

Business Cycle Basics, Part 2 Money Drives Asset Prices

John Greenwood

International Monetary Monitor

January 2022

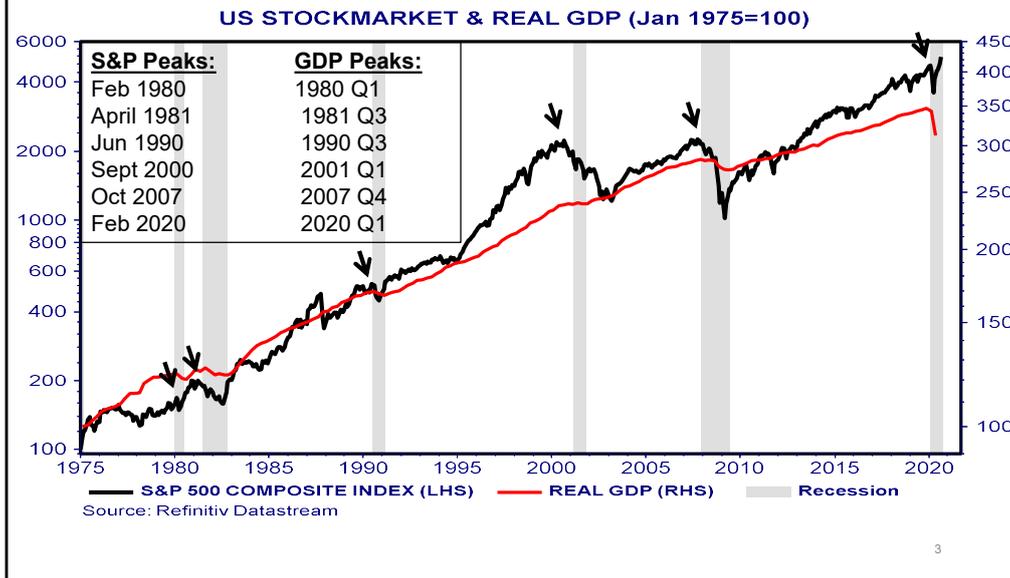
“Monetary policy is not about interest rates. It is about the rate of growth of the quantity of money.” Milton Friedman, interviewed on NBC’s Meet the Press, October 24, 1976.

Outline of the Series



- **Part 1: Business Cycle Basics – The Monetary Framework**
- **Part 2: Business Cycle Basics – Money Drives Asset Prices**
- **Part 3: Business Cycle Basics – Money Drives (Nominal) Spending**
- **Part 4: Business Cycle Basics – Money Drives Inflation**
- **Part 5: Business Cycle Basics – The Transmission Mechanism**
- **Part 6: Business Cycle Basics – Money versus Credit**

