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DISSECTING THE DISCONNECT

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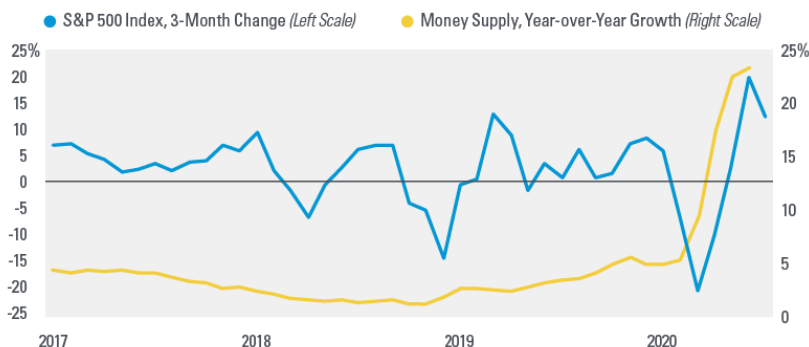
One of the most difficult questions for investors to answer right now is how can the US economy be struggling so much while the stock market keeps churning higher? Even harder to answer questions are: When will that gap close and what will be the catalyst that starts to close it? We highlight some differences between the stock market and the economy in an attempt to explain the disconnect.

MAKING SENSE OF THE RALLY

The stock market continues to do quite well. The S&P 500 Index, which has risen four straight months, has returned 5% so far in 2020, despite probably the worst pandemic in the United States in 100 years and one of the sharpest economic contractions since the Great Depression. How does that make sense? Let's start with some context for the stock market's recent strength:

- 1) **The pandemic has an end date.** Markets are looking forward to better days ahead. Although the timing is uncertain, the stock market is expressing confidence that the pandemic will end eventually with a vaccine—or multiple vaccines—and with help from better treatments in the interim. Progress has been tremendous with many shots on goal that are likely to score at least one and maybe more success stories.
- 2) **Low interest rates.** Stocks are expensive, no doubt, but they look cheap compared with US Treasuries yielding about 0.5%. When discounting future profits back at such low interest rates, equity valuations get a significant boost.
- 3) **Massive monetary stimulus.** The stimulus from the Federal Reserve has driven the money supply, measured by M2, sharply higher—roughly 25% above last year's levels. Some of that money has found a home in the stock market. Historically, money supply growth and stock prices have tended to move together, which has certainly been the case over the past few months **[FIGURE 1]**.

1 STRONG MONEY SUPPLY GROWTH HAS CONTRIBUTED TO STOCKS' RALLY



Source: LPL Research, Federal Reserve 08/06/20

Money supply growth is measured by the Federal Reserve's M2 statistic.

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

- 4) **Support from the winners.** The so-called stay-at-home stocks have thrived in this environment. We saw evidence of that in the blowout earnings reports from some of the technology giants on July 30. The good news extends beyond those companies, however, with about 40% of the S&P 500 classified as technology, digital media, or e-commerce. Add in some of the most defensive industries within the consumer staples, telecom, and utilities sectors, and more than half of the index is well positioned for this difficult environment.

S&P IS NOT GDP

We also think it's instructive to look at the differences between the economy and the stock market to help make sense of the latest rally in the face of stiff economic challenges. More specifically, the S&P 500 is very different from GDP (gross domestic product) that we use to measure the output of the US economy.

Some of the key differences include:

- **The S&P 500 is more manufacturing driven, while GDP is more services driven.** The services economy was harder hit during the lockdowns and, with social distancing, faces a tougher road back than manufacturing.
- **The S&P 500 is more investment driven than consumption driven.** Capital investment has been supported by technology spending and has not been hit as hard as consumer spending during the pandemic. As a result, the S&P 500 has been more resilient to the pandemic. We also believe the value of tech-based intellectual property is better captured by the S&P 500 and its profits than the GDP calculation.
- **The S&P 500 is global, while GDP is domestic.** Roughly 40% of the sales for the S&P 500 are derived internationally, while US exports in the GDP calculation make up only 13% of US GDP. The US economy is a net importer, while the S&P 500 is a net exporter, which is why the S&P 500 prefers a weaker US dollar. A weaker US dollar helps make US companies' goods cheaper around the world and enhances international profits. A strong dollar hurts US exports, but it helps control inflation and supports consumer activity, which is a big part of the US economy.
- **The S&P 500 likes higher oil, while GDP likes cheaper oil.** Profits for the energy sector benefit from higher oil prices, but higher energy costs crimp consumer spending. The industrials sector also generally benefits from higher oil prices through capital spending by energy producers.

Finally, higher stock prices during recessions are not out of the ordinary. As we wrote in our LPL Research blog, [Are Recessions Good For Stocks?](#), stocks have risen during 7 of the past 12 recessions going back to WWII, with a median advance of 5.7%. In short recessions, such as the one that we believe just ended, stocks have been more likely to rise.

CONCLUSION

By listing the factors behind the strong rally and highlighting the differences between the US economy and the S&P 500, we don't mean to imply the rally will keep going uninterrupted. As we discussed in our [Midyear Outlook 2020](#), stocks may likely face bouts of volatility over the rest of the year. We may get a dose of it in the coming weeks if lawmakers can't agree on a stimulus bill before their August recess.

The next leg of the economic recovery may be tougher. Although we expect a COVID-19 vaccine, if not multiple vaccines, to clear human trials by year-end, it may take additional time to find a vaccine that's safe and effective.

With the S&P 500 already having eclipsed the high end of our year-end fair-value target of 3,300, and given a number of risks in addition to COVID-19, such as the upcoming US presidential election and escalating US-China tensions, the upside for stocks over the rest of the year may be limited. But we would say the same thing about bonds, which leads us to maintain our tactical overweight equities allocation.



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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full [Midyear Outlook 2020: The Trail to Recovery](#) publication for additional description and disclosure.

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