

Barry Ritholtz: Why Markets Don't Seem to Care If the Economy Stinks

August 5, 2020

by Barry Ritholtz

The stock market has been on a tear, yet the economy is in the dumps. So why do so many people believe -- undoubtedly incorrectly -- that the stock market has decoupled from reality?

The economy many people experience, while bleak, is local, personal and, for the most part, either not publicly traded or plays only a small part in the stock market's moves. To explain why these personal experiences have so little effect on equity markets, we must look more closely at the market role of the weakest industry sectors.

The surprising conclusion: The most visible and economically vulnerable industries are also among the smallest, based on their market-capitalization weight in major indexes such as the S&P 500. Markets, it turns out, are not especially vulnerable to highly visible but relatively tiny industries. The 30 most economically damaged industry categories could be de-listed before tomorrow's market open, and it would hardly shave more than a few percentage points off the S&P 500.

This is so despite the worst U.S. economic collapse since the Great Depression. All of the economic data is so bad that figures on gross domestic product, unemployment and initial jobless claims must be re-scaled to even fit on charts.

But the U.S. economy is not the stock market and vice versa. As we discussed before, ignoring overseas strength is a major oversight. The so-called FAANGs (along with Microsoft) derive about half -- and in some cases even more -- of their revenue from abroad. Beyond that, the pandemic lockdown in the U.S. has benefitted the giant tech companies' sales and profits. No wonder the Nasdaq Composite 100 Index, which is dominated by big tech companies, is up about 26% this year.

But a reasonable person might argue that GDP fell by about a third in the second quarter and the S&P 500 should be in synch with that. What's more, of the 500 companies in the S&P 500, about 450 of them are doing terribly. Industries such as retail, travel, energy, entertainment, dining have seen sales evaporate. Bankruptcies are piling up -- legendary retailer Lord & Taylor is just the latest -- and more are surely coming. Yet, the S&P 500, after a huge plunge in March, is up 2% this year.

Market capitalization explains why.

Start with some of 2020's worst-performing industries: Year-to-date (as of the end of July), these include department stores, down 62.6%; airlines, off 55%; travel services, down 51.4%; oil and gas equipment and services, down 50.5%; resorts and casinos, down 45.4%; and hotel and motel real estate investment trusts, off 41.9%. The next 15 industry sectors in the index are down between 30.5% and 41.7%. And that's four months after the market rebounded from the lows of late March.

These are highly visible industries, with companies that are well-covered by the news media with household names known to many consumers. Retailers are everywhere we go. Gas stations, chain restaurants and hotels are ubiquitous in cities and suburbs across the country.

So although high visibility industries may be of considerable significance to the economy, they are not very significant to the capitalization-weighted stock market indexes.

Consider how little these beaten-up sectors mentioned above affect the indexes. Department stores may have fallen 62.3%, but on a market-cap basis they are a mere 0.01% of the S&P 500. Airlines are larger, but not much: They weigh in at 0.18% of the index. The story is the same for travel services, hotel and motel REITs, and resorts and casinos.

The market is telling us that these industries just don't matter very much to stock market performance. And the sectors that do matter? Consider just four industry group -- internet content, software infrastructure, consumer electronics and internet retailers -- account for more than \$8 trillion in market value, or almost a quarter of total U.S. stock market value of about

\$35 trillion. Take the 10 biggest technology companies in the S&P 500 and weight them equally, and they would be up more than 37% for the year. Do the same for the next 490 names in the index, and they are down about 7.7%. That shows just how much a few giants matter to the index.

On some level, it's completely understandable why many people believe that markets are no longer tethered to reality because the performance doesn't correspond to their personal experience, which is one of job loss, economic hardship and personal despair. But what's important to understand is that indexes based on market-cap weighting can be -- as they are now -- driven by the gains of just a handful of companies.

We can argue about whether the way the market reacts is good or bad and never reach a satisfying conclusion. But one thing the market isn't is irrational or disconnected from the reality of market capitalization, and its impact on stock indexes.

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