Stock Market Peaks Almost Always Precede the Peaks of Economic Expansions

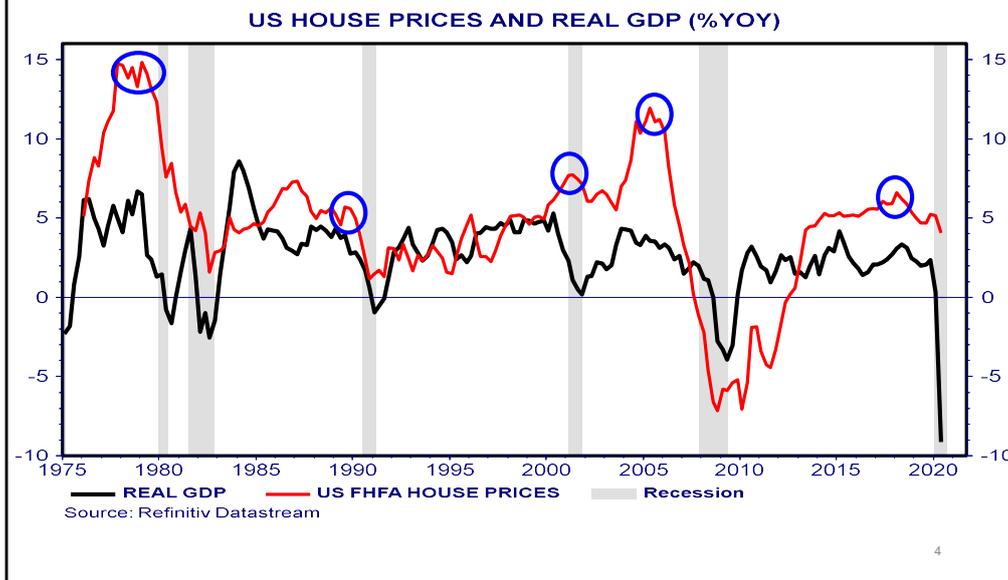


The chart above illustrates the relation between stock market peaks and business cycle expansion peaks in the US. The business cycle peaks are measured by the NBER’s Business Cycle Dating Committee and are judged to have occurred when activity across a broad range of indicators peaks and is followed by a sustained downturn – i.e. a decline of economic activity in absolute terms. The shaded panels indicate recessions on this definition. While the NBER does not rely exclusively on GDP or its components to determine the start or end of the cycle, the movements of real GDP (shown in red) nevertheless match the timing of the NBER-designated cycles very well.

The key message of the chart is that every business cycle peak was preceded by a peak in the stock market as measured by the S&P 500 Composite Index. The S&P peaks are shown by the small black arrows, and it will be noticed that every stock market peak since 1975 has occurred shortly before the onset of a recession. By the same token, the stock market has typically declined before and during the early part of recessions.

Of course, there have been other temporary declines in the stock market that have not always aligned with the business cycle (e.g. the October 1987 crash), but the market later rallied and continued to rise to a new peak before the end of the business expansion.

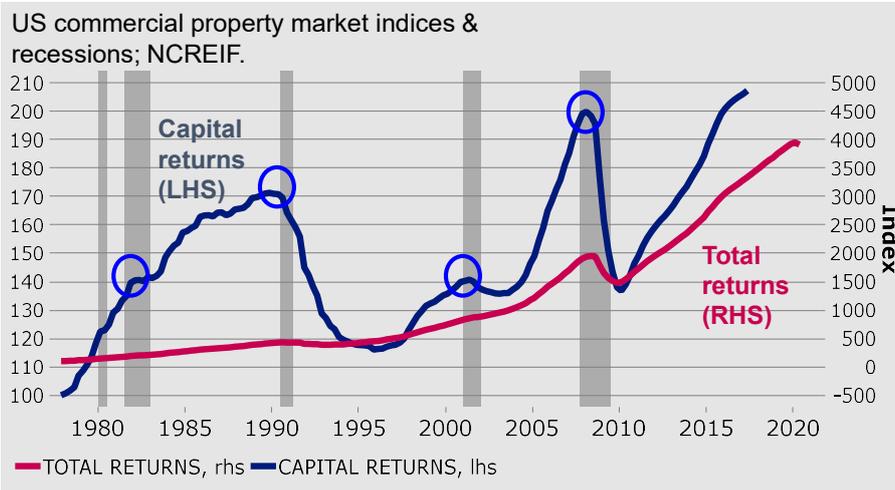
US House Price Peaks also Precede Business Cycle Peaks



Taking another class of asset prices – house prices – the relationship outlined in the flow charts on pp. 2-4 is reinforced by the data shown in the chart above. Although many commentators had generally assumed until 2007 that US house prices almost never declined, that does not mean there was no cycle. In fact the cycle can be readily shown by means of year-on-year percentage changes of the Federal Housing Finance Agency (FHFA) House Price Index (red line), as in the chart above which also shows real GDP on a year-on-year percentage change basis (black line).

Judged on this basis, house prices have generally peaked shortly before the onset of each recession since 1975. Each peak is highlighted by a blue circle. Note that the back-to-back recessions of 1980 and 1981-82 are treated here as a single recession. Only in the recession of 2001 did house prices peak during the recession (2001 Q2).

US Commercial Property Price Peaks also Generally Precede Recessions



Source: Macrobond as at 14 June 2018.

5

The data for commercial property prices (from NCREIF, or the US National Council of Real Estate Investment Fiduciaries) can be viewed in terms of their level. The chart shows two series – capital values and total returns (which include rental returns). Restricting the analysis to capital returns, each pre-recession peak has again been highlighted by a blue circle. This time the only real anomaly is the lack of any peak ahead of the 1980 recession, probably due to the prevailing high inflation at that time. The same observation applies to the flattening out -- rather than any decline -- of the index in the 1981-82 recession (circled).

The total returns are far less cyclical, even on a year-on-year basis – testimony to the large role played by rental yields in total return on commercial real estate.

US190