

# Intelligence MEMOS



From: William B.P. Robson, Jeremy M. Kronick, and Nikki Hui  
To: Worried Canadian Stock Market Watchers  
Date: February 12, 2018  
Re: **THE DURABILITY OF THE CURRENT EXPANSION**

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A slumping stock market – the S&P/TSX index was down 10 percent from its January high mid-Friday – has prompted concerns about the broader economy.

People associate ups and downs in equity markets with economic booms and busts. And with good reason: corporate earnings rise and fall with the economic cycle, and changes in financial asset prices can affect consumption and investment. Yet those correlations are clearer in retrospect than when stock prices are moving: the daily and weekly market fluctuations are hard to relate to economic fundamentals. But some clues about whether the recent ominous-looking drops prefigure a recession are available.

One source of insight is previous recessions and expansions. The C.D. Howe Institute's Business Cycle Council has looked at the longest consistent indicators of economic activity we have – the amplitude and scope of real GDP growth, and changes in employment – and that record allows some tentative judgments about whether the current expansion will shortly expire.

Ranked alongside two of the three expansions with definite beginnings and ends since 1975, the current expansion does look somewhat elderly ([see this graphic](#)). Compared to the 1992-2008 expansion, however, it looks more youthful – only about half as long.

If old age alone is not a threat to an expansion, what about unsustainable booms, with unsustainable spending fuelled by easy money or speculative excesses, until rising inflation, central bank tightening and bursting bubbles kill them off? Central bank interest rates have been very low, and real estate in some major Canadian cities looks bubbly. But average GDP growth has been slower in this expansion than its predecessors – 0.6 percent annually compared with 1.0 percent in both the 1975-81 and 1983-90 expansions, and 0.75 percent during the 1992-2008 expansion – and it has already weathered an unusually large number of negative quarters. Job growth has also been more subdued this time around.

So we don't have much evidence of the kinds of excesses that have propelled previous expansions into the graveyard. And the Bank of Canada and other central banks have signalled their caution about tightening when growth is subdued and inflation under control.

If neither old age nor riotous living threatens the expansion, what should we make of the stock market's abrupt drop? Perhaps valuations were reflecting an implausible combination of rapid earnings growth discounted at interest rates reflecting very low long-term bond yields. With the 2008 crisis nearly a decade in the past, yields have been rising toward the levels one might expect in a world where saving and investment are in better balance, and inflation is back where central banks want it.

As for the abruptness of the drop, volatility has been ultra-low for a long time, and its reversal in a world of indexing and other auto-pilot investment strategies was bound to be jarring.

For people looking at 10-percent losses on their equity portfolios, the idea that the stock market has simply corrected to a level more consistent with fundamentals is cold comfort. But for those worried that the correction prefigures a recession, there is a reassuring message in the record of past expansions in Canada.

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