It’s complicated

The U.S. economy is poised to boom in 2021. Does that mean stocks will boom too?

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- The U.S. economy is accelerating, and it’s tempting to assume that stocks will boom with it.
- But a booming economy doesn’t necessarily translate to a booming stock market; to wit, equity market cycles aren’t always in sync with economic cycles.
- In fact, neutral- and moderate-growth environments may be the sweet spot for stocks.
- Either way, trying to take advantage of swings in the business cycle is like trying to solve two nearly impossible equations simultaneously — the state of the economy and the market’s reaction to it.

Following 2020’s COVID-inspired shutdown, the U.S. economy is roaring back to life. Signs of a potential post-pandemic boom are everywhere, from rapid improvements in manufacturing activity and business sentiment to surging retail sales, accelerating commodity prices and an ongoing “vee-bound” in U.S. housing. Economists are calling for annualized GDP growth of 6-7% by mid-year, roughly twice the post-war average and well ahead of trend. If it continues, that trajectory would fully heal the massive hole in economic output wrought by the pandemic (and then some).

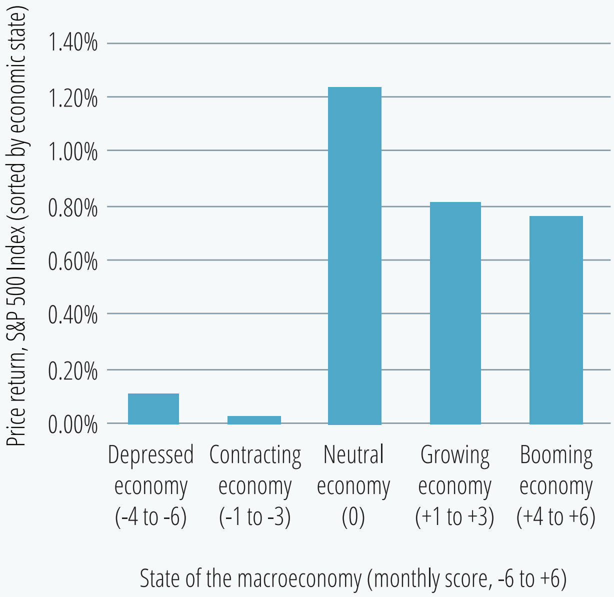
With all that optimism in the air, it’s tempting to assume that risk assets in general — and equity markets in particular — will boom alongside a rapidly improving economy for the remainder of 2021. The logic runs thus: If stocks are nothing more than a claim on future corporate earnings, it naturally follows that a booming economy will dramatically improve corporate profits and lift equity prices in the process.

Not so fast. While it’s true that stock prices tend to prefer a growing economy to a contracting one, the relationship is not as straightforward as you might assume. In fact, our research suggests that moderate growth environments — periods when growth is neutral, even — may be the most favorable for equity market investors.

While it’s true that stocks follow fundamentals like growth and earnings over the long term, it’s equally true that market participants try hard to anticipate those fundamentals before they actually appear. (That, after all, is why Wall Street analysts spend so much time and effort

Goldilocks lives!

Neutral-to-moderate growth environments have historically been better for stocks



trying to forecast earnings in the first place.) To the extent that those efforts are successful, stock prices should tend to be at least partially out of sync with economic trends themselves. Said differently, if Wall Street is any good at what it does, the market cycle won't always line up perfectly with the economic cycle, at least not in real time.

There are other reasons to be skeptical of the idea that stocks and the economy are joined at the hip. Beyond the influence of active traders discussed above, markets and the state of the macroeconomy are themselves influenced by countless other factors, such as valuations, the level and direction of interest rates, style factors, the geopolitical backdrop, and idiosyncratic risk (among scores of others), that are each in turn at least partially independent of one another. To use an example that may prove to be particularly relevant to today's environment, a robust economy coupled with stretched equity market valuations may not be at all preferable to a contracting economy coupled with bottom-basement valuations.

