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Do the economy and the stock market move together?

Synopsis
The S&P 500 is down for all three quarters in 2022 - this has happened only four times in the last 50 years. Both US stocks & bonds are down substantially in the first 9 months of the year, which has happened only 3 times in 100 years.

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Devina Mehra, Chairperson and Managing Director of First Global, is a gold medalist from IIMA as well as from Lucknow University where she broke several records. She had a seven-year-long stint at Citibank in Investment Banking & Corporate Credit/ Risk before becoming a member of the Bombay Stock Exchange in 1993 - her proprietorship which later corporatised and became India's leading institutional brokerage firm, First Global. She spearheaded First Global's globalisation over two decades ago, making First Global the first Asian (ex-Japan) firm to become a member of the London Stock Exchange and then the NASD.

First Global has since become a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds.

She has been quoted widely on Global as well as Indian markets by global financial media like Wall Street Journal, Barron's, Business Week, Fortune, Forbes, CNBC, Financial Times etc.

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A few days ago, I tweeted that an indicator that had historically forecasted a US recession is now on, ie it is nearly certain that the US economy is headed into a recession.

The question I got asked most often thereafter was: Should I now steer clear of US markets?

At the same time, the story in India is that the economy is booming and hence the stock market looks great.

In this leap from the economic prospects of a country to its stock market, most people forget that the economy & markets are very different animals.

There is no one-to-one correlation between the economy of a country and its stock market - more so not in the same time frame. At the minimum, there are leads and lags.

Plus, there are many other adjustments to be made. Simplistic predictions don't work. Neither do stories.

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So assuming the economic prospects look soft, the question for the US is how much of the bad news is already in the price?

Probabilistically speaking, it appears more than likely that most of the bad news is already in the price, especially for stable, traditional businesses. The impact of the rate rise will, of course, be higher for companies where profits and cash flows are still far away as the discounted value of these companies goes down as the interest rates go up. It is usually the case with tech/new-age platform space.

Therefore one can say in a sense that in the US, the stock markets have been a leading indicator of the bad news that is still unfolding in the real economy.

To really understand a possible disconnect between economic reality and stock market performance, go back to March 2020. If someone had told you that this would be the impact of the pandemic

- About 7 million people would lose their lives
- There would be extreme uncertainties throughout the world
- Industries like airlines, hotels, cruises would have zero business for at least a year
- There would be little shopping or eating out for months on end

What would you've predicted about the markets?

I'm guessing many would have said there is no chance of the market going up, yet the stock market zoomed in the US, in India and in many other parts of the world - and how! Both India and the US were up nearly 30% in a matter of five weeks from the March 2020 lows.

Yes, there was the impact of the governments handing out money in certain countries, but markets went up even in places like India where nothing like that had happened.

In real-time, there was a clear disconnect between what was happening in the economy and the stock markets and that continued for almost two years.

Currently, in India, the narrative is that India is on some new growth path and the markets can only go up.

I've been saying clearly and unambiguously for over a year that India will outperform in 2022. But one shouldn't extrapolate this to mean that there are no issues with the economy.

The narrative that India is becoming an asset class in itself or 'The next decade belongs to India' is what I call storification. As is the assertion that the US is yesterday's story.

Similar stories were heard in 2003-07 when the US underperformed hugely while emerging markets went up 3.5 times and India 6 times.

Remember that whether it is stocks or markets, we look for stories but most stories are just explanations in hindsight along the lines of, 'This happened, so, therefore, it's logical that this should have happened because of....',even though it wasn't the only possible outcome.

For an interesting exposition of this phenomenon, read Duncan J. Watts' book, 'Everything Is Obvious: Once You Know the Answer'.

These are examples where the stock markets went up in spite of problems with the country's economy but the reverse can also happen.

For instance, the Chinese stock market is still at the levels it first crossed in 2007 and at about half its all-time high set in that year, despite the fact that its GDP has gone up 6.5 times since then!

Coming back to the Indian stock market, I expect it to outperform partly because it had underperformed hugely relative to the rest of the world, as well as relative to its own history, for the entire 2010-20 decade.

As against the long-term equity compounding of 15-16% in India, the CAGR was only 8.5% for the decade 2010-20, which was about the same as the fixed deposit returns for that period.

In the world ranking of 42 countries, it ranked 20 to 25 for most of the years. It was like a coiled spring. Then, when the outperformance started around 2021, I knew it would last for a while.

None of this means that there're no issues with the economy.

Fundamentally speaking too, while there is still widespread distress in the economy which shows up in the demand for free rations, MNERGA jobs etc, there is also another side to the picture -- The organised sector employees, and the so-called creamy layer, are doing well.

This is apparent in data like two-wheelers, or entry-level cars, not selling as well as the higher-end cars & SUVs.

Plus, as far as the listed space is concerned, the companies have benefited from two broad trends.

One, post demonetisation and GST implementation, the economy has become more formalised and the share of the organised sector, which obviously includes listed companies, has generally increased.

Two, the listed companies tend to cater more to the mid to creamy layer.

Eg, the listed real estate companies don't build rural houses. Even in FMCG, footwear or apparel, lower-end consumers buy from informal or regional-level unlisted players.

Therefore with a K-shaped recovery, where the higher income categories do well, listed players are relatively insulated from the distress.

Hence, if you're looking for a story for market outperformance, there are two points:

1. The listed space is doing better than the overall economy (The share of corporate profits relative to GDP is a topic for another time)
2. The market performance relative to its history created room for outperformance.

The bottom line: A country's economy and stock market can go in different directions, sometimes for extended periods - whether it is the US, China or India.

The market moves depend on a whole host of factors.

There is no one-to-one correlation, especially in exactly the same timeframe.