

Tales From the Emerging World

No, the Markets Aren't Crazy

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Amid the sharpest global contraction since World War II, global stock markets around the world just finished one of their best quarters on record, triggering a flood of commentary about how the market has “lost its mind,” even its morals. Many people we talk to these days seem deeply offended by the spectacle of the market rising while the world is still suffering from the coronavirus.

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But there is a method behind the market “madness.” Since the March crash, the market has surged back to levels that are very pricey, but there is nothing irrational about the fact that stock prices have posted such strong gains even as the pandemic has rolled on.

Market prices are a collective bet on the future of the economy, and this market has been way ahead of professional economists in anticipating the path of the ongoing recovery. This is prophetic, not delusional, and also quite typical. Our research shows that, in the post-World War II era, markets have a much better record of accurately anticipating booms and busts than economists do.¹

At the surface, the market is now indeed very inflated relative to economic fundamentals. On some valuation metrics, the U.S. stock market is currently the most expensive that it has been outside of the bubble period in 1999-2000.² The very-easy money policies of the Fed and other central banks have clearly inflated asset prices.

But the stock market’s valuations have always been very sensitive to interest rates, with lower rates making stocks look more attractive. Unsurprisingly, many investors now say they prefer stocks simply because fixed income instruments are yielding so little.

¹ MSIM. As of 2019.

² MSIM, Bloomberg, Factset, Haver. Data as of June 30, 2020.



Stimulus money is also finding its way into the stock market, unleashing speculative juices and further inflating prices. Over the past few months, the amount of money in U.S. money market funds and bank deposits has increased by a trillion dollars each,³ and many people—bored at home under lockdown—are using some of that money to day trade. Retail investors now account for 20 to 25 percent of all trades, up from 15 percent at the end of last year.⁴

While the flood of newbie investors and easy money may have turbocharged stock market returns, that does not mean the overall direction of the market is “crazy.” Any period of volatility as unusual as this one will leave individual investors in varying states of fear and greed, depending on their temperament and biases. But acting together, their individual extremes cancel each other out, and the market takes on the character of a forecasting machine, incorporating new information constantly and, though not perfectly, at least more efficiently than individual experts do.

The stock market bottomed in late March this year and, on cue, the economy troughed a few weeks later. Then, as economists kept downgrading their GDP growth forecasts in April and May, the stock market kept rallying. It was looking ahead on the notion that with countries gradually coming out of lockdowns, and governments providing record levels of fiscal stimulus, economic activity was bound to improve.

It was only after the U.S. monthly employment report for May was released in early June, and it surprised massively on the upside, that the consensus forecast of economists registered even a faint hint of improvement. By then the global economy had, by one estimate, recovered nearly a third of the 17% drop it had experienced due to the pandemic.⁵

The market is constantly trying to capture every zig and zag in economic sentiment, so its ups and downs at times suggest only that economic conditions are shifting at the margin—getting less bad or less good. Over time, the fit between the economy and the

market has been quite tight in countries with sophisticated capital markets such as the United States.

Now, the market is treating the pandemic for what it is, a major natural disaster that hits suddenly and then disappears—only this time it is not at all clear how long it will take to fully disappear. In recent weeks, as U.S. cases surged and some large states halted or reversed the reopening process, the market started moving sideways, watching and waiting to see if this turns into a full blown second wave, with more deaths and extended lockdowns.

In short, the market’s sudden plunge, sharp recovery and current state of suspended animation have mapped very closely—and far more presciently than the economic forecasting consensus—the path of a very unusual economic cycle, which now ranks among the sharpest and shortest recessions in post WWII history.⁶

This is consistent with our historical research, which shows that, whatever the armchair experts may say, stock markets generally have a clearer vision of the future than economists do. Of the 11 U.S. recessions between 1947 and 2007, the stock market started falling before every one, on average about eight months before.¹

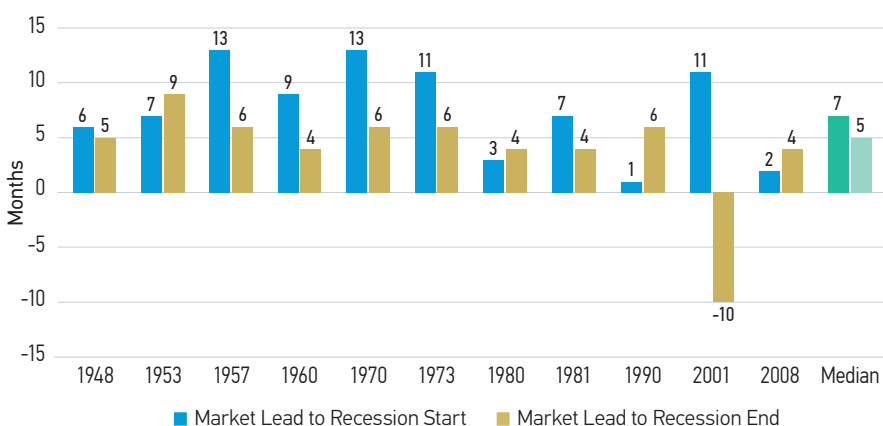
It is true, as critics like to point out, that the market has also sent false signals, plunging when no recession was coming (as it did in 1987) or disconnecting sharply from economic fundamentals (as it did during the tech bubble of 2000). But it is still a more reliable barometer than the consensus call of professional economists. Their record in forecasting postwar recessions is 0 for 11.⁷

On the flipside, in 10 of the 11 postwar recoveries, the stock market bottomed out well before the economy troughed.¹ The gains were often most powerful at the beginning phase of a new bull market. So to see the stock market

DISPLAY 1

The Markets Are Prescient

Market moves typically lead the start of a recession by 7 months, and the end of a recession by 5 months



Source: MSIM analysis, NBER, Bloomberg, Factset.

³ Crane Data. As of April 2020.

⁴ Bloomberg. As of July 2020.

⁵ Goldman Sachs. As of June 8th 2020.

⁶ MSIM, Bloomberg, Factset, Haver. As of July 2020.

⁷ Ned Davis, “Ned’s Insights,” November 14, 2014.

rise strongly in the face of continuing economic hardship—as it did in the second quarter—is hardly inconsistent with historical experience.

Still, below the surface the market is sending a more subtle message about the future than the headlines suggest. While the S&P 500 is flat for the year, it has been held afloat largely by the explosion in the virtual economy,

which is benefiting above all the tech giants like Amazon and Microsoft. The performance and valuation gap between the heavyweight tech stocks and the rest of the market is about as wide as it has ever been. While sensing that the economy as a whole is past the point of maximum decline, the market also sees stronger growth prospects for tech than for the rest, as the pandemic drives economic activity online.

Though stock valuations have been inflated by lower and lower interest rates, the market remains the best barometer of the economic cycle. Over the course of history, and of this pandemic, the market has been a step or two ahead of commentators and experts in anticipating the future. Yes, easy money has juiced up the market, but it has not “lost its mind,” as yet.

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