The horse that ran away

There's a lot of anger in the world right now. In several developed countries, people are angry at their governments for overpromising and underdelivering in managing a health crisis. In SA, people are angry that they can't go for a run outside their property, have a drink and smoke a cigarette (though not necessarily all at the same time).

Lots of people are also getting angry with each other based on differences in terms of how the Covid-19 pandemic should be approached.

On the one hand, there are those who agree with lockdowns and would continue with them for an extended period to lighten the burden on hospitals and save the lives of as many people as possible.

On the other hand, there are also many who believe that the cure may be worse than the disease, and that more people could end up losing their lives due to the economic contraction caused by lockdowns than those saved in the process.

Google "wealth and life expectancy" and you'll find nearly 20-million webpages discussing the correlation between these two measures.

Financial markets have also been infuriating.

To illustrate, Howard Marks, the co-chair of Oaktree Capital Management in the US, tells his father's story of the gambler who lost regularly: "One day he hears about a race with only one horse in it, so he bet the rent money. Halfway around the track, the horse jumped over the fence and ran away."

In similar vein, many stock market participants have been positioning themselves for bearish outcomes over the past few months, believing this to be "a sure thing" given the scale of economic destruction in the face of a pandemic. Just last week, for example, the International Monetary Fund published an updated outlook of the global economy, which is projected to contract by as much as 3% in 2020 (much worse than even the 2008/2009 financial crisis).

And yet, equity prices around the world have staged a strong comeback after shedding more than 30% in the first quarter of 2020.

The contradiction was captured succinctly in a screenshot from CNBC's *Mad Money* show with Jim Cramer on the eve of the Easter weekend which has since gone viral, juxtaposing the following two bylines: "The Dow's best week since 1938" and "More than 16m Americans have lost jobs in 3 weeks".

How does any of this make sense, or has it just been a bear market rally?

It seems obvious to equate what's happening in the real economy with movements in the stock market: both concepts purport to measure business activity and how much money is being made or lost in the process.

When the world goes into lockdown and the global economy contracts at a pace not seen since the Great Depression, it therefore seems equally obvious that equities should follow suit.

The short answer, however, is that the correlation between the economy and the stock market is tenuous at best, especially when measured over months or quarters rather than years and decades.

Financial markets are discounting mechanisms after all, looking far into the future. Share prices today are already taking into account consensus estimates of a potential recovery in 2021 and beyond.

Moreover, the stock market is but a narrow representation of the real economy. Your local florist might not be able to reopen when the lockdown finishes, but it's probably not listed either.

It's the largest and strongest businesses in the world that are members of stock exchanges, and while some of them may suffer for an extended period in a post-coronavirus world (airline bailouts, anyone?), a company like Microsoft will probably get through this crisis with an even stronger business than before.

And the Microsoft share price reflects this today: at the time of writing, it's up about 10% for the calendar year to date.

Add to this the US Federal Reserve, which has been acting in financial markets as a buyer of last resort, and you really get people's blood boiling.

How the role of this institution has evolved over time is probably a topic for another day, but it has never been a good idea to fight the Fed.

I am not suggesting that we've seen the last of the market dislocations based on the Covid-19 pandemic. To use a cricket analogy: we're probably on Day 2 of a five-day test match — a lot can still happen, both in terms of the pandemic itself as well as the financial market response.

But what I am saying is that you shouldn't get angry when financial markets confound your short-term expectations. And never bet the rent money on that one horse that might yet jump the fence and run away. x

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