Perspectives

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Est. 1980

TERRIBLE ECONOMY, SURGING STOCK MARKET: WHAT IS GOING ON?

The last four months have presented investors with a situation unlike any other in the history of the U.S. economy and stock market. After the fastest and deepest fall—a full 35% in about six weeks—it then turned on a dime and proceeded to recover all its lost ground and more. Although it has now retreated somewhat from its high point, the turnaround is truly historic. What is so confusing to many investors is the fact that it has done so in the face of devastating economic data. Real Gross Domestic Product (GDP) is expected to decline by 30 to 40% on an annualized basis in the second quarter, and over 40 million people are unemployed in the U.S. It is hard to imagine worse economic conditions.

If there was ever evidence of how difficult it is to predict what the stock market will do over the short term, the experience of the last four months is exhibit number one.

This striking contrast in rising stock prices and a shrinking economy is baffling to many. The most often asked question goes something like this: "Is the stock market ahead of itself by rallying so strongly from its low point in the face of disastrous news?" Yes, it is counterintuitive, but we have attempted to answer the question with a few points.

- First, we believe investors have to put a value on the current and expected earnings of a company. This is most commonly expressed through a price-to-earnings ratio. Presently, because current and one-year-forward earnings are severely depressed, the price-to-earnings ratio is high. Does this mean stocks are overvalued? It is certainly worth considering, but it should be kept in mind that investors value companies partially on the current and next year expected earnings, and partially on what they believe about the recovery potential of a company and its longer-term profitability. The assurance of sustainability in the business over the long term counts for a lot, and investors seem to be betting that many companies can get back to normal and stay there for a long time.

- Second, the alternative to stocks is less attractive than normal since bond yields are so low. Many would rather take a stock dividend at a higher rate than bond yields and live with the added risk of equity ownership. In other words, stocks are moving higher because of the absence of an alternative.

- Third, the Fed is making an unprecedented effort to inject liquidity into the economy. To the extent that all of the liquidity is not absorbed by basic economic activity, such as lending and borrowing, some of it will leak into demand for risk assets, such as stocks. This appears to be happening now and forms the basis for the popular phrase, "Don't fight the Fed."

- Fourth, it is safe to say that equity investors are of a more optimistic nature and are willing to discount the probability of future events. This looking-ahead aspect can be demonstrated by the severe decline in stocks in March and the fact that, at that point, investors were discounting the disastrous unemployment figures that are now being reported. In contrast, the same investors now assume the worst is over economically and are looking forward and discounting a recovery in the economy and corporate profitability. Are they ahead of themselves? Only time will tell, but as investors who want exposure to the equity markets, we have to deal with what the market gives us. We attempt to do this by getting positioned in high-quality companies with a strong likelihood of future success in their businesses.

This list is not comprehensive, and others may have additional reasons to explain the strong action of stocks. Market participants will choose to weigh more heavily on any of these points, but taken as a whole, they seem plausible. However, they do not imply an absence of risk in the stock market nor do they assume a straightforward path for stocks at this point. For investors who take a long-term view and desire growing income and appreciation, we advise equity exposure. Importantly, we believe our experience has taught us that staying invested for the long term and owning high-quality companies is a better approach than trying to guess what the stock market will do over the short term. If there was ever evidence of how difficult it is to predict what the stock market will do over the short term, the experience of the last four months is exhibit number one.

CRAWFORD INVESTMENT COUNSEL, INC.
600 Galleria Parkway | Suite 1650 | Atlanta, GA 30339
main 770.859.0045 | *fax* 770.859.0049
www.crawfordinvestment.com