

Why Is the Market Going Up When Economic News Looks Grim?

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In the early part of the second quarter of 2020, many of our clients, and investors broadly, are asking this important question: How do we reconcile the recent equity market gains, particularly in the United States, with the poor state of the current economy and the weak outlook?

The answer involves recognizing that financial markets are forward-looking. Current pricing is based on expectations of the future. Markets are always incorporating new information and comparing it to current expectations. Investors are asking: Am I surprised by today's news? Are things getting better than what I expected yesterday? Are they getting worse? Or are they about what I expected?

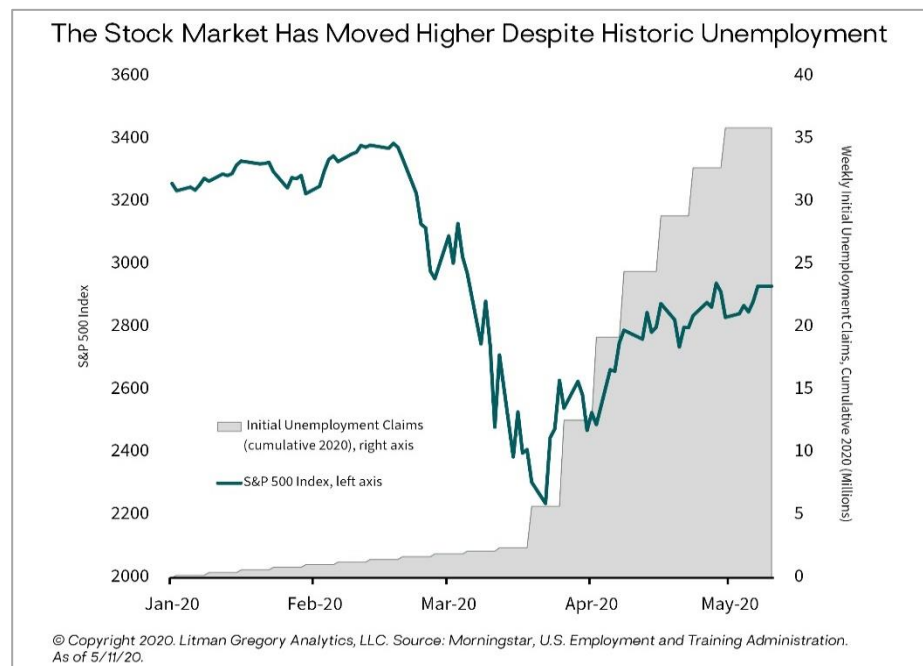
For example, hearing that 21 million people became unemployed in April (a month-over-month spike never seen before in U.S. history) and that the unemployment rate rose to 15% was terrible news. But however dreadful this sounded, it was already widely expected. Thus, the stock market did not sell off, as it had already factored in this news in advance. It wasn't a negative surprise.

So, why does the market continue to rally in the face of negative news? No one knows for sure. There are

so many variables that impact investor behavior. After all, financial markets are just like any other market: Prices are determined by the intersection of supply and demand at any given point in time.

The recent rally shows that investors think things are moving in the right direction. They seem to view the economy as a patient placed in a voluntarily induced coma, with government policy providing life support, to suppress the spread of the virus until we can resuscitate the patient and return to normal. Investors appear to be anticipating a rebound in the economy and employment starting in the second half of the year. This is based on a number of factors:

- **Virus Spread:** On the medical side, investors are clearly optimistic that the "flattening of the curve" will allow states to reopen and economic activity to restart.



- Government Stimulus: The market was also very encouraged by the government's fiscal and monetary policy response to support the economy and financial markets while much of the economy was shut down.
- Profile of Unemployment: About 80% of the 21 million newly unemployed workers in April say they are being furloughed temporarily. If that is true, those workers could be quickly rehired and the recovery could be more rapid than is normally the case coming out of a recession.

Despite the strong equity rally, a great disparity has emerged underneath the surface of the broad stock market's performance. Big Internet/tech stocks (names like Amazon.com, Netflix, and Microsoft) have generally held up well this year or rebounded strongly. The tech-heavy NASDAQ Index is actually positive for the year. In contrast, economically sensitive stocks in energy, financials, and other "value" areas have lagged. This suggests investors remain concerned that a strong economic rebound in the near term is less likely and that it is safer to hide in more defensive areas of the market.

We all hope the positive scenario that the overall stock market is currently factoring in does in fact play out and life starts getting back to normal. But hope is not a strategy. From an investment perspective and based on our understanding of the virus and all the unknowns still associated with it, we think that a near-term positive outcome is far from certain. There is significant risk that the market's current outlook is overly optimistic. In which case, at some point in the next several months, the incremental news could be very disappointing relative to current expectations. We would then expect stocks to decline.

While we don't have certainty or even a high degree of confidence in any particular scenario playing out, we are prepared for any number of scenarios, as both humans and investors. After the recent market rebound, our five-year return outlook for the U.S. stock market is still not terribly attractive. Our base-case scenario expectations show low-single-digit returns for U.S. stocks, and this drives most of our tactical portfolio allocation decisions. So at current market levels, we remain slightly underweight to U.S. stocks versus our neutral allocation. We will wait for a better buying opportunity.

—Litman Gregory Investment Team

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