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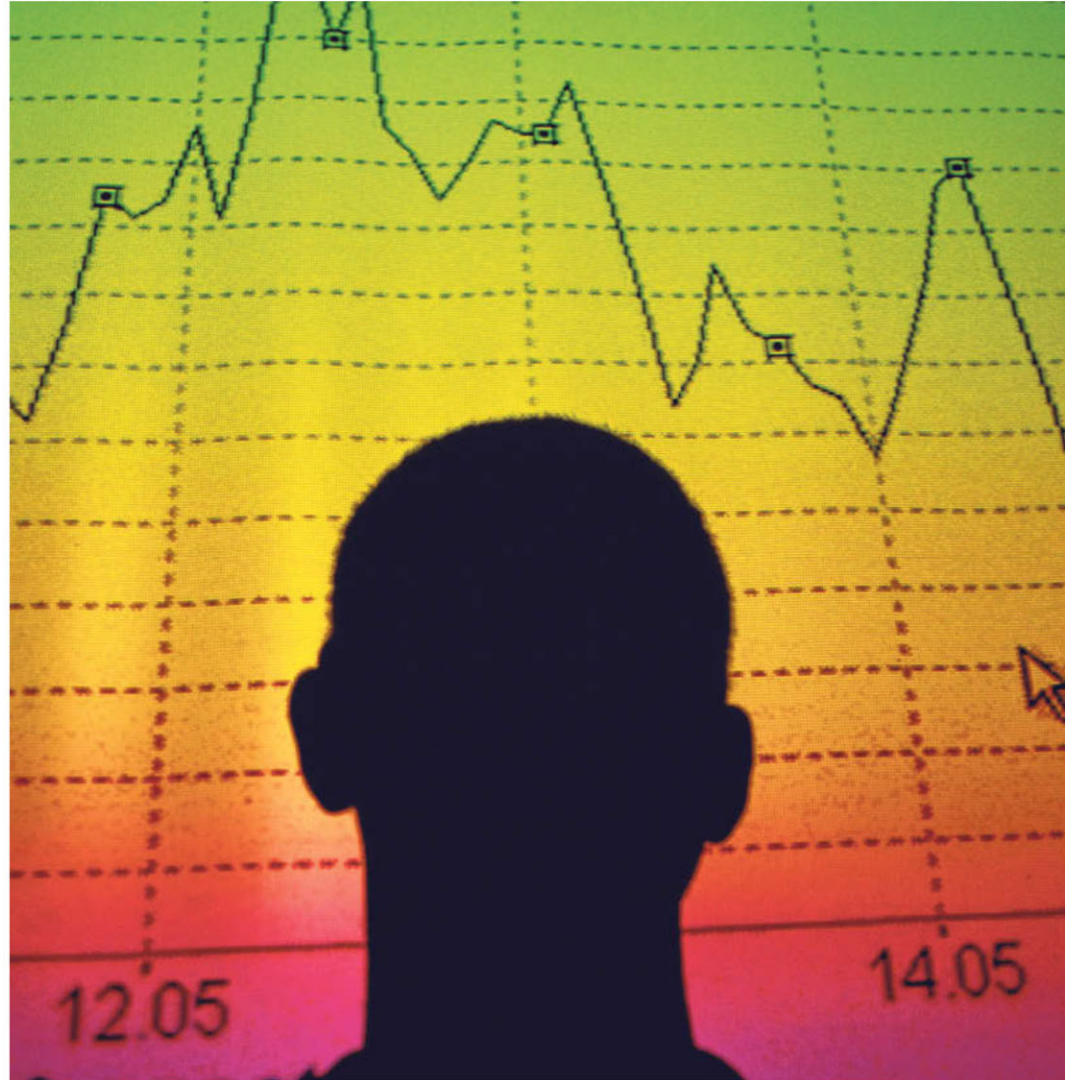

Economic turmoil does not necessarily translate into a market downturn, especially if the turmoil is expected to be short-lived, says the writer. Since stock valuations are determined by future corporate earnings, the belief of a robust economic rebound once coronavirus lockdowns are lifted provides justification for a rallying market. PHOTO: REUTERS

Why the stock market does not follow reality

Investors need to study the facts and not just follow the herd

Charles Shi

The first half of 2020 was unprecedented in many aspects. A global pandemic no one expected appeared and triggered widespread lockdowns, which quickly brought the global economy to a virtual standstill.

In a short span of several weeks, the S&P 500 along with other major indexes plummeted nearly 30 per cent, ending the longest bull market in the United States.

Millions of Americans lost their jobs, with the unemployment rate reaching the highest level since the Great Depression. Sharp contraction of economic activities also caused a tidal wave of bankruptcies by companies.

While the stock market bottomed out on March 23, US stocks have since staged numerous rounds of powerful rallies.

Despite a recent resurgence of Covid-19 cases and the heightened tensions between the US and China, US stocks finished the second quarter with the best quarterly performance in more than two decades.

A rallying market accompanied by a stumbling economy left many Wall Street veterans perplexed. Analysts at Goldman Sachs repeatedly warned its clients of correction risk in February and May. Their predictions have yet to be proven right.

