The Relationship of the Stock Market and the Economy

By Thomas E. Nugent

The U.S. stock market may have hit a low point on September 21st, driven by the events of September 11th. The subsequent rally in the stock market, almost a "V" shaped rise, surprised most market forecasters. The S&P 500, the basic benchmark for the stock market has risen from a low point of 966 to a recent high of 1158, a gain of 19.9%! The tech-heavy NASDAQ Composite experienced a stronger rebound. It rose from a low point of 1423 to a recent high of 2021, a gain of 42.0%. Crises usually precipitate government action and the military response to the terrorist attacks has helped to lift the U.S. stock market out of major bear market.

On November 26th, the National Bureau of Economic Research declared that the U.S. economy entered a recession in March—essentially the second quarter of 2001. While few economists or market prognosticators forecast the onset of a recession in early 2000 when the stock market peaked, the subsequent gradual and then rapid decline in stock prices through the end of 2000 accurately anticipated the recession that is now upon us.

Similarly, rallies in stock prices lead economic recoveries. The short economic recession of 1990-1991 officially ended in March of 1991. However, the stock market, as measured by the S&P 500, increased from a low of 294 in October 1990 to a high of 380 six months later, an increase of 30%. To the extent that the current economic weakness and recovery tracks parallels financial market performance, a recovery should be underway no later than the second quarter of 2002.

There are still a few key pieces to the economic puzzle that should be in place before confidence about the future of the stock market and the economy is solidified. First and foremost is the passage and implementation of the additional fiscal stimulus package that is now pending in Congress. The bipartisan spirit that emerged in the aftermath of the terrorist attacks seems to have collapsed as reflected in the stalemate over the components of the stimulus package. One side wants greater spending, while the other side wants greater tax cuts. If we don't get some movement on this package by the end of the year, we are likely to see a relapse in the stock market and the postponement of the recovery until later in 2003 as the existence of the budget surplus will continue to contract the economy.

The second impediment to a return to good times is the continuing prosecution of the war on terrorism. While the stock market has rallied in tandem with successes in Afghanistan, further gains may not be as easy to come by although the elimination of Bin Laden may have a short-term positive impact. Taking the next step to root out terrorism in other countries that have sponsored and supported terrorists may not be as dramatic as the search for Osama bin Laden. As other market observers have pointed out, further terrorist attacks may unnerve financial markets around the world.

One unexpected positive note has been the dramatic decline in the price of oil. As Larry Kudlow has pointed out on a number of occasions, this price decline actually can be viewed as an enormous tax cut for American consumers and will contribute to an increase in after-tax disposable income since lower spending on gasoline and heating oil will translate into higher spending on other goods and services. We have Russia to thank for some of the recent decline in oil prices as it refused to go along with the OPEC cartel, which was trying to keep oil prices around $25.00 per barrel. Since Russia is the third largest oil producer, their decision carried a heavy weight in international markets. In addition to oil prices, commodity prices across

the board have been declining and have contributed to actual declines in inflation benchmarks such as the producer price index and the consumer price index. While bad news for producers, it's good news for consumers who will benefit from lower prices at the supermarket and department store.

The Outlook for Corporate Earnings

The stock market tends to move with the rate of change in corporate profits. In other words, corporate profitability can still be expanding while the stock market is declining. The stock market anticipates not only the economy but also improving corporate profitability. In other words, when corporate profits reach a peak, the stock market usually reaches a high point prior to the peak. For example, the peak rate of earnings for this cycle occurred in the third quarter of 1999, well before the onset of the bear market. Similarly, a trough in corporate profits usually is near the low point in the rate of change in corporate profits. So, since the economy is expected to recover next year, corporate profits should benefit from that recovery. Stock prices have begun to rise as a result. Since it is possible that corporate profits experienced the largest rate of decline in the third quarter of 2001, the stock market troughed simultaneously. Therefore, from a corporate profit perspective, there is support for a continuation of the current market rally into 2002.

Corporate managers at the highest level are paid large salaries to produce growth in profitability. Many of these managers are paid bonuses based on the level of profitability they achieve. During a roaring economy, profits are easy to produce and sometimes lead to less disciplined management decisions. When an economic downturn is underway, corporate executives scramble to maintain profitability. Early in an economic down cycle, many managers are caught by surprise as revenues and profits weaken. Once the trend is evident, managers react quickly to the downturn by moving to cut costs since revenue expansion in the short-term is unlikely. Many times the first casualty in the battle to maintain profitability is the workforce. As corporations lay off workers to reduce costs, the unemployment rate rises and corporate costs decline. Rising unemployment continues until such time as some equilibrium is reached to where management can no longer reduce the workforce without impinging on the ability to produce goods and services. When companies have moved to lower other costs as well, they reach a level where they will benefit from any economic upturn.

The importance of managements' quick reaction to maintaining profitability is that Wall Street will tend to underestimate the degree to which corporate profitability will fall and then underestimate how quickly corporate profits will rebound. As analysts begin to ramp up their earnings expectations in early 2002, the market should be rallying accordingly.

Conclusions

- The rally in the stock market is signaling an economic rebound in early 2002.
- The sustainability of the market rally and the economic recovery will depend upon the timing, size and composition of the pending fiscal policy package.
- Earnings growth in 2002 should be higher than consensus estimates from Wall Street as corporate managers strive for improved corporate profits.
- The bond market rally of 2000-2001 is probably over and both long-term and short-term interest rates should rise during 2002.
- Stock market valuations based on an assessment of current P/E ratios relative to historic experience are incomplete without the inclusion of current and future inflation estimates. If we include such estimates based on consensus economic inputs, the stock market is not as overvalued as one would suspect.