

Don't Confuse a Soaring Stock Market for a Roaring Economy

The Stock Market Has Become a Poor Proxy for the U.S. Economy

By Michael Eisenband

Does anybody find it strange that so much of the conversation in the business media these days is focused on slowing economic growth, record amounts of corporate leverage and a possible recession in 2020 while the stock market is in full melt-up mode and flirting with near record highs? Or that the Fed's expressed concerns of economic headwinds that justified its pivot on monetary policy caused stocks to rocket higher? Or that a yield curve that recently inverted, historically a reliable leading indicator of recession, has been virtually ignored by equity markets?

This seemingly contrary reaction by stocks is a stark reminder that equity markets often can be a poor proxy for the performance or condition of the U.S. economy. This has always been true to some degree but especially so in recent times, for reasons we'll discuss shortly. Yet too many commentators and policy makers continue to conflate the two and refer to them almost interchangeably when in fact there have been considerable stretches of time when they are disconnected. Arguably, we are in one of those moments.

Let's use the S&P 500 Index as a proxy for the U.S. stock market, as it represents about 80% of the total market value of domestic equities. Generally speaking, what's been good for S&P 500 companies usually has been beneficial for the U.S. economy but that relationship is not nearly as definitive as it once was. The S&P 500 has been comprised of only U.S.-domiciled stocks since 2002 but increasingly has global exposure as domestic companies sell more goods and services abroad. Today approximately 44% of sales of S&P 500 companies are derived from foreign markets, a percentage that has remained fairly consistent over the last decade but is considerably higher than it was a generation ago. S&P 500 companies have taken advantage of global business opportunities arising from strong or surging economic growth in developing countries. Such growth in foreign

demand is not necessarily indicative of strong domestic growth nor does it necessarily redound to the benefit of our economy. It depends. For instance, our farmers greatly benefit when the Chinese government buys lots of their soybeans but it hardly impacts our domestic growth when YUM! Brands opens new Pizza Hut restaurants across China. Moreover, as foreign demand for U.S. goods increases, S&P 500 companies often have moved production closer to these sources of demand. Harley Davidson, one of the most iconic American brands, increasingly has moved manufacturing to foreign plants to meet demand for bikes sold in international markets. In short, globalization has made many S&P 500 companies increasingly dependent on foreign markets for sales and production, which still benefits our domestic economy but often less than fully or just marginally.

Another factor contributing to the disconnection between the stock market and the economy is the growing prominence of technology stocks within the S&P 500 Index and other broad averages. Tech stocks, particularly those connected to the internet, social media and machine learning, have created enormous amounts of wealth for shareholders this century but most are not huge job creators relative to their market valuations or global reach. Tech companies today account for 11% of the S&P 500 Index in number, 25% of the S&P 500's total market value but just 8% of its total employees. Tech leaders in the S&P 500 Index, such as Microsoft, Google or Facebook, have domestic headcount totals that pale in comparison to corporate giants of decades past, such as General Electric and IBM. Consider that Twitter enjoys a market cap of \$27 billion—roughly the same as global farming giant Archer-Daniels-Midland Co.—but employs a mere 4,000 people, about one-eighth of ADM's workforce. Silicon Valley spawns new tech companies and millionaires every day, but tech companies, even the successful ones, generally do not create lots of jobs.

Indeed, the very goal of many tech companies is scalability, that is, the ability to generate sustainably high revenue growth that far outpaces its asset base or human capital investment. From a business perspective, this is the primary driver of tech's huge profits—the ability to derive much more output or usage from a relatively fixed resource.