What is causing the apparent disconnect between Wall Street and Main Street?

DISMAL REALITY VERSUS OPTIMISTIC OUTLOOK

The widespread lockdowns caused record unemployment numbers and drastic contraction of economic activities.

Economic turmoil does not necessarily translate into a market downturn, especially if the turmoil is expected to be short-lived.

Note that the jobless claims are backward looking. The market is a leading indicator of what is to come in the economy. Investors, therefore, should look beyond current data and focus more on the future.

Many investors think current economic contraction and job losses are self-inflicted by mandatory lockdowns. As states begin to reopen, business activities would pick up quickly and those who were laid off would be rehired.

The recently released strong May employment data lent support to such expectations. Since stock valuations are determined by future corporate earnings, the belief of a robust economic rebound provides justification for a rallying market.

THE FED

The US Federal Reserve has long played an outsized role in global capital markets. When the economy was on the verge of collapsing several months ago, the Fed moved in swiftly and aggressively by pledging unlimited liquidity support through asset purchases and slashing interest rates to near zero.

The aggressive moves by the Fed coupled with trillions of dollars of stimulus measures by the US government helped cushion the devastating blow brought about by the pandemic.

Indeed, analysts in prominent brokerage firms including JP Morgan's Dr Marko Kolanovic expected the Fed policy would more than compensate for the temporary hit to corporate earnings. The unwavering support by the Fed boosted market sentiment and propelled the market forward.

LIQUIDITY

Given ongoing high uncertainty over the pandemic outlook and economic recovery, the market is expecting more stimulus. By many estimates, the monetary injection by the Fed is likely to exceed US$8 trillion (S$11.1 trillion) eventually, which would be more than double the US$3 trillion aid used in the last financial crisis.

Bond yields have been on a steady decline thanks to near zero or negative benchmark rates. Returns on commodities like gold have been volatile and underperforming major stock indexes.

This leaves stocks as a remaining viable option. A tsunami of liquidity coupled with the lack of attractive investment alternatives prompted many investors to bet on equities.

If it were only about ample liquidity, one would expect that the stocks would have gone up across the broad sectors. A deeper dive into the data tells a different story.

NEW ECONOMY

The pandemic has wreaked havoc on bricks-and-mortar retailers and energy sectors. Many household brands like GNC and Hertz have been forced into bankruptcy. A dozen energy firms, including shale pioneer Chesapeake Energy, went under when the pandemic caused the oil price meltdown.

But not all have suffered. The pandemic provided a powerful boost to the businesses of many technology companies. Leading the way are five high-tech heavyweights – Facebook, Amazon, Apple, Microsoft and Alphabet – whose shares have gone up more than 35 per cent since March lows, while many other sectors remain depressed.

With a combined market cap of more than US$5 trillion, the strong performance of the new economy firms is a leading cause for the sustained advancement of the market cap-weighted S&P 500 and Nasdaq, which are influenced most by the performance of the tech giants.

Therefore, the divergence of the new economy and the bricks-and-mortar sectors contributes to the disconnect between dismal economic reality and the rising market.

FOMO

Stocks are determined by the prospect of future corporate earnings. Market recovery leads economic activities. An example is the broad market rally on May 18, in response to favourable vaccine development news.

Given so many ongoing uncertainties, the second half of this year is likely to be eventful and volatility will remain high. Trading on short-term forecasts and engaging in market timing – popular with a rising number of day traders – are not investing but speculating.

The market collapse in March resulted in a large cash pile on the sidelines as a result of massive selling. The balance of money market funds ballooned to a near record high of US$4.7 trillion. In the meantime, massive monetary and fiscal measures have boosted the economic recovery outlook, propelling market rebounds.

The fear of missing out (Fomo) on the next big rally led many of those investors who had stayed on the sidelines early this year to return to the market, adding more fuel to power the market forward.

LOOK AHEAD

A previously widely held belief of a rapid V-shaped recovery looks less likely as the number of virus cases continues to rise quickly and the timing of vaccine delivery remains anyone's guess.

Other prominent risk factors include the upcoming US election and the ensuing policy changes as well as rising geopolitical tensions.

Given so many ongoing uncertainties, the second half of this year is likely to be eventful and volatility will remain high. Trading on short-term forecasts and engaging in market timing – popular with a rising number of day traders – are not investing but speculating.

What we do know is the pandemic will go away, eventually. Long-term investors should stay invested and buy the dips selectively if one has excess cash.

Last, but not the least, it is critical to distinguish between good firms and good investments. Good firms with low debt and high earning power may turn out to be bad investments if one pays too much.

As legendary value investor Benjamin Graham famously said, the secret of sound investment is to seek "margin of safety" – the extent of stock price below its value. Therefore, a stock's past high return should never be a reason to buy.

• Dr Charles Shi is dean's chair and associate professor of accounting and finance in NUS Business School. The opinions expressed are those of the writer and do not represent the views and opinions of the National University of Singapore (NUS).

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