Everyone likes to see the value of their portfolio increase. However, in the current market environment, something may not feel quite right. The spring 2020 rally has seen equity markets enjoy a strong rebound off the March 23 lows. Yet the rebound has coincided with sustained growth in COVID-19 caseloads and rampant unemployment. How so?

It's not easy to reconcile the stark disconnect between the stock market and the economy. You may be left questioning how markets could stage a rally when tens of millions of jobs have disappeared across Canada and the U.S. To help make sense of this, let's explore the competing forces in more detail – starting with a high-level overview of each:

- **The stock market.** Reflects the consensus view about the health and future earnings potential of publicly traded companies. Across headlines, the stock market is widely represented by the S&P 500, an index comprised of 500 large companies that trade on U.S. exchanges. Many of these companies operate on a global scale including Microsoft, Walmart, Starbucks and Amazon.

- **The economy.** Captures how money is made and spent. For a country, this is represented by the aggregate activities of its consumers, corporations, financial institutions and governments. Within the headlines, the economy is widely measured and tracked through changes in Gross Domestic Product (GDP).

**The relationship between the stock market and the economy**

It's natural to expect the path of a country’s stock market to closely track that of its economy. However, in reality it's not that simple.

As investors gauge the future earnings potential of publicly traded companies, they are influenced by the broader environment – which includes the latest economic developments. But there are a number of other factors to consider as well. Some of these play an even greater role in the way investor’s value companies.

As a result, there has never been a consistent relationship between the stock market and the economy. While the two tend to loosely move in the same direction, they act in widely different ways – particularly in the short term. In fact, the stock market is often seen as a leading indicator for the economy. Investors often look toward the future and may begin to discount potential risks while they focus on growth opportunities.

As a result, the moderate and steady pace of the economy is often at odds with the abrupt movements of the stock market. There are several forces that shape this divergent relationship. Below we'll explore these factors in detail. We'll also look at what happened during the global financial crisis as further evidence of how financial markets digest economic news.
1. The stock market only represents a portion of total economic activity.
Across the U.S., small businesses (those with fewer than 500 employees) are considered to be the lifeblood of the economy. Consider the following:

- Small businesses make up almost half (47.3%) of private sector employment and 65% of net new jobs\(^1\). In comparison, publicly traded companies constitute about one-third of U.S. employment\(^2\).
- Small businesses account for roughly 44% of economic activity in the U.S.\(^3\)

Yet the stock market fails to properly reflect this important slice of the economy. For example:

- **Companies driving the market.** Microsoft, Apple, Google, Amazon and Facebook currently make-up over 20% of the S&P 500. A differentiating factor between these company's and many small businesses across the U.S. is that their business models and service offerings have allowed them to benefit from recent stay-at home measures. In addition, their excellent balance sheets, dominant market positions and strong free cash flow generation are the envy of many.

- **Realities faced by others.** Meanwhile, recent studies indicate small businesses are highly vulnerable to the economic shock of the pandemic. The Federal Reserve Bank of New York found that only one in five small businesses would be able to withstand a two-month revenue loss and continue their regular operations.\(^4\)

The size and nature of the companies that comprise the S&P 500 means they often fail to capture the economic realities that are taking place in large pockets of the country. This speaks to the inherent disconnect between stock markets and the economy – namely, they aren't the same thing.

2. The stock market and the economy look in different directions.
The stock market is forward looking. Investors base the prices they are willing to pay today upon reasonable expectations for the future. By contrast, economic data often looks backward at what’s already occurred. Things like GDP and employment numbers report on the past, helping to provide an indication of where we are in the economic cycle. This disconnect produces a notable lag between the economic cycle and that of the market.

**The stock market and the economy: How the two cycles are related**

![Diagram of the stock market and economic cycles](image)

Source: RBC GAM. For illustrative purposes only.

