Investment Insights

The Economy/Stock Market Disconnect

Patrick Boyle
Senior Investment Strategist

Highlights

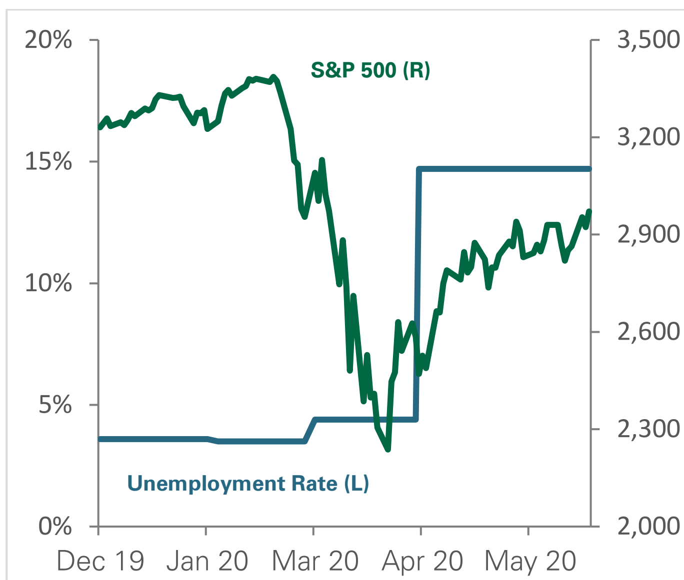
- In this *Investment Insights*, we provide a high-level update on recent stock market gains as the COVID-19 virus negatively impacts economies around the world.
- The U.S. stock market is up 33% from its low at this writing, supported by a massive fiscal and monetary response, a slowdown in the spread of the COVID-19 virus, and a gradually reopening economy.
- While economic activity is likely near its trough, second quarter earnings and GDP will be among the worst in history.
- The stock market often leads the economy and moves higher even in the face of bad economic news.
- We expect the stock market to remain volatile, and given the enormous economic uncertainty tied to the future path of COVID-19, we remain comfortable with our slightly defensive positioning.

Since bottoming on March 23, the S&P 500 is up more than 30%. This rise has coincided with a massive contraction in the economy. Many clients question this disconnect. In this *Investment Insights*, we provide high-level perspective on moves in the stock market, historical context, and insight into corporate earnings. For further details on how internal and external managers are navigating the current environment within portfolios, we encourage you to read our "Active Equity Management Amid Turbulence" and "Active Management: The View from External Managers" *Investment Insights* reports. We also point you to further in-depth recent publications at the end of this piece.

At first glance, the stock market move off its low seems inconsistent with the emerging economic numbers. The unemployment rate, which was at 3.5% in February, stands at 14.7% today (Exhibit 1). Three million Americans filed for unemployment claims during the week of May 9, bringing the eight-week total to 36.5 million — and approximately 60% of those filing have yet to receive benefits, adding to their economic pain. Industrial production fell 11.2% in April, the largest drop in the index's 100-year history, and manufacturing output was down 13.7%. Retail sales were off 16.4% in April, and J.C. Penney, J. Crew, and Neiman Marcus have all filed for bankruptcy. In the second quarter, GDP could be down a staggering 40% on an annualized basis. So why has the stock market been going up?

Exhibit 1: S&P 500 vs. U.S. Unemployment Rate

Key takeaway: Despite the rapid deterioration in economic data, the stock market has moved higher recently.



As of May 20, 2020.
Source: Bloomberg

Looking at History

Much of the economic data published is backward looking and is reported with a lag, while the stock market, a leading indicator of the economy, is more forward looking. The stock market has a long history of rising in the face of tough economic news.

Looking at the 11 recessions since World War II, in every single one, the stock market bottomed and headed higher while the economy remained in recession. On average, the stock market bottomed five months before the recession ended, and the average gain from the low while the economy was still in a recession was 25% (Exhibit 2).

Exhibit 2: S&P 500 Returns During Recessions

Key takeaway: In the past, the U.S. stock market has typically rallied while the economy is still in recession.

