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The Stock Market Is Not the Economy

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Snapshot

- At the end of July, many economic indicators were at levels that would indicate trouble in the U.S. economy.
- After falling over 30% in March from its peak in February, the S&P 500 Index finished July ahead for the year-to-date.
- Despite the apparent disconnect from daily economic headlines, we believe there is still room for equities to go higher.

Despite improvements in some economic indicators in June and July, most are still at levels that would otherwise indicate trouble in the U.S. economy. In fact, economic growth in the U.S. contracted by over 30% at an annualized rate in the second quarter, its worst drop on record and four times the level seen during the worst of the global financial crisis.

American workers submitted more than one million unemployment claims for 19 consecutive weeks through the end of July (a level of joblessness previously never breached in the data series' 50-plus years), and the unemployment rate remains over 10%.

Yet, after falling over 30% from its February peak as the COVID-19 pandemic spread to the U.S., the S&P 500 Index ended July positive for the year-to-date, just 3.4% down from its all-time high. The second quarter of 2020 was its best in more than 20 years.

Causes for the Disconnect

Market-cap indexes like the S&P 500 reflect the performance of the largest and usually most profitable companies within a given universe.

The technology, communication services and health care sectors all benefited for different reasons from the spread of COVID-19. These companies accounted for almost 50% of the value of the S&P 500 Index at the end of July but represented a much smaller percentage of U.S. GDP.

Because almost all of the large companies in these indexes also have global operations, their prospects can be heavily shaped by the economic outlook outside the U.S.

On the other hand, small business—typically neighborhood restaurants, bars and other small enterprises that aren't listed on a stock exchange and do not have a diversified global footprint—were least prepared or able to survive the widespread lockdowns or reluctance of consumers to return; however, these companies make up close to 50% of U.S. GDP[1].

[1] Source: U.S. Small Business Administration. Data as of 6/30/2020.

Increasingly optimistic news that a COVID-19 vaccine could be a reality within the next year has also been beneficial for the economy's long-term outlook, helping to mitigate the pessimism associated with daily death tolls. However, the associated headlines are nothing tangible that will directly affect the current economic numbers.

Our View

It's challenging to make accurate economic calls even under more normal circumstances. Add in the direct and knock-on impacts of lockdowns, the range of potential paths that COVID-19 could still take, and the countless combinations of business and policy responses under each of these scenarios, and it is truly anyone's guess what the future holds.

However, we believe there is still room for equities to go higher:

- Federal Reserve policy remains extremely expansionary; excess liquidity has continued to flow into equities
- Government fiscal policy continues to provide a good deal of income support to households and business, although a fiscal cliff looms immediately ahead if negotiations over the latest stimulus package founders on the shoals of election-year politics
- Government bond yields are negative in inflation-adjusted terms; we believe equities remain one of the few investments capable of producing increased wealth
- Record-low interest rates justify higher-than-normal valuations
- One should not underestimate the ability of equity markets to adapt to a changing environment, especially given the breakneck advances in technology and knowledge now taking place

Even if one assumes the S&P 500 Index may post sub-par returns in the years ahead, we believe:

- Equities beyond the technology sector and mega-caps appear cheap
- International equities can outperform U.S. equities, especially if the dollar enters a sustained period of currency weakness

Our investment managers are thinking in terms of years, rather than months, before the corporate earnings environment recovers from below-trend economic activity to more normal conditions. We believe there will be plenty of opportunities for skilled managers to capitalize on and that investors will be rewarded for their patience and moderation.

Index Definitions

S&P 500 Index: The S&P 500 Index is an unmanaged, market-weighted index that consists of 500 of the largest publicly-traded U.S. companies and is considered representative of the broad U.S. stock market.

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