Mitch on the Markets

The 3 Most Important Stock Market Indicators

By Mitch Zacks
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A more appropriate title for this week's column might be, "The 3 Most Important Stock Market Indicators *That Few People Talk About."* If you are a regular reader of my column or are a Zacks Investment Management client, you know that corporate earnings are the single most influential indicator we use to make investment decisions. We developed a proprietary system for analyzing earnings and earnings revisions that guides our buy and sell discipline, and it's a key tenet of our Pure Investing philosophy. I won't get into those details here, but since you won't find corporate earnings in my "3 Most Important" indicators below, I wanted to make sure I got that point across.

And before I jump into the indicators that we believe are very important but that few people talk about, let me just take a moment to share a piece of data on corporate earnings that really reinforces my bullish outlook.

During the first two months of the first quarter, analysts actually *increased* earnings estimates for companies in the S&P 500. The Q1 bottom-up earnings-per-share estimate (which is an aggregation of the median EPS estimates for all companies in the index) rose by +5.7%. That number is hugely significant, in my view. We know that on average, the bottom-up EPS estimate usually *decreases* during the first two months of a quarter. Companies tend to want to downplay their earnings outlook, to keep expectations on the conservative side. Indeed, during the past ten years, (40 quarters), the bottom-up EPS estimate recorded an average *decline* of -4.0% during the first two months of a quarter. This time, estimates are *up* +5.7% (according to Factset).

In short, the outlook, to us, appears quite rosy.

The 3 Important Indicators that Few People Talk About:

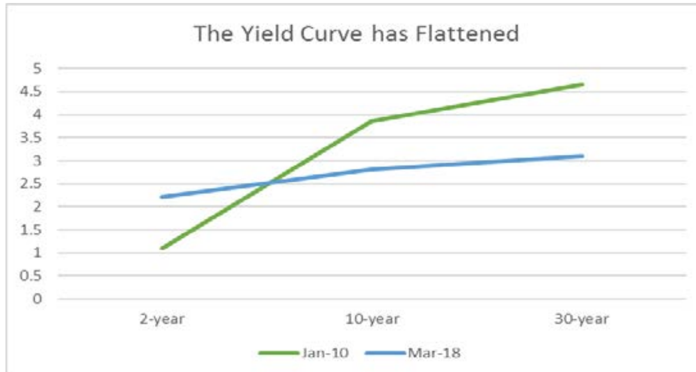
1) **Leading Economic Indicators**

We believe that the Conference Board Leading Economic Index (LEI) is arguably one of the most underrated macroeconomic metrics/indicators out there. If you try to find an instance where the LEI was going up and the economy fell into a recession, you wouldn't find one. Any time the LEI is high and rising, the economy has grown. It makes sense then that the key elements of the LEI are designed to signal peaks and troughs in the business cycle. It coincidentally looks at factors like manufacturers' new orders, building permits, the interest rate spread, weekly claims for unemployment insurance, amongst a few others. These are all indicators that may be able to offer *forward*-looking insights into economic activity, versus a metric like GDP that looks backward.

As of this writing, the LEI is high and rising – another good sign, for now (according to Conference Board LEI).

2) **The Yield Curve**

Regular readers have seen me mention the yield curve before, and I do so again to drive home its importance. A flattening yield curve generally tends to indicate that a slowdown lies ahead, and that's exactly what we've been seeing over the last few years. A recession does not necessarily follow a flat or inverted yield curve immediately, however. On average, the yield curve inverts 16 months prior to an economic recession and 13 months before major stock-market corrections (according to Silverlight Invest). As you can see below, we are not quite to inversion yet – the blue line (today's yield curve) is notably flatter than the green line (the yield curve at the beginning of 2010). If the yield curve continues to flatten and eventually inverts, it could be a major warning signal in our opinion. (according to data from the US Department of the Treasury).



Source: US Department of the Treasury

3) **Investor Sentiment**

This indicator is more qualitative than quantitative. One can measure investor sentiment somewhat by looking at University of Michigan Consumer Confidence numbers, and there are other indices that attempt to measure investors' comfort with risk. But in reality, this indicator relies more on intuition than data.

The two most recent bear markets provide useful examples. The 2000 tech bubble, of course, is notorious for wildly overpriced IPOs and investors' blindly throwing darts at start-ups in an attempt to make fast money. In 2008, the "euphoria" in investor sentiment came not from people overbuying and overpaying for stocks, but in consumer credit gone wild in subprime mortgages, home equity lines of credit, and ultimately massive defaults. That "bubble" was a bit harder to spot, but the road still led to overenthusiastic investors and consumers.

A key question with this indicator is, *are investors getting too comfortable with risk?*

Bottom Line for Investors

Fortunately for investors, I believe that all three of my aforementioned indicators seem to be on solid footing, for now. The LEI is high and rising, the yield curve is flattening but not yet inverted, and investors aren't quite "euphoric" about this market, in my opinion. I believe we are teetering towards a moment when all three could signal more bearish conditions, however, and it makes these indicators worth watching closely.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.