



## The Daily Dish

# COVID-19, the Recession, and the Stock Market

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### Eakinomics: COVID-19, the Recession, and the Stock Market

The coronavirus continues to ravage the world (20.7 million confirmed cases and 751 thousand deaths) and the United States (5.2 million cases and 166 thousand deaths). The resulting recession is deep (there are currently 12.9 million fewer working Americans than in February) and persistent (new claims for unemployment insurance finally dropped below 1 million this week, but still remain more than 50 percent above the worst week in the Great Recession). So, of course it makes sense that U.S. equity markets (as measured by the Dow Jones Industrial Average, the S&P 500, or the NASDAQ) are flirting with record highs.

Wait! What?

That's right. Not surprisingly, one of the most common questions is how to explain why the stock market is so good when the economy is so bad. There is the general observation that the stock market is not closely connected to day-to-day real economic conditions. ("The stock market has forecast nine of the last five recessions," famously said American Nobel Prize winning economist Paul Samuelson.)

But at present, there are three additional considerations. First, arithmetically, owning a share of stock permits one to receive a stream of dividend payments in the future, plus the sales value of the stock. Thus, an investor will bid or value a stock on the basis of expectations of those future dividends and sales prices, which in turn may (or may not) be rooted in expectations of future economic conditions on the ground. The upshot is that valuation of shares — and the market as a whole — is built on investors' expectations that cannot be directly observed. But we do know that these are expectations of the *future*. So, it does not matter if conditions on the ground *now* are miserable. Investors are betting that the economy will recover enough to make the investment worthwhile.

Second, the stock market is not reflective of the whole economy. It is reflective of the valuation of future cash flows for publicly traded companies. There is a whole lot left out - hundreds of thousands of small businesses, co-ops, owner-occupied houses, non-profit theater companies, charities, the American Action Forum...you get the point. Indeed, the stock market is probably pricing the sector of the economy with the greatest wherewithal to weather the pandemic storm, so it is far from a barometer of the entire economy's future.

Finally, the stock market does not care *how* those cash flows are created. But the economy as a whole, and the American people, have a preference that those cash flows come from greater production and sales, and not exclusively from cost-cutting and layoffs.

A strong stock market can coexist with a damaged economy. The important thing is for policymakers to keep a strong focus on the latter and not be fooled by the former.