



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

Key Points:

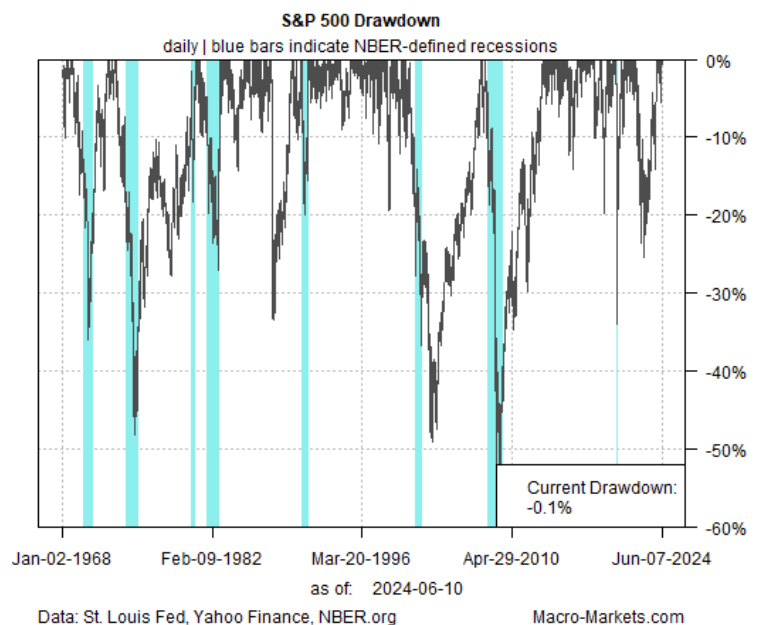
- *US equities tend to fall during economic recessions, but the market also has a history of correcting even when the economy is expanding*
- *The stock market is a useful tool for monitoring recession risk, but not as a stand-alone indicator*
- *Using the stock market as part of a multi-indicator model 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 drawdowns¹ can occur with economic contractions, as defined by the National Bureau of Economic Research.



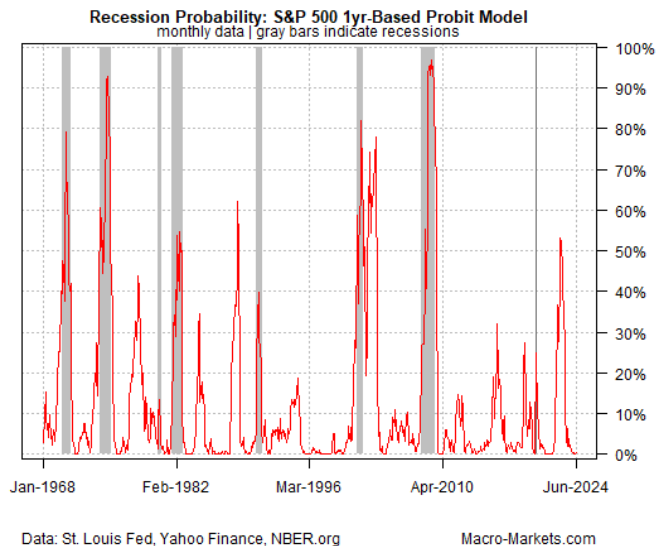
¹ Drawdown is a measure of the market's decline relative to the previous peak.



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.

This Report is provided for informational and educational purposes only and is not intended to be, and should not be construed as, financial or investment advice. The views and opinions expressed in this commentary are solely those of the authors and do not necessarily reflect the official policy or position of The Milwaukee Company.

Investors are urged to consult with their own financial advisors before making any investment decisions. The information contained in this commentary has been compiled from sources believed to be reliable, but no representation or warranty, express or implied, is made as to its accuracy, completeness, or correctness. Market data and trends are subject to rapid change and may become unreliable for various reasons, including changes in market conditions or economic circumstances.

Past performance is not indicative of future results. All investments involve risks, including the possible loss of principal. No representation or warranty is made that any return or performance indicated will be achieved.

Nothing in this commentary constitutes legal, accounting, or tax advice or individually tailored investment advice. This material is prepared for general circulation and may have been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The investments or services mentioned may not be suitable for all investors, and it is recommended that you consult an independent investment advisor if you have any doubts about the suitability of such investments or services for your needs.

This commentary may contain forward-looking statements, which are based on assumptions and subject to risks and uncertainties. Actual outcomes may differ materially from those expressed or implied in any forward-looking statements due to various factors.

To the fullest extent permitted by law, neither The Milwaukee Company nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this communication or the information contained herein. By accessing this commentary, you acknowledge and agree to the terms of this disclaimer.