

The Stock Market in Long Expansions

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This study is a joint effort by Bob Dieli and Erik Conley. Since it will be sent to their respective subscriber lists, we thought it might be helpful for everyone to have a chance to get acquainted.

Bob Dieli is President of RDLB, Inc., an economic research and management consulting firm based in Lombard, Illinois which he founded in 2001.

Bob began his professional career in 1978 as an industrial economist in the Economic Research Division of the Continental Illinois National Bank and Trust Company of Chicago, Illinois where later he became Manager of the Portfolio Analysis Unit of the Credit Risk Evaluation Department.

In 1987 Bob moved to The Northern Trust Company of Chicago as Vice President and Economist in the Economic Research Department. In 1994 he became Vice President and Portfolio Manager in the Northern Advantage unit of the Cash Management Department of the Northern Trust where he ran about \$3.5 billion in discretionary short-term fixed income accounts for high net worth individuals and corporations.

Bob received a Bachelor of Science in Finance, with honors, from Boston College, a Master of Arts in Latin American Studies from the University of Texas at Austin and a Ph.D. in Economics from the University of Texas at Austin.

Erik Conley is president of Conley Investment Group, Inc., advisor to The Zen Investor hedge fund. He also runs the website ZenInvestor.org, an independent, non-profit, investigative research organization that advocates on behalf of consumers of financial advice and investment management services.

After graduating with a finance degree from Marquette University, Erik began his professional career as a hedge fund trader for Kemper Securities in 1977. He became head trader and co-manager of the Kemper Convertible Arbitrage Fund in 1983.

He joined Harris Associates, advisor to The Oakmark Funds, in 1992 as head of derivatives trading.

In 1995 he joined Northern Trust Company as head of the equity trading desk. He left Northern Trust in 2001 to start his own investment firm.

Executive Summary

-) This report explores the relationship of the business cycle to the performance of the stock market. The question we want to answer is, can stock market investors use this relationship to their advantage? Specifically, can an investor improve performance by adjusting equity exposure based on cues from the business cycle? We find that the answer to these two questions is yes, as long as the investor knows what clues to look for, and has the discipline to act.
-) Stock market crashes, corrections and bears cause significant damage to investors who are unprepared to deal with them effectively. But investors who are able to tell the difference between market declines that are linked to a business cycle turning point, and those that are not, have a distinct advantage in the market.
-) In *Stocks For The Long Run*, Wharton Professor Jeremy Siegel shows that switching out of stocks and into Treasury bills before the onset of recessions, yields a performance bonus of more than 4% over a simple buy-and-hold strategy. And being in Treasury bills during the worst market declines has the additional benefit of reducing overall portfolio volatility.
-) Is there a way to know - ahead of time - that getting out of the way of a market decline is the right move? We find that the answer depends on whether or not the decline is associated with a business cycle turning point.
-) It is almost as hard to forecast the business cycle using the stock market, as it is hard to forecast the stock market using the business cycle. The two are connected, but the lines of causality are blurred, at best. Going through each of the market events that took place during the longest economic expansions will give us important clues about the nature of the connection.

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Executive Summary -- Continued

-) The stock market begins to decline several months before the business cycle turns. But the market is also prone to sounding false alarms. Since 1802, there have been 12 instances where the market fell by 10% or more, but no recession followed. Perhaps the most infamous episode was the market crash of 1987. That's one of the key points of this inquiry, and we will attempt to arrive at some conclusions by studying each of the market events that took place during the four longest economic expansions of the last 50 years.
-) If you want to build meaningful wealth as an investor, you're going to need an edge. The Enhanced Aggregate Spread is a navigational tool designed to help you get that edge by establishing the proximity of a business cycle turning point.
-) Our analysis will pivot on two questions: "Where are we and how did we get here"? And: "What did they know and when did they know it?"
-) Our goal is to leave you with some tools and information that will help make your investment decisions more profitable.
-) Please do not hesitate to contact either Bob or Erik with any questions or comments you might have.

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Chart 1

Introduction



Last year we published the first part of this report in which we reviewed the performance of the stock market, as measured by the S&P500 Index during long expansions. Since that time there has been another correction. This report will look into that episode and that episode only. While most of you have seen the report we published last year, we thought that it might be helpful to reprise some of the charts from the first report as well to bring those who are just joining us up to speed.

In order to let you know who is “talking”. The text in black was authored by Bob Dieli. **Text in blue was authored by Erik Conley.** **Text in green was jointly authored.** In order to keep the statistical reporting on a common basis, we are using the month-end closing value of the S&P500 stock index. Many of you are close students of this topic and have probably seen the starting, ending, and percentage changes of the events we will be reviewing done based on the daily stock data. However, since we are comparing the stock market episodes with data that are reported on a monthly basis we think the format we have adopted is more consistent and more congenial for the project. There are, however, a couple of exceptions. We will note them as we come to them.

Market crashes, corrections, and bears are the bane of every investor - with two exceptions. Skilled short-sellers, and investors who are able to tell the difference between market events that are linked to a business cycle turning point, and those that are not. Investors who were fortunate enough to have missed the last two bear markets (2000 & 2008) have significantly higher portfolio returns than those who remained invested throughout. Since both of these market events were linked to recessions, was there a way to know - ahead of time - that getting out of the way was the right move?

Corrections & Bear Markets - The Facts

A Bear Market is defined by a 20% DECLINE or greater.

A Correction is a decline between -10% and -19%.

Since 1960 there have been 5 bear markets and 6 corrections.

A bear market begins on average every 10 years.

A correction begins about every 4.5 years.

The average duration of a bear market is approximately 17 months.

The average time it takes for the market to fully recover from a bear is approximately 60 months.

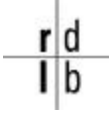


Chart 2 Introduction



These charts extend and update the analysis of the report that we published in August of 2015. In that report we said:

"Of the 47 recessions since 1802, 43 (9 out of 10) have been preceded (or accompanied) by declines of 10% or more in the stock market.

...but the stock market is also prone to sounding false alarms. Since 1802, there have been 12 instances where the market fell by 10% or more, but there was no recession within the next 12 months.

Perhaps the most infamous episode was the market crash of 1987, where the decline in stocks was so deep and dramatic that there was a nearly universal belief that a recession would soon follow. Alas, it failed to show up.

This brings up an interesting question. If one could anticipate, with even a modicum of accuracy, the onset of a cycle peak, would that help investors to protect their portfolios by "getting out of the way" of the recession?"

What follows is an illustrated discussion of a classic example of one of the above-mentioned "false alarms." Between May of 2015 and February of 2016, the stock market fell by 14.2%. Throughout this period the economy stuttered and stumbled, but did not succumb to recessionary forces. The economic indicators, both leading and coincident, that Dr. Dieli uses in his recession forecast remained positive, or "Green" as you will see. We use the phrase "Green Board" to describe the condition of the economy, and the likelihood that a recession will begin in the next 9 months.

The fundamental message of this report, as it was in our previous one, is that investors who pay attention to the Green Board are in the enviable position to take advantage of the occasional stock market false alarms by either waiting out the correction or adding to portfolio positions that may have been unfairly punished by those who were fleeing a recession that never arrived.

