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The Stock Market Is Not the Economy

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Snapshot

- Despite improving data at the end of October, many U.S. economic indicators remained 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 reached an all-time high in October and finished the month 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 recent months, most are still at levels that would otherwise indicate trouble in the U.S. economy. U.S. GDP 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.

However, even after a 33% increase in the third quarter, U.S. economic growth remains down about 3.5% for the year and still in recession territory.

American workers submitted more than 750,000 unemployment claims for 32 consecutive weeks through October 24 (a level of joblessness previously never breached in the data series' 50-plus years), and the U.S. unemployment rate remains over 7%.

Yet, after falling over 30% from its February peak as the COVID-19 pandemic spread to the U.S., the S&P 500 Index reached an all-time high in October and ended the month up 2.8% for the year-to-date (USD). The second quarter of 2020 was its best in more than 20 years.

Canadian GDP data showed a 1.2% gain in August, the fourth consecutive monthly gain following March and April declines of -7.4% and -11.6%, respectively. Still, at the end of October, the S&P/TSX Composite Index was up over 40% from its March low and off about 2% during the previous 12 months, while economic growth over the same period remained well below zero.

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 October 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 businesses in the U.S.—typically neighbourhood 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].

In Canada, economic hardship also hit small- and medium-sized businesses, which make up 70 per cent of private-sector employment, the hardest. These companies were most endangered by the early lockdowns because they had the least cushion to endure through the bad times[2].

Increasingly optimistic news that a COVID-19 vaccine could be a reality within the next year has helped to mitigate some of the pessimism associated with daily case numbers and death tolls. However, the associated headlines are nothing tangible that will directly affect the 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:

- U.S. Federal Reserve policy remains extremely expansionary; excess liquidity has continued to flow into equities
- Current projections suggest that the Bank of Canada will maintain its policy lending rate for at least the next several quarters
- 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:

- U.S. 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.

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

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