

Two streets diverged in a yellow wood...

The macroeconomic narrative has generally turned for the worse in the last few months as the dataflow provides indications of a softening in global growth momentum, while anecdotes of rising hardship and related risks are becoming more frequent in the media.

At the same time, financial markets have continued their upward climb with the global benchmark MSCI World Index¹ up 15% in Canadian dollar terms since April to sit at a new all-time high.

The divergence in the direction of travel between Wall/Bay Street and Main Street was particularly clear on August 22, when the Chairman of the U.S. Federal Reserve suggested that the perceived downside risks to growth, particularly with respect to the job market, increased the likelihood that the American central bank would need to cut policy interest rates. In response to these less-than-optimistic views on the state of the economy, global equity markets turned in their best day since the U.S. and China temporarily de-escalated trade tensions three months ago. Stocks broadly rallied, though the sharp appreciation in the Canadian dollar in the “risk on” environment did temper gains for domestic investors.

While this appears to suggest cognitive dissonance among investors, it is important to remember that while the economics of daily life — such as current profitability of a business, committed orders, inputs on hand, status of employment and payrolls, etc. — are about the “here and now”, markets, in contrast, are “forward-looking.” The “now” is known, unchanging and priced in already, whereas the inherent unknowns on the extremely long road ahead can be subject to rapid change that has little impact now but significantly affects potential operations going forward.

While the assessment of current conditions clearly carries weight in the development of forecasts — you cannot tell where you are going if you do not know where you have been and where you are currently — movements in market prices tend to be more reflective of those expectations than what is currently happening.

A more significant slowing in activity has long been expected, given economic headwinds (trade policy-induced uncertainty chief among them), but the new indication that central banks may well adopt a more proactive approach to managing risks to growth (and job markets) suggests that any downturn could be shorter and less severe than assumed. This, in turn, would translate into less of a hit to corporate earnings over the medium-term and prove to be relatively more constructive

¹ The MSCI World Index captures mid- and large-cap representation across 23 developed market countries.

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for valuations, hence the market response before that assumed economic rough patch has even materialized.

With that said, treating the stock market as a leading economic indicator tends not to be the most prudent decision, as history shows that there are plenty of head fakes, especially around periods of uncertainty and volatility. Equity rallies (and sell-offs) do not necessarily portend economic booms (or busts). Nobel Memorial Award-winning economist Paul Samuelson famously quipped that “Wall Street Indexes predicted nine of the last five recessions.”

The bottom line is that while Wall/Bay Street and Main Street often travel in the same direction, especially over the longer run, short-run divergences do occur. In such instances, the health of one does not necessarily reflect the other. Despite the tendency to view them as such, the market is not the economy (and vice versa).

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