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Can the stock market crash even without an economic recession?

–by Enrico Marro 16 May 2018

Can the stock markets crash even if the real economy is not in recession? The answer is a stark “yes”, and there is plenty of proof that this is so. It happened, for instance, when the internet bubble burst at the end of the millennium: in 2000, US GDP scored a strong 3% growth while Wall Street slipped by 9%, a phenomenon that recurred in 2002 (with US real GDP at +2%, but the S&P500 index plummeting to -22%). Have there been other years when the economy has grown and the stock market fallen? Yes: 1981, 1977, 1973, as well as 1969, 1966 and 1962.

There are plenty of examples of the opposite too, i.e. the economy contracting while the stock markets rise. This happened, for instance, in 2009, when GDP growth in the US slowed by 0.2% while the S&P500 index gained a spectacular 26.2%. But even looking further back, it is not unusual to find that the stock markets have risen when the economy was slowing: between July 1990 and March 1991, US GDP decreased by 1.4% but the S&P500 gained a robust 11.6%. The events that occurred between January and July 1980 were also incredible: the US economy contracted by 3.7% but Wall Street literally hit the jackpot, soaring by 35.5%.

This doesn’t mean that there is no connection between the real economy and the stock markets: that connection does exist. In fact, looking at the statistics year by year from 1948 on, the correlation is 0.31 positive (where 1 is a perfectly identical trend: the economy grows and the stock markets increase at the same pace). The problem is that the relation is not linear and is often counter-intuitive: as we have seen, there are years of economic recession when the stock markets perform well and years when the stock markets crash even if GDP is growing steadily. Why does this happen?

Often, the stock markets act as “leading indicators”: they try to anticipate the trajectory of corporate profits (and hence of the real economy). This explains why, in years like 2009, the stock markets forged ahead while GDP lost ground: the financial sector had already twigged that the real economy would resume its growth and had drawn its own conclusions. In 2000 as well, the stock markets moved first, beginning to fall while GDP was still growing: in the euphoric climate of the internet bubble some quarterly results had acted like a cold shower, anticipating the economic difficulties that led to the recession of March 2001.

Let’s consider the present situation: the US markets are stalled but the economy is still healthy. What does this mean? Does it mean that we should expect the real economy to come to a halt in a few months’ time? Not necessarily, although it’s unlikely we will again see stock market graphs that climb diagonally from bottom left corner to upper right.

“The stock markets, which have for some time benefited from a greater risk-taking propensity on the part of investors, growing profits and a favourable macroeconomic scenario (aside from the geopolitical tensions), are taking a breather. They’re looking ahead towards a period in which profit growth could slow”, explains Francesco Lomartire, manager for Italy of SPDR ETF, “partly because of the structural changes taking place in some sectors”. One factor that is never taken sufficiently into account is the not always rational behaviour of investors faced with announcements or fears of a change of trend. Very often it is this behaviour that causes some cycles to accelerate without the economic scenario playing any role, as Lomartire underscores.

Then, there is the “duel” between rises in bond rates and corporate profit growth, which is a good barometer of what will happen on the markets. “The 50-60 basis point rise in ten-year US Treasury Notes since the beginning of the year largely offsets the increase in the expected profit on the S&P500”, explains Angelo Meda, head of equities at Banor Sim. “It has risen from 146 to 158 dollars since the beginning of the year, according to valuation models based on capitalising cash flows/future dividends”.

It is therefore of key importance to consider both factors: which direction long-term interest rates will take and where corporate profits will be channelled. “At the moment, no one is predicting quite the same thing. The general consensus is that ten-year interest rates will stand at 3.1% at the end of 2018, while profits will be boosted by fairly synchronised global economic growth and an impact on costs (labour and raw materials) that remains manageable for the time being”, explains Meda. It will be necessary, therefore, to monitor the progress of inflation, which can influence both factors.

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