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Relationship Status : It's Complicated - Part 2

Last week we had a look at the relationship between the stock market and the economy and how there can be instances, especially over the short term, where the two move in opposite directions. There are several reasons why this can occur.

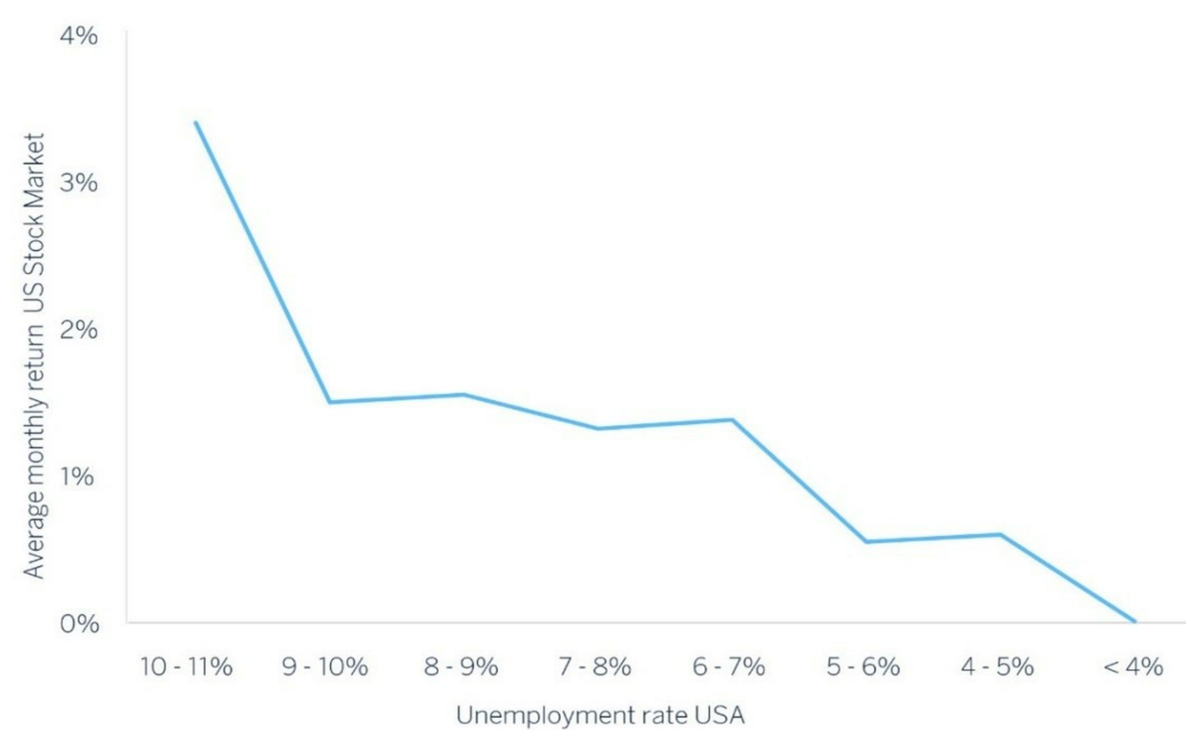
Firstly, the economy and the stock market look in different directions. The stock market is forward looking, meaning that valuations reflect expected future earnings. The price investors are willing to pay for a stock today is based on how they expect the company to do in the future. Economic data, on the other hand, is mostly backward looking. Most of the common measures that reflect the economic condition of a country, such as gross domestic Product (GDP), inflation, employment levels, housing markets, consumer confidence, and spending, report on what has already happened, often with a significant time lag.

Secondly, expectations affect how investors digest economic data. Economic data can be either good or bad, however, what has a greater influence on markets is whether it is better or worse than what investors expected. This means that markets can react negatively to positive economic data if their expectations were for it to be better, and vice versa.

Relationships can also vary between markets and economies on a country-by-country basis due to the composition of a country's stock market. Different stock markets have different weights to different sectors, some countries' stock markets are heavily weighted to cyclical stocks, which will be more affected by macroeconomic changes in the country's overall economy.

Another factor to consider is that markets can get influenced by a variety of factors that don't directly impact the nation's economy. For instance, everything from geopolitics, natural disasters and interest rates to tax rates, can impact the stock prices but not necessarily the economy. Similarly, changes in corporate law can, for example, directly impact the share buybacks or dividends, which will directly impact share prices, but not the GDP.

An example of where good economic news does not equal good market returns can be found when looking at unemployment rates. Intuitively, one would think that a low unemployment rate is good for the stock market. However, stocks typically do best when unemployment is high, not low. This is illustrated in the graph below, that looks the average monthly return of the US Stock market under different levels of unemployment.



The lesson here is to not try and predict how markets will perform in the short term or make knee jerk reactions based on economic data. Investors should focus instead on ensuring that the return horizon of their investments is in line with their investment horizon. This will help mitigate the risks associated with the ups and downs of economic and market cycles and can make it easier to stay the course across all market conditions.

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