OCTOBER 13, 2020

On the Radar

FAQS ON THE MARKETS AND ECONOMY

What explains the disconnect between the economy and stock market?

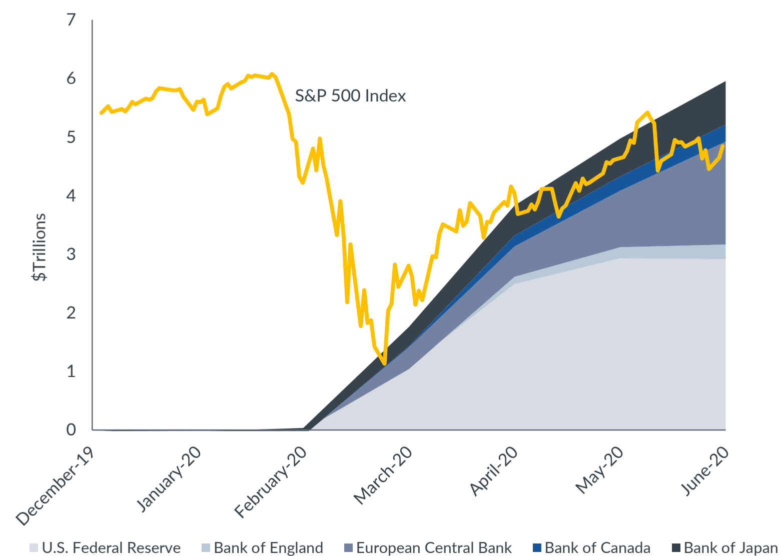
The recovery in equity markets has confounded some given the economic damage created by the COVID-19 crisis. However, it's important to remember that stock prices are forward looking in nature. So, from this perspective, it makes sense then that investors have quickly looked passed the near-term damage, instead eyeing the reopening of the economy and a rebound in corporate profits.

Another thing to keep in mind is that the stock market is not the economy. Not only are the hundreds of thousands of nonpublic businesses still enduring hardship not counted in major stock indexes, but the market is heavily weighted toward technology companies that have actually benefited from societal changes forced by the pandemic.

The technology sector makes up 39% of the S&P 500, but only 6.9% of U.S. GDP. In contrast, the service industries most impacted by the crisis (retail, restaurants, hotels, transportation, tourism and entertainment) amount to 19% of GDP, yet these same industries represent only about 7% of S&P 500 earnings.

Finally, policy actions have played a leading role in the market recovery. Fiscal relief from Washington has, so far, been effective in helping fill the income gap created by the historic spike in unemployment. Meanwhile, the Fed and other global central banks have implemented unprecedented monetary-policy stimulus, which has lowered interest rates, driving investors into stocks and providing confidence that policy makers will do whatever is necessary to support the economic recovery and functioning of financial markets.

Funds Injected into Economies by Central Banks



Source: Bloomberg.

KEY QUESTIONS

Has Fed Chair Powell given a recent update on the economy?

Are equity valuations a concern?

Is consumer spending holding up despite the cutback in federal relief payments?

What insight can we glean from the latest labor report?

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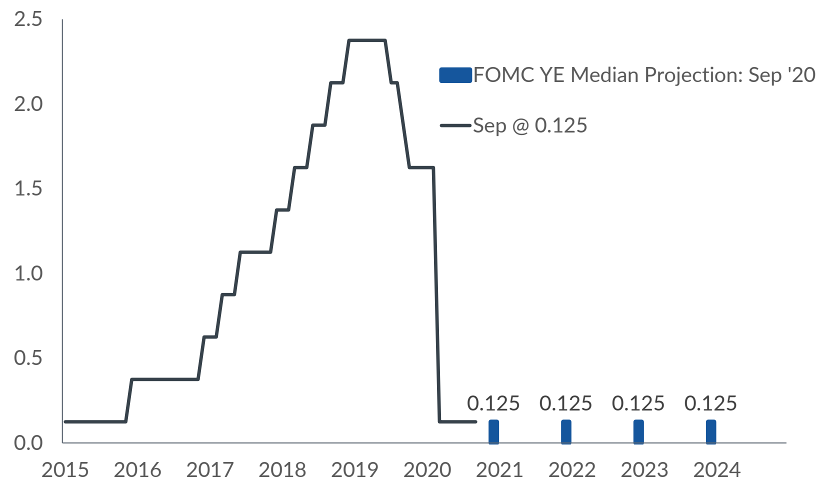
Has Fed Chair Powell given a recent update on the economy?