In an effort to explore the relationship in more detail, we have created a simple model designed to represent the state of the overall economy and overlaid the monthly price performance of the S&P 500® against our modeled data to test whether markets and the business cycle are truly in sync. If that thesis was true, we would expect the most positive economic environments to also be those with the best equity market returns (and vice versa). But, as the chart below suggests, while there does seem to be some positive correlation between stock market returns and the state of the economy, equity market performance tends to be stronger and more consistent when the economy is closer to a neutral state than when it is at either extreme. (In fact, the worst single month for stocks in our sample occurred when our model suggested the economy was booming. Likewise, the best single month in our sample occurred when macroeconomic trends were only modestly positive.) If we shift our perspective and instead look through the lens of equity market return quintiles, we arrive at a similar conclusion: Moderation is best.

The takeaway is this: A booming economy doesn't necessarily imply a booming stock market. In fact, our analysis suggests that monthly returns have tended to be best when the economy is growing moderately or, better yet, occupying the rare middle ground between robust expansion and deep contraction. Those who assume a booming economy in 2021 will automatically translate into robust gains for their portfolio may ultimately be disappointed.

But this analysis also illustrates an even bigger point — those who might be tempted to try and time their investments with the ebbs and flows of the business cycle are trying to simultaneously solve two nearly impossible equations: the state and future direction of the economy at any given moment in time and the market's ultimate reaction to it. And that, dear reader, is a complicated task indeed.

	S&P 500 INDEX*			
STATE OF THE ECONOMY	AVERAGE RETURN	BEST PERIOD	WORST PERIOD	BATTING AVERAGE
Depressed economy (-4 to -6)	0.11%	12.68%	-12.51%	0.510
Contracting economy (-1 to -3)	0.03%	13.18%	-11.00%	0.556
Neutral economy (0)	1.24%	10.75%	-11.93%	0.717
Growing economy (+1 to +3)	0.81%	16.30%	-16.94%	0.600
Booming economy (+4 to +6)	0.76%	11.83%	-21.76%	0.612
All periods	**0.66%**	**16.30%**	**-21.76%**	**0.602**

MONTHLY RETURN QUINTILE	AVERAGE RETURN	AVG. STATE OF ECONOMY
Best monthly return	6.10%	1.84
2nd quintile	2.74%	2.47
3rd quintile	0.89%	2.48
4th quintile	-1.19%	2.50
Worst monthly return	-5.51%	1.62

* Price returns.

Data: GWI Calculations, FRED St. Louis Federal Reserve, Morningstar Direct. See page 3 for methodology.

Fruit flies and expert views

Trying to tease out the relationship between equity market performance and the economy

Attempting to draw sound conclusions about the relationship between stocks and the state of the overall economy is a frustratingly hard thing to do. For starters, you need to begin by creating a framework for evaluating the strength and direction of the economy at any given moment in time. That's because economic data such as GDP growth is notoriously stale by the time it's published, and the seemingly natural candidates for such an analysis — the peaks and troughs in economic activity as determined by experts at the National Bureau of Economic Research (NBER) — usually occur in arrears, often several months after economic activity has either peaked or troughed. That's far too slow for today's market, which operates in real time and has the attention span of a fruit fly.

In an effort to reconcile that disconnect, we developed a simple scoring method for the economy that relies on readily available data and tries to capture the spirit of the NBER's analysis while at the same time shortening the analysis period to more closely coincide with market data. To summarize, we used three monthly data points — payroll employment, income excluding government transfers and industrial production — to assess the overall strength of the economic environment on any given month. When a variable is positive and/or rising, the score for that factor will be positive; when low and/or falling, it's negative. All three factor scores are summed together, yielding a score ranging from +6 (booming) to -6 (depressed) for each month in our time series (which extends from March 1959 through February 2021).

While far from perfect, our simple model does a fairly decent job of mirroring the NBER's conclusions but at a higher frequency, particularly with respect to economic recessions: When our monthly scores fall to their minimum (-6) and remain low, the NBER has tended to ultimately declare recession. It was also interesting to us to note that the economy tends to spend far more time expanding — and expanding robustly — than it does contracting. (This, too, squares with reality.) Finally, and perhaps most importantly, our monthly scores are volatile — they jump around from month to month as the underlying variables move and change direction rapidly in an independent fashion. That, of course, is exactly the intent: Because capital markets operate in real time, individual actors are constantly making (and remaking) real-time assessments of the macroeconomic environment and investing accordingly. Those assessments rarely coincide perfectly with the release dates of macroeconomic data or pronouncements regarding recessions or recoveries.