Weekly Market Commentary

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Crystal Ball?

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Highlights

We believe the LEI is one of the better indicators to foreshadow recession.

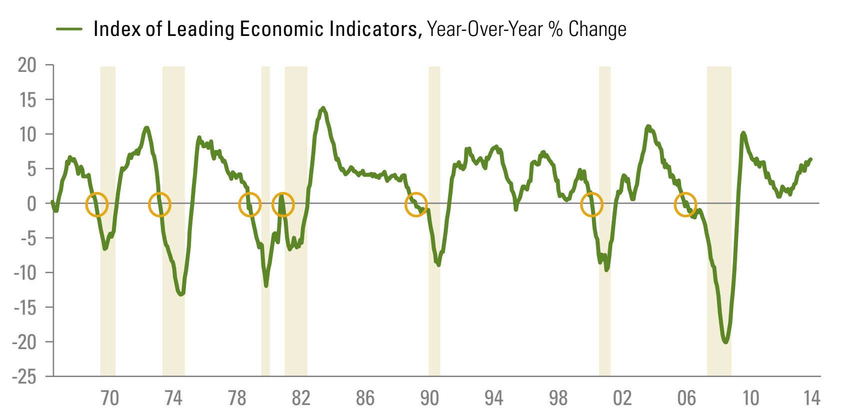
The latest information from the LEI suggests a positive backdrop for stocks and low risk of recession.

Since the dawn of financial markets, investors have been searching for signals of impending declines. Many economic indicators correlate highly with the stock market, which means they are coincident and not leading, and they tend to move at the same time as stocks. Some are lagging, meaning they move after stocks, which of course is not very predictive. An important goal for all investors is to find leading indicators in an attempt to anticipate big down moves.

One leading indicator that we have found with reliable predictive power is the Conference Board Index of Leading Economic Indicators (LEI). It is always difficult to predict small stock market pullbacks, such as the two 4–6% drops that the S&P 500 Index has experienced in 2014. Such pullbacks can be driven by temporary fears and can contrast with the fundamental underpinnings of the market. Larger, longer-lasting pullbacks are usually driven by deteriorating economic or fundamental data that can be foreshadowed by the LEI. The LEI data for July are due out on Thursday, August 21, 2014. (Note that the stock market is one of the 10 components of the LEI, though that does not detract from its usefulness as a predictor. Stock market movements and the nine other components of the index have proven to be a powerful combination.)

The LEI is one of the Five Forecasters featured in our *Mid-Year Outlook 2014: Investor's Almanac Field Notes* that have consistently signaled increasing fragility of the economy, a transition to the late stage of the economic cycle, and increased likelihood of an oncoming recession and ensuing market downturn.

1 LEI Provides Early Warning of Recession



Source: LPL Financial Research, FactSet 08/15/14

Shaded areas indicate recession.

Predictive Power of the LEI

The LEI is comprised of 10 primarily fundamental economic indicators and is designed to predict the future path of the economy, with a lead time of between six and 12 months. When the year-over-year rate of change in the LEI turns negative and begins to fall, a recession has historically followed within the next 14 months [Figure 1].

The year-over-year increase in the LEI in June 2014 was 6.3%. Since 1960, the year-over-year increase in the LEI has been at least 6.3% in 178 of 654 months. Not surprisingly, the U.S. economy was not in recession in any of those 178 months. Thus, it is highly unlikely that the economy is in a recession today. (The 4.0% real gross domestic product [GDP] reading reported for the second quarter of 2014 adds to the market's and our conviction in that regard.) In the 12 months following an increase in the LEI of 6.3% or more, the economy was in recession in just 6 of the 187 months, or 3% of the time.

Therefore, the statistical history of the LEI indicates the risk of recession in the next 12 months is small at about 3%, but not zero. This information from the LEI about the economy, and low risk of recession, suggests a positive backdrop for stocks.

Historical stock market performance shows the benefit of investing in an environment in which the year-over-year change of the LEI is positive [Figure 2]. Returns during the following six months when the LEI is up year over year are 11% annualized and stocks are up 71% of the time. When the LEI is down versus the prior year, stocks are up only 6% annualized, on average, during the following six months. The trend is also relevant. The S&P 500's returns are similar when the LEI is on an uptrend over the prior three months. But when the LEI is on a downtrend returns are on average a more meager 4% annualized.

