Stocks and the Economy: Mind the Gap

Since late March, stocks have surged, while the economy has tanked. What's going on?

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U.S. stocks have been on a tear. Following a 34% plunge between February 19 and March 23, the S&P 500 bounced back, recouping the majority of those losses. As of May 30, 2020, the index had climbed 36% from its March low, only 10% below its all-time high set in February. That puts it on the same level it was in late October 2019, only seven months ago.[1]

Meanwhile, the economy presents a very different picture. Unemployment in the U.S. skyrocketed to 14.7% in April, its highest level since the Great Depression. Institutional loan default rates are up sharply, and bankruptcy filings are expected to follow suit, especially among retailers. The Congressional Budget Office expects second quarter GDP to tumble by 12%, its largest drop since the early 1930s. At this point, any hope for a V-shaped recovery is gone, and even the Federal Reserve has cautioned that it could take time for the economy to bounce back, especially if second-wave virus outbreaks emerge. In fact, many economists are calling for a drawn out recovery, with fits and starts, as secondary waves of infections keep some businesses shuttered and scare consumers away from stores and travel.

To put the disparity in perspective, consider some recent bear markets and their economic fallout. In the 2007-2009 financial crisis, the S&P 500 lost 56% of its value. Yet unemployment never topped 10%, and GDP fell only 2.5% in 2009. Or, consider the dotcom bust, when the S&P 500 fell 49% (and the NASDAQ Composite lost three quarters of its value) The ensuing economy saw unemployment top out at 6.3%, while annual GDP growth remained positive.

Clearly, the current market would seem to be at odds with economic reality. But there are several different factors at work here.

Stocks Are Not the Economy

As Nobel Prize winning economist, Paul Samuelson, famously quipped back in the 1960s: the stock market has predicted nine of the past five recessions. Paul Krugman, another Nobel laureate, suggests three rules when considering the economic implications of stock prices: "First, the stock market is not the economy. Second, the stock market is not the economy. Third, the stock market is not the economy."[2]

As both men emphatically point out, the dynamics driving stocks differ from those driving the economy. The major market indexes such as the Dow Jones Industrial Average (DJIA) or the S&P 500 reflect a limited segment of the economy, and the majority of stocks are owned by a small percent of the population. The widely followed DJIA, for instance, is composed of just 30 blue-chip stocks. Even the broader S&P 500 index contains only the largest of U.S. companies. Small businesses, which represent the lion's share of U.S. businesses and employ almost half of Americans working in the private sector, have little representation in stock indexes. Yet it is those smaller businesses, many with limited cash reserves, which are taking the biggest economic hit from the pandemic.

Stock index prices are also driven largely by constituent companies' earnings and profits, which may have little to do with economic metrics such as unemployment. Furthermore, stocks are highly sensitive to interest rates and monetary policy changes, which typically take much longer to be felt in the economy.

Government Moves to Shore Up the Economy Have Been Unprecedented

The optimism of investors in the face of economic freefall may be justified in part by the bold steps taken by the Federal Reserve and Congress to stem the fallout from lockdowns and closings. The Federal Reserve has slashed interest rates, increased the money supply, and taken different measures to support capital markets. For its part, Congress has passed unprecedented stimulus legislation, boosting weekly unemployment checks by $600, and passing such bills as the CARES Act. Meanwhile, the Small Business Administration is also supporting businesses through its Paycheck Protection Program. Collectively, such moves -- and many others by state and local governments -- not only provide immediate relief to millions of companies and workers, they also send the message to investors that the government is willing to take whatever steps are necessary to get the economy back on track.

Stocks Are Still the Investment of Choice

Long before the coronavirus struck, anyone seeking return was turning to stocks. Yields on bonds and cash had been historically low for years. Now, with recent interest rate cuts, that trend is more pronounced than ever. The interest rate on 10-year U.S. government bonds is currently only 0.64%, down from more than 3% in late 2018.[3] After inflation is factored in, that works out to a negative return. Meanwhile, higher-yield bonds are riskier than ever as cash-strapped issuers struggle to make interest payments. So it's no wonder that capital continues to gravitate toward stocks -- even in the face of economic turmoil -- since they are pretty much the only game in town for return-hungry investors.

The Road Ahead

Whether stocks will continue on a divergent path from the economy is anyone's guess. Ultimately, the longer-term health of both the stock market and the economy will largely hinge on the success in slowing and stopping the pandemic. A slowdown in new cases and the early results of a vaccine in development are promising signs. But any resolution will take time, and there will likely be bumps in the road. In the interim, fasten your seatbelts, stick to your plan, and consult with a professional before making any major financial decisions.

[1]Google Finance.

[2]New York Times, *Crashing Economy, Rising Stocks: What's Going On?*, April 30, 2020.

[3]U.S. Department of the Treasury, *Daily Treasury Yield Curve Rates*, May 1, 2020.