ON OUR MINDS

Connections and Disconnections

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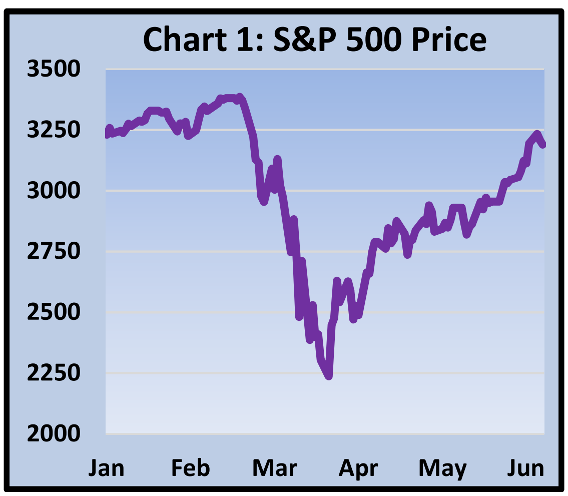
Be honest – you didn't expect the stock market to recover all of its year-to-date losses in just two months, did you? I know I didn't. After 40 million job losses and a steep drop in GDP growth, the economy looks very different than it did back in January, but here we are. And you may ask yourself, well, how did we get here? How can the stock market's ebullience be so disconnected from the real economy's misery? Don't investors fear a second wave of Covid-19? Hasn't the splattering over the past few trading sessions been long overdue and a taste of things to come?

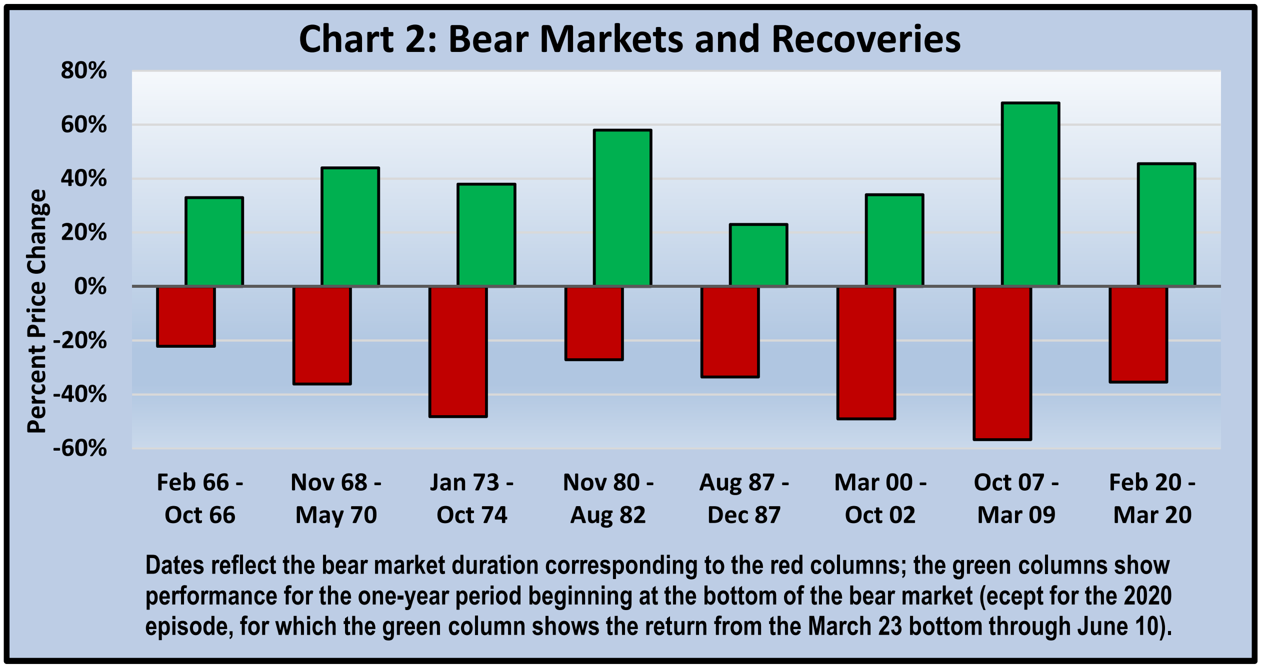
The talking heads on cable television have all sorts of theories about what's happening in the markets: They will tell us that economic data looks backward while markets look forward; they will remind us that the market is all about *companies*, not *economies*; they may surmise that the pendulum has swung irrationally from fear to greed simply because that's human nature. Rather than pontificate with the pundits, I'd prefer to look at a few pictures and see what they tell us. Perhaps the economy and the markets are more connected than it may appear at first glance.



