-10 holdings represent roughly 35% of the index; of those ten, seven are technology stocks, such as Microsoft and Nvidia, the two biggest names.

The optimism surrounding artificial intelligence (AI) has powered many tech stocks this year, which in turn has been a boon for the tech-heavy S&P. It's debatable if the AI premium for some shares is warranted, but it's clear that this narrative is relatively immune to old-school business-cycle factors, such as housing. How long this AI-fueled factor lasts is anyone's guess, but it's certainly cast an increasingly bullish influence on the S&P this year.

For some context, note the growing divergence between large-cap shares and their small- and mid-cap brethren. Using a set of ETFs to proxy for the S&P 500 (SPY), small stocks (IJR) and mid-caps (MDY) reveals a growing performance chasm in recent weeks in favor of the big caps (see chart at right).



The implication: the S&P 500, which is widely used to define and track US shares, has become somewhat immune to conventional business-cycle factors – immunity that's far less pronounced in smaller firms. Housing may still be the elephant in the room for the business cycle, but AI and related factors appear to be increasingly driving the S&P's fortunes down a different path – fortunes that don't necessarily extend to smaller-cap firms, at least in comparison with the biggest S&P firms.

If the AI factor continues to propel the S&P 500, an obvious question is whether this index is becoming less sensitive to the conventional business-cycle influences that have influenced this equities index in the past? Recent history suggests that evolution is unfolding. The caveat is that the AI boom is still in its early stages and so it's premature to conclude that business-cycle factors no longer cast a long shadow over the broad stock market, even if recent history suggests otherwise.

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