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Key points:

1. Recession period comparison
2. How the economy reacted to the recession from 1980 to 2020 : The last 6 recessions
3. The relationship between the economy and share market

Data source: for S&P 500 companies

<https://www.economicsobservatory.com/does-the-stock-market-reflect-the-economy>

<https://www.rbcgam.com/en/ca/learn-plan/investment-basics/whats-the-relationship-between-the-stock-market-and-the-economy/detail>

<https://www.macrotrends.net/2526/sp-500-historical-annual-returns>

https://www.macrotrends.net/2526/sp-500-historical-annual-returns

1. Recession period comparison



Chart, bar chart

Description automatically generated

The 1990s were the longest period of economic growth in American history up to that point. The collapse of the speculative dot-com bubble, a fall in business outlays and investments, and the September 11th attacks, brought the decade of growth to an end.

1. How the economy reacted to the recession from 1980 to 2020

GDP and unemployment declined. Covid 19 lasted only two months, but it hit the worst.

The rates of GDP and unemployment were the highest

Chart, waterfall chart

Description automatically generated

1. The relationship between the economy and share market

Diagram

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The graph below shows it is a negative relationship between GDP declined and Time since last recession

Chart, scatter chart

Description automatically generated

If we further assume that:

♣ the share of company profits in the total economy remains constant;

♣ investors have a claim on a constant proportion of those profits;

♣ valuation ratios are constant;

♣ the country’s stock market only lists domestic companies;

♣ the country’s economy is closed, then we would expect an exact match between real price increase and real GDP growth. This theory is simple and makes intuitive sense. But is it true in practice? Several studies (Dimson et al. [2002], Ritter [2005]) have examined whether countries with higher long-run real GDP growth also had higher long-run real stock market return. The surprising result was contrary to expectations -- the correlation between stock returns and economic growth across countries can be negative! Our own analysis confirms this empirical finding: Exhibit 1 plots stock returns

Chart

Description automatically generated with medium confidence

Fluctuations in the prices of financial assets in the stock market can sometimes seem to be inconsistent with what is happening in the rest of the economy – what’s sometimes referred to as the ‘real economy’.

For example, in 2020, US GDP fell by 3.5% – the largest contraction since the end of the Second World War ([Furman and Powell, 2021](https://www.piie.com/blogs/realtime-economic-issues-watch/what-us-gdp-data-tell-us-about-2020)). But the S&P 500 – a weighted index used to measure the US stock market – increased substantially during this period, more than recovering any temporary losses and ending the year 15% higher than its pre-pandemic level.

How do we explain this apparent disconnect?

The market value of a company should reflect how much cash investors believe the firm will make in the future. If changes in the broader economy are likely to affect company performance, then this should lead to changes in share prices. But it is important to emphasise that investors will consider not only what is happening now, but also what is likely to occur in the future.

Research has shown that a considerable proportion of the variation in share prices can be explained by key economic variables such as industrial production, inflation and interest rates, as well as changes in the dividends that companies pay to shareholders (Cutler et al, 1988). The evidence suggests that expectations about future changes in the economy play an important role in current pricing, although there may be some feedback effects involved, as changes in the stock market may actually cause changes in the wider economy.

But it has been has argued that share prices fluctuate more than they should – they exhibit ‘excess volatility’ (Shiller, 1981). What this means is that asset prices fluctuate more than is justified by changes to the fundamental characteristics of the underlying companies, which suggests that share prices may not always predict accurately what will happen in the future.

Prices are also affected by changes in the interest rate that is used to ‘discount’ future cash flows (Cochrane, 2011). Again, this means that prices may not necessarily reflect only predictions about company growth.

Chart, scatter chart

Description automatically generated

Limitation:

It cannot predict the future share price because of the world volatility and ongoing Ukraine war