Source: FactSet; Data through June 10, 2020

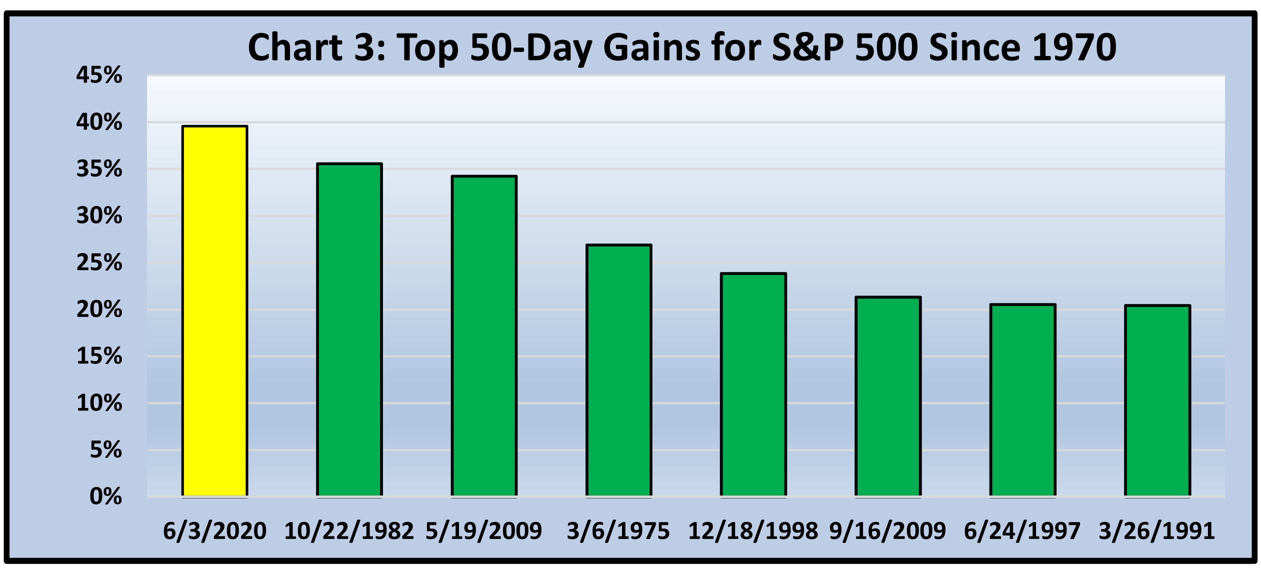
Chart 1 shows the S&P 500 index from the beginning of this year; the V-shaped pattern of collapse and rebound is unmistakable and is in sharp contrast to the majority of Wall Street economic forecasts, which speculate that real GDP growth will look more like a U, a W, an L, a square-root sign, or perhaps even the Nike swoosh – pick your favorite shape, but it's not likely to be a V. This makes intuitive sense, because many industries will probably take a long time to recover; even the Federal Reserve thinks we won't be back to full strength until at least 2022. The market's apparent disconnection from this economic reality seems all too obvious.

Charts 2 and 3 provide some historical context. Chart 2 shows that the severity of the 2020 bear market and the ensuing rebound are reasonably comparable in magnitude to previous episodes. In this sense, the rally since late March doesn't seem at all disconnected from the downdraft that preceded it. Indeed, it is the *pace*, not the *magnitude*, which sets this year's bear market apart: The prior seven bear markets developed over the course of time, as prices dropped an average of 4.1% per month over a protracted period; the 2020 bear plunged about 35% in just five weeks. The pace this year has resembled the market's typical response to a natural disaster like a hurricane, even while the magnitude has been more reflective of the kinds of deeper distress inflicted by recessions.



