



Relationship Status : It's Complicated

Investors generally have the idea that the stock market and the economy move together in unison. As such, people often scan economic data to try get a grasp of stock market prices and to form an expectation of the trajectory they will follow.

Others may look at market indices to get a perspective of the state of the actual economy. While this can be helpful as there certainly is a degree of correlation between the two, the reality is that the relationship between the stock market and the economy is much more complicated, and it is by no means a stable one.

Typically, the two tend to loosely move in the same direction, but they can also act widely different, particularly over shorter time periods. An analogy useful to explain this relationship is that of a man walking his dog, wherein the man is the economy, and the dog is the stock market. The man's gait is smoother and more predictable, as opposed to the excitable, easily distracted dog who can jump around and randomly dart in any direction at any given moment.

In the long run, they're both likely to head in the same direction and to an extent the markets are controlled (leashed like a dog) by the economy. In the short run, however, the movements of the man and the pooch can look very different, sometimes even going in opposite directions.

This sometimes divergent relationship is displayed in the graph below, looking specifically at the US where the US economy is measured by the country's Gross Domestic Product (GDP), and the US stock market is represented by the S&P 500.



It is important for you as an investor to be informed about the state of the economy and to keep up with new economic data releases. Equally important, however, is understanding the dynamics of the stock market's relationship with the economy. It will help you digest economic news, block out the noise and stay focused on the long term.

In next week's article, we will explore reasons why and instances where economic data and stock market returns can diverge.



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