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In the Markets Now

2020's trickiest question

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

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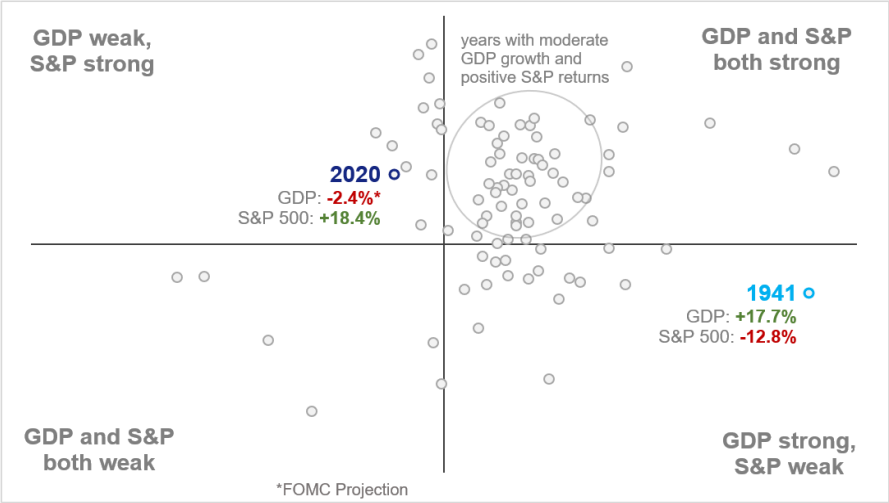
DO THE ECONOMY AND STOCKS MOVE IN TANDEM? NOT ALWAYS.

For most of 2020, investors grappled with a difficult question: how can the stock market be doing so well when the world seems to be doing so poorly? After crashing in March, the S&P 500 rallied over 70% through year-end despite a deep and historic recession, depression-era unemployment, and a still-ongoing global pandemic. How could this be?

Ultimately, the answer is a cocktail of the following (and more): the forward-looking nature of stocks, historic monetary and fiscal policy response, and a market structure that reflects outsized contributions from thriving big tech firms. And while this might feel inappropriate—Wall Street ascendant, Main Street suffering—the disconnect is not all that uncommon.

Consider the chart to the right. Each dot represents a single year between 1930 and 2020; the y-axis is the GDP growth for that year, the x-axis is the S&P 500 return. While most of the years are concentrated in the top right quadrant (moderate GDP growth, positive stock returns), there isn't much of a pattern, and many years don't conform to what we'd think at all.

GDP growth is not necessarily a predictor of S&P 500 returns, or vice versa



Case in point: there have been 18 years since 1930 in which the US posted negative GDP growth (2020 will likely be the 19th). The average S&P 500 return for those years has been 13%. On the flip side, the US has posted 23 years with GDP above 5% and the average S&P 500 return was only 10% in those years. GDP growth and stock returns are simply just not that related over a short-enough timeframe.

But with 2020 in the rearview, why bring it back up now? We are set up for immense economic growth in 2021—widespread vaccination, historic stimulus still coursing through the nation's veins, and a populace teeming with pent-up demand, ready to travel, see concerts, and eat out. The question becomes—will the stock market match? It's possible that the blockbuster GDP growth expected in 2021 does not result in similarly high-flying equity returns, that much of the 2021 boom is already priced into a stock market at all-time highs. It's also possible that S&P 500 (and other market-cap weighted index) returns lag as small-cap, international, and value-oriented stocks take leadership on the back of booming economic growth.

We can't predict the future, but we can learn from the lessons of the past. Last year showed that dislocations between the stock market and economy over shorter time periods are extremely possible. Next year may look different but feature a similar phenomenon. It also reinforces the notion that investing when things seem dire or difficult (e.g. 2020) is necessary to capture all of the market's long-term gains. To discuss this and more, reach out to your Baird Advisor today.

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