Source: Morgan Stanley

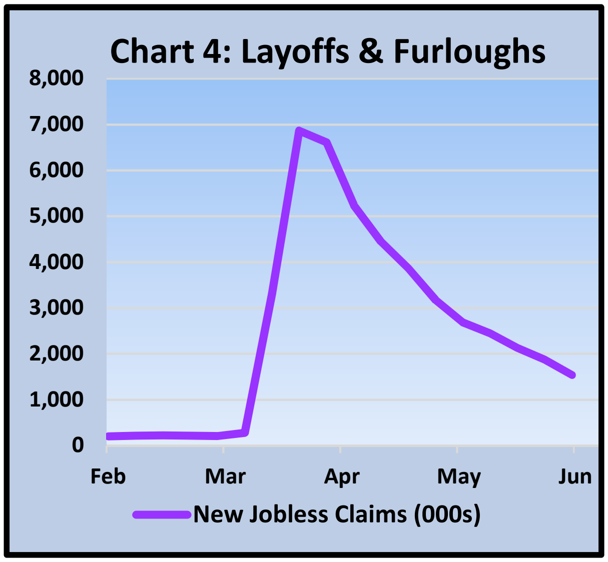
Chart 3 shows the rebound effect: The 50-day trading period ending June 3 was the strongest such period in the past 50 years.[1] In the current instance, the rally is most likely tied to the progress of Covid-19: As cases nationwide – and especially in the New York area – started to fall, and as states started to reopen their economies, markets grew increasingly optimistic that the bottom was truly in the rear-view mirror.

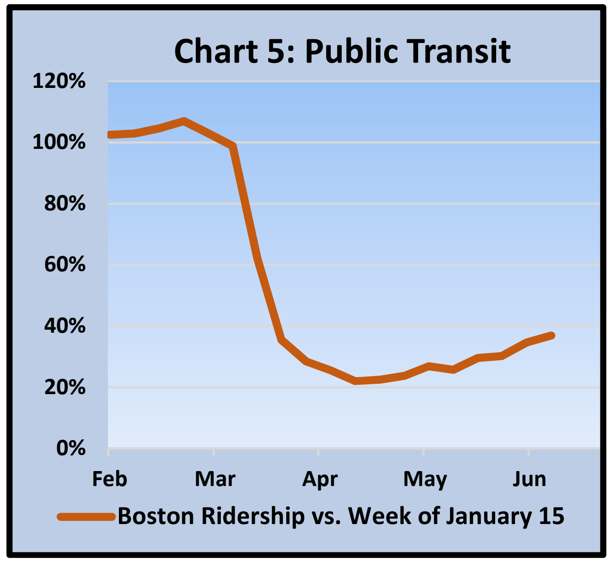


Source: FactSet

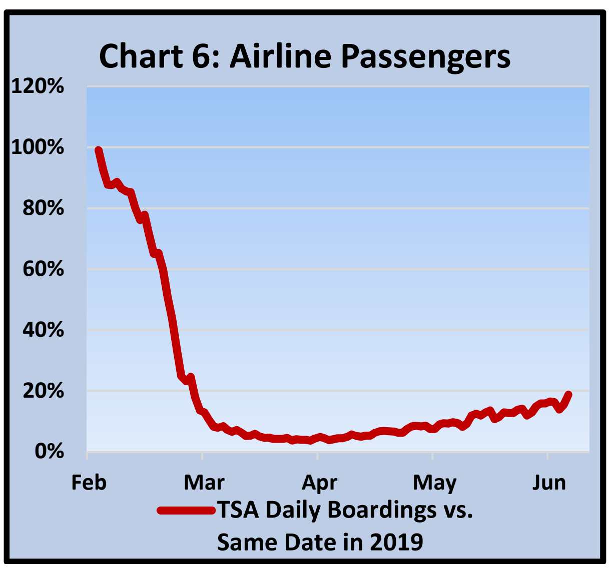
[1] Note that *all* of the big 50-day spans in Chart 3 came immediately after bear markets or significant corrections. That's why it's so important for investors to remain fully invested: You can't know in advance when a bear market will end, but that's when the biggest gains emerge.

