Dorchester Advisors

Money worked harder

The Economy and the Stock market may walk hand in hand, but they are not joined at the Hip.

Dushyant Pandit
Dorchester Advisors
New York, NY
(908) 608-1608
dpandit@dorchesteradvisors.com

ECONOMIC INDICATORS

Why you shouldn't confuse the economy and the stock market

KEY TAKEAWAYS

- A bad economy doesn't necessarily mean a poor stock market, and vice versa.
- Stocks move on anticipation of future profits and interest rates.
- Economic growth is often driven by capital investment and consumer spending.

Many investors conflate the economy and the stock market and expect the two to act in tandem. While the two are related, they are not the same thing. That matters because what is good for the economy is not necessarily beneficial to financial markets, and vice versa.

Media coverage can sometimes confuse the matter for the public. "People assume that a weak economy means it's time to divest stocks, but it doesn't always mean that," says Bob Stammers, director of investor engagement for the CFA Institute in Charlottesville, Virginia. "In COVID-19, the economy was poorly, but the market was on fire."

Struggling economy, surging stock market

The description "poorly" hits the bullseye. During the beginning of the pandemic in 2020, the economy suffered. New claims for unemployment insurance in the U.S. jumped from a nearnormal level of 256,000 per week on March 14, to a staggering 6.1 million on April 4, according to data from the Federal Reserve Bank of St. Louis.[1] There haven't been millions of layoffs in a single week in the U.S., apart from the first several months of the pandemic.[1] By the second quarter of 2020, the economy also had contracted by 32.4%.[2]

These dire statistics resulted from the government-imposed pandemic restrictions and the subsequent fall in business activity across the U.S. economy.

However, despite these ominous events, the stock market began to rally and continued to do so for the rest of the year. From March 23 through December 31, 2020, the S&P 500 Index of large-capitalization stocks rallied more than 65%, even as unemployment rates remained elevated.[1,3]

There are other examples of the stock market and the economy acting in different ways. When the internet bubble started around 2000, the S&P 500 fell more than 40% from March 20, 2000, through September 30, 2002. However, during that time the economy contracted in only one quarter, and even then by less than one-tenth of one percent.[1,3]

Profits matter to investors

The stock market is an indicator of how much money companies may earn in the future. "It's not looking at or valuing the economy," says Robert Wright, a senior fellow at the American Institute of Economic Research, in Great Barrington, Massachusetts.

In other words, most investors are not worried so much about the economy or unemployment in isolation. Instead, they tend to focus on whether public companies will see their earnings increase or decrease regardless of how strong the economy is.

"Earnings can go up when the economy is doing poorly," Wright says. For instance, companies providing inexpensive food products might see their sales boom in a recession as cash-strapped people spend less on groceries. In the pandemic, some technology companies, such as Zoom, did well by providing video conferencing services.

Future earnings aren't the only thing that drives the major indexes up and down; there are other factors such as the cost of borrowing money. "Interest rates play a role," Wright adds.

Specifically, many investors evaluate stocks against the relative attractiveness of the interest income they could earn on bonds or the potential returns on other assets. Put another way, if investors think the yields on bonds look more favorable than the possible gains from stocks, they may sell their stock investments for fixed income assets.

That evaluation of interest rates also explains why many investors watch the Federal Reserve closely to see if the cost of borrowing money will rise or fall in the immediate future. Such Fed decisions, which are often based on the strength of the economy, can have significant effects on stock prices, with a strong economy leading to higher rates and then, possibly, lower stock prices. “A rise in interest rates, or a belief that they’ll rise, can sometimes send stock prices lower,” Wright says.

In other words, when investors choose which stocks to buy, it’s important that they consider the factors that drive stock prices, such as corporate earnings and changes in interest rates. It could be a mistake to focus too heavily on what is happening in the broader economy.

[1] Federal Reserve Bank of St. Louis[2] Trading Economics[3] Morningstar

---

INSIGHTS

NEWS

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

Statements attributed to an individual represent the opinions of that individual as of the date published and do not necessarily reflect the opinions of Capital Group or its affiliates. This information is intended to highlight issues and should not be considered advice, an endorsement or a recommendation.

This content, developed by Capital Group, home of American Funds, should not be used as a primary basis for investment decisions and is not intended to serve as impartial investment or fiduciary advice.

may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar, its content providers nor Capital Group are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. Information is calculated by Morningstar. Due to differing calculation methods, the figures shown here may differ from those calculated by Capital Group.

Standard & Poor's 500 Composite Index is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks. Each S&P Index ("Index") shown is a product of S&P Dow Jones Indices LLC and/or its affiliates and has been licensed for use by Capital Group.