Jobs Down, Stocks Up: Is the Market Being Irrational?

Description

Since late March, stocks have been undergoing an unprecedented rally, with the **TSX** rising 38% in just a few months. While the index is down for the year, it has bounced back very quickly and recouped much of its earlier losses.

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At the same time, real economic figures have been negative across the board. This month, Canada's unemployment rate reached a record high of 13.7% (30% for younger Canadians), while GDP contracted 8.2%. Other countries, like the U.S., are posting similar figures.

In light of all this, it's natural to wonder if the markets are being irrational. Stock market forums have been replete with threads mentioning the apparent disconnect between the economy and the markets. Michael Kantrowitz of *Cornerstone Macro* recently opined that the current market action *"smells like irrational exuberance."*

Indeed, stocks *are* heading in precisely the opposite direction of the economy. However, it's a well-established fact that stocks are an economic leading indicator, peaking or bottoming before the underlying economy. In light of that, the market action we're seeing may not be as irrational as it appears.

Recovery expected in Q3

The first thing to keep in mind when looking at the stock market is that a dramatic economic recovery is expected in Q3. Even **Goldman Sachs**, whose economic forecasts have been bearish, concedes that the third quarter should see major GDP growth.

The current downturn is, after all, artificial: businesses were *forced* to close, the underlying demand for their products didn't go away. So once businesses are allowed to re-open, the economy should roar back to life.

Of course, that thesis doesn't account for the fact that some businesses are closing permanently because of the economic damage in Q2. We're already seeing big chains go belly up, a recent example being two Reitmans' subsidiaries. But broadly speaking, the economy should grow in the third quarter — at least according to most forecasts.

Possibility of second wave

That said, a massive recovery in the third quarter isn't guaranteed. If there is a major second wave of COVID-19 cases, we may see lockdown orders re-introduced. In that case, businesses would be forced to close again. Additionally, there is a possibility that economic damage from the second quarter could linger longer than expected, blunting the expected Q3 rebound.

If any of these scenarios played out, it would be disastrous for certain stocks.

Case in point: **The Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM). As a domestic-focused Canadian bank, CM has heavy exposure to Canadian mortgages, oil & gas loans and credit cards. All of these would be put under pressure in the event of a second wave of COVID-19.

Mortgages could go into default as borrowers lose their jobs; oil & gas loans could default with falling demand for oil; and credit cards could see a surge in delinquencies. Any of these outcomes would be devastating for a bank like CM.

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And banks aren't the only example. As we saw in the first COVID-19 market crash, airlines and hospitality companies would be hit even harder.

So while the economic optimism regarding Q3 looks sound for now, there are factors that could bring it to a halt — a major second wave of COVID-19 being just one among many.

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