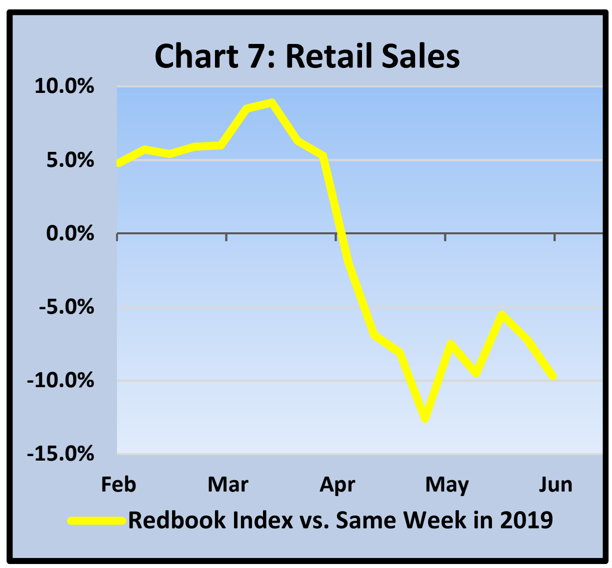
Markets got excited because the high-frequency data[2] in recent weeks has begun to show signs of improvement. Charts 4 through 9 provide a sampling; in some of these charts, improvement from abysmal levels seems to be taking hold: People are traveling again, at least a little; and we're beginning to return to restaurants. In the other charts, however, conditions still seem to be worsening: We may be traveling, for example, but it's apparently not to the mall. In this respect, the stock market's sudden recovery seems to be at best premature; nonetheless, the optimists on Wall Street have latched onto small improvements and projected them out into a rosier future for which the evidence just isn't yet there.





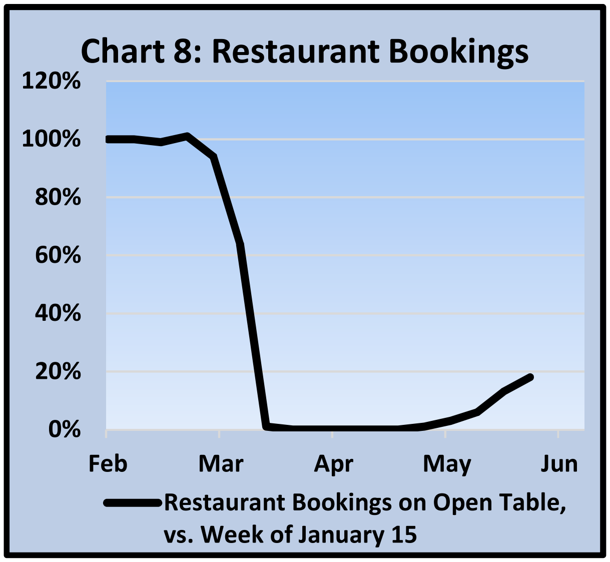
Sources: Chart 4: Labor Department; Chart 5: moovit.com

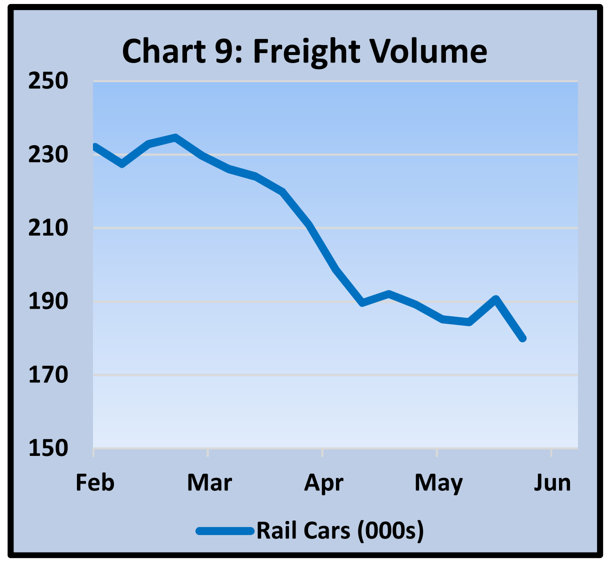




Sources: Chart 6: Transportation Security Administration; Chart 7: Redbook Research

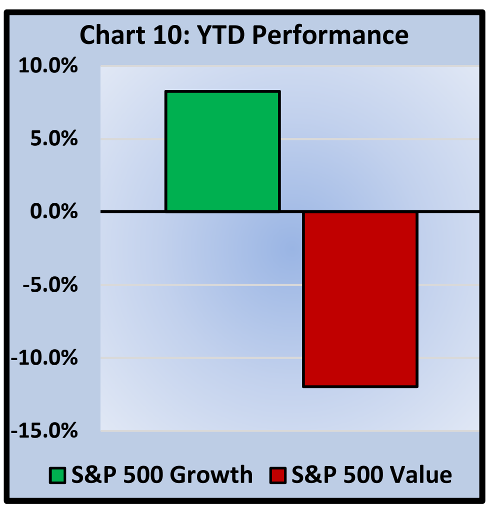
[2] The term "high-frequency" simply denotes mostly unofficial metrics that are tracked weekly, as opposed to most official government statistics that are published on a monthly basis. High-frequency data is presumed to give us a reading closer to real-time than the delayed government reports.