Until the arrival of COVID-19, the U.S. economy was considered in the “late cycle” stage – enjoying growth while approaching the peak of the cycle. Now a recession has clearly struck, albeit in a way that is entirely outside the parameters of a normal business cycle. This recession wasn’t the classic result of too much risk-taking or an expansion simply becoming fragile as it aged. It was the result of a black swan event.

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1. U.S. Small Business Administration: Office of Advocacy
2. The National Bureau of Economic Research
4. Federal Reserve Bank of New York
Nonetheless, we find ourselves somewhere in the shaded area in the above chart. The stock market recovery has begun, while alarming headlines continue to swirl regarding the economy. This disconnect can be puzzling. A number of factors have come together to help investors look over the valley – pricing in a narrative that suggests the challenges stemming from the COVID-19 pandemic will be temporary:

- **Massive stimulus from governments.** Policymakers across the globe have provided tremendous support for economies with a response that has been aggressive, fast and fairly well-targeted.

- **Extraordinary support from central banks.** In addition to lowering interest rates, central banks moved promptly to offer support for credit markets. This area played a large role in the market decline we saw in March. In particular, the U.S. Federal Reserve pledged support for the municipal debt market, corporate debt market, and even small business loans.

- **Optimism surrounding a COVID-19 vaccine.** A vaccine typically takes four to five years to develop. However, thanks to new technologies, researchers are accelerating their timelines.

While the stock market isn’t always completely rational, it is (more often than not) relatively efficient at incorporating all known information into current prices.

### 3. Expectations affect how investors digest economic news

Economic news can be good or bad. However, what has a greater influence on markets is whether the news is better or worse than investors expected. That is, it’s a question of what investors have priced into their assumptions surrounding reasonable expectations of the future.

Consider these two scenarios:

- Positive announcements around job numbers and the unemployment rate could surprise to the upside, driving optimism amongst investors that the economy may be reopening faster than expected.

- Indications of a stronger consumer pulse than presently expected would be welcomed by investors. This is because, in the developed world, consumer spending drives the bulk of economic activity – sustaining the earnings potential of publicly traded companies.

While markets have reacted favourably to these developments in recent months, this reaction should not be misinterpreted as a signal that the economy is in a good place. Neither does it mean the easing of government restrictions is going off without a hitch, or that consumer spending will quickly rebound. The reality is, the figures being cheered remain well off their recent peaks. But the data has simply been better than expected. And, from the perspective of markets, that’s what matters.

To gain further understanding of how this kind of thinking has played out in the past, let’s explore the backdrop surrounding the Global Financial Crisis (GFC) of 2008/09. There’s no way to predict the future, but we may draw some interesting conclusions.

### A lesson from the past

We can now easily identify March 9, 2009 as the day markets bottomed following the biggest drawdown of our lifetime. However, at the time, you’d have found it hard to convince investors that the tide was about to turn. Yet we now know:

- The recession caused by the GFC officially ended three months later, in June 2009.

- The unemployment rate continued to climb for months – peaking in October 2009 at 10% and remaining elevated at 9.3% through the end of 2010.

However, by the time we saw a reduction in the unemployment rate, the S&P 500 had already advanced 66%. It rose another 15% in 2010 – producing a total return of 93% over the 22-month period.
One of the primary drivers of the rally was that the market expected the economy to do worse than it did – pricing in widespread bankruptcies as part of a worst-case scenario. The fact that the economic news was simply better than expected helped sustain the market’s strong performance.

The importance of a long-term plan

History has shown that “sitting on the sidelines” while economic news continues to be negative often results in missing a significant upturn in the market. Stocks are cheapest when everything looks grim – creating opportunities for investors that are willing to look to the future.

As an investor, understanding the dynamics surrounding the stock market’s relationship with the economy is an important element to ensuring you’re able to remain focused on the future. Often, this relationship is best outlined within the confines of a well-thought-out financial plan. One that anticipates with certainty that you will encounter many cycles – both economic (recessions) and market related. Crafting this plan alongside a financial advisor can help ensure your portfolio’s risk does not exceed your ability or tolerance for taking it – providing you with fortitude required to stay the course along your investment journey.

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