Tales From the Emerging World

No, the Markets Aren’t Crazy

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.

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.
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, 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.

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.

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.

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.

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.

On the flipside, in 10 of the 11 postwar recoveries, the stock market bottomed out well before the economy troughed. The gains were often most powerful at the beginning phase of a new bull market. So to see the stock market rise strongly in the face of continuing economic hardship — as

---

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.
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.

**Risk Considerations:** There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g., natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equities securities’ values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks. The risks of investing in emerging market countries are greater than the risks generally associated with investments in foreign developed countries. Stocks of small- and medium-capitalization companies entail special risks, such as limited product lines, markets, and financial resources, and greater market volatility than securities of larger, more-established companies. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio’s performance. Illiquid securities may be more difficult to sell and value than public traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

**About Morgan Stanley Investment Management**

Morgan Stanley Investment Management, together with its investment advisory affiliates, has 718 investment professionals around the world and approximately $584 billion in assets under management or supervision as of March 31, 2020. Morgan Stanley Investment Management strives to provide outstanding long-term investment performance, service and a comprehensive suite of investment management solutions to a diverse client base, which includes governments, institutions, corporations and individuals worldwide. For more information, please visit our website at www.morganstanley.com/im. This material is current as of the date specified, is for educational purposes only and does not contend to address the financial objectives, situation or specific needs of any individual investor.

---

Certain information herein is based on data obtained from third party sources believed to be reliable. However, we have not verified this information, and we make no representations whatsoever as to its accuracy or completeness. The information herein is a general communications which is not impartial and has been prepared solely for information and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The material contained herein has not been based on a consideration of any individual client circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Past performance is no guarantee of future results. This communication is not a product of Morgan Stanley’s Research Department and should not be regarded as a research recommendation. The information contained herein has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy’s product’s relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

**DISTRIBUTION:** This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.