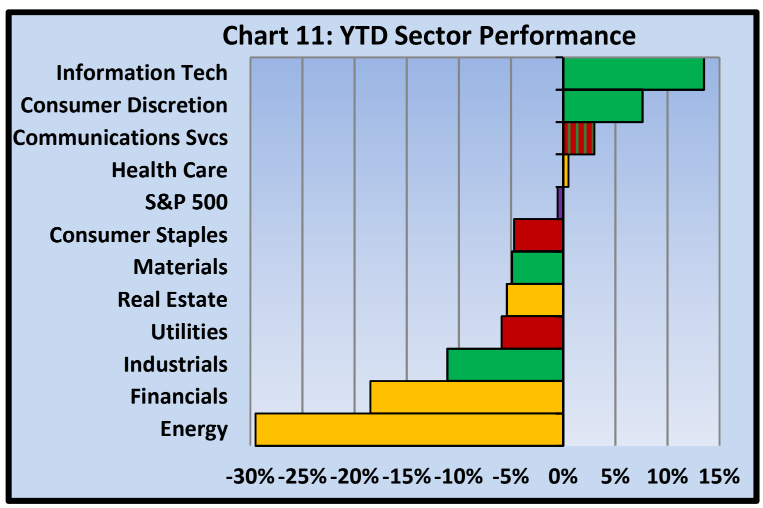




Sources: Chart 8: Open Table; Chart 9: Association of American Railroads

Perhaps, though, the markets are smarter than we might think. The companies in the S&P 500 index don't all act the same way, and in fact the performance of different companies and industrial sectors has varied dramatically through the course of 2020. Most notably, investors have consistently been willing to pay up for earnings growth and dividend growth. As Chart 10 shows, the "growth" half of the market index is actually *up* for the year, and it has sharply outperformed the "value" half. Chart 11 provides a more finely grained slice of the same data: Growth sectors such as technology, consumer discretionary, and communications services have posted gains this year, while the industrial economy has lagged badly.[3]

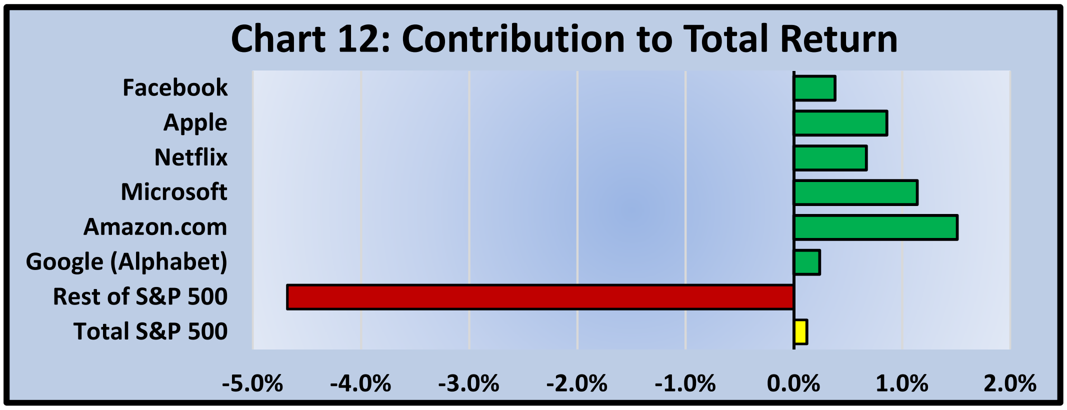




Source (both charts): FactSet; Data through June 10, 2020

[3] If it seems odd that consumer discretionary stocks have done well (since the category includes airlines, retailers, restaurants, and other industries that have been decimated this year), remember that it also includes companies like Amazon.com and Netflix, which have larger market capitalizations and a bigger impact on the sector's performance. Likewise, the staid-seeming communications services sector includes high-growth names like Facebook and Alphabet, the parent of Google.