2 LEI Above Zero Bodes Well for Stocks

LEI Level and Change	S&P 500 Annualized Return	Batting Average
>=0	11%	72%
<0	6%	57%
>=0 AND Rising	11%	71%
<0 AND Falling	4%	52%

Source: LPL Financial Research, Bloomberg data, Conference Board 08/18/14

The S&P 500 is an unmanaged index, which cannot be invested into directly.

Past performance is no guarantee of future results.

No Recession Usually Positive for Stocks

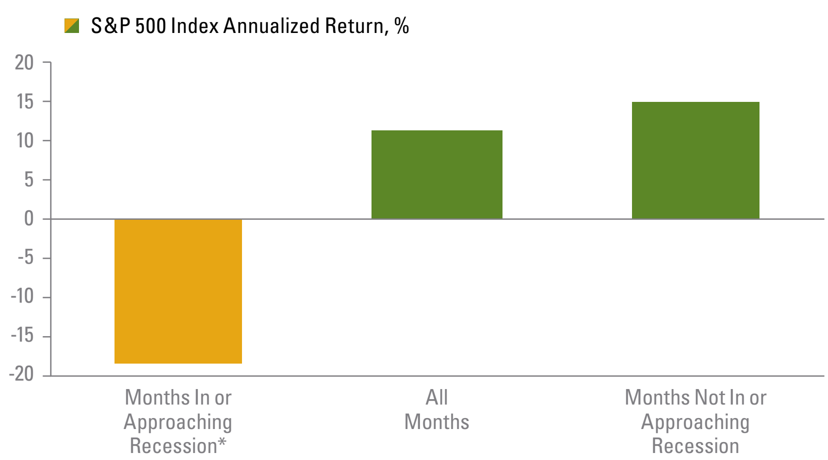
Common sense would lead all of us to believe investing outside of recessions would be more profitable than doing so during recessions. The data does indeed bear this out. During the six recessions since 1970

(1973–75, 1980, 1981–82, 1990–91, 2001, 2008–09), the S&P 500 on average generates a zero return. When the economy is not in recession, the S&P 500 produces, on average, a positive return of 13%. Stocks also go up more frequently outside of recession (65%) than during one (48%). Stocks tend to decline ahead of officially declared recessions as the market begins to anticipate the economic contraction, which helps explain why returns are not even worse during these periods.

But predicting recessions ahead of time is extremely difficult. Even knowing when a recession has already begun a month or two after it has started is difficult to assess, making this investment strategy challenging. The National Bureau of Economic Statistics is the official arbiter of U.S. recessions and waits quite a while before officially dating the start or end of a recession. As a result, this exercise is somewhat theoretical. Still, we believe attempting to gauge the start of recessions, and their end, can be a productive pursuit for those trying to add value through tactical asset allocation. This highlights the usefulness of the LEI.

Suppose you did have a crystal ball that could accurately predict the starting and ending dates of recessions. How much better off could you be as an investor? Well, the answer is quite a bit. The numbers get even better if you could predict the start of recession six months in advance and knew when the end was just three months away. If you bought the S&P 500 three months prior to the end of a recession, and sold stocks when the subsequent recession was six months away, you would have one heck of an investment strategy. As shown in Figure 3, this strategy produces an average annualized return of 15% when invested, while avoiding an average annualized loss of 18% (data going back to 1970 and including the past six

3 Better Foresight Into Timing of Start and End of Recessions Is Extremely Valuable



Source: LPL Financial Research, S&P 500, Bloomberg, NBER 08/15/14

*Approaching recession defined as six months before, and end of recession excludes last three months.

Based on monthly data, annualized, as of 08/15/14.

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recessions) when not invested. Stocks rise during two-thirds of these non-recession months, and fall the rest of the months.

Is the LEI a Crystal Ball?

So, is the LEI a crystal ball for investors? Unfortunately, no. The LEI cannot tell us the exact start and end dates of a recession. However, we believe the LEI is one of the better indicators to foreshadow recession, which is why we chose to include it in our Five Forecasters in our *Mid-Year Outlook 2014: Investor's Almanac Field Notes*. But there is no one crystal ball that we should have high confidence in as a predictor of a stock market correction. The market is a mosaic, and it is important to look at the whole picture. We will continue to analyze the Five Forecasters, and other data, to try to help us find signals of oncoming market distress. For now, we remain comfortable with our positive outlook for stocks over the balance of 2014, and will continue to share regular updates on these indicators in future publications. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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