S&P Trough	Recession Ends	S&P 500 Trough Leads Economy (Months)	S&P 500 Return From Trough until Recession Ends (%)
Jun-49	Oct-49	5	18%
Sep-53	May-54	9	29
Oct-57	Apr-58	6	11
Oct-60	Feb-61	4	21
May-70	Nov-70	6	26
Oct-74	Mar-75	6	34
Mar-80	Jul-80	4	24
Aug-82	Nov-82	4	35
Oct-90	Mar-91	6	27
Sep-01	Nov-01	2	18
Mar-09	Jun-09	4	36
	Ave.	**5**	**25%**

As of May 20, 2020.
Source: Bloomberg

Today: Lower Interest Rates vs. Lower Earnings

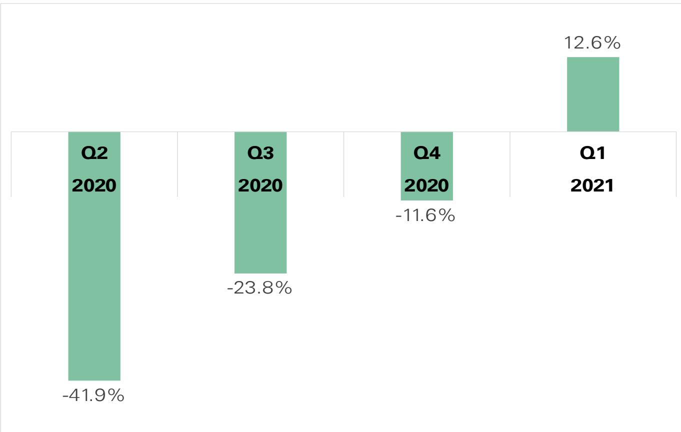
The 10-year Treasury yield began 2020 at 1.92%. Today, its yield is 0.68%, driven by collapsing economic growth, a flight to safety, and the Fed's stepped-up purchases of Treasuries (and other securities). With bond yields so low, and far below the 2% dividend yield of stocks, stocks look more attractive relative to bonds. If stocks are valued based on the present value of future cash flows, then, all else equal, lower interest rates increase the intrinsic value of stocks.

But earnings have clearly been affected as well. 90% of companies in the S&P 500 have reported their earnings for first quarter 2020, and earnings are down about 15% in aggregate. However, the headline number masks underlying dispersion among S&P 500 sectors. For example, healthcare, consumer staples, and utilities all reported year-over-year earnings growth while financials, energy, consumer discretionary, and industrials all reported a contraction in earnings. Loan loss provisions in the financial sector caused earnings to fall 48%; excluding extra provisions, growth in financials earnings would have been +12.3%.

Exhibit 3 shows consensus earnings estimates for the S&P 500 for the next four quarters. Analysts expect the second quarter to be the worst, and they expect a resumption in earnings growth in the first quarter of 2021. However, we note that many analysts have yet to revise their estimates, having received little clarity and guidance from company management teams. And, year-over-year earnings growth of 12%+ in first quarter 2021 may be optimistic, considering the bulk of the virus impact occurred in just the last few weeks of first quarter 2020.

Exhibit 3: Consensus Earnings Expectations

Key takeaway: The S&P 500 earnings decline in 2020 is expected to be deep but possibly temporary.



As of May 20, 2020. Earnings estimates compared to actual earnings from year-ago quarter.
Source: FactSet

Looking a Little Closer at the Current Rally

Even as many small, family-owned businesses experience severe business disruptions and lower asset values, the stock market features larger companies with broader access to capital. Importantly, we note that the COVID-19 shock is difficult to compare to prior economic shocks, as the S&P 500 composition is very different. Five big technology-related stocks (Alphabet, Amazon, Apple, Facebook, and Microsoft) have performed strongly in recent years, and now collectively represent 20% of the market capitalization of the S&P 500. And energy stocks, for example, were 25% of the S&P 500 in the early 1980s, and today they are only 3%.

Following two exogenous events — the oil supply and demand shock, coupled with the COVID-19 shock — there has been a large dispersion between winners and losers, and leadership has been narrow. The five big technology-related stocks referenced above have gained on average 16%, driving overall tech sector outperformance (Exhibit 4). Given their large weightings, they are pulling the market capitalization weighted S&P 500 index up with these strong returns.