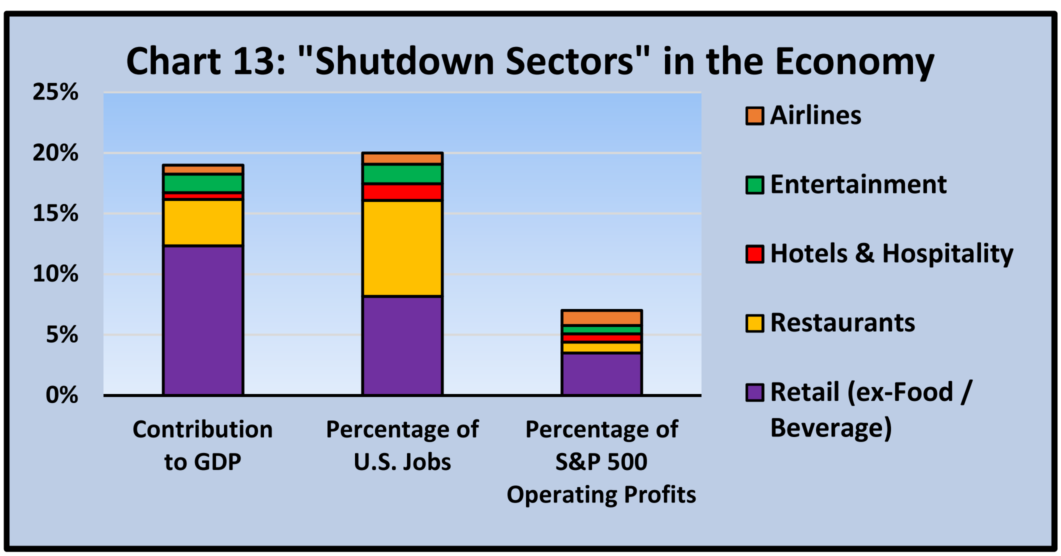
We can take this analysis even further, to examine the impact of individual companies on the overall index return – both the good and the bad. In Chart 12, the seven so-called FANMAG stocks have been superstars, while nearly the *entire* remainder of the S&P 500 has been in the dumps this year. The markets have rewarded these six stocks (and a few others) because they have strong growth profiles; they were well-positioned to capitalize when the world was in lockdown, and they remain well-positioned as we collectively emerge as well.



Source: FactSet; Data through June 10, 2020

As it happens, these six stocks have gigantic market capitalizations, too. They account for nearly 23% of the overall index's value. The combination of huge market caps and robust earnings growth has been enough for the FANMAGs to pull the entire market close to breakeven for the year so far.

The other side of this assessment, of course, is that the Covid-19 pandemic has nearly destroyed several entire sectors of the U.S. economy, crushing the profitability of companies in a wide array of industries. Their impact on the stock market, however, has been surprisingly muted; Chart 13 shows why.



Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; FactSet; JP Morgan Asset Management

Chart 13 aggregates data for five groups of companies that can broadly be labeled as the "shutdown sectors," those industries most severely affected by the pandemic response: Hotels, restaurants, non-essential retail, entertainment outside the home, and airlines. Collectively, these industries produced 19% of American GDP in 2019, and they accounted for 20% of all American jobs. Yet these companies typically operate with slim profit margins, and they contributed only 7% of S&P 500 profits last year. That's why even though the shutdown of these industries has had a profound impact on the economy and on employment, it has had only a minor impact on S&P 500 profits.

We have a bifurcated stock market today: Sectors that are showing robust sales and profit growth – in many cases *because* of the lockdown, in some cases *despite* it – are being handsomely rewarded; a half-dozen companies make up nearly a quarter of the market's value, and their prospects are very healthy. At the other extreme, a much larger group of companies constitutes about one-fifth of the entire economy and has a severely compromised outlook, but they only represent about one-fourteenth of the stock market's value. These two groups have roughly offset each other, leading to an overall market index that has regained almost all of the value it had lost earlier this year.

In short, the stock market's recent action is rational, albeit seemingly disconnected from the American economy. Even the market action over the last week makes sense in this rubric: A sudden uptick in Covid-19 cases cast into question market expectations for a reopening economy. California, Texas, and Florida all reported record-high numbers of new cases last week, and several other states reported that case totals had grown by more than 30%. If this is the vanguard of a second wave, states will have to rethink their plans, potentially dampening profit growth again – hence the market's 6% nosedive on Thursday and further 2% dip this morning. The stock market is, after all, the same as it ever was, reflecting both corporate prospects and investors' emotions.