



Chart of the week

For now, tighter financial conditions appear unlikely to cause damage to real-economic activity

Incoming economic data suggests that the economy is doing fine. At the same time, financial markets are struggling, after a strong start into 2018. Is this just a return of market normality after an unusually calm 2017? Or are we seeing a significant worsening of the financial environment, which could derail the economy? To address these questions, we take a look at a financial-conditions index in this week's "Chart of the Week".

Comparing the Goldman Sachs Financial Conditions Index¹ for the U.S. with the ISM Manufacturing Index (also known as the ISM Purchasing Manager Index), we find that there seems to be some correlation. Of course, sentiment in the corporate sector is not only driven by financial markets, hence the two indicators do not entirely move in sync. Where do we stand right now? "Obviously, the easing in financial conditions, which we have observed in 2017, has come to an end", notes Josh Feinman, DWS's Chief Global Economist. While properly measuring financial conditions is far from straightforward, the readings so far on this and other measures do not indicate that the economy is in trouble. It would take, for example, a substantial further rise in credit spreads, or decline in stock prices, to have a significant negative impact on the economy. The last time this happened, namely in late 2015 and early 2016, we witnessed a deterioration in financial conditions. The ISM index indeed duly fell below 50, indicating shrinking activity. Currently, such a scenario is still some way off.



Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH as of 4/4/18

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¹The Goldman Sachs Financial Conditions Index is a weighted sum of a short-term bond yield, a long-term corporate yield, the exchange rate, and a stock market variable. Source: FINANCIAL CONDITIONS INDEXES: A FRESH LOOK AFTER THE FINANCIAL CRISIS, by Jan Hatzius, Peter Hooper, Frederic S. Mishkin, Kermit L. Schoenholtz, Mark W. Watson. NBER Working Paper 16150, July 2010. <http://www.nber.org/papers/w16150>



Glossary

Correlation

Correlation is a measure of how closely two variables move together over time.

ISM Purchasing Managers Index

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

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