Macro Indicators Signal Best Buy Opportunity Of The Year

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Summary

Four macroeconomic indicators rang the alarm before every recession since 1950.

Sustained bear markets in equities unfolded in recessions only.

The macro indicators are not flashing warning signals yet.

The S&P 500 remains on target for 5000-5200.

The economy is not the stock market

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Assessing the odds of a recession helps investors judge if stock market weakness is likely a correction or a bear market. Historically, it has been profitable to buy the dips or sit through corrections. However, investors were best off preserving capital and selling their equity holdings during bear markets.

Four macroeconomic indicators have a reliable track record in signaling recessions. Credit spreads, labor market conditions, the yield curve, and the Conference Board Leading Economic Index (LEI) rang the alarm before every recession since 1950. Moreover, they signaled an economic downturn most often ahead of the stock market.

Credit Spreads

Bond traders are the smartest people in the trading room

is another proverb among professionals in financial markets.

There is some truth to this proverb because credit was a leading indicator. Credit spreads did not only deteriorate before recessions. They also preceded cyclical equity peaks. Bond traders have to estimate real economic activity to anticipate future corporate defaults. Historically, they were largely successful as several academic research papers have emphasized.

US corporate credit spreads have been stable lately. They were rangebound and we just stated witnessing some potential stress in Europe during the past few days. If the stress gets confirmed by the US bond market, it will likely still take a while until stocks end their rally and the economy goes into recession. Historically, it took several months until the wheels came off after credit spreads widened.

Labor Market

The second chart summarizes US labor market conditions over the past 70 years. It plots the unemployment rate and official NBER recessions in grey and labor market strength in black. The unemployment rate marked a cyclical low ahead of every recession. Moreover, labor market strength fatigued about 16 months before the unemployment rate hit its absolute low historically. There has been only one exception, the 1973-1975 recession, out of the past ten recessions that did not record a gradual deterioration of the labor market every month.

The labor market is strong and does not signal an imminent recession today. It is still recovering from layoffs during the corona crisis.
Yield Curve

In the late '80s, professor Campbell Harvey at Duke University researched the yield curve and found a significant relationship for an inverted yield curve before the US economy entered a recession.

Today, the yield curve is normal and upward sloping. Moreover, it took on average five months before equities peaked after a yield curve inversion. The yield curve does not flash a bearish signal yet. It merely indicates that we are in the late-cycle stage.

Leading Economic Index

The Conference Board Leading Economic Index (LEI) is a composite of ten economic indicators. It peaked on average nine months ahead of a recession. Moreover, the indicator warned correctly about seven of the past eight recessions. The signal missed only the second part of a double-dip recession in the '70s, which might be solely academic as it could have been part of a prolonged recession. Nonetheless, the indicator even peaked seven months before that second dip of the '70s downturn as the chart shows.

The index hit an all-time high last month and could reach a higher high at its next release in one week. Historically, the stock market started a cyclical correction three months after the LEI climaxed. Hence, there is no signal for a bear market.
In a stock picker's market, how do you find winners?

During the first wave of COVID, Goldman Sachs calculated that 80% of stock performance was driven by macro factors - with the whole market sharply correcting and rebounding.

Since then, company-specific 'micro' factors have become much more important. And this has caused returns to vary more significantly from company to company. In short, stock picking matters more and more. So the fundamental question is: Which stocks do you want to own?

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**Conclusion**

The US stock market has most likely not peaked yet. Macroeconomic indicators signal that the late-cycle stage may have begun. Equities had positive returns during that stage. Nonetheless, a retest of the late-January low is likely and sentiment indicators remain pessimistic. The bottom line remains that the S&P 500 is on target for 5000-5200 despite a bumpy road ahead. Bulls want to see that retest of the January lows on diverging strength. That will most likely set up the best buy opportunity of the year.

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