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Discounting helps fuel equity gains

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Stocks have recovered quickly from their earlier losses. But does this make sense?

Equities have recovered their losses since they first began tumbling in February. It's been an astonishingly fast round trip in historical terms. And for some, it defies common sense. The natural question is whether financial markets are ahead of the economy and whether they should be. At the risk of spoiling the plot, the answer to the first question is "Yes!" And for the second, again, "Yes!"

Colin Moore
Global Chief Investment Officer

It's generally accepted that investors "discount," or take into consideration, all available information including present and potential future events. This means security prices (bond and equity) reflect significant expectations about company earnings, defaults, inflation, and monetary and fiscal policy. They also reflect views about the current robustness of a company's liquidity and balance sheet, and the stability of the financial system generally. Admiring a building without understanding the strength of its foundation is folly.

When unexpected, major developments occur, investors tend to move rapidly and attempt to incorporate the new information into security prices. The efficient market hypothesis (EMH) assumes that investors as a group (the "market") are a very efficient discounting mechanism. If efficiency is defined as the speedy consideration of all new, public, accurate information, then I agree: the markets are "efficient." For example: when an individual company publicly announces new profit forecasts, the possible range of interpretations by investors is relatively narrow, so the adjustment to the valuation of related securities is fast and accurate. But in a more complex situation (such as a global pandemic or a global financial crisis) investors may act quickly, but there's a wide range of interpretations — both short- and long-term. So, it's less clear that the initial reaction is an accurate reflection of the eventual consequences.

Over time, we expect financial markets to move in the same direction as economic data. After all, companies (and their revenue) do not occur in a vacuum. When global economies are growing, more goods and services are sold, enhancing corporate revenues, and creating the circumstances that tend to foster stock and corporate bond market appreciation. In contrast, if there's a downward trend in the economy, there's a chance the stock market will follow suit.

However, because of the concept of discounting, financial markets may rise when there's an expectation of future economic growth, even if the current situation is dire. Investors experienced this phenomena when the stock market crashed due to the global financial crisis in 2008, but began recovering in 2009 before the economy recovered. In my view, financial markets are and should be anticipating the size and growth of global economies in 2021 and 2022 rather than focusing on backward-looking economic reports.

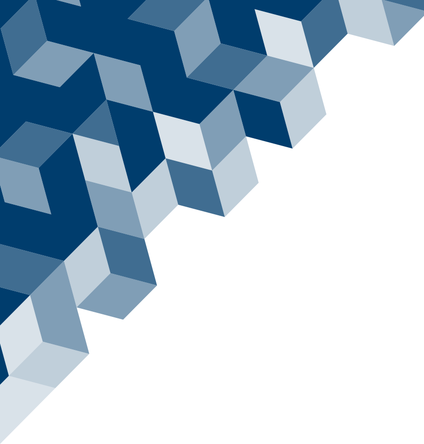
Headline data on indices can also be deceiving. According to Empirical Research:

“Big growers, the 75 large-cap stocks with the very best all-around growth credentials, are now trading at almost five times the market’s trailing-P/E on an equally weighted basis, a valuation last seen in December 1999. They’ve had an extraordinary pandemic, outperforming the market by double-digits on the way down and again on the way back up."

In other words, it’s not an abundance of optimism about the recovery from COVID-19 driving market performance; it’s companies with visible growth prospects in a growth-starved world.

Bottom line: Expect market volatility as expectations change with events

The future is capricious, which is why forecasting is very hard and partly why financial markets exist in the first place. We should expect markets to try to anticipate complex future events. But we may experience additional volatility as those expectations change when new events unfold. An irrational market would be one that does not attempt to discount the future.



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