



Can The S&P 500 Predict Economic Cycles?

SYNOPSIS

- Anytime the S&P 500 sells off, as it did at the beginning of 2016, market pundits use the weakness to predict an imminent recession.
- The problem is that the internal composition of the S&P 500 differs from the economy, which exposes it to risks that the economy does not face at the same time.
- Use the S&P 500 as a gauge for large-cap stocks, but to get any insight into the economy, it's best to dig deeper to assess the drivers of each.

STOCK INDICES

Arguably the most famous of all stock indices is the S&P 500, which tracks a selection of large-cap stocks listed on U.S. exchanges across eleven sectors.

The index is “market-cap weighted,” meaning larger companies constitute a higher proportion of the index than smaller ones. For example, Apple is the largest publicly-traded company, so its weighting in the index is higher than Goldman Sachs.

This weighting methodology differs from other indices like the Dow Jones Industrial Average (DJIA). This index consists of 30 companies that are “price-weighted,” meaning the stock price determines its proportion of the index. Here, Goldman Sachs has a higher weighting than Apple because Goldman's share price is around \$160/share versus Apple at \$90/share.

NOTE: *Although the DJIA receives a lot of attention in the media, most professional investors exclusively use the S&P 500 as their benchmark for large-cap stocks. Stock prices can be misleading whereas the size of a company cannot.*

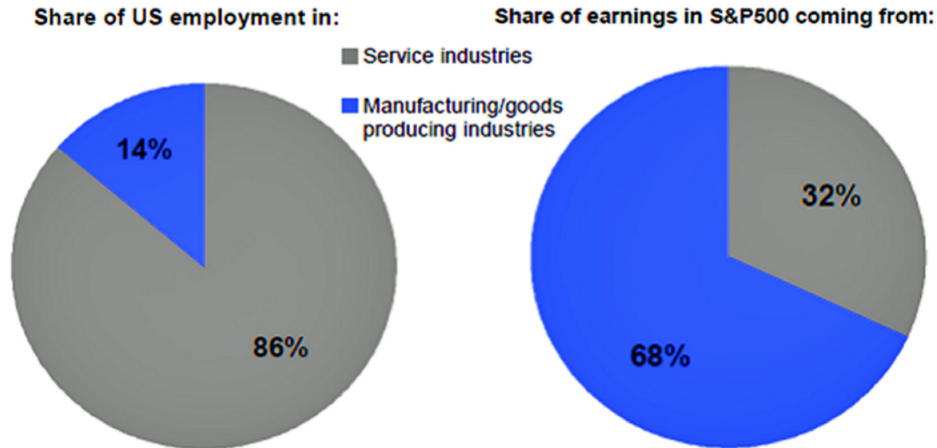
The internal composition of the S&P 500 and the U.S. economy vary quite dramatically.

Since the S&P 500 is the de facto benchmark for the U.S. stock market, it's often considered to also be a barometer for the health of the economy. When the economy is strong, stocks are expected climb higher, and when the index falls, it could be a sign that tough times are ahead.

In reality, the S&P 500 and the economy are quite different for two key reasons, which will explain why the stock market should not always be used as a leading indicator for the near-term direction of the economy.

1. DIFFERENT COMPOSITIONS

The internal composition of the S&P 500 and the U.S. economy vary quite dramatically. For instance, manufacturing and energy combined represent a very small portion of the economy at just 14 percent, but more than half of the S&P 500 earnings comes from manufacturers.



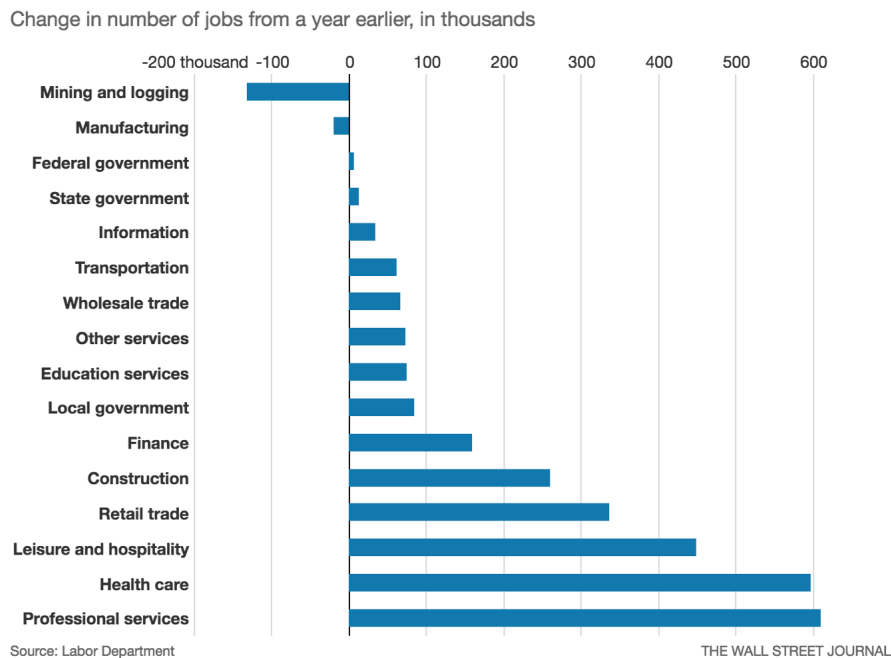
Note: Service industries are: Financials, Multiline Retail, Specialty Retail, Internet & Catalog Retail, Diversified Consumer Services, Hotels, Restaurants & Leisure, IT Services, and Health Care Providers & Services. Source: David Bianco, Ju Wang, Winnie Nip.

