On The Mark

May 22, 2020

The great disconnect: the markets & the economy

Key Takeaways

- The recent stock market rally has left many investors scratching their heads on what is driving the rally in the midst of terrible economic data.

- Resilience from a narrow group of mega cap technology and healthcare names have been the salvation of the recent rally.

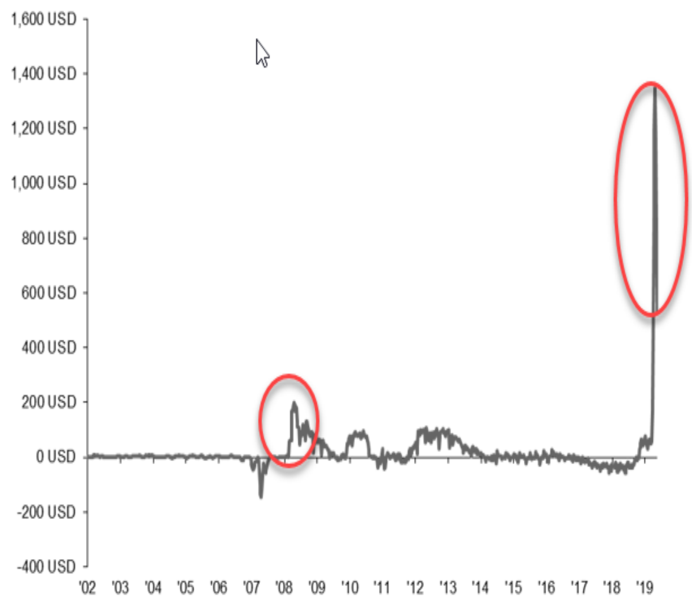
- Massive stimulus and a concentrated rally have made it harder to read what's going on in the stock market, partially answering the question of how the stock market appears to have become so unhinged from the real economy.

Over the past few weeks investors have likely struggled to reconcile a rallying stock market and a stumbling economy. Since the lows on March 23, 2020, the S&P 500 has rallied over 28%[1] through May 15, 2020 reducing the year to date losses to -10.7%[2] despite record unemployment of 14.7%[3].

What is driving the recovery in stocks?

A key driver in the market recovery has likely been the unprecedented level of monetary and fiscal support for the economy. In terms of monetary stimulus, in a short time period, the Federal Reserve (the "Fed") cut rates to zero. It also announced unlimited asset purchases and established several lending facilities. These comprehensive actions have been aimed at alleviating liquidity pressures in the financial system and broadly supporting the flow of credit. Clearly, the Fed is not messing around this time after learning the lessons of the Great Recession — that is—to go big and go bold. The chart from J.P. Morgan[4] shows how the scale of recent Fed support through bond purchases dwarfs the response during the Financial Crisis.

Federal Reserve Bond Purchase Program (Billions)

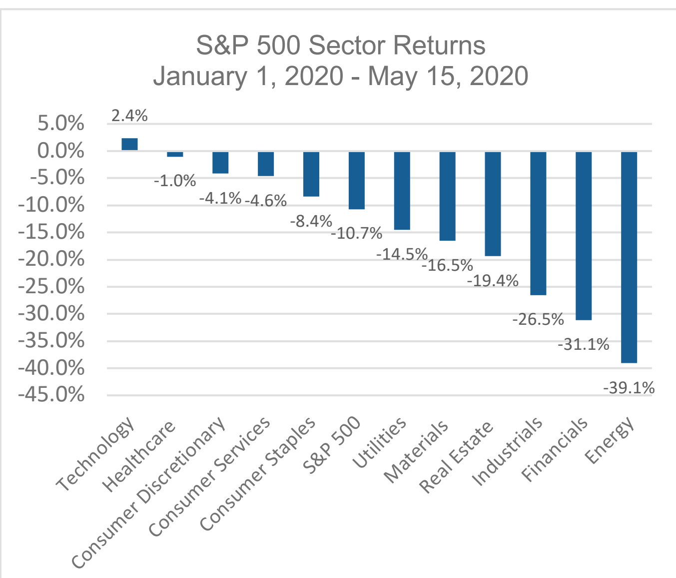


Source: J.P. Morgan

What do we know about the rally?

The headline stock market returns alone does not paint the full picture, which is, not all stocks have participated in the rally. The stock market recovery has been led by a narrow group of winners within the technology and healthcare sector. Technology and healthcare sectors alone make up nearly 41% of the S&P 500 index market cap[5] (dollar market value). Within the technology sector, five companies Microsoft, Apple, Amazon, Alphabet (Google's parent company) and Facebook have driven nearly 22%[6] of the rally from the March lows through May 15th, 2020. These companies have certainly benefited from many people sheltering at home, spending time on social media and ordering goods online. Not only have the five biggest stocks helped power the market higher, they alone represent roughly a 20%[7] share of S&P 500 market capitalization continuing a trend that was prevalent during the nearly 11-year bull market. Research by Ned Davis shows this is especially the case now that the Microsoft, Apple and Amazon alone account for 9% of the All Country World Index (ACWI), a global equity market cap that exceeds the percentage for every country outside of the U.S. For reference, the U.S. accounts for 58% of the ACWI weight while Japan's weight is a distant second at 7%[8].

Looking at the year-to-date S&P 500 sector returns through May 15, 2020 further highlights the uneven nature of the rally[9]. Energy, despite being the worst performing sector for the year, only makes a small dent in the returns because it represents a mere 2.8%[10] of the S&P 500 index. This is seen by the difference in the S&P 500 equal weight index, which uses the same stocks as the cap weighted S&P 500 but is allocated a fixed weight, is down -20.3%[11] year to date in comparison to -10.7% for the market cap weighted S&P 500. In other words, the rally from the select mega-cap growth stocks in technology and healthcare, which make up the majority of the index, are masking the pain continued to be felt by a large segment of the companies in the S&P 500 index as seen by the sector performance for the year.



Source: Morningstar

What does this mean for investors?

Given the Fed support and the concentrated rally, it has been harder to read what's going on in the market, partially answering the question of how the stock market could become so unhinged from the real economy. Following a bear market low, it is not unusual for a relatively small group of stocks to lead the S&P 500 out of the trenches. As the market continues to work through the uncertainties in the COVID-19 crisis, it is likely to include more volatility. Going forward, we will need clarity on the containment of the virus and a successful strategy to reopen the economy to drive broader participation from a wide range of stocks and sectors.

In the meantime, it is important investors maintain diversity in their portfolios. Diversification across asset classes as well as within equities is the most prudent way to manage portfolio risk over the long term, as it tends to lower volatility and reduces the likelihood that any one stock or a small group of stocks can severely damage overall portfolio returns.

[1] FactSet, Data as of 3/23/2020 - 5/15/2020
[2] Morningstar, Data as of 1/1/2020-5/15/2020
[3] https://data.bls.gov/timeseries/LNS14000000
[4] https://am.jpmorgan.com/us/en/asset-management/gim/adv/has-the-fed-done-enough
[5] FactSet, Data as of 5/15/2020
[6] FactSet, Data as of 3/23/2020 - 5/15/2020
[7] FactSet, Data as of 5/15/2020
[8] Ned Davis Research: https://www.ndr.com/invest/products/INF20_17.PDF?card=3&source=WKLYCRH_EST202005011.HTML&downloadType=EL

[9] Morningstar, Data as of 1/1/2020-5/15/2020

[10] FactSet, Data as of 5/15/2020
[11] FactSet, Data from 1/1/2020-5/15/2020

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