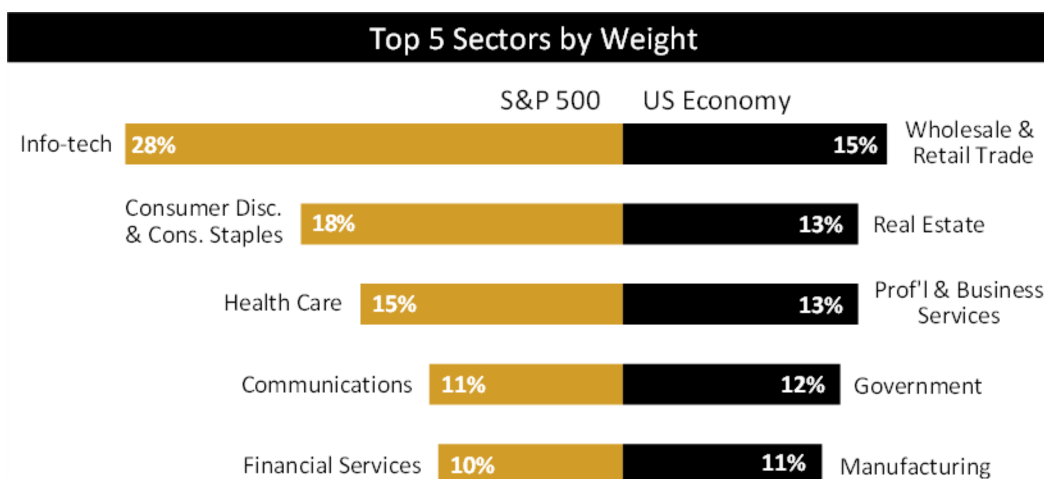
Stock Market ≠ Economy

In what has already been one of the most jarring and upside-down years in modern investing history, it's perhaps not surprising that both equity bulls and stock market bears have used variations of the same argument to justify their positions. Those who are positive on stocks, despite the recent plunge in economic activity, have regularly dismissed naysayers with the retort "the market and the economy are not the same thing", while pessimists forecasting more trouble ahead warn that "stocks have become dangerously disconnected from the real economy". Since both views are expressed frequently without much in the way of supporting evidence, we've devoted this commentary to examining their validity.



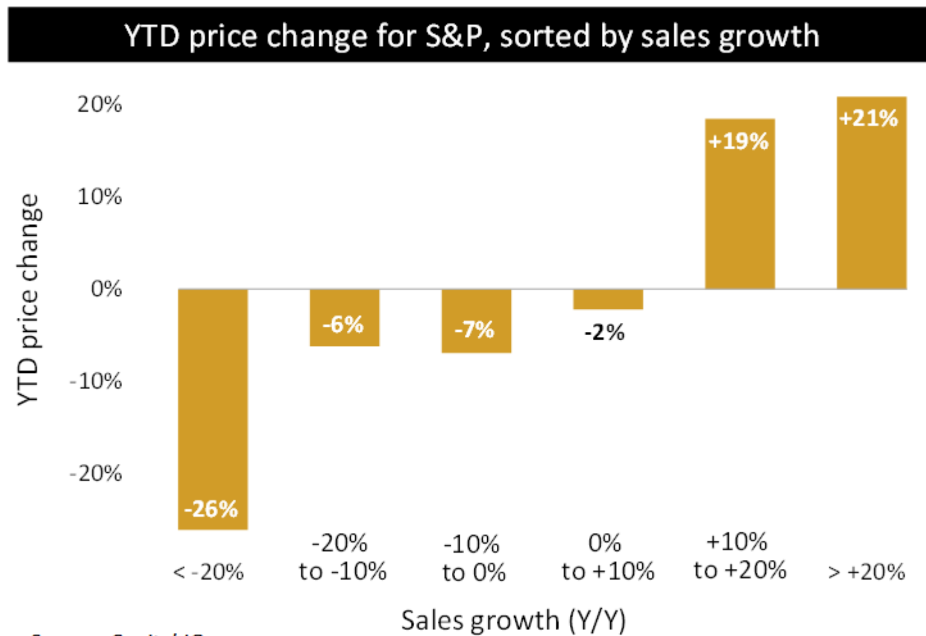
Using data from the US Bureau of Economic Analysis (BEA), we created the first accompanying chart to compare the composition of the S&P 500 with that of the US economy, as measured by industry contribution to GDP. By looking at the top 5 groups in each, we capture nearly 2/3 of the US economy and more than 80% of the broad stock market and, although the US government doesn't organize economic data in precisely the same way that Standard & Poors segments its member industries, the categories are close enough to make a fairly accurate comparison.

