Markets still a good litmus test for the economy, finance expert says

March 2 2009

Don't put much stock in rumblings that financial markets are a faulty barometer of the nation's economic climate, a University of Illinois business expert says.

While day-to-day ups and downs can be misleading, finance professor David Ikenberry says broader stock market trends are a good indicator of how the economy is faring and whether it's on the rise or sputtering.

"Markets are made up of a lot of people with a strong motivation to discern the truth because it's in their own best interests financially," he said. "To ignore that dynamic, you're turning your back on a valuable tool in terms of gauging economic health."

Questions about whether markets accurately reflect the economy have surfaced as stock indexes continue to slide despite massive government initiatives to stem the deepest economic downturn since the Great Depression.

Ikenberry concedes that one-day swings are sometimes deceptive, rooted in overreactions to news reports or other market nuances. Over time, though, trends typically mirror the state of the economy, he said, including a nearly 50 percent market plunge during the current meltdown.

"While investors may not be able to get it right all of the time, they do get it right on average," said Ikenberry, whose market research includes long-horizon stock returns.

He says a close look at recent market activity shows that the economy may indeed be responding to an unprecedented wave of bailouts, stimulus plans and other government efforts to reverse the slide.

Most of the market's recent tumble came last fall, and declines have ebbed in the wake of government moves to shore up credit, housing markets and industries such as auto making that were on the verge of bankruptcy, Ikenberry said.

Trading that was once furious also is stabilizing, based on the Chicago Board Options Exchange Volatility Index, a popular measure of the implied volatility of S&P 500 index options. The index shows volatility remains twice as high as normal, but four times lower than last fall during the peak of the financial crisis.

"After big, precipitous declines in October and November, it really looks like the market is going sideways now," Ikenberry said. "That reinforces that the market is taking everything into account and trying to look forward."

Restoring the flow of credit is a key to recovery, and markets are showing early signs that government efforts to mend the banking system are working, he said.

"There's still a lot of negative news on the horizon and there are still going to be negative contractions," Ikenberry said. "Things will continue to get worse before they get better and we're a long way from saying we've turned the corner, but there are weak signals that the economy is starting to stabilize a little bit."

Source: University of Illinois at Urbana-Champaign