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MARKET PERSPECTIVE *from the Investment Advisory Group*

Making Sense of the Market-Economy Disconnect

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What Happened

After a dramatic fall, stocks have enjoyed one of their strongest rallies in the past 90 years. The S&P 500 is now down only 15% from the February record high. Intuitively, this does not seem to make sense as the US economy just had its worst quarterly contraction since the financial crisis. The second quarter is set to be significantly worse. The April employment report showed a staggering 20.5 million job losses. Furthermore, uncertainty regarding the economic reopening process and the potential of reinfection continue to weigh heavily on investors.

Our Take

Offsetting the unprecedented shock to the economy is a fiscal and monetary response that has been equally unprecedented in the size and speed of its implementation. The $2.0 trillion fiscal plan, known as the CARES Act, is more than double the fiscal plan enacted during the Great Financial Crisis on a dollar basis. The stimulus was implemented almost concurrent with the onset of the recession versus taking about 10 months to pass during the financial crisis of 2008.

Markets also tend to be forward looking — improving even while the economic data and headlines remain bleak. On average, stocks have found their low about five months before the end of past recessions. Notably, following the 12 previous quarters where the US economy fell at an annualized rate of 4% or more, as it did in the first quarter, the S&P 500 was higher a year later in all cases, averaging a gain of 27% (table 1 on next page).

This analysis included the 1957-1958 recession, a period in which the global pandemic of influenza, known as the Asian flu, occurred. According to the CDC, the estimated number of deaths was 1.1 million worldwide and 116,000 in the United States. In the fourth quarter of 1957, US GDP shrank 4.1%, which was followed by a 10.1% decline in the first quarter of 1958. US stocks were up more than 30% a year following each of these negative quarters, even while it was far from a straight line higher in most cases.

Table 1: S&P 500 Returns Following 12 Worst US GDP Quarters

Quarter Ending	US Quarterly GDP % Decline	3-Months Later	6-Months Later	12-Months Later
Mar-49	-5.4	-6%	4%	17%
Dec-53	-5.9	10%	18%	45%
Dec-57	-4.1	5%	13%	38%
Mar-58	-10.0	7%	18%	33%
Dec-60	-5.0	13%	12%	22%
Dec-70	-4.2	9%	8%	10%
Mar-75	-4.8	14%	3%	23%
Jun-80	-8.0	8%	18%	15%
Dec-81	-4.3	-7%	-11%	15%
Mar-82	-6.1	-2%	9%	35%
Dec-08	-8.4	-8%	-1%	25%
Mar-09	-4.4	15%	33%	47%
Mar-20	-4.8			
Average	-5.8	5%	10%	27%
Median	-5.0	8%	10%	24%
% Positive	--	67%	83%	100%

Data Source: SunTrust IAG, FactSet
Gray shading = Asian Flu; Past performance does not guarantee future results.

Beyond stimulus, a key reason the S&P 500 has held up despite weak economic data is sector composition. The S&P 500 has a significant weighting to growth and defensive sectors, such as technology, health care and consumer staples. These sectors are holding up well on a price and earnings basis relative to more cyclical areas, which are down much more but have a smaller weight in the index. Thus, the market has acted somewhat rationally in differentiating between winners and losers.

Table 2: S&P 500 Heavily Weighted Toward Growth and Defensive Sectors

S&P 500 Sector	S&P 500 Sector Weight	% Below 52-Week High	1 Month Change to Forward Earnings
Growth & Defensive	63%		
Technology	26%	-13%	-5%
Health Care	15%	-7%	-3%
Comm Services	11%	-13%	-12%
Consumer Staples	8%	-11%	-3%
Utilities	3%	-21%	0%
Average		-13%	-5%
Cyclical Sectors	24%		
Financials	11%	-30%	-30%
Industrials	8%	-27%	-31%
Energy	3%	-44%	-97%
Materials	2%	-18%	-13%
Average		-30%	-43%
Other*	13%		

Data Source: SunTrust IAG, Bloomberg

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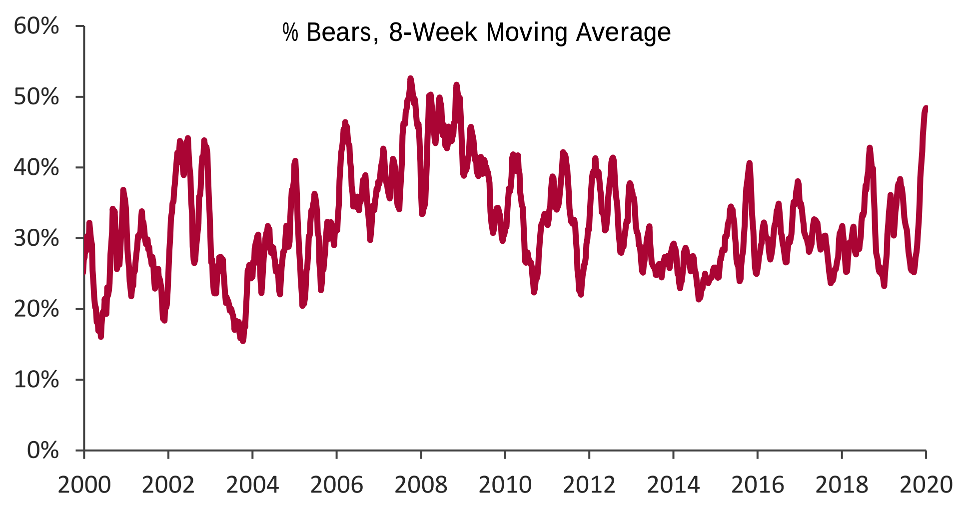
Depressed Sentiment Should Help Cushion Market Downside

Another factor feeding into the perceived disconnect between markets and the economy is that stocks tend to move up or down based on how data comes in relative to expectations as opposed to whether data is good or bad on an absolute basis. Investors are no longer surprised by weak economic numbers.

From a contrarian perspective, the broad skepticism of this rally is a positive insofar as it suggests investor expectations are low and positioning is not aggressive. This should help to cushion the market's downside on any pullback.

- The percentage of individual investors who are bearish has averaged 48% over the past eight weeks, the highest level since 2009, according to the American Association of Individual Investors (AAII).
- There has been an additional $29 billion of net fund outflows from mutual funds and exchange-traded funds over the past two weeks.
- The average recommended equity exposure from newsletter writers is just 20% compared to near 80% coming into the year, according to the Hulbert Sentiment Index.
- Short interest (bets that stocks will go down) as a percentage of the S&P 500's float is at its highest level since 2016.
- Hedge fund beta to the market, a measure of equity exposure, remains in the bottom 10% since 2003.

Individual Investors Most Bearish Since 2009



Data Source: SunTrust IAG, AAII, FactSet

Bottom Line

There is a disconnect between the stock market and the economy. However, this is almost always the case around turning points. The disconnect is even more exacerbated now given the enormity of the coronavirus shock to the economy, which has been met with unprecedented fiscal and monetary stimulus. Also, the composition of the S&P 500, which is heavily weighted towards growth and defensive sectors, has helped this widely-followed index hold up well relative to the broader economy.

Unlike the very positive risk/reward near the lows, there is less of a short-term edge for investors after the snapback. The unevenness of the economic and earnings recovery is likely to cap the near-term market upside. However, depressed investor sentiment and positioning remains a positive from a contrarian perspective. This should cushion the extent of a market decline and also sets the market up well should there be an upside surprise on the economy or progress toward a therapeutic drug/vaccine. Accordingly, we favor an averaging-in approach for investors underweight equities and becoming more aggressive on pullbacks.

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