No. 18 | JULY 2020

ECONOMICSFORALL

SG Economic and Sector Research

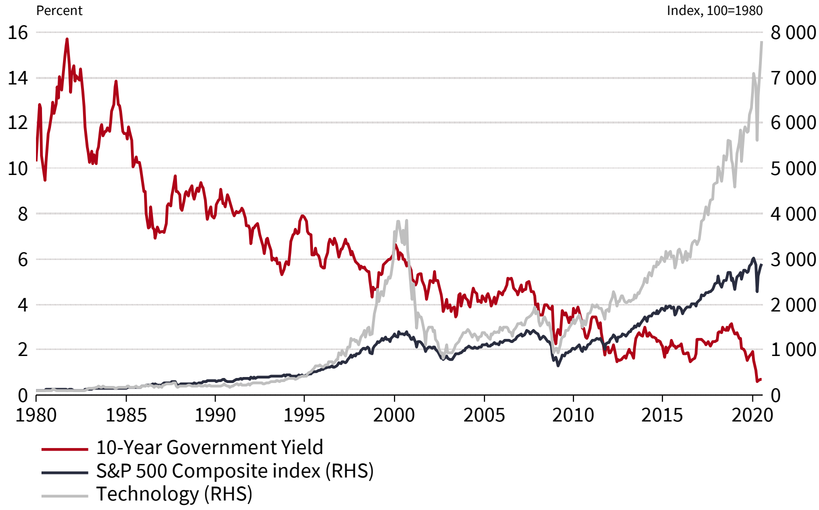
Stock market, real economy: The great paradox

Marie-Hélène Duprat
Senior Advisor to the Chief Economist

As the COVID-19 pandemic has plunged the global economy into an unprecedented recession in peacetime, stock market valuation multiples have, in general, returned to their historic heights. Never before has the relationship between economic reality and the reality of the stock market been so loose. How to explain this strange disconnection? Three points stand out: a handful of mega-cap stocks that drive indices upwards; a bet on the unconditional support of central banks; ultra-low interest rates.

While the global economy plunges into a recession it has never known, in peacetime, for nearly a century, stock markets, after suffering from an outbreak of panic in March, **have, in general, returned to their historic heights.** Today, there is a striking contrast between stock market indices that are at or nearing their zenith, which seem to anticipate a strong economic recovery, and bond yields, at historic lows, which seem to predict a long period of weak growth or non-growth (secular stagnation). How should we understand this apparent contradiction?

US: Bond yield & Equity performance



A handful of mega-caps driving indices upwards

The spectacular stock market rebound in the face of the health crisis in the second quarter has left many astounded. Inasmuch as the value of a stock reflects a company's future profits (or the updated value of its anticipated revenue flows), some may consider stock markets to be good predictors of the future. And yet, we know that investors, victims of psychological biases (herd behaviour, overconfidence, etc.), are not fully rational in the processing of information, and that the simultaneous action of a large number of irrational investors can cause major anomalies in valuation (over- or under-evaluation with regard to fundamentals).

What should we take away from the recent surge in the stock market? There are winners in this health crisis. Sectors such as healthcare, information technology, communications, and consumer staples have only marginally suffered from the crisis, or even benefited from it. The pandemic has given a tremendous boost to the digital transition, strengthening the dominance of the web giants.

A handful of global large caps are driving indices upwards. Propelled notably by technological stocks, Nasdaq climbed to unprecedented heights and the S&P 500 recovered all of its losses. The GAFAMs (Google, Amazon, Facebook, Apple, Microsoft), whose index rose nearly 30% in T2 (the best quarter since Q4 1999), represent almost 40% of the Nasdaq index and more than 20% of the S&P 500. The information technologies, communication and healthcare sectors alone represent more than 52% of the US stock market capitalisation. But the valuations of the winners of this crisis could evoke an exuberance that some might qualify as irrational.

Due to its composition, the stock market offers only a very distorted picture of the real economy. This is not a V-shaped recovery that the market anticipates; what it is expressing is a strong selectivity between the winners and the losers of the COVID-19 pandemic. For there are, of course, losers in this crisis: many listed companies, in deeply affected sectors such as transport and tourism, are struggling to pick themselves up again.

A bet on the unconditional support of public authorities

Aside from this handful of large caps, **equity markets are stimulated by the record injection of liquidities by central banks and the sheer scale of support plans put in place by governments**.

Investors have convinced themselves that in a time of crisis, central banks and governments would come to their rescue. This conviction is not new; it dates back to the Greenspan era when the Fed injected liquidities in the aftermath of the stock market crash of 1987. Investors then acquired the feeling that central banks would always be there to neutralise their exposure to downside risk in the stock markets (the “Greenspan put”). But this sentiment is now taking root in the light of the record scale of central banks’ asset buyback programmes, notably in the United States, and the avalanche of billions spent to support the economy.

The search for yield in an ultra-low-rate environment

Another factor supporting the stock markets, and not the least important, is the **ultra-low interest rate environment.** In an environment of low or negative rates, investors, in search of yield, are turning towards more remunerative (but riskier) assets such as equities. What is more, the lower the interest rates (which are used to discount future dividend flows) the higher the valuation of equities.

And why are interest rates so low? Because the bond market expects the economy to remain depressed and central banks to pursue ultra-accommodative policies for years to come.

One can then wonder whether the weaker the economy, the higher the valuation of the stock markets is likely to be, amid bouts of volatility.

Contacts

Michala Marcussen
Group Chief Economist
+33 1 42 13 00 34
michala.marcussen@socgen.com

Olivier de Boysson
Chief Economist Emerging Countries
+33 1 42 14 41 46
olivier.de-boysson@socgen.com

Marie-Hélène Duprat
Advisor to the Chief Economist
+33 1 42 14 16 04
marie-helene.duprat@socgen.com

Ariel Emirian
Macroeconomic Analyst
+33 1 42 13 08 49
ariel.emirian@socgen.com

François Letondu
Macrosectoral and Macrofinancial Analyst
+33 1 57 29 18 43
francois.letondu@socgen.com

Constance Boublil-Groh
Central and Eastern Europe
+33 1 58 98 98 69
constance.boublil-groh@socgen.com

Benjamin Cabot
Economist Assistant, Editing
+33 1 58 98 98 71
benjamin.cabot@socgen.com

Juan Carlos Diaz Mendoza
Americas
+33 1 57 29 61 77
juan-carlos.diaz-mendoza@socgen.com

Clément Gillet
Africa
+33 1 42 14 31 43
clement.gillet@socgen.com

Alan Lemangnen
Eurozone, France, Germany
+33 1 42 14 72 88
alan.lemangnen@socgen.com

Simon Ray
Macrofinancial Analyst; UK
+33 1 4213 70 80
simon.ray@socgen.com

Valérie Rizk
Macrosectoral Analyst
+33 1 58 98 82 85
valerie.rizk@socgen.com

Danielle Schweisguth
Western Europe
+33 1 57 29 63 99
danielle.schweisguth@socgen.com

Edgardo Torija Zane
Global economic forecasts
Middle East, Turkey and Central Asia
+33 1 42 14 92 87
edgardo.torija-zane@socgen.com

Bei Xu
Asia
+33 1 58 98 23 14
bei.xu@socgen.com

Yolande Narjou
Assistant
+33 1 42 14 83 29
yolande.narjou@socgen.com

Societe Generale | SG Economic and Sector Research | 75886 PARIS CEDEX 18 | France
https://www.societegenerale.com/en/news-and-media/economic-studies

DISCLAIMER