Due to the recent drop in commodity prices, a large portion of these companies are under tremendous pressure. In fact, close to 50 energy companies have filed for bankruptcy in just the past six months, and investors should expect to see even more down the road.

benefit as cheap energy keeps more money in the pocket of consumers.

However, the impact to the economy is quite different, and over time should actually provide a net

The chart below drives this point home even further by breaking down April's payroll data to show that jobs are being added to services industries, which makes up 86% of U.S. employment.



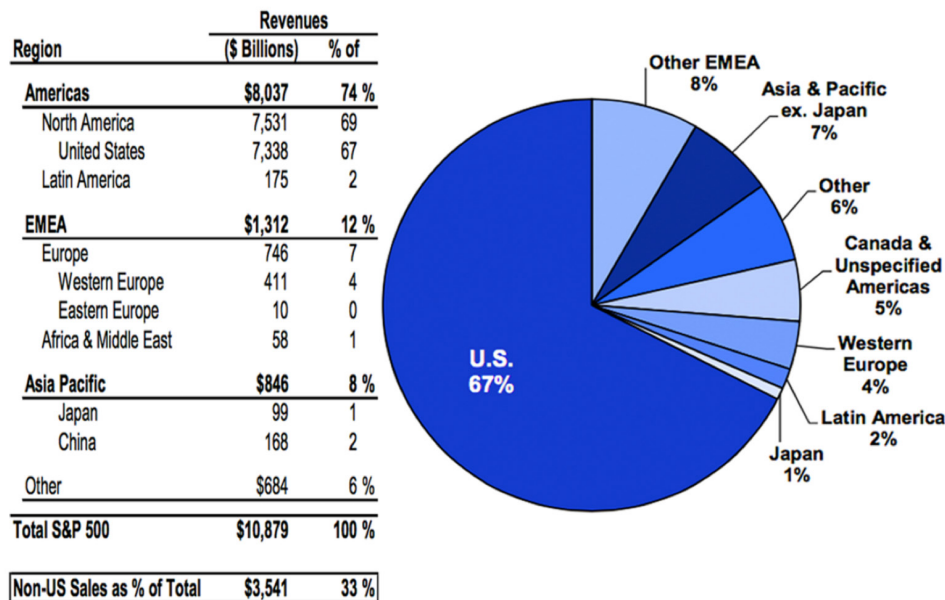
Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.

Simply put, weak manufacturing is having a far greater impact on the S&P 500 than our economy.

2. INTERNATIONAL SALES

A large portion of revenues from U.S. based compa-

nies come from selling goods and services overseas. According to Goldman Sachs research, foreign sales accounted for 33% of aggregate revenue for the S&P 500 in 2014. The chart below provides a geographical breakdown of these revenues:



Source: Company filings, FactSet, Worldscope, Compustat, and Goldman Sachs Global Investment Research.

Companies with earnings overseas must convert them back to U.S. dollars (USD), which exposes them to the rise and fall in the value of our currency. For example, if a U.S. company sells €50M in goods across the Eurozone in a three-month time period, then that company must convert those Euros (EUR) to USD on their financial statements.

Therefore, companies often face “currency risk” when reporting quarterly earnings because exchange rates between currencies fluctuate over time. In the example above, if at the beginning of the period the exchange rate is 1.3 USD for each EUR, and at the end of the three months the exchange rate moved to 1.2 USD per EUR, the firm will lose a portion of their earnings to currency. Here’s the math to see the actual impact:

$$€50M \times 1.3 = \$65M$$

$$€50M \times 1.2 = \$60M$$

$$\text{Total Loss } € \$65M - \$60M = \$5M \text{ in lost earnings}$$

The USD had risen in value relative to most other major currencies rather steadily over the last two years (until recently), and the impact has hurt many of these company’s bottom lines.

However, the impact on the U.S. economy and its citizens is minimal at best. In fact, a stronger dollar arguably helps Americans more than hurts them. For example, consider a couple planning a trip to Europe today versus two years ago. Since the dollar has risen in value relative to the Euro, that trip is now considerably cheaper.

IMPLICATIONS FOR INVESTORS

Paul Samuelson, one of the most well-respected economists in modern history, famously said:

“Wall Street indexes predicted nine out of the last five recessions”

Sarcasm aside, this statement is rather intuitive because it drives home one of the most important concepts for investors to remember, and that is the economy and the stock market are not the same.

That's not to say the S&P 500 is useless or flawed in some way. Often, it provides a tremendous amount of insight into the health of portions of our economy or can even unearth trends that the agencies collecting economic data fail to observe.

The critical point to keep in mind is that when stock prices fall or remain flat for a period, don't just assume that it's due to broad-based economic weakness. Instead, isolate the drivers for the selloff and then assess their impact on the economy.

In the example above, manufacturing weakness will certainly hurt, but since it's such a small portion of the overall economy, it's highly doubtful that it will drive us into a recession on its own.

Furthermore, economies that are driven by consumer spending do better with stronger currencies than weaker ones, despite the loss in earnings from companies that do business overseas.

The bottom line is that over the long run the stock market and the economy are in sync with one another, but over the short-term, they often march to their own tune.

Sincerely,



Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com

This commentary is not intended as investment advice or an investment recommendation. It is solely the opinion of our investment managers at the time of writing. Nothing in the commentary should be construed as a solicitation to buy or sell securities. Past performance is no indication of future performance. Liquid securities, such as those held within DIAS portfolios, can fall in value. Global Financial Private Capital is an SEC Registered Investment Adviser.

Global Financial Private Capital, is an SEC registered investment adviser principally located in Sarasota, Florida. Investment Advisory Services offered on a fee basis through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC, Member FINRA/SIPC.