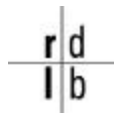


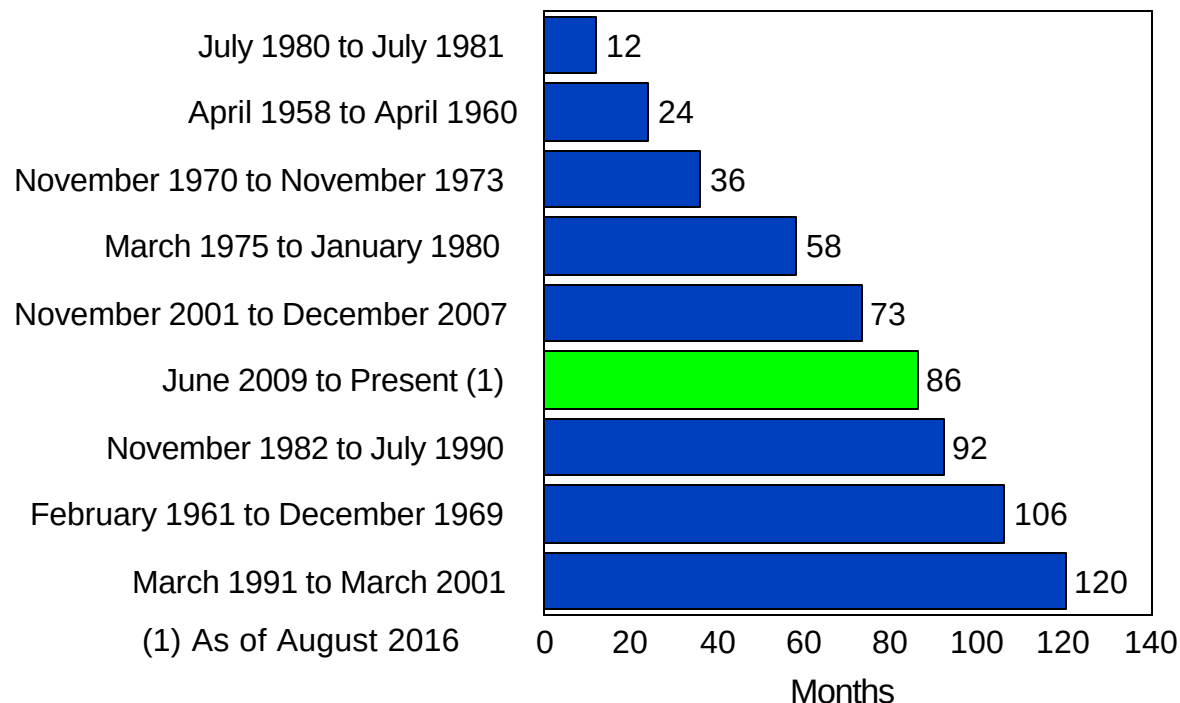
Chart 3

Expansion Periods as Defined by the National Bureau of Economic Research



In this report we will look at the relationship between economic cycles and the performance of the stock market. But before we begin we must tell you that we do not make stock market calls, nor do we provide investment advice. The reason for this is straightforward. Each investor has a unique set of goals, risk tolerance, and time horizon. There is no universally correct way to use the information contained in this report.

As you can see in the chart, the current expansion is now in its 86th month, making it the fourth longest on record. We will focus on how the stock market has performed in the other four long expansions. Specifically, we will look at previous market declines of 10% or more that took place during other long economic expansions. Then we will look at the most recent market correction, and ask whether lessons learned from past declines can help us do a better job of managing portfolio risk in the future.



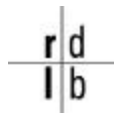


Chart 4

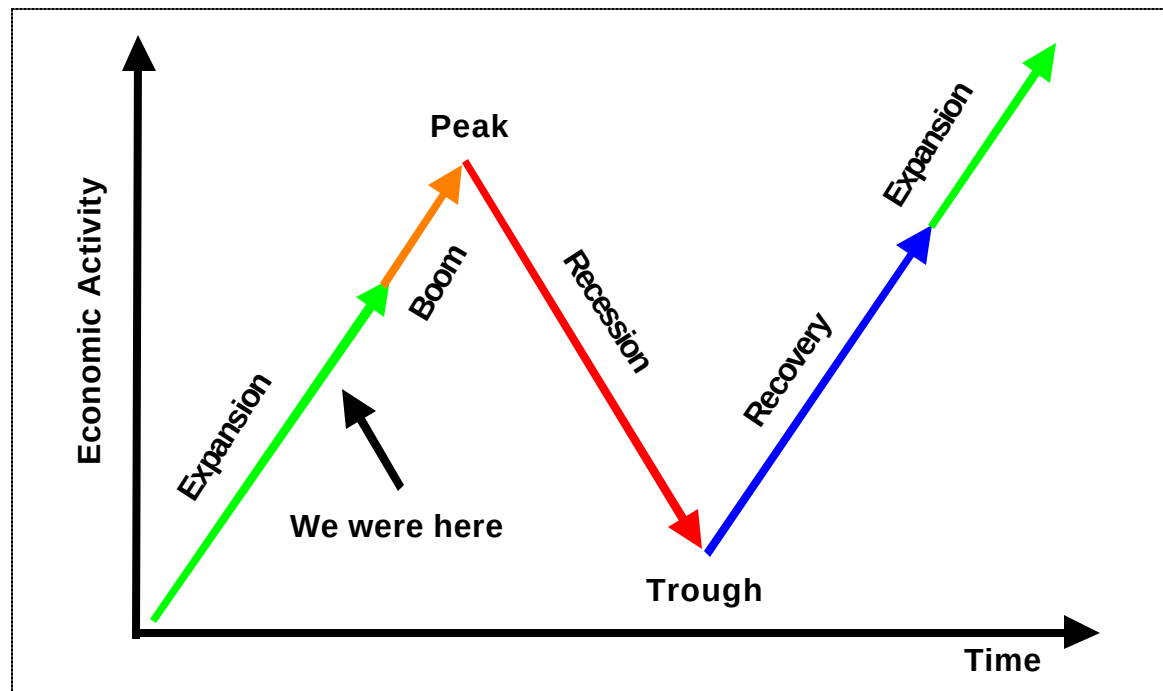
The Phases of the Business Cycle

Correction of 2015



As we came into the second quarter of 2015, economic activity, as measured by GDP growth, had settled into a more stable pattern following the disruptions caused by the Polar Vortex in the first quarter of 2014. After spiking at a 5% annualized growth rate in the third quarter of 2014, GDP turned in three consecutive quarters of growth that averaged 2.3%. While hardly robust, this pattern was consistent with what had been established in the early part of the current expansion.

Furthermore, this growth pattern was consistent with what had been forecast by the Enhanced Aggregate Spread. Namely that growth would continue without interruption over the course of 2015 and into 2016. This meant that, at minimum we would remain in the expansion phase of the cycle and, at worst could enter the boom phase of the cycle.



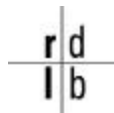


Chart 5 Standard and Poor's 500 Stock Index



The red and the green lines on the chart mark the -10% and +10% levels. I call the space between them the Zone of Death. So named because the blue line (the stock market) tends to traverse the gap fairly quickly in both directions. Much more quickly on the way up than on the way down.

One lesson from this chart is that not every decline in the stock market is associated with the onset of a business cycle peak. Which brings me to the first general conclusion of this study: It is almost as hard to forecast the business cycle using the stock market as it is hard to forecast the stock market using the business cycle. The two are connected, but the lines of causality are blurred, at best.

