Stock Market Perspective: New and "better" indicator?

Most stock market commentators, pundits and experts say that trying to time the market is almost certain to result in subpar investment returns, so one is foolhardy to even think about it. (Obviously, that is not my point of view.) Nonetheless, there seems to be a continuing stream of articles in mainstream publications about how some new and better indicator is telling us that now may be a good time to own or not own stocks. A recent example appeared in the September 21 *Wall Street Journal*. My answer to the question posed above is definitely not. Although it might qualify for my occasional gibberish section, I am discussing it here because it illustrates a not so unusual analytical mistake, adding together quantities that are not on the same scale or do not have the same marginal effects.

After graduating from college, Mark Hulbert had a clever idea for an investment publication. There were quite a few newsletters and services providing recommendations about the overall market and individual stocks. However, there was no widely available "Consumer Reports" evaluating how accurate they were, and, more importantly, whether one could make money by following the advice. In 1980, he started the Hulbert Financial Digest for that purpose. In addition to providing ratings of the relative merits of the services, the publication had the beneficial effect of motivating newsletters to make their recommendations more understandable and precise. Some writers had complained that he did not follow their advice as they intended, but Hulbert said he was using reasonable interpretations to what was said. His reporting about those services that were imprecise in their recommendations led most to take corrective actions.

Hulbert's publication is now owned by Marketwatch/Dow Jones, which has several financial periodicals, including the *Wall Street Journal* and *Barron's*.

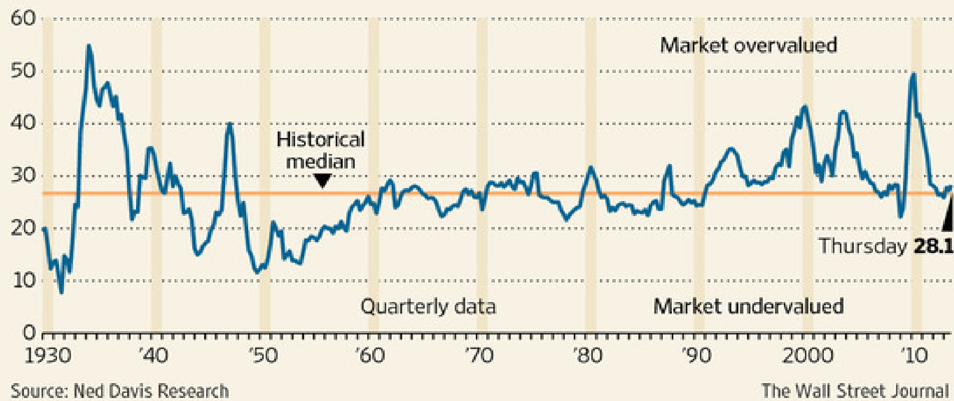
His September 21 column reported on a new indicator formulated by Ned Davis Research, a highly respected and often innovative firm whose high-priced products and services are marketed to institutional investment companies. My opinion is that this was not one of their better efforts. Perhaps that is why it was being "given away" in the newspaper.

The indicator is based on the sum of three values: the current rate of inflation, the unemployment rate, and the price/earnings ratio of the S&P 500 index based on its earnings in the prior 24 months. When this sum gets too high, it is not a good time to own stocks, and conversely. The article and the accompanying graph, which is shown below courtesy to the *Wall Street Journal*, imply too high means above the historical median value. That value since 1930 is 26.7, and a couple of days before the article it has moved up to 28.1. Is that meaningful?

My first problem with this indicator results from the scales of the components. Inflation has been negative and as ranged as high as the mid-teens. The unemployment rate can't be negative, and except during the great depression has never gotten as high as the teens. The P/E ratio can be negative, which really has no meaning since a larger negative value results from a lower level of losses, to extremely large when earnings are a small positive number.

Can an extension of the "misery index" often seen in political campaigns predict stock price movements?

My second big problem with this indicator is that it says a one point change in any of the three components has the same effect on the outlook for stocks. For example, If inflation rises from two percent to say six percent, this has the same negative implications as the P/E moving from 20 to 24. I think the former would be a strong negative while the latter would be at most a mild one.



(The indicator is reminiscent of the "misery index" that has been part of some presidential campaigns. It adds the inflation and unemployment rates. As a rough indicator of whether times are better worse than they were four or eight years previously, it likely is appropriate. However, it would not be a meaningful economic gauge.

In a similar vein, a popular current baseball statistic is the OPS that is the sum of the on-base and slugging averages. As a "ballpark mathematician" I have analyzed it and written about it. The first issue is the scale. On-base percentage can range from 0 to 1 while slugging can range from 0 to 4. My analysis has shown that the marginal effect on run scoring of on-base average is about twice as great as that of slugging average with some variations depending on the offensive level of the team or baseball as a whole.)

Now let's get an idea of how effective this indicator is. The graph appeared in the article. Notice that for all of the 1990s the indicator was above the median saying the market was "overvalued." That may have been true, but that did not mean it was a bad time to own stocks. In fact, it was a very good time, one of the best in history. The indicator moved deeper into overvalued territory later in the decade before the "dot com bubble" burst in 2000. Moreover, it moved much higher in 2010, but the stock market has continued to gain. I think anyone taking this indicator seriously and acting upon it would have been quite disappointed.

The graph shows that the indicator moved back down to the median level until recently creeping above it. How did that happen? As earnings recovered from the "great recession" P/E ratios plunged. Although unemployment and inflation have fallen by a few percent each, most of the move from 50 to around 26 is due to the P/E ratio, illustrating the marginal effects concern.

I have no idea how the "flashing yellow" showing the market is getting "overpriced" follows from the evidence in the graph. Perhaps it is a subtle way of showing that "market-timing" is a bad idea. It is if one does not use better tools.

Normally when I hear or read about a new indicator for timing the market, I try to get the data needed to evaluate it over a long period of time. In this case, that was not a temptation for the reasons discussed here. Moreover, my strong preference is for trend following tools, and this indicator is not one of those. In a way it is trying to tell the market what it should do. Instead, I want to let the market tell me what to do.