The largest contributor to US economic output is "Wholesale & Retail Trade", roughly analogous to the S&P's Consumer Discretionary and Consumer Staples sectors, which we've combined for the purpose of this analysis. As you can see, this is the only industry subset that carries a similar weight in both the market and the economy. While real estate accounts for the second largest slice of GDP south of the border, it's the second smallest sector in the S&P, accounting for less than 3% of market value. Government activity and manufacturing round out the economic top 5, with the former obviously not included in the stock market and the latter not making it into the index's upper echelon.

Even though Information Technology is by far the biggest group on the market side of the ledger, it isn't afforded its own classification in US economic data (tech is likely part of the much smaller "Professional & Business Services" segment). The other three important sectors in the S&P – *Health Care, Communications, and Financial Services* – contribute proportionately much less to the broad

economy and don't count as top five categories.

This simple review reveals that the stock market and the economy *are*, in fact, different animals when it comes to configuration and so perhaps shouldn't be expected to behave in lockstep. Another area of contrast between the two can be found in the median size of their participants. Looking inside the S&P's Consumer Discretionary and Consumer Staples sectors, for example, we find companies like Home Depot, Nike, Starbucks, Walmart, and Coke … along with an upstart retailer named Amazon. The smallest enterprise in either group is worth $4.2bn and registered more than $8bn in sales over the past 12 months. Though all of these companies also appear in the BEA's Wholesale & Retail Trade category, they share that space with thousands of owner-operator firms, partnerships, and mom & pop shops, similar to the establishments we all frequent in our daily lives and which have become the faces of economic strife and uncertainty.



Source: *Capital IQ*
Notes: sales growth is 12 mos. to end of Q2-20; price change is ytd to 30-Sep-2020

Even after acknowledging the stark differences in composition between the market and the economy, the S&P's relentless surge during such an economically, politically, and socially uncertain time may still seem perplexing. A popular narrative asserts that markets are mostly being buoyed by the recent surge of government stimulus and central bank easing that was meant to stabilize the economy, but which has instead its way to stocks. This tsunami of liquidity, it is said, has lifted all boats and stoked a climate of indiscriminate speculation that will ultimately end badly.

To be sure, there have been more than a few head-scratching episodes of excess in recent months, some of them harkening memories of reckless investor behaviour in the late 1990's. To date, though, these indulgences have mostly occurred at the edges of the market, while at its core investors seem to be behaving quite rationally. To illustrate what we mean by this, we created the chart to the left which shows the price change of S&P stocks for the first nine months of 2020 grouped according to sales growth.

When we disaggregate results in this way, stock returns begin to make sense and the capital allocation decisions of the investing public seem reasonable. The shares of companies which have experienced a 12-month revenue drop of 20% or more have been severely punished so far this year, while those suffering smaller declines have been hurt less. At the other end of the spectrum, the cohorts posting revenue appreciation of 10-20% and greater than 20% have, on average, experienced share price gains roughly equivalent to top line growth.

Not surprisingly, the businesses that have thrived in our constricted world participate in areas like

cloud technology, online retailing, streaming media, home improvement, and health care, all of which include members which carry meaningful weights in the S&P 500. Because of this, the winning groups have had an outsized impact on index performance, while challenged industries such as energy, hotels and airlines, bricks and mortar retailers, and restaurant operators have exerted comparatively little influence, despite their steep share price declines.

It can be difficult to square the strong recent performance of stocks with the challenges we see all around us, embodied in closed restaurants and half empty office towers, cancelled community sports and tentative back-to-schoolers. Taken together, though, the data presented above have us less worried about the market's position than what Main Street conditions might suggest. In fact, the recent uncoupling of winners and losers within the index might not only be a rational response to what we see happening in front of us, but a recognition that the long term drivers of progress and innovation sit at an important point of inflection. As always, we'll continue to pursue a balance between current valuation and future growth in the equity component of your portfolio, as we digest and appraise a rapidly evolving economic backdrop.