JOURNAL REPORTS: FUNDS & ETFS

Why the Strong Economy Is a Poor Predictor for the Stock Market

The stock market usually tops out well before the economy slips into a recession

Bear markets in stocks often begin regardless of what the economy is doing. ILLUSTRATION: TIM BOWER FOR THE WALL STREET JOURNAL

By Mark Hulbert

March 4, 2018 10:12 p.m. ET

A month ago, when the stock market suffered its first correction—a 10% drop—in years, many found comfort in the economy's apparent strength: Surely a severe bear market can't begin when the economy is growing so strongly?

Their argument provides false comfort, however, since the stock market usually tops out well before the economy slips into a recession. And by the time you *know* the economy is in a recession, odds are overwhelming that a bear market (which is confirmed when stocks drop 20% from the high) will have long since begun.

JOURNAL REPORT

- Insights from The Experts
- Read more at WSJ.com/FundsETFs

MORE IN INVESTING IN FUNDS & ETFS

- If Volatility's Back, Are You Ready?
- U.S.-Stock Funds Fell 3.6% February
- Just in Case You Die Young, Be Prepared
- Sallie Krawcheck's Best and Worst Bets
- Investor Quiz: Student Debt

To measure how far in advance of a recession a bear market typically begins, I compared the recession calendar compiled by the National Bureau of Economic Research—the semiofficial arbiter of when recessions begin and end in the U.S.—with a bear-market calendar maintained by Ned Davis Research , the Venice, Fla., quantitative-research firm. Of the 22 recessions since 1900, 20 have coincided with a bear market and the average lead time of those bear markets was eight months.

120-year lesson

An interesting, but separate, topic for discussion would be why those other two recessions weren't accompanied by a bear market. They occurred from October 1926 to November 1927 and from February to October 1945. But if we assume that they are exceptions that prove the rule, the lesson of the past 120 years is that the economy likely will continue to grow for at least two quarters after a bear market begins.

To be sure, there is wide variability in the lead time previous bear markets have had before recessions. Some have begun more than a year in advance, while others have begun at almost the same time as the recession. But, crucially, none of the 20 bear markets that coincided with post-1900 recessions began after the economy had started contracting.

Assuming the future follows past patterns, therefore, stock-market bulls shouldn't be basing their bullishness on current economic activity. This advice becomes even more compelling when we realize that we typically don't know how the economy is performing in real time, but rather only well after the fact.

Consider the 2008-09 financial crisis. When the stock market topped out on Oct. 9, 2007, the economic news was still largely favorable. On Oct. 31, the government released its advance estimate of economic growth in the third quarter of that year, reporting that gross domestic product had grown at an annual rate of 3.9%, up from 3.8% in the second quarter.

It wasn't until two months later, in December 2007, that the economy began its recession, according to the National Bureau of Economic Research. But the bureau didn't make that determination until a year later, in December 2008. So in this case, a bear market began two months before the economy started contracting, and 14 months before the NBER made that start date official.

If the discussion ended here, you might conclude that bear markets are a good forecaster of an imminent recession. And that does stand to reason, since the stock market is a discounting mechanism that anticipates what is coming down the pike. That's why the S&P 500 is one of the indicators included in the Leading Economic Index compiled by the Commerce Department's Bureau of Economic Analysis.

False positives

However, the stock market issues many so-called false positives, signaling a recession when none occurs. Since 1900, for example, there have been 36 bear markets, according to the Ned Davis calendar, but only 22 recessions. There have been countless more stock-market corrections of at least 10% that didn't end up turning into a bear market. The late Paul Samuelson, a Nobel laureate in 1970, was quite close to the mark when he famously said that the stock market had predicted nine of the last five recessions.

Yes, the stock market cares about the economy. But the relation between recessions and bear markets isn't quite what it's cracked up to be. **PHOTO:** ISTOCKPHOTO/GETTY IMAGES

The two most recent bear markets on the Ned Davis calendar were each false positives: the one that lasted from April to October 2011 and the one that ran from May 2015 through February 2016. To be sure, some may not consider these two declines as genuine bear markets, since the Dow Jones Industrial Average and the S&P 500 didn't drop 20% based on their daily closing levels.

That may be splitting hairs, however. In the first of those markets, the S&P 500 did fall by more than 20% on an intraday basis. And the Russell 2000 index, a widely used proxy for the small-cap sector, dropped 25% in the 2011 bear market and 24% in the more recent one.

Yet in neither of these bear markets did the economy experience even one quarter of economic contraction, much less the two in succession that the NBER uses as its criterion of a recession.

None of this discussion should be taken to mean that the stock market doesn't care about the economy, or that the economy is immune from the wealth effects of a bear market in stocks. But it is surprisingly difficult to translate these undeniable truths into actionable investment advice.

Mr. Hulbert is the founder of the Hulbert Financial Digest and a senior columnist for MarketWatch. He can be reached at reports@wsj.com.

Appeared in the March 5, 2018, print edition as 'Bear Markets Can Fly In on Their Own.'