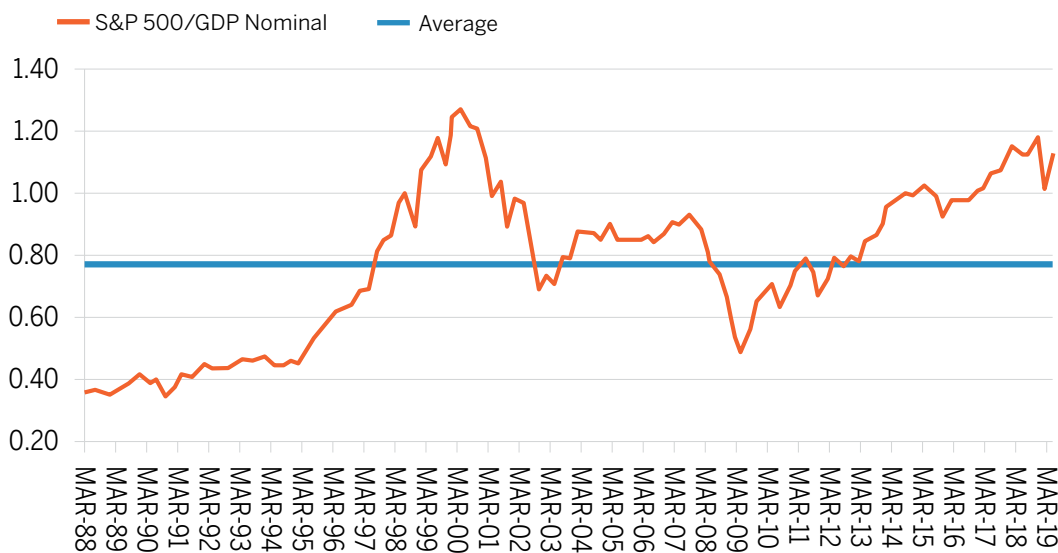
IT-driven efficiencies have now permeated most large corporate enterprises, reshaping the corporate labor force while also taking a toll on less skilled workers. The U.S. economy has created 21 million private sector jobs since March 2010, more than double the number of jobs lost during the recession, but most have been modest paying positions, with an analysis by Axios in September 2018 reporting that 75% of new jobs created since the end of the recession paid annual wages of less than \$50k. Truth be told, the U.S. economy since 2010 has been great at creating lots of not-so-well-paying jobs. Average hourly earnings of private sector jobs have increased by a mere 2.3% per annum (not adjusted for inflation) since 2010, though wage gains have accelerated a bit since late 2017. While the headline unemployment rate touches multi-decade lows, we know that several million working-age Americans have exited the workforce and are not counted among the jobless or job-seeking. We also know that the Tax Cuts and Jobs Act of 2017, which led to nearly \$1 trillion of announced stock buybacks, has hardly been the investment stimulus or hiring jolt it was supposed to be.

All of these factors, among others, have contributed to market outperformance coupled with sub-par economic growth and tepid spending for much of the post-recession period. Real GDP growth in excess of 3%, a threshold of healthy economic growth, was achieved in 25 quarters during the 1990s but just 12 times so far this decade. The stimulative impact of the Tax Cuts and Jobs Act didn't even get us to 3% GDP growth in 2018. But you'd never recognize how spotty and substandard this economic recovery has been if you only looked at the performance of U.S. equity markets.

We can illustrate this point in one metric—the ratio of the market value of the S&P 500 Index to nominal U.S. GDP (see **Exhibit 1**). Over the past 30 years, this ratio has averaged just under 0.80. Prior to the 2008 financial crisis, this ratio reached 0.95—a modest reading relative to recent years. Today this metric weighs in at 1.14, just below its September 2018 peak of 1.20. It's worth noting that the only time this ratio was higher was in early 2000 just prior to the dot-com crash—a memorable period when market valuations became untethered from economic performance. It's easy to forget that it wasn't just the dot-com companies that were ascribed sky-high valuations back then—it extended to the broader market as well, with the S&P 500 subsequently falling by 45% through 2002.

EXHIBIT 1

S&P 500 Market Cap/Nominal GDP



Source: FTI Consulting

We're not in the business of opining on the stock market but certainly we recognize a pickup in business distress when we see it. Incidents of large Chapter 11 filings and corporate debt defaults both have experienced an appreciable uptick in recent months—nothing alarming but notable enough to signal a likely trend reversal in business failures, which were waning in 2018. Inbound inquiries for our turnaround and restructuring services remain robust. Broadly, there is mounting evidence that U.S. economic growth and corporate profits growth both are slowing. Financial markets remain convinced this is just a momentary blip, but such unflinching confidence may be misplaced this time. Don't tell that to the perma-bulls, who have been rewarded just about every time we've come to one of these crossroads.

An extraordinary abundance of lendable capital continues to forestall the start of the next default cycle but that can't go on indefinitely. What we're confident in saying is that it seems we are at a critical juncture in this economic cycle, and within a year or so either the pessimists or optimists will have been proven quite wrong.



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