On October 6, Powell warned of a potentially weak economic recovery without sufficient government aid. He encouraged Congress and the White House to provide additional support to households and businesses disrupted by the coronavirus.

He believes the current support level is not enough and will lead to a weak rebound in economic growth. He noted that the economy would be more robust and move faster if the monetary policy (the Fed) and fiscal policy (federal government) continue to work together to provide support. The Fed plans to keep the federal funds rate near zero for the foreseeable future (see chart).

The recovery is far from complete. He is fearful that economic growth could stall if the coronavirus is not effectively controlled, thus the need for more help for businesses and households.

Federal Funds Rate & FOMC Projections (%)



Source: Federal Reserve Bank as of September 2020.

Are equity valuations a concern?

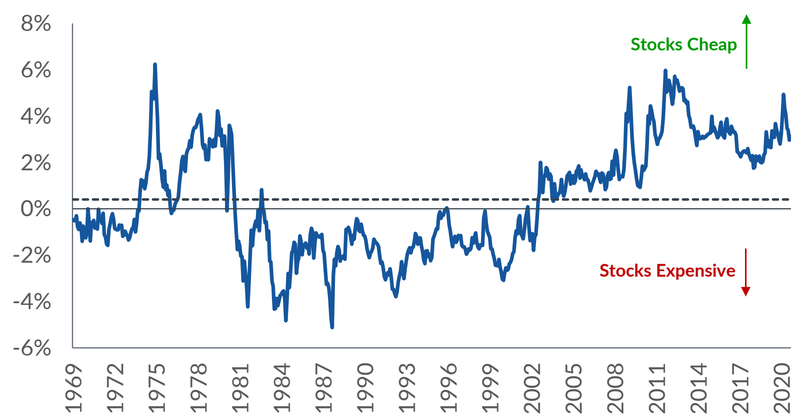
Going strictly by historical price/earnings ratios might suggest U.S. stocks are expensive. However, this paints an incomplete picture of the current opportunities and risks in financial assets.

While high valuations are historically associated with lower long-term returns, research shows that valuations have limited predictive value over shorter investment horizons. Factors such as the state of the business cycle, profit growth, policy support and interest rates all tend to be more important.

With interest rates at record lows, and poised to stay there for some time, we believe equity valuations are full but are not excessive. For instance, the S&P 500 equity risk premium (earnings yield minus the 10-year Treasury yield) is near the highs of the past 50 years, suggesting stocks are still attractive relative to bonds.

The economy is currently in the process of exiting a severe recession. As a result, corporate earnings have likely bottomed out and are expected to recover heading into next year, which should help valuations improve somewhat. Much of the market rally from March lows has also been driven by more narrow leadership from a handful of the mega-cap technology stocks. The median stock in the S&P 500 is still, on average, notably below its previous high.

Equity Risk Premium



Source: Bloomberg, FactSet.

Given the unprecedented amount of monetary stimulus, record-low interest rates and lack of attractive alternatives to equities, we believe valuations can remain elevated. Nevertheless, from this point forward, we expect that earnings expectations will likely take over as the primary driver of market returns in the year ahead rather than further valuation expansion.

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Is consumer spending holding up despite the cutback in federal relief payments?

