**FACETOLOGY**

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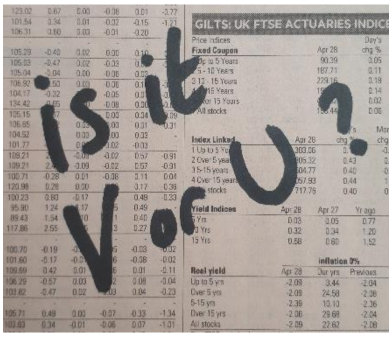
# The conventional wisdom regarding markets and GDP




*"The stock market is the only market where things go on sale and all the customers run out of the store"* – R W Baird

Whilst the Covid-19 pandemic has had an unprecedented impact to the economy and the way we live our lives, there is a certain sense of déjà vu when trying to tackle the knotty question of how the economy will come out of the resulting recession.

If we look at the data following the recessions from 1969 to 2009 we can see that the UK emerged from 6 of the last 7 recessions reasonably quickly in that GDP recovered to pre-recession levels in the same time, or less, than the recession itself. Financial pundits often refer to this as a V-shaped recovery, denoting a sharp decline, a short-lived bottom and rapid rise matching both the scale and duration of the fall.

Other descriptive letters include U (a long recession before recovery), W (an initial recovery but a fragile return to growth fraught with setbacks) and L (a sharp recession with little or no bounce back). Understandably, all these scenarios are being touted by someone somewhere as we speculate about when, or if, people get their jobs and livelihoods back again. The fall in global stock markets has also impacted investors and those with savings and pensions.

Of course, it's worth remembering that when we read about recessions in the media, what they are actually talking about is a fall in Gross Domestic Product, or GDP. There are various ways to measure it but, broadly speaking, it's the monetary value of all finished goods and services made within a country during a specific period. If you have two quarters of negative GDP growth, you're in recession.

Anyone who watches the financial TV channels will see daily how effortlessly financial pundits link the direction of GDP growth to the performance of the stock market. If GDP is falling and you're in recession, the stock market will be falling. It stands, to reason, right?

Actually, no. Historically, the correlation is not only low, it's negative. Views on why this should be vary widely, but one interesting observation is that the interests of companies and their shareholders are not necessarily aligned to employees and the population at large. This may surprise no one…

Let us say that Company A makes widgets, the demand for which is rising in line with economic growth. A well-run company with a degree of scalability will eventually enjoy super normal profits. If all of these super normal profits are then re-invested in additional employees and machinery in a never ending pursuit of growth, then the earnings-per-share (which ultimately underpins the value of the company shares) will not rise as fast as sales. However, the value of units sold will make a positive contribution to GDP.

Theoretically, overinvestment of this nature will throw up future problems including over-supply, which will lead to falling prices. This could be further compounded by new entrants to the widget manufacturing industry and a fight for market share leading to a price war. At the margin, it will be the new entrant that attracts investment in new shares (perhaps via an Initial Public Offering, or IPO), rather than shares in the incumbent.

Incidentally, this was a notable feature of the Chinese stock market for many years during its period of GDP expansion throughout the 1990's and Noughties. GDP grew at an astonishing 9% per year, yet stock market returns were negative to the tune of minus 5%. The stock market grew in size, due to numerous IPOs, but not a lot of the money found its way into existing investors portfolios.

**This is a very simplistic way of illustrating the point that GDP growth is not always good for equities – and vice versa.**

If you are looking for a correlation with stock market returns, then it is dividends to shareholders that count and, specifically, dividend **growth**. All things being equal, assuming the number of shares in issue remains unchanged, the syphoning of ever-increasing dividends to shareholders would make the shares attractive to anyone so long as they are in line with business profits. Such a mechanism helps to restrain overinvestment in extra production for the sake of it.

Another way to benefit shareholders is to use excess profits to buy back shares, thus increasing the earnings-per-share for every shareholder. Thanks to cheap money since the Great Financial Crisis of 2008, this has been going on for years and helped fuel the rise of the US S&P500 stock index to record highs earlier this year before Covid-19.

In short, the benefits of economic growth accrue mostly to the consumer and employee and less to existing shareholders. The same could be true in reverse.

This brings us importantly to the subject of employment. In the USA, the figures for job losses alone are mind boggling. Last week's new claims for unemployment benefits were over 3.8 million, bringing the total to 30 million. The knock-on effect to household spending was an equally dire fall of 7.5%, the worst fall on record in modern times.

Equally unprecedented has been the amount of stimulus unleashed by the Federal Reserve to support business. We cannot know how many of the job losses are temporary but the offset from the stimulus should be significant, and this has been recognised by bond and credit markets, and also the stock market. The S&P500 has retraced half the initial loss from the mid-March low.

Whether we are facing a V-shaped or U-shaped economic recovery is of interest but is not the current driver of the bounce in the stock market. It is best seen as a reflection of the prospects for corporate profitability a year from now.

Trying to correlate economic data with corporate earnings may risk failing to recognise that the balance of risk has improved significantly since mid-March.