THE 2020 MARKET VS. MARKET HISTORY

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THERE'S NO QUESTION THAT 2020 HAS BEEN AN EXTREMELY CHALLENGING YEAR, FROM THE CORONAVIRUS EPIDEMIC AND MASSIVE UNEMPLOYMENT TO A DEEP RECESSION AND HEIGHTENED MARKET VOLATILITY.

Many observers have commented on the apparent disconnect between the stock market and the "real economy." In the second quarter of this year, US GDP contracted at an unprecedented annual rate of 32%. Yet in the same April-June period, stocks (as represented by the S&P 500) surged 20%, the best Q2 performance in more than 60 years. As we navigate the current market, the research team at People's United Advisors studied the similarities and differences with prior markets in recessionary periods.

MARKET ≠ ECONOMY

First, we examined the historical relationship between recessions and market performance. We looked at all 1-, 3-, 5-, and 10-year forward rolling returns from July 1947 to March 2020. Since GDP data are reported quarterly, we moved the chains forward three months at a time and measured recessionary stock performance from the start of the quarter following the beginning of negative growth. For instance, the recession of 2020 began in the first quarter of this year, so for the purposes of our study, the first forward one-year period for stocks stretches from April 2020 to March 2021. What we found is that market returns following periods of negative GDP growth are higher than the average stock returns over the entire period. Exhibit 1 summarizes the results of our study. For example, forward 1-year returns are four percentage points higher when current GDP is negative, 3-year returns are nearly three points higher, and 5-year returns are 2.7 points better. Note also that the market's returns are negatively correlated with GDP, which is measured in nominal terms. It may seem counterintuitive, but periods of negative GDP growth may be the best time to invest in stocks.

Several explanations may account for why a bad economy does not necessarily mean a bad market.

First, during periods of high market volatility, very low expectations are built into the market. People tend, for behavioral reasons, to extrapolate current conditions too far into the future. Eventually, prices revert; thus far, as described below, we

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EXHIBIT 1: AVERAGE FUTURE RETURNS AND CORRELATIONS

1-, 3-, 5-, AND 10-YEAR FORWARD ROLLING RETURNS: JULY 1947–MARCH 2020

	Forward 1-Year	Forward 3-Year	Forward 5-Year	Forward 10-Year
Entire Period	9.4%	8.4%	8.0%	7.3%
When Current GDP<0	13.0%	11.3%	10.7%	9.5%
Correlation	-0.14	-0.09	-0.09	-0.11

Sources: PUA Research, Bloomberg

Second, in response to the current recession, the Federal Reserve and Federal Government acted swiftly and decisively; their monetary and fiscal policies helped to establish a floor under the market, which Wall Street viewed favorably (stocks rebounded a remarkable 45% from March 23 to June 8). The scale of stimulus was enormous, and is still playing out. In past recessions the government has also rolled out similar (if smaller) economic stabilizers.

Finally, let's remind ourselves of the basic function of the stock market: Market prices are based on forward expectations, not on today's headlines or current events. The pricing mechanism attempts to forecast the situation in two, three or even five years from now. Of course, no one can accurately predict the future, but the market tries—and is volatile due to the inevitable gap between prediction and actual future events.

In sum, as described above, time and time again we have seen that bad economies don't necessarily mean bad markets. This year we have, thus far, experienced a similar pattern of a bullish market amid an economic recession.

PATTERNS OF MARKET RECOVERY

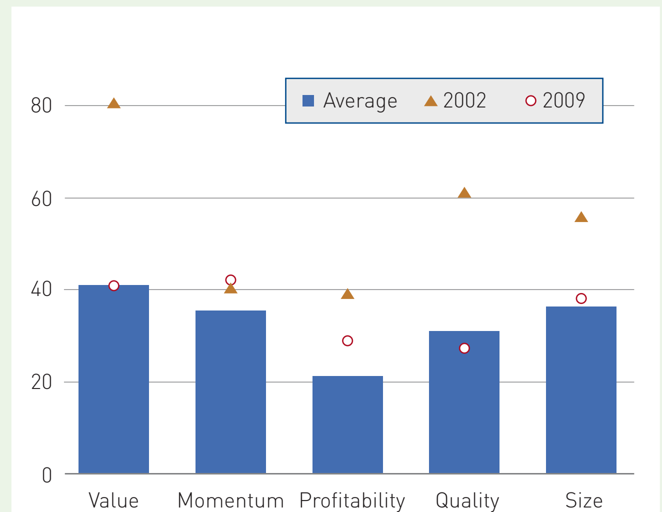
What is different this time? Several factors, or stock characteristics, tend to explain market returns. We have identified which ones have historically performed well coming out of periods of market volatility. The themes, or factors, that tend to shine are Value (i.e., buy inexpensive stocks), Momentum (buy companies that have performed well recently), Profitability, Quality (conservative balance sheets), and Size (small caps vs. large companies).

We looked back at all market corrections from 1960, and how the five factors cited above performed when exiting these periods of market volatility. In the past, Value, Momentum and small companies tended to perform particularly well following the market bottom and to lead in market recoveries (see Exhibit 2). In 2020, however, we have seen the leadership almost flip, with Momentum and Profitability the clear leaders and Value and Size lagging.

From January 1 to July 31, 2020, large cap growth stocks (as measured by the Russell 1000 Growth Index) returned 18%, while large cap value (Russell 1000 Value) returned -13%. The valuation gap between small cap value (Russell 2000 Value) and small cap growth (Russell 2000 Growth) is particularly wide, with the small value discount relative to growth having doubled over the course of the past decade. We would not be at all surprised if Value and Size pick up their performance as out of favor segments of the market tend to do. Holding a well-diversified portfolio means you are exposed to all of these stock characteristics and don't need to engage in market timing, which can be dangerous to the performance of a long-term portfolio.

EXHIBIT 2: FACTOR PERFORMANCE OF TOP DECILE TWELVE MONTHS FOLLOWING POST-CORRECTION MARKET LOW

January 1, 1960—June 30, 2020



Sources: PUA Research, MSCI, Sharadar

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