EDITORIAL

THE US STOCK MARKET AND THE LABOUR MARKET: WORLDS APART?

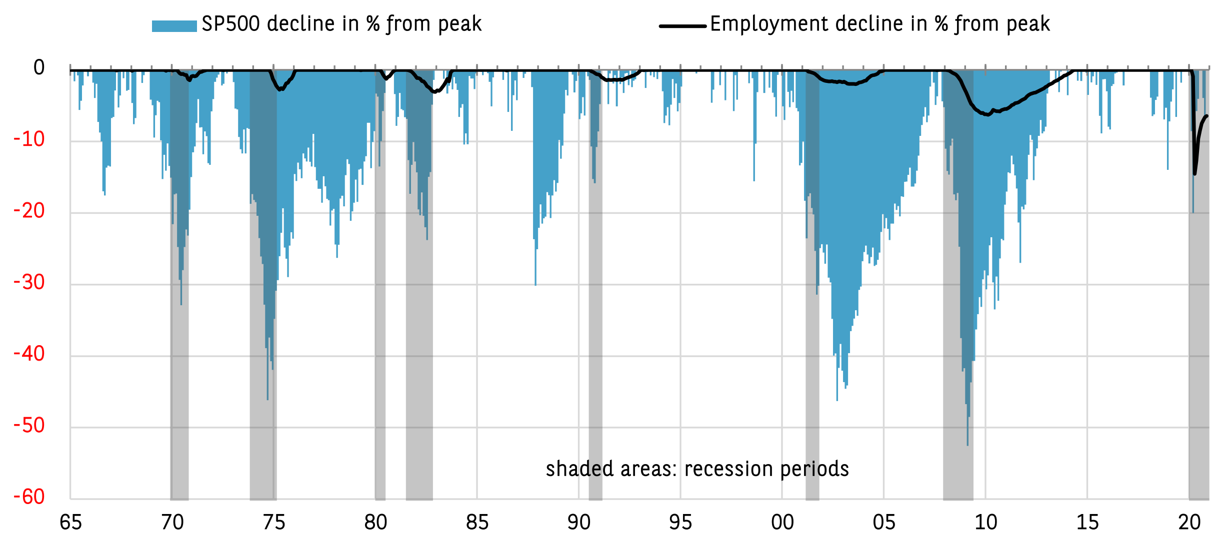
In the US, the behaviour of the equity market versus the level of employment is very different in the current recession compared to previous recessions. The recession this year stands out because of its sudden, enormous job losses, which were quickly followed by a significant albeit very incomplete recovery. The equity market, after a huge drop, has rebounded swiftly and made new highs although earnings – on a 12-month moving average basis – still have to rebound. For 2021, more than anything, earnings growth matters.

The Covid-19 recession is atypical in many respects: its suddenness, its depth, the extent of the rebound, its impact on both demand and supply. Another area of differentiation compared to previous recessions is the behaviour of the equity market versus the level of employment in the US. Focusing on employment rather than e.g. GDP makes sense because the way people feel about the economy very much depends on the labour market. The first chart shows the labour market drawdown, i.e. the percentage difference in a given month between the employment level –the number of non-farm jobs in the economy- and its most recent historical peak. When the economic downturn gathers pace, the drawdown increases. Subsequently, when the economy is recovering, it decreases as new jobs are created.

The chart allows to assess the extent of the deterioration in the labour market as well as the time it has taken to recoup the jobs lost during recessions. Some employment drawdowns have been short and shallow –in the early 70s and in 1980-, others have been severe and long, like during and after the Great Recession. The recession this year stands out because of its sudden, enormous job losses, which were quickly followed by a significant albeit incomplete rebound. The chart also shows the drawdown of the S&P500 equity index. During a downturn, the percentage decline in the equity market tends to be a multiple of the equivalent number for the employment level. This doesn't come as a surprise. Equities are a discounting mechanism, their price being dependent on expectations about earnings far into the future. In addition, the discount rate can fluctuate significantly. Although the risk-free rate will decline when growth is slowing or even negative and rise when activity has sufficiently recovered, the other component of the discount rate –the required risk premium- will rise significantly during difficult economic times and vice versa when things are improving. This causes big swings in equity prices. Equity markets and employment levels are obviously correlated: they rise and fall together. Yet, in history we have frequently seen that it took longer for the stock market to make up for the losses and make new highs than for the labour market. Although commentators often focus on the spectacular nature of equity rallies when the economy starts to recover, this performance is essentially a matter of making up for huge losses during a recession.