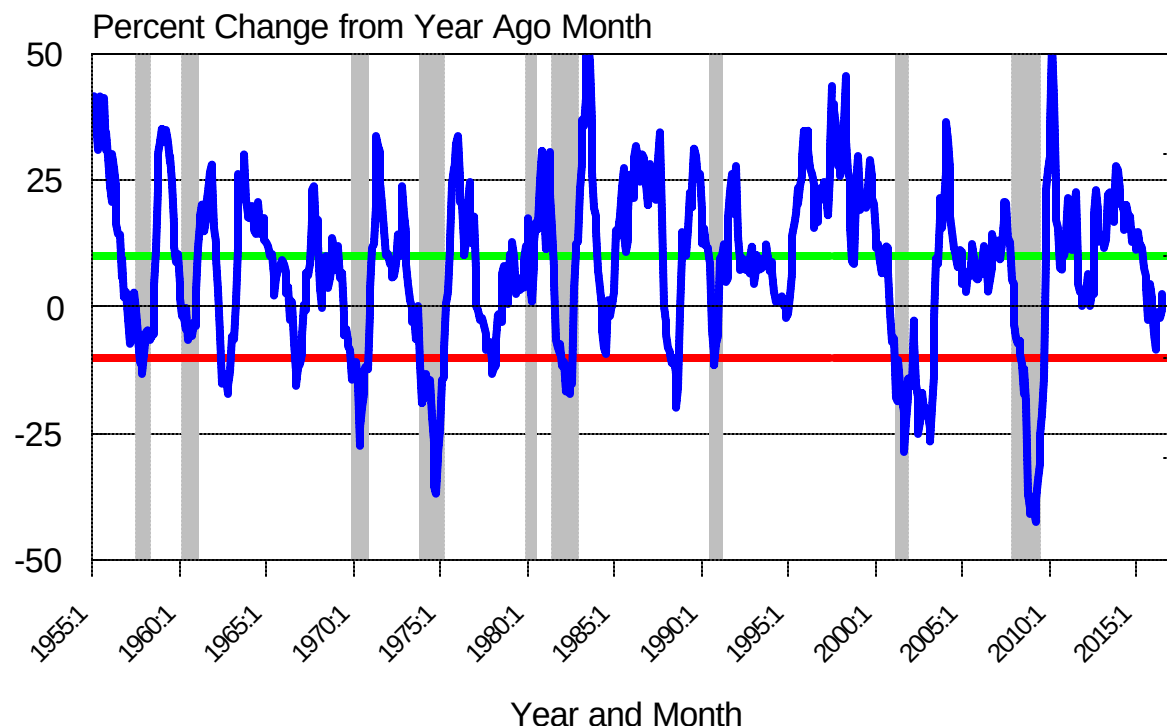
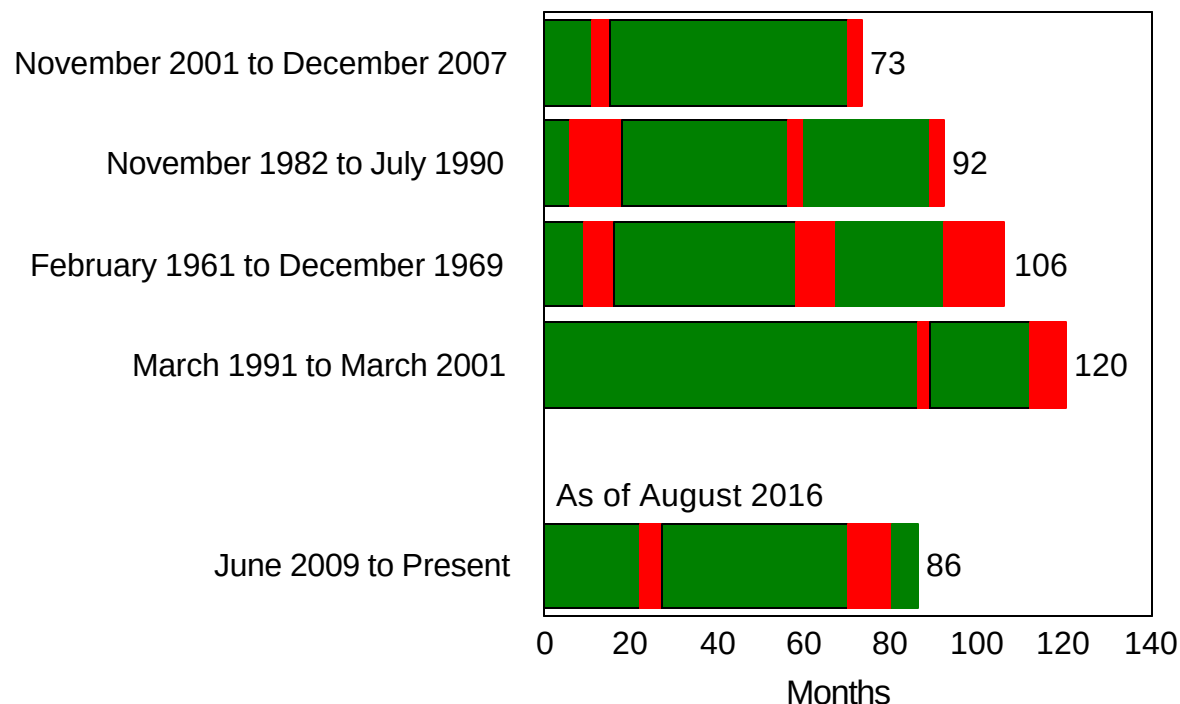


Chart 6

Correction or Bear Episodes in Long Expansions

Among the reasons why we showed you a chart that counted the length of the expansions (see Chart 3) was so that we could then extend that analysis by showing you where, in each of those long expansions, market downturns occurred.

Each of the prior long expansions ended with a market downturn, the length and depth of which we discussed in the earlier report. But, as you also see there are intervals within the expansions where the stock market underwent either a correction (down 10% or more) or a bear episode (down 20% or more). Knowing whether a market downturn will be the one associated with the end of the expansion depends on your ability to identify the end of the expansion. And it is to that task that we turn next.



Red bars are months in which the SP500 was in either a correction or a bear market.

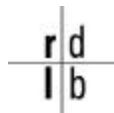


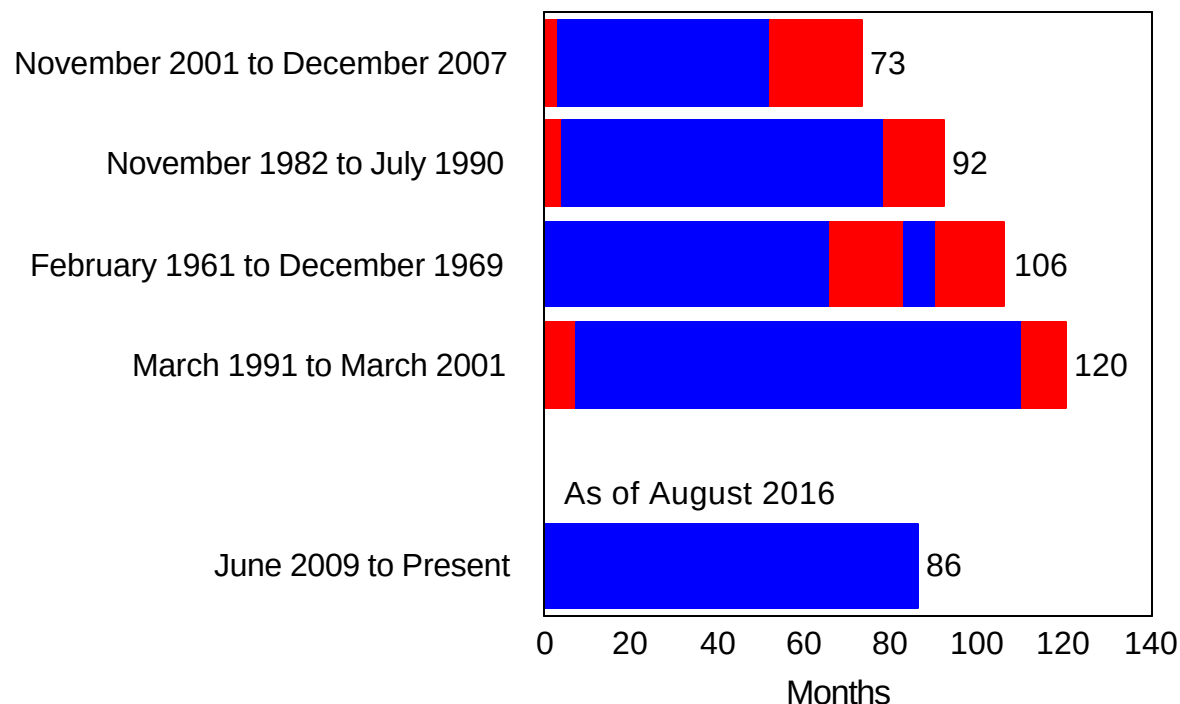
Chart 7

Recession-Eligible Months in Long Expansions



While the previous chart showed us the location of the stock market corrections and bear markets, this chart shows us when the EAS was giving the signals we associate with changes in the phases of business cycle itself.

