GDP vs the Market

Should hedge funds be worried about the economy? Maybe not as much as they think.

Full Story

Hege fund returns tend to be positively correlated with equity markets, and we might expect equity markets to go down in a recession, but the link between equity markets and the economy is much weaker than most people suspect.

It is well known that people suffer from what psychologists call an availability bias. In pondering the link between recessions and the stock market, for most people the first example to spring to mind —the one that is most available— is the Great Recession of 2007-2008. Both the market and the economy performed horribly during this period. It is much harder to remember the 2nd quarter of 1980, when the economy shrank at an 8.0% annual rate, but the market was up 11.9%. And who can recall the 1st quart of 1958, when GDP dropped at a 10.0% rate and the market was up 5.3%.

Over the past 73 years, on a quarterly basis, when GDP was down, the market was actually *up* slightly more often than it was down. 22 out of 41 down GDP quarters coincided with positive returns for the S&P 500.

		SPX		
		dn	up	
GDP	dn	19	22	41
	up	81	168	249
		100	190	290

		SPX		
		dn	up	
GDP	dn	6.6%	7.6%	14.1%
	up	27.9%	57.9%	85.9%
		34.5%	65.5%	100.0%

U.S. GDP Growth and S&P 500 Returns, 2Q 1947 to 3Q 2019

Sources: Standard & Poor's and U.S. Bureau of Economic Analysis. S&P 500 do not include dividends.

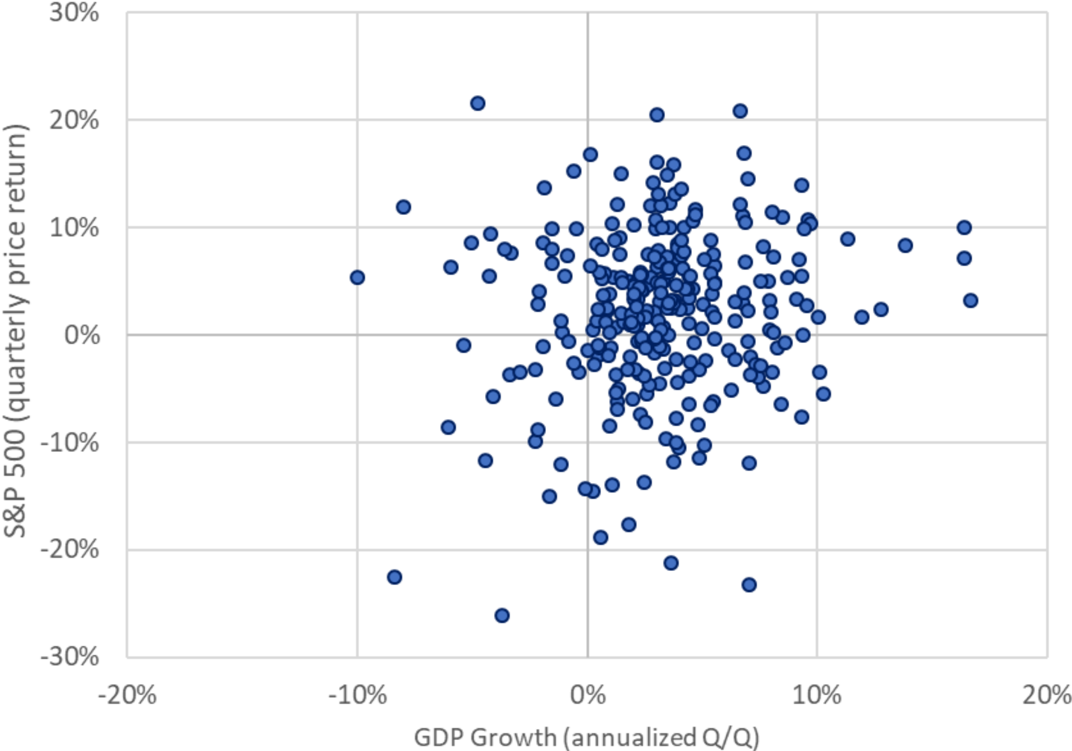
Of course, the market tends to go up over time (65.5% of quarters in our sample were up). The market was up more often than it was down when GPD was down, but when GPD was up it was even *more* likely to be up. In quarters when the economy shrank the market was up 54% of the time, but when the economy was growing the market was up 77% of the time. The correlation between GPD growth and market returns is positive, but it is weak, just 12.3%.

The pattern of seems to hold even if we restrict ourselves to more recent data or more extreme downturns. 47% of the down quarters since 1980 have seen up markets, and 6 of the 10 worst quarters for GDP growth saw up markets.

Based on theory, these results should come as no surprise. Markets are forward looking. If anything, today's lower interest rates should lead investors to put less weight on current earnings and more weight on the future.

© 2019 Northstar Risk Corp. All rights reserved.

We shouldn't overlearn the lessons of the Financial Crisis. A downturn in the economy could still have important consequences for different sectors and style factor, but a downturn in the economy need not lead to a downturn in equities overall.



U.S. GDP Growth and S&P 500 Returns, 2Q 1947 to 3Q 2019

Sources: Standard & Poor's and U.S. Bureau of Economic Analysis. S&P 500 do not include dividends.

© 2019 Northstar Risk Corp. All rights reserved.
info@northstarrisk.com