The current cycle is very different. Although the maximum drawdown of the equity market was, as usual, larger than the percentage loss of employment (-20% versus -14.5% using monthly data), it was also extremely short: after its trough on 23 March, the S&P500 reached a new record high as early as 18 August. For the labour market, the story

UNITED STATES: DRAWDOWN OF EQUITY MARKET AND EMPLOYMENT

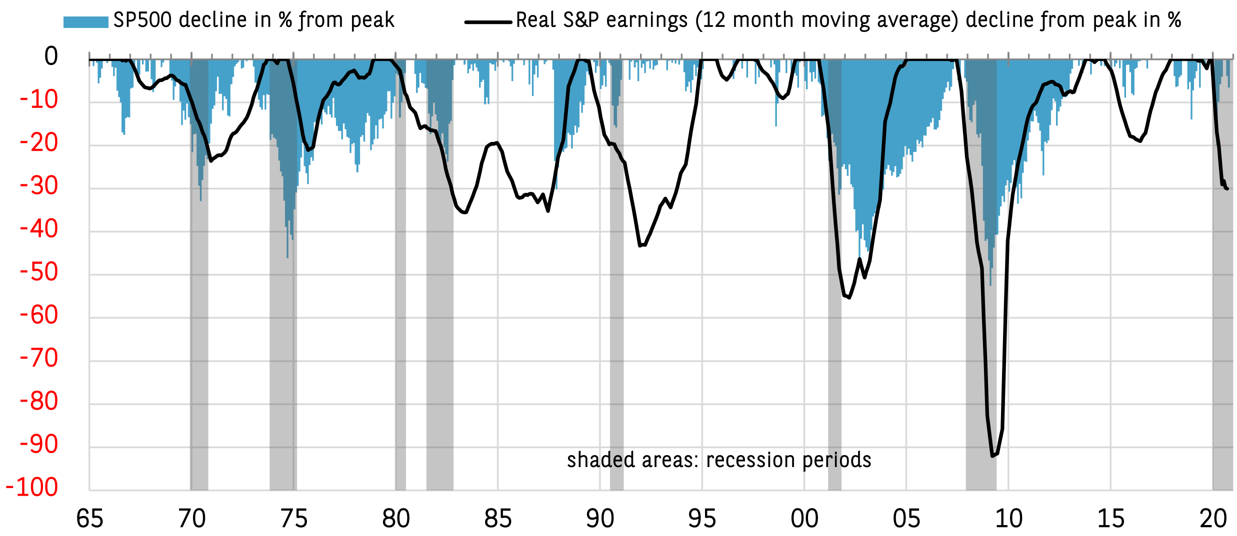


SOURCE: STANDARD & POOR'S, BLS, NBER, BNP PARIBAS is different. In November, there was still a gap of 10 million jobs and it will probably take years until the pre-pandemic employment level will be reached. After the Great Recession, it took about 50 months to recoup the 8 million jobs that had been lost before. Currently, job creation, in particular in the leisure and hospitality sector, is held back by social distancing and administrative closures. Job creation might accelerate strongly once the infection rate has fallen to a level that allows these restrictions to be removed. The upcoming mass vaccination against Covid-19 gives hope that this could soon be the case. However, it remains to be seen what it means for the economy as a whole. Faced with this uncertainty and the still huge cumulative job losses, the Federal Reserve has no choice than to give guidance that its very accommodative policy will be maintained for a long time. Ironically, fears about a lack of traction in the real economy facilitate making new highs on Wall Street. This begs the question what role the earnings outlook plays. Either it is completely dominated by low interest rates or the equity investors are more upbeat than the Fed and bond investors. However, not everybody can be right at the same time.

Chart 2 shows that in the two previous recessions, real earnings and the equity market evolved in a rather synchronised way –in terms of timing and speed of the recovery- whereas this year, the market has made new highs recently whereas earnings –on a 12 month moving average basis- still have to rebound. For 2021, more than anything, earnings matter.

William De Vijlder

SP500: DRAWDOWN OF EQUITY MARKET AND REAL EARNINGS



SOURCE: STANDARD & POOR'S, ROBERT SHILLER WEBSITE, NBER, BNP PARIBAS

> In the two previous recessions, real earnings and the equity market evolved in a rather synchronised way. Not so this year. The market has made new highs whereas earnings still have to rebound. For 2021, more than anything, earnings growth matters.