You will note that all of the business cycle peaks were signaled well ahead of their onset by the right end of the bars turning red. But, you will also have noticed that there are some red bars on the left side of several of the expansions. This is because the EAS does not make the actual call of the start and end of recessions. What it does is identify the times in which the economy is likely to make a turn. So, at the end of contractions, there will be months in which the EAS says that recession-eligible conditions still prevail. You will also note that in the expansion that ended in December of 1969 there is an interval of red bars that does end when the expansion ends. This is the period where the Federal Reserve made an effort to slow the pace of the expansion but did not induce a full-fledged recession.



Red bars are months in which the Enhanced Aggregate Spread with the nine month lead [EAS+9] was below 200 Basis Points

Chart 8

Standard and Poor's 500 Stock Index

Current Expansion, now at 86 Months, From June 2009 to August 2016

In the current expansion, there have been two stock market corrections (so far). The first was a 15.9% decline in 2011. This correction was covered in the report we published in 2015. In this edition we will focus exclusively on the second correction of this expansion - the 14.2% decline from May 2015 to February 2016.

Here is a brief summary of what we know about the correction of 2015:

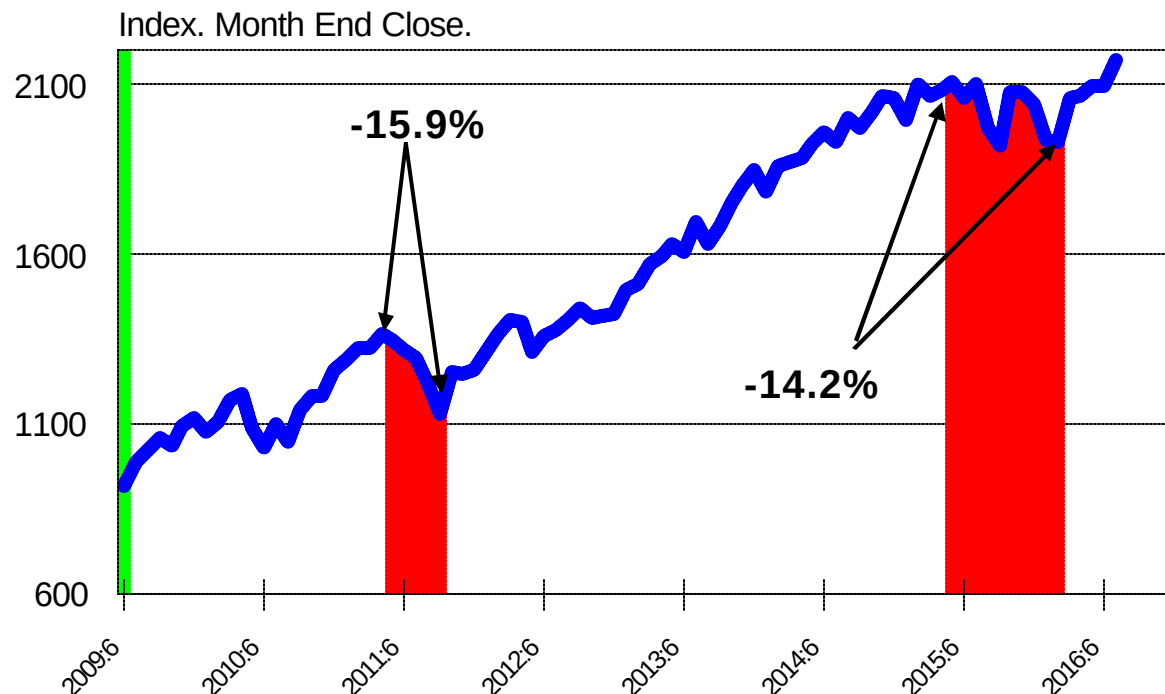
It was a very long episode, taking nine months to find a bottom, and another five months to recover.

It included two separate selloffs, or down-legs, each of which was associated with a distinct cause.

Mutual fund and ETF investors fled equities and sought the safety of bonds throughout the episode.

These investors didn't return to equities until after the market made a new high in July 2016.

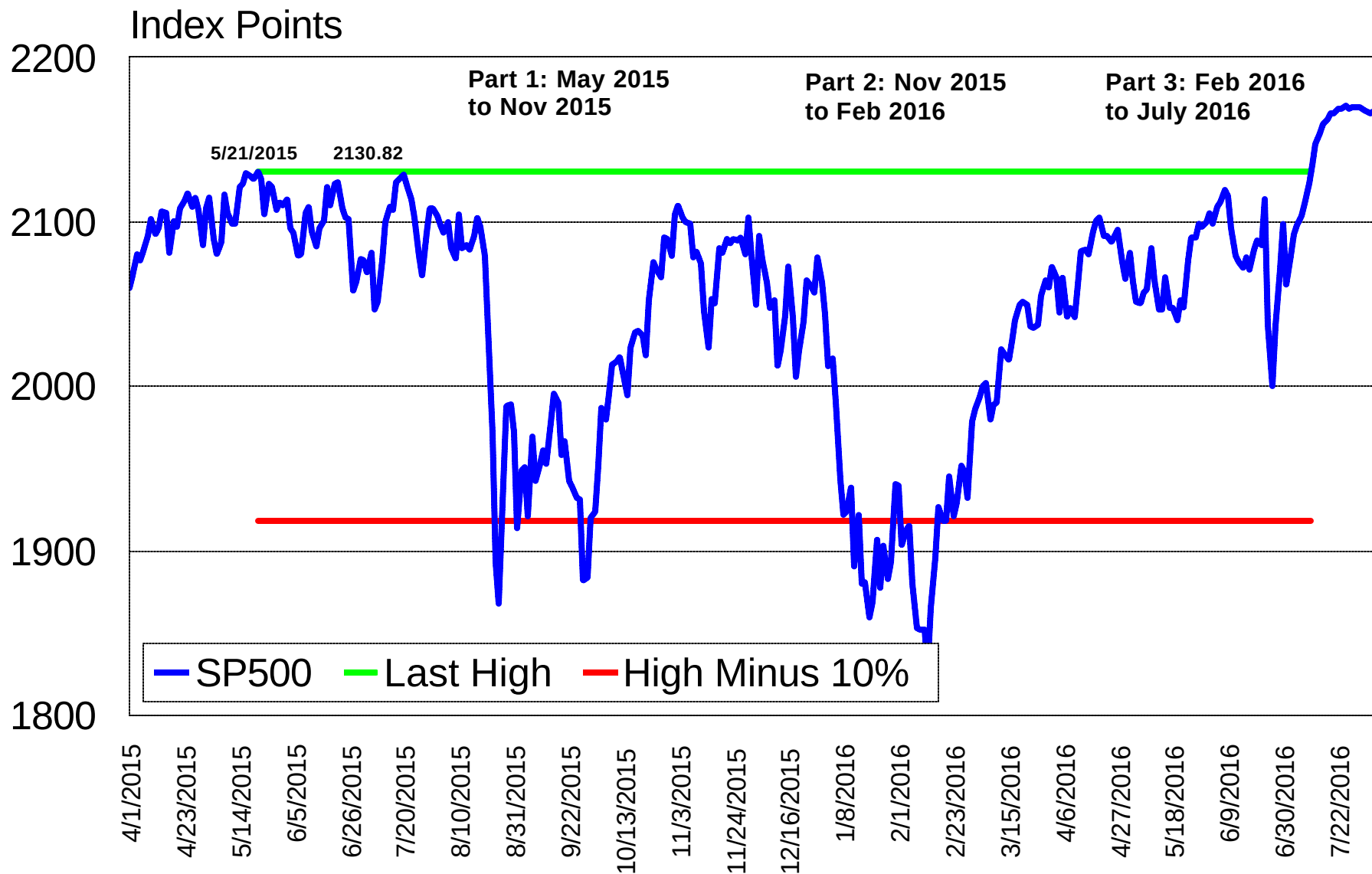
There was a Green Board throughout the entire 14 month episode.



