Have Markets Decoupled from the Fundamentals?

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This market recovery is perplexing to most and has many asking, “What’s causing the disconnect between stock market performance and economic data?” What are investors looking at that is causing this enthusiasm? In short, policy response, the rate of COVID-19 case growth, and the potential for a rapid rebound in corporate profits over the next 18 months have all contributed to optimism for a V-shaped economic recovery.

Policy Response: Both the Federal Reserve and Federal government responded rapidly as COVID-19 took hold in the United States. The Federal Reserve (the Fed) wasted no time in mid-March when they dropped interest rates to 0%. They moved quickly and decisively again, just a short time later, to provide significant liquidity to the fixed income markets, assuring investors they would do whatever was in their power to keep the financial markets running smoothly. In June, the Fed provided reassurance to corporations by initiating their corporate bond buying program; they also stated they are comfortable keeping rates at 0% as long as necessary. All of these moves have been highly successful in calming investor fears and restoring order to the markets.

Additionally, the Federal government stepped in to provide a fiscal policy response to the services sector and delivered nearly $2.8 trillion worth of aid to impacted individuals and businesses. This provided cash to those who needed it most and, presumably, helped prevent a significantly worse economic recession.

Rate of COVID-19 Case Growth: With businesses shuttered and Americans sequestered in their homes, we saw the case growth of COVID-19 slowly decline throughout May and June. Some states reopened quickly and saw their cases start to rise, which prompted fear that a second wave of infections was starting. This coincided with market declines we saw in early June but the market correction some were expecting never took hold. In recent weeks, cases and hospitalizations across the U.S. appear to have plateaued and may have started to decline. We still have some challenges ahead of us, though. Schools reopening and the possibility of a second wave of infections as autumn arrives are potential headwinds the markets may need to work through. Nonetheless, if we can keep virus cases and the growth rate low enough to continue to open the economy, then we should expect to see economic data continue to recover and the markets should respond accordingly.

Rebound in Corporate Profits: Historically, after a recession, it takes approximately three years for corporate earnings to recover to their pre-recession levels. However, current market levels are telling us investors expect earnings to recover by the end of 2021. We are seeing signs of an improving economy – GDP for the second quarter was slightly better than expected, retail sales are improving, manufacturing activity is expanding, and the unemployment rate is declining. Additionally, corporate earnings for the second quarter are mostly coming in ahead of expectations. But this was a deep recession, and it will take more than two months' worth of economic data for us to determine just how swift the recovery will be.

At just 124 trading days since the February 19 high was reached, the S&P 500 is on pace for its fastest recovery on record. So far, investors and markets seem to be paying attention to the *direction* of change of economic and corporate data (meaning they are seeing the unemployment rate decline instead of increase, they are seeing foot traffic in retail stores increase instead of decline, etc.). As the recovery evolves, we will continue to assess and analyze the data relative to historical norms and market expectations. When times like these arise and there appears to be an inconsistency between stock market performance and available information, it's important to stay focused on the bigger picture, which is the long-term investment strategy. Sticking with your strategic plan, through good times and bad, has been proven time and again to be the most effective strategy for investment success. At JGP, we are continuously monitoring portfolios and making changes as appropriate to keep you on the road to financial success – providing you peace of mind while you're out living your best life.

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