Exhibit 4: S&P Sector Performance

Sector	Year-to-Date Total Return Relative to S&P 500
Information Technology	14.2%
Consumer Discretionary	7.9
Communication Services	7.0
Healthcare	6.1
Consumer Staples	-0.5
Materials	-4.7
Utilities	-5.1
Real Estate	-8.2
Industrials	-13.8
Financials	-20.5
Energy	-27.3

As of May 20, 2020.
Source: Bloomberg

On the other hand, the S&P 500 equal weighted index (where every stock has the same weight) is still down 15.6% for the year, compared to the market-capitalization weighted index, which is down 7.3%. The Russell 2000 Index, which measures small capitalization companies in the U.S., is still down 19.3% year-to-date at this writing.

With the U.S. equity market more biased toward growth sectors and less toward cyclical sectors, the U.S. market has performed better than international peers during this volatile period. For example, France, Italy, and the U.K. are down 25% to 30% in 2020 to date.

Where Do We Go From Here?

The economy is already starting to reopen. But how quickly will economic growth return to normal? Unfortunately, the answer is not for a while, and it is difficult to get much more specific than that. The success of reopening the economy and the economic rebound that follows is largely dependent on answers to questions where we simply don't know the answers:

- Will we have a vaccine for COVID-19?
- If so, how soon until the vaccine is mass produced?
- When will we have in place adequate testing measures and contact tracing?
- Will we see a spike in cases as the economy reopens?
- Will the virus return next fall or winter if we don't yet have a vaccine?
- Will recovered patients have full immunity?

Even though the economy is likely near its trough, the chances of a quick V-shaped recovery seem remote. The hope is that the massive job losses will prove temporary, but a business that isn't able to survive this interim period won't be around to rehire employees when the economy gets better. The quick response of the federal government with bold monetary and fiscal policy provides a lifeline to the individuals and businesses most impacted, and it should contain the recession and prevent a depression. But until we are much closer to having a vaccine or widespread testing, the economy may not return to normal. Growth will improve relative to where it is now, but it is likely to fall far short of where it would have been absent COVID-19.

With every crisis comes opportunity. Companies able to reach their customers and deliver products under difficult conditions may see an opportunity to increase their long-term market share. Some may need to adjust supply chains to be better prepared for the next crisis. Businesses don't stand still, and even though the landscape will change, companies will be more resilient as a result of what they are now experiencing. While we do not intend to downplay the severity of the current crisis — ongoing layoffs and business closures are bringing painful dislocations for so many — we do believe the global economy is dynamic and will once again bounce back.

Bessemer Portfolio Implications

Given the enormous uncertainty around the future path of COVID-19, we advise staying invested with a proper amount of diversification in portfolios, and that clients remain focused on the long term. We have a slight defensive tilt in portfolios and recommend clients maintain their long-term asset allocations. Within our equity mandates, we remain committed to our philosophy that the key to long-term success is investing in companies with solid balance sheets, cash flow generation, and strong management teams that are aligned with shareholders. Portfolio managers have taken the opportunity to adjust certain sector weightings and upgrade holdings. For example, in an internal large cap mandate, the team added new holdings in the pharmaceuticals sector and several technology companies, including a semiconductor chip company with an exciting outlook. In our bond portfolios, we maintain a bias toward high quality; in the municipal and corporate space, we favor issuers with strong balance sheets.

We encourage you to reach out to your Bessemer team to discuss these topics, and for any other support you need. Thank you for your trust in us.

Recent Insights

Active Management: The View From External Managers — Investment Insights (May 15, 2020)

Changing Energy Market Dynamics — A Closer Look (May 2020)

Active Equity Management Amid Turbulence — Investment Insights (April 27, 2020)

Beyond the Headlines: Your Investments and Wealth Plan — Webcast (April 23, 2020)

Stabilization in the Municipal Bond Market — Investment Insights (April 8, 2020)

Navigating an Evolving Crisis — Quarterly Investment Perspective (Second Quarter 2020)

Addressing Municipal Market Volatility — Investment Insights (March 23, 2020)

Navigating an Evolving Crisis — Webcast (March 16, 2020)

Market Sell-Off Continues Despite Fed Actions — Investment Insights (March 12, 2020)

Latest Thoughts on Market Turmoil – Investment Insights (March 9, 2020)

Taking a Long-Term View During Volatile Times — Webcast (March 3, 2020)

Taking a Long-Term View During Volatile Times — Investment Insights (February 28, 2020)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.