We begin our discussion of this long episode with the chart on the next page. It covers the entire 14 months, and shows in detail how each of the two down-legs unfolded. After that, we'll look at each leg separately, and find out what the Green Board was telling us at the time.

Chart 9 S&P 500 Stock Index

S&P500 2015 & 2016 Daily Close with Correction Indicators



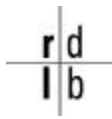


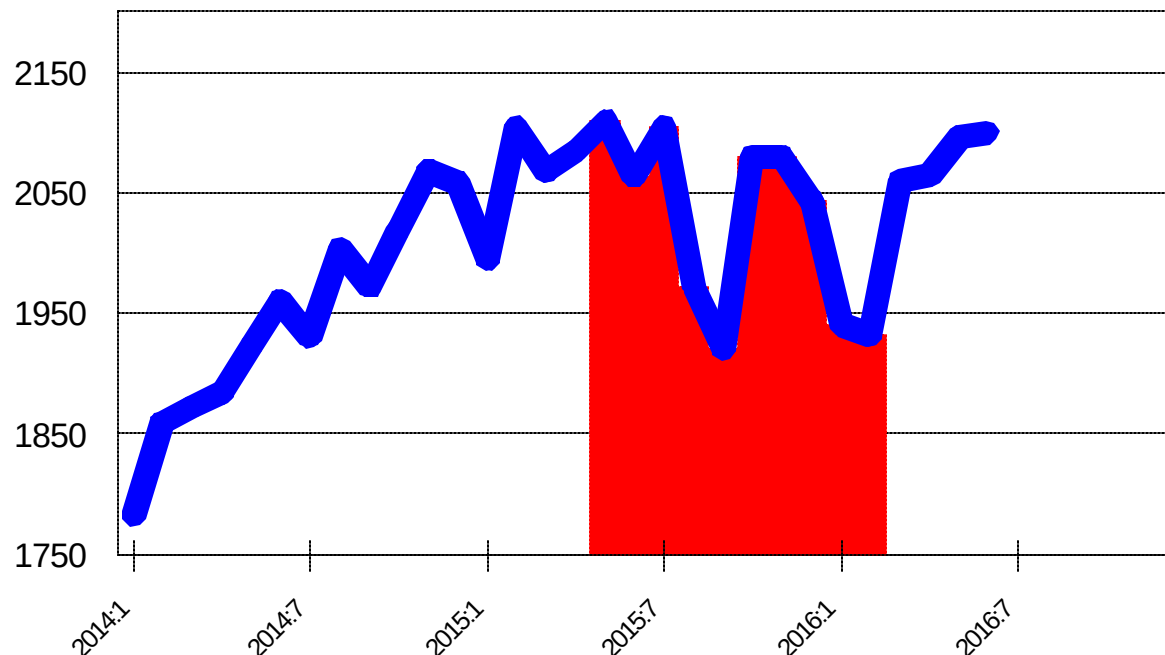
Chart 10

Standard and Poor's 500 Stock Index



Current Expansion, now at 86 Months, From June 2009 to August 2016

Index. Month End Close.



Start Date	Start Level	End Date	End Level	% Change
2015:May	2130.82	2016:Feb	1829.08	-14.2

It began innocently enough.

On May 21st, 2015 the market closed at an all-time high. It was just one more record in a string of records that stretched all the way back to March of 2013. But it was the last record high that investors would see for the next 14 months.

At first the decline was gradual. Some pundits called it the summer doldrums. Others blamed it on the "Sell in May and Go Away" syndrome. Then, on August 17th all hell broke loose.



Chart 11

The Correction of 2015



Emerging markets lead the plunge. What happens in Vegas may stay in Vegas, but what happens in emerging markets can spread like wildfire. Emerging markets had been weakening for months, and the trouble came to a head when China's speculative stock market bubble burst, forcing policy makers to effectively devalue the yuan. The Chinese market crashed, with the Shanghai market plunging 8.5% on one day alone in late August.

Of greater concern was the slowing Chinese economy. Investors were worried by projections that the growth rate of China's economy in 2015 would be the slowest in decades.

Those concerns led to panic selling in the U.S. equity market. In one five-minute window during late August 2015, the Dow Industrials were down by more than 1,100 points.

Fearing a meltdown in China's economy, investors everywhere began to flee stocks and seek safety in government bonds, most notably U.S. Treasuries.

Within a week, the S&P 500 hit 1,867 - a 12% cliff dive from the May high of 2,130. When Chinese leaders pledged to do whatever was necessary to stabilize the market and support the economy, traders and investors bought it. The market recovered for a few weeks, then nosedived again, but didn't make a new low. It seemed as if disaster was averted.

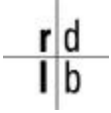


Chart 12

The Correction of 2015



With the benefit of hindsight, we can see that investors overreacted. Of course the world didn't come to an end. In fact, late August 2015 was a great buying opportunity.

And, yet, some investors never learn. Since that China swoon, the U.S. stock market has suffered at least three additional bouts of doom and gloom:

- o The January-February 2016 stock market correction.
- o Concerns about first-quarter GDP and a disappointing earnings season.
- o The unexpected outcome of the U.K. Brexit referendum.

Following the China scare, the market seemed to be returning to normal. By the end of 2015, the drama had subsided, and market chatter turned to predictions about when we would make the next record high. But the drama wasn't over yet.

The second leg down for this correction began as soon as the calendar flipped to 2016. This time it was the energy sector that lead the way down. Investors began to worry that the sharp drop in oil prices might tip the U.S. economy into recession. This chatter continued for about six weeks until the market finally stabilized for good and began a long recovery that eventually lead to that elusive new all-time high in July.

