Why are Assets Booming When the Economy is Falling?

The Bank of England recently said that this will be the deepest dip in the UK economy for a hundred years. Then the following day, leading UK Bank Halifax reported that house prices hit an all-time record in July!

And the UK is not alone in this situation…

So what's going on? Why are assets booming while the rest of the economy is in the doldrums?

Take a look at this strange juxtaposition, the world seems to be going 2 different directions at once, with a huge contrast between what is happening to the economy and what is happening to asset prices.

The latter are shooting up everywhere. The gold price recently went above $2,000 an ounce for the first time in history, before suffering a fairly dramatic correction.

In the US, the big driver has been share prices rather than houses, with the S&P 500 index, the largest companies in the US, hovering around all-time highs.

The main German equity index, the DAX, is down less than 5 per cent so far this year despite the blow from the collapse of the financial payments company Wirecard, and the consequent hit to German banks.

In China, where this all began, the volatile Shanghai composite index is well up on the level it was before the virus hit. As for the world economy, some sort of recovery is clearly taking place.

However, the Bank of England's 'Good News' (according to them anyway!) is that they are thinking that this year the UK economy will be down by 'only' 9.5 per cent! I wonder what bad news would look like!

For what it is worth, the International Monetary Fund forecasts the US and Germany economies will be down 8 per cent this year, the UK down a bit over 10 per cent , with France, Italy and Spain all down between 12 per cent and 13 per cent.

The IMF suggests that no major developed country will be back to its 'pre-Covid level' until well into 2022.

Yet asset prices, which have historically reflected optimism or pessimism about the future, are booming. When faced with confusion on such an industrial scale, the simplest explanation is usually the best.

And that is that the world's central banks are piling huge amounts of money into the global economy – and that money has to go somewhere.

In the case of the UK, the big companies tend to be in unfashionable sectors that are going through tough times, such as oil, banking and conventional retailing.

So while the FTSE 100 index has made a reasonable recovery, it has been held back by a combination of fashion and dividend cuts. So UK money goes into homes.

Of course, the UK housing market has been given an additional boost by the recent stamp duty concessions passed by the government, but not all property segments are so solid.

The future of inner cities worldwide, particularly large cities like London and New York, may be a worry as people are working more from home and don't need to be located near the office anymore.

But a home will always be there, and in the past even if you did buy at the wrong time in the property cycle, eventually you nearly always got your money back.

In the US the housing market has been a more uneven performer. Recently it is the high-tech equity sector that has made its followers rich.

The American economy in 2020 is a "best of times, worst of times" contradiction that would leave even Charles Dickens scratching his head.

Tech billionaires like Jeff Bezos and Mark Zuckerberg have become $637 billion richer under COVID-19, according to Business Insider, whilst an estimated 51 million people in the USA are unemployed and a multitude of well known companies like Hertz, J.C.Penny, Dean & DeLuca and even the Boy Scouts of America have filed for Chapter 11 Bankruptcy protection.

In both the US and the UK, Gross Domestic Product (GDP) just saw its largest quarterly drop since records began, indicating this may be a long recession that recovery may take some time.

In the Middle East and India the default asset has for many people been gold, which has done stunningly well.

The vaults of the Bank of England, by the way, hold the second largest stock of gold in the world after the New York Federal Reserve Bank - more than £200 billion of the stuff.

Unfortunately, thanks to Gordon Brown's decision in the early 1980's to sell half the UK's reserves when he was Chancellor, most of it is now owned by other countries – but at least the UK did get some interest on the US treasury securities they bought instead!

Therein lies a further clue to what is happening, and a warning for us all.

Gold produces no income. That has been the argument against us holding too much of what the famous economist John Maynard Keynes called 'a barbarous relic'.

But if you get no income from Government stocks, you might as well have the gold. The ten-year yield on gilts on Friday was down to 0.14 per cent; on the equivalent US treasuries it was 0.5 per cent; on German bunds it was minus 0.5 per cent!

So the soaring price of gold is both a reaction to central banks driving down interest rates, and a chilling warning about the prospect of yet more (unsustainable?) price growth down the line.

Then there's the stock market…

It still might crash with the rest of the economy, but central banks seem determined to ensure it doesn't - investors just don't know it yet.

All of the small business closures, bankruptcies, and lower consumer spending may eventually erode stock market gains if a broader economic recovery doesn't soon materialise.

Mark Zandi, chief economist for Moody's Analytics recently said; "The stock market and the economy have parted ways. I'm not sure what will trigger a sustained sell-off in stocks, but surging [virus] infections and another round of more business closures will be difficult for investors to ignore much longer."

But the stock market does not appear to represent what investors think of the economy right now — it represents their assumed future value of the market.

If a stock price is high, buyers think the investment will be worth more in the future. Investors seem to think the future looks bright for the companies whose stocks they buy.

It’s also possible investors think that stocks will be more valuable than other assets, like cash or property, in the long run. Commercial property investment is a particularly risky proposition right now, as retail, office, and general commercial properties are all pretty uncertain prospects given the way companies are closing down.

Therefore, stocks may represent the most attractive current investment option, so more investors are driven to that market.

However…

Indices like the Dow Jones Industrial Average are Misleading

When we discuss whether the stock market is up or down, we typically refer to indices like the Dow Jones Industrial Average (DJIA). But that’s not really the Dow Jones average—the DJIA only includes the prices of the Dow’s 30 top companies, even though there are thousands of other stocks on the exchange.

And as MarketWatch points out, more stocks are going down than going up, so the market overall is not in terribly good shape. Moreover, certain tech companies that are doing particularly well financially during the pandemic, like Apple, IBM, and Microsoft, are dragging the average up in a way that can be misleading.

So having taken you up and down like a yoyo in the last few paragraphs, here’s the conclusion…

The Stock Market Always Rebounds.

A Forbes analysis shows that the stock market always rises before a recession ends. By that logic, the stock market’s current boom means a recovery is in store.

“Stock prices usually begin rising 4 or 5 months before the recession is over,” Forbes observes based on analysing nearly 50 years of market data. If that rule holds, the current recession would end in September or early October.

The strength of the stock market is a reflection that wealthy (and very intelligent) investors think that the future still looks bright and the economic woes will end soon. The markets don’t think the damage coronavirus has done to the economy will be permanent, but we’ll soon see whether the markets know best in this very unusual situation.