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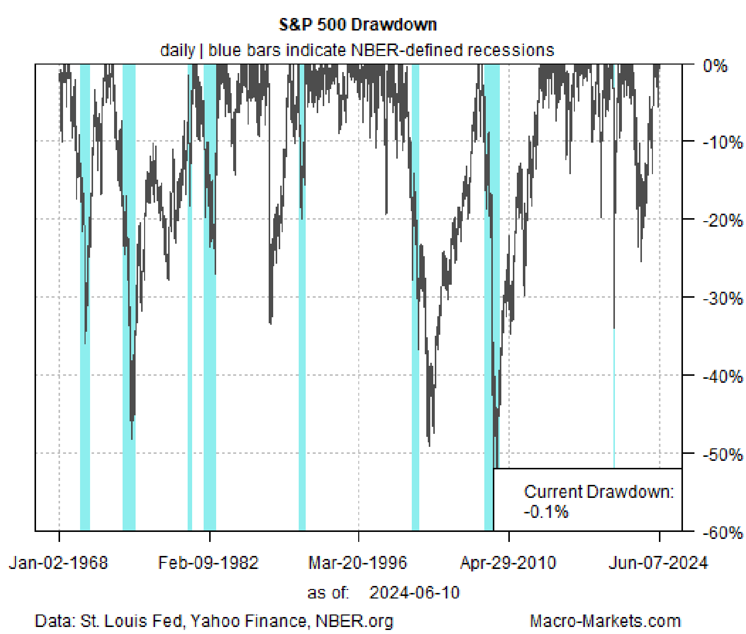
The Stock Market's Reliability As A Recession Indicator Is Mixed At Best

Key Points:

- *US equities tend to fall during economic recessions, but the market also has a history of correcting even when the economy is expanding*
- *The stock market is a useful tool for monitoring recession risk, but not as a stand-alone indicator*
- *Using the stock market as part of a multi-indicator model provides a more reliable measure of real-time recession risk*

Professor Paul Samuelson famously quipped that "the stock market has predicted nine out of the last five recessions." His reasoning, which is spot-on: market corrections can occur for various beyond rising economic recession risk.

Perhaps the starkest example is the October 19, 1987 stock market crash. In a single trading session, equities fell more than 20%, based on the S&P 500 Index. This unusually extreme, sudden decline initially convinced many analysts that an economic collapse would soon follow. In fact, the US continued growing for several more years before the next recession started in mid-1990. Analysis of the event later revealed that a key catalyst for the market's crash was program trading run amuck.



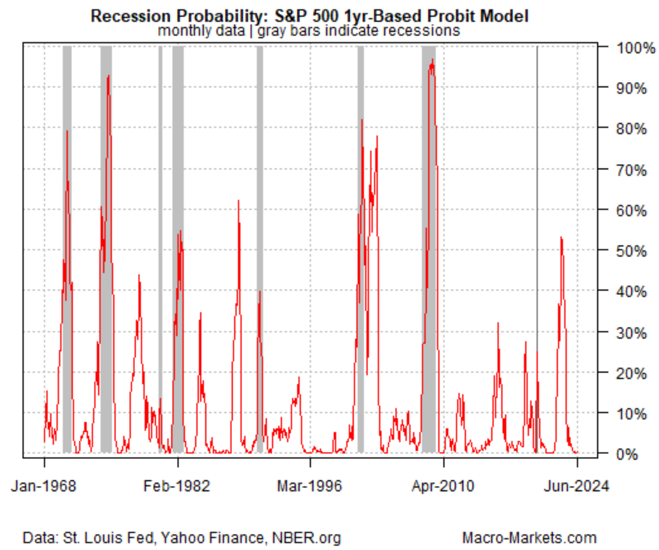
There are other instances in history of sharp market declines that didn't signal an economic recession – a history that serves as a reminder that using the stock market in a vacuum for estimating recession risk may be prone to an uncomfortably high degree of error.

To be fair, ignoring corrections for macro analysis is also short-sighted. As the chart at right shows, steep S&P 500 drawdowns[1] can occur with economic contractions, as defined by the National Bureau of Economic Research.

[1] Drawdown is a measure of the market's decline relative to the previous peak.

Although the market is a useful sentiment indicator for monitoring recession risk, it's best to use it in context with other metrics with the goal of building a statistically robust model.

For clearer evidence of the stock market's flaws for estimating recession risk, consider the second chart at right. Filtering the rolling 1-year changes of the S&P 500 through a probit model to generate implied recession-risk probability estimates shows that the market sometimes issues warnings that are unrelated to formal economic contractions.



The latest spike (to just above 50% in 2022) was assumed by some analysts in real time to be an early warning of recession. But reviewing the stock market in context with other indicators raised doubts about how vulnerable the economy was at the time to contraction.

The key lesson here is not that the stock market is useless for building models to nowcast recession risk. Au contraire – it's a valuable, perhaps more so than any one indicator. But a "trust but verify" approach is advisable. Using the equities market alone, and assuming it's flawless for anticipating the next recession, is assuming too much.

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