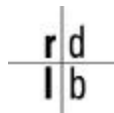


Chart 13

S&P 500 Stock Index and Associated Indicators

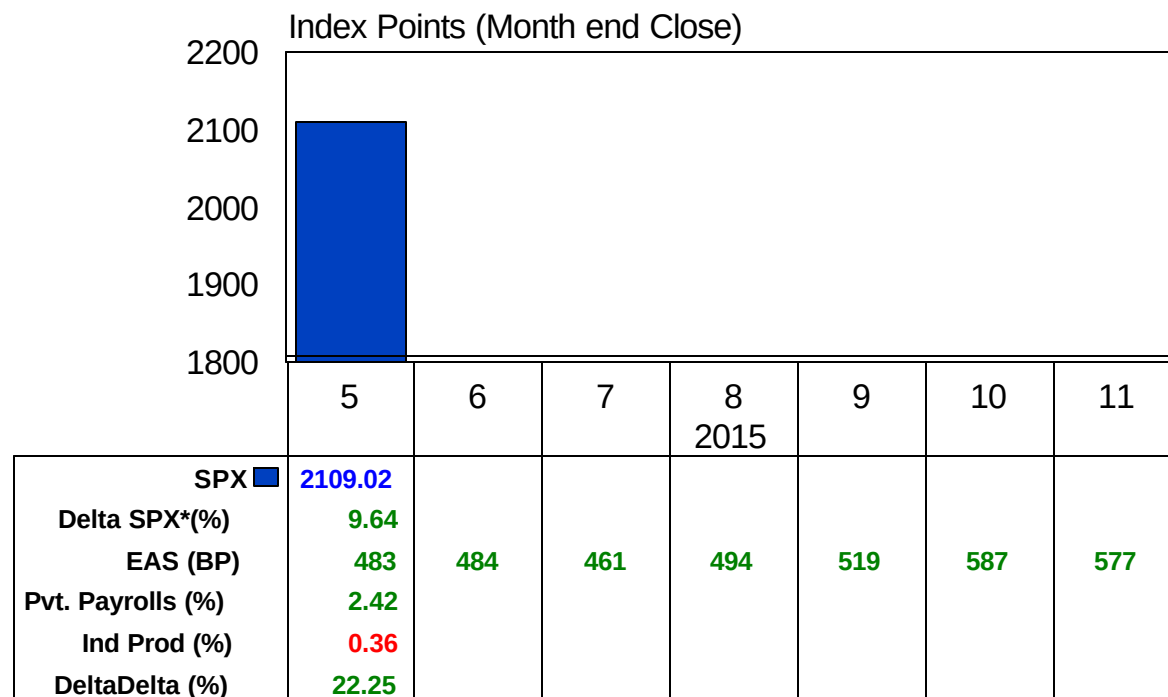


Correction of 2015 -- Part 1

As the correction got underway, the signal from the Enhanced Aggregate Spread was for the expansion phase of the cycle to continue for at least the next several months. This is what we had referred to in the first round of the analysis as a "Green Board".

We created that term to refer to all of the charts that look like this one. On this chart, what we knew was the level of the SP500 and the track of the EAS. With the EAS sending a continuous signal of further expansion, we put the numbers in green type and we called this a "Green Board".

Although no one knew it at the time, the market peaked on May 21, 2015. On that day, the S&P 500 index closed at 2,130. It wouldn't see that level again until 14 months later.



Delta SPX = % Change from Year Ago Month

Recession Associated Level

Delta SPX <10% and falling

EAS < 200 Basis Points

Private Payrolls <1.00% and falling

Industrial Production <1.00% and falling

DeltaDelta <0.0% and falling

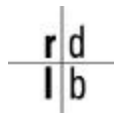


Chart 14

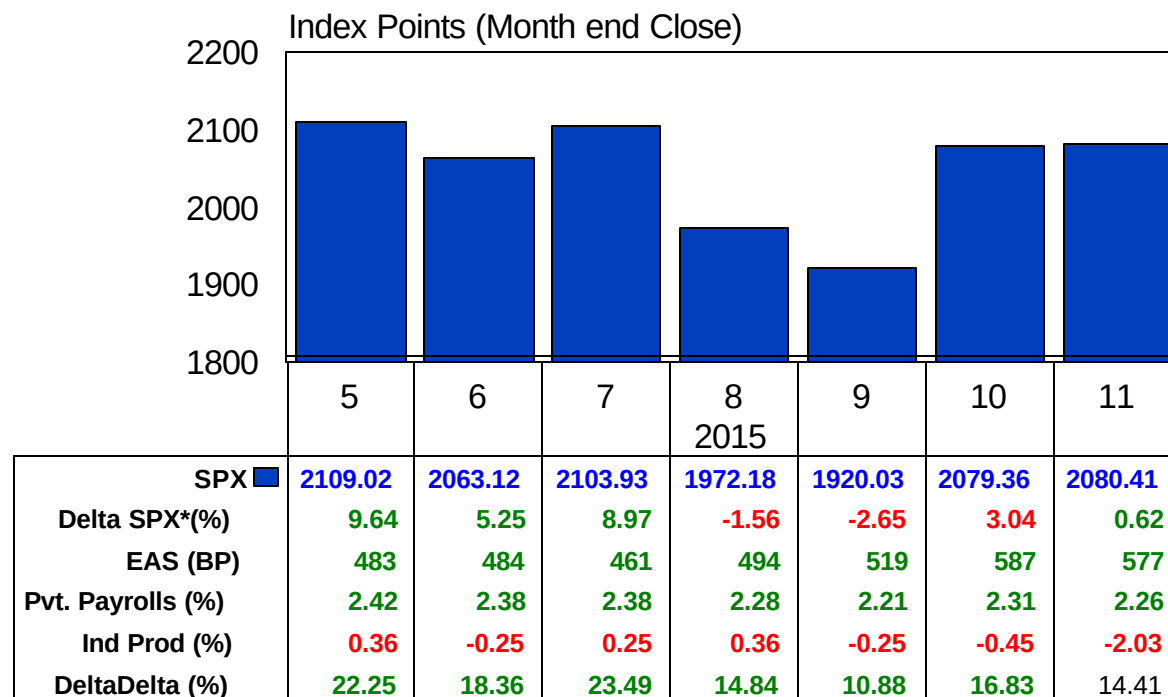
S&P 500 Stock Index and Associated Indicators



Correction of 2015 -- Part 1

Because we continued to get confirmation from our coincident indicators that the expansion did indeed continue over the length of this board, we concluded that the EAS was correct and that the correction that was underway would not be the one associated with the business cycle peak.

The decline in the market started gradually at first. May was down just 1% from the peak. June dipped another 2%, bringing the total decline to 3%. In July the market rallied, but failed to take out the May high. Then came August and September, when the China scare sent investors fleeing for the exits. By the end of September the market had taken a hit of nearly 12%.



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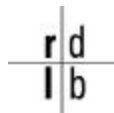