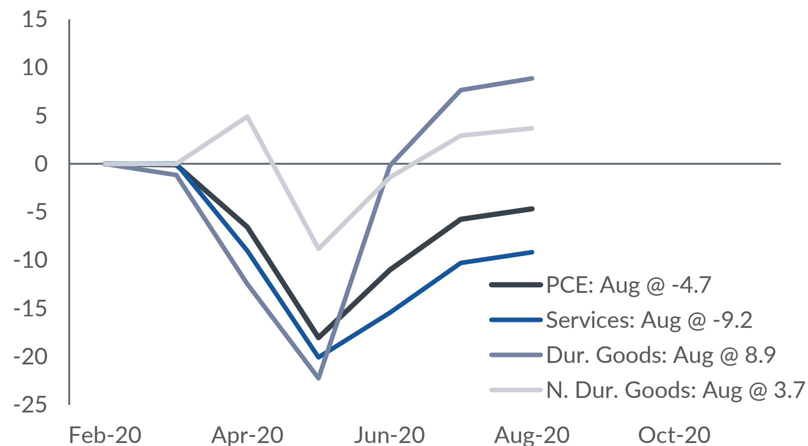
The consumer continues to surprise forecasters with hearty spending. Shoppers increased outlays by 1.0% m-o-m, driven by strong expenditures on services, up 1.4%. Meanwhile, spending on goods increased by 0.2%. This marks the first time since the pandemic that the growth rate of services outpaced that of goods. Total spending stands 4% below the Q1 high.

Spending on services got a boost from a 7.1% increase in restaurant sales, as there has been some relaxation to some social distancing rules. The slower pace of spending on goods is not surprising given that they are above February levels (see chart, both durable and nondurable goods are above February levels).

There are concerns about the future. Many households are highly dependent upon various federal relief programs, and most of them have now expired. As it stands now, there will be no further debate on federal relief until after the elections. This will probably result in a drop in household income in October and November, which will impact spending.

Real Personal Consumption Expenditures

change from February through August 2020



Source: Bureau of Labor Statistics as of August 2020.

What insight can we glean from the latest labor report?

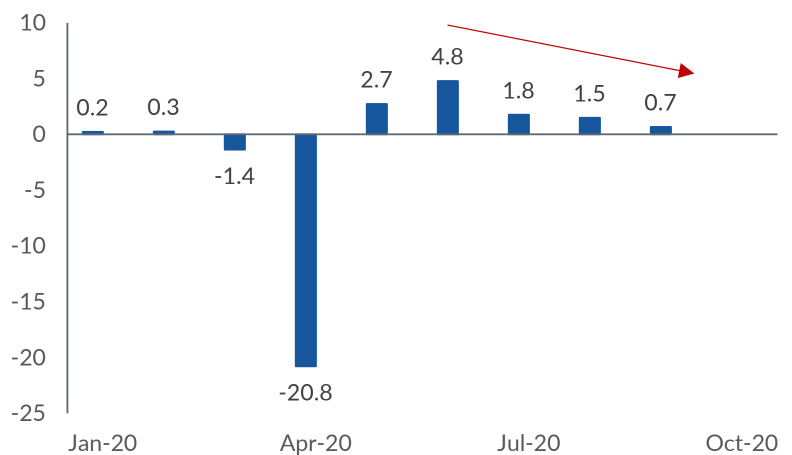
The growth rate in job gains is moderating. Since hitting a monthly peak of 4.8 million in June, following the lockdown, job gains have been declining (see chart). The September gain was 661,000.

The swift decline in the momentum of job gains is the challenge to this recovery. This report was the first labor report since the end of the lockdown that came in below expectations. One report does not make a trend, but the recovery pace is highly dependent upon how quickly the labor market can regain lost jobs.

The unemployment rate declined to 7.9% from 8.4% in August. The decline in the unemployment rate was driven heavily by the drop in the labor force participation rate. The household survey showed a gain of just 275,000 in September, which would have pushed the U.R. down by 0.1%, but 695,000 individuals dropped out of the labor force, contributing to the other 0.4% drop. This decline could be due to unemployed people giving up looking for work or child-care responsibilities.

Nonfarm Payrolls ('000)

millions, monthly change



Source: Bureau of Labor Statistics as of September 2020.

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Returns include the reinvestment of interest and dividends.

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Past performance is no guarantee of future performance.

Index Definitions

The S&P 500 Index (S&P500) is a stock market index that tracks the 500 most widely held stocks on the New York Stock Exchange or NASDAQ. It seeks to represent the entire stock market by reflecting the risk and return of all large-cap companies.

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