Chart 15

S&P 500 Stock Index and Associated Indicators

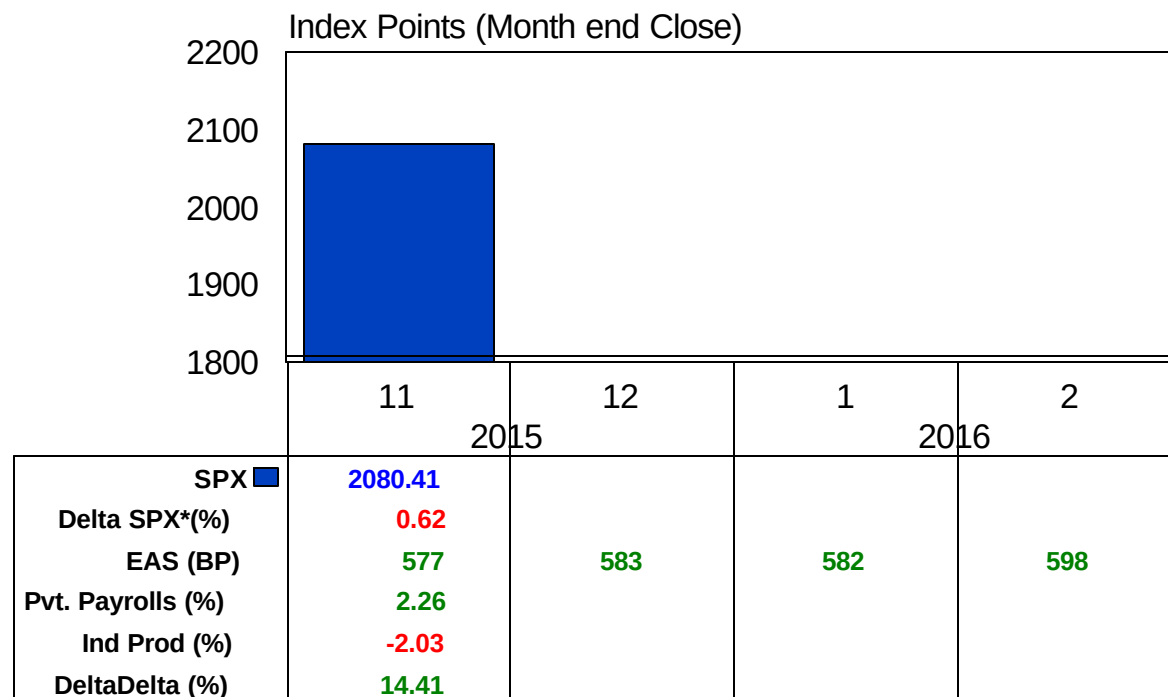
Correction of 2015 -- Part 2



As we proceeded with the analysis of the correction, we knew that there had been a bottom in September of 2015, with a rebound that lasted through November.

The stock market was poised to head lower, yet this board, like the one that preceded it also has a signal from the EAS that the expansion phase of the cycle is going to continue.

When Chinese leaders stepped in to stabilize the market and support the economy, traders and investors seemed to be on board. The market recovered for a few weeks, then nosedived again, but didn't make a new low. It felt like disaster had been avoided, as volatility subsided and the selling frenzy began to abate. But then came the second down-leg.



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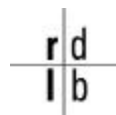


Chart 16

S&P 500 Stock Index and Associated Indicators



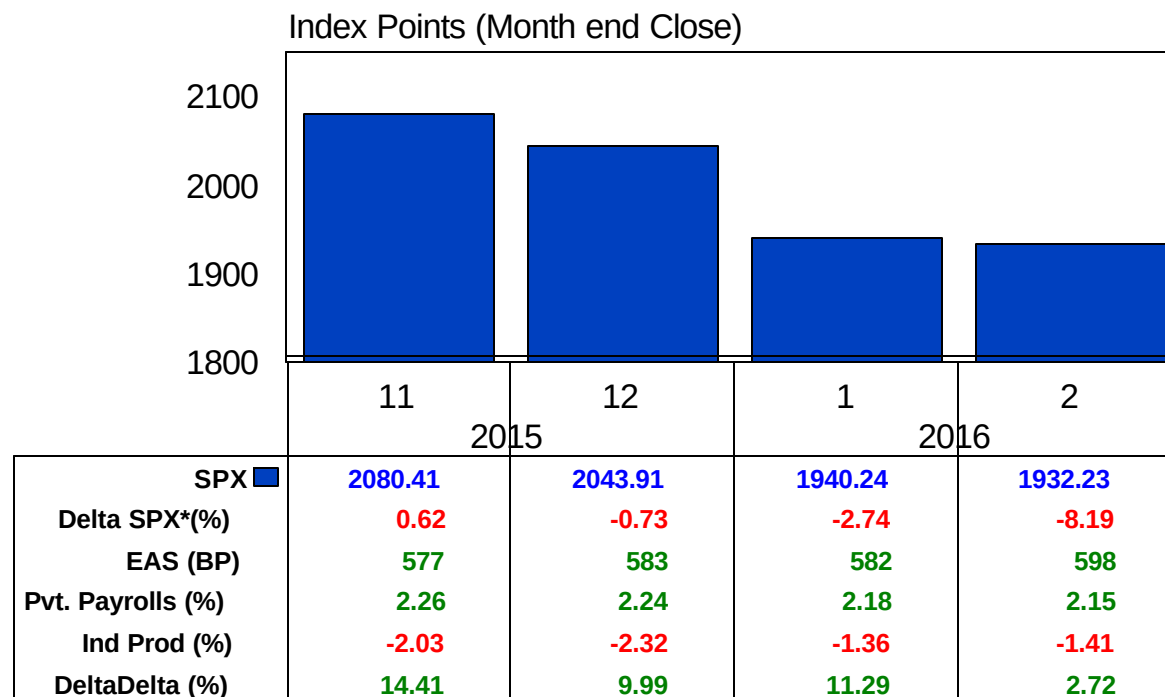
Correction of 2015 -- Part 2

The second leg down for this correction began as soon as the calendar flipped to 2016. This time it was the energy sector that lead the way down. Investors began to worry that the sharp drop in oil prices might tip the U.S. economy into recession. This chatter continued for about six weeks until the market finally stabilized for good and began a long recovery that eventually lead to that elusive new all-time high in July.

As you might expect, as the second down leg of the correction got underway, the number of forecasts of an imminent downturn in the business cycle increased sharply. We stood

by our methodology and noted with no small amount of satisfaction that the forecast of the EAS for continued growth continued to be confirmed by our set of coincident indicators.

We did, however, take the time to explain to our readers that the drop in Industrial Production was something that we were keeping our eye on as a possible source of forecast error. Meaning, the drag that the slower pace of industrial activity had the potential carryover effects that could impact the overall rate of growth. But, all of the information we saw suggested that all such damage would be contained.



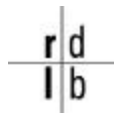


Chart 17

S&P 500 Stock Index and Associated Indicators

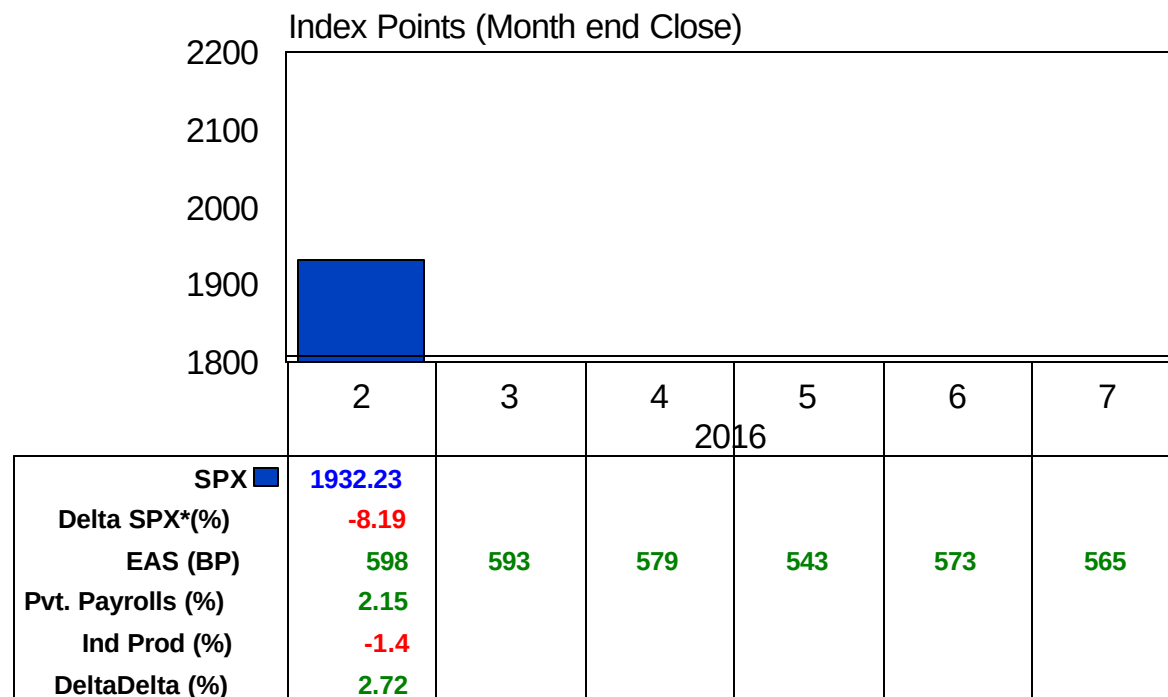


Correction of 2015 -- Part 3

What turned out to be the recovery phase of the correction got underway with another Green Board in place.

No one can say for sure what caused the market to finally find its bottom in February, but I think it had a lot to do with the stabilization and rebound in the price of crude oil. This second down-leg was accompanied by predictions of widespread losses and even bankruptcies in the oil patch. But when crude prices stabilized, the bargain-hunters stepped in and the market began its five month rally to new highs.

If you've been involved in the equity markets for a few years, you probably know that some investors' emotions change as often as the weather. And with that realization comes the recognition that you won't beat the market by constantly reacting to news headlines



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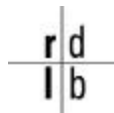


Chart 18

S&P 500 Stock Index and Associated Indicators



Correction of 2015 -- Part 3

The coincident indicators confirmed the forecast of continued growth that EAS provided. Thus, as expected, the stock market correction of 2015-2016 was NOT the stock market event associated with the end of the expansion.

During the 14 month correction, investors bailed out of equity mutual funds to the tune of \$185 Billion. But The Enhanced Aggregate Spread provided steady guidance on the continued growth of the economy. As such, we saw that the high of May 2015 was not the cycle high.

According to the Green Board analysis, the correction of 2015 and all of the accompanying doom & gloom predictions turned out to be great buying opportunities. To illustrate, I ran some more numbers using two popular trading methodologies to see the impact on investor returns.

Strategy 1. Buy & Hold for the entire 14 months - May 2015 - July 2016 = a gain of 3.1%

Strategy 2. Sell when 50 DMA is below 200 DMA; buy back when reversed = a loss of 6.1%

The total cost (before tax implications) of getting whipsawed by these trades was 9.2%

The benefit of paying attention to the Green Board = priceless.

If the time to buy is when there is blood running in the streets, the time to sell is when there's a Red Board. And right now the board is Green.

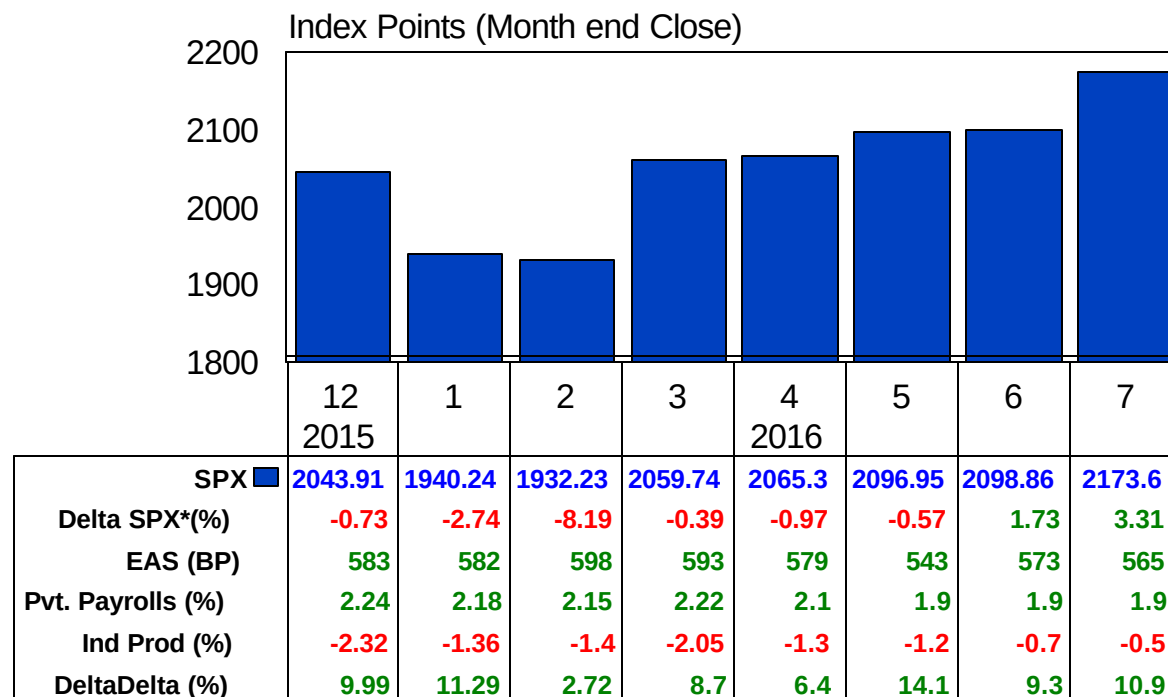




Chart 19

Conclusions -- Part 1



"All I want in life is an unfair advantage." - former AIG chief Maurice R. "Hank" Greenberg

If you want to build meaningful wealth as an investor, you're going to need an edge. For Hank Greenberg, it was an uncanny ability to bend the rules while outmaneuvering the insurance regulators. Warren Buffett has an edge, too - exceptional skill coupled with access to cheap money. While edges like these aren't readily available to most investors, there is something that can provide a significant edge to you, right now: situational awareness.

An investor who is aware of where we are in relation to the business cycle, and who is able to take advantage of this awareness by adjusting his asset allocation accordingly, will have an unfair advantage in the market. The question is how to make the most of it. The answer will be different for every individual.

For someone who is very sensitive to losses - even temporary ones - there is the option of reducing equity exposure at the first sign of a red board. Continue selling until the board turns green, or until equity exposure is zero.

For someone who can tolerate a little pain, the appearance of a red board could be monitored but not acted upon at first. When the market does begin to turn down, and assuming the board stays red, equity exposure could then be adjusted. The best way to use the situational awareness that Mr. Model provides is really a matter of individual risk preference.

The same goes for market downturns that take place with a green board. An aggressive investor might want to load up on equities, but a conservative investor might prefer to nibble around the edges. There is no one-size-fits-all solution. But one thing is certain. Having this awareness will put any investor in a better position to manage risk and boost returns than not having it. In a way, it's like counting cards at the Blackjack table. Knowing when the deck is full of 10s gives the player a distinct advantage over the dealer, who must take a hit until he has at least 17. Or playing high-stakes poker against an opponent who giggles uncontrollably whenever he's bluffing. In both cases, you have a significant information advantage. How you bet depends on who you are as a player.

However you choose to use this edge is up to you. But you might as well capitalize on your unfair advantage.

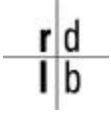


Chart 20

Conclusions -- Part 2



The 2015 stock market correction took place during an interval where the Enhanced Aggregate Spread [EAS] was calling for the Expansion phase of the business cycle to continue without interruption. Not only that, it was a forecast that said we would not approach the Boom phase of the cycle. We had a Green Board during the entire period from May of 2015 to July of 2016 that comprised the correction event in the stock market. Erik has mentioned the implications of the Green Board for the setting and execution of equity investment strategies. I would like to make only three comments about economic and stock market forecasts:

First: Don't try to forecast the stock market using only the economy. It can't be done. Which is why you never see it attempted here.

Second: Don't try to forecast the business cycle using only the stock market.

Third: Don't listen to those who do.

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