The stock market and the economy: Insights from the Covid-19 crisis

During the Covid-19 pandemic, the response of the stock markets has raised concerns as well as questions. Overall, it is hard to deny that the links between stock prices and fundamentals have been loose at best, writes Gunther Capelle-Blancard and Adrien Desroziers for VoxEU.

The disconnect between the economy and the stock market

On 8 June 2020, the World Health Organization (WHO) announced that the Covid-19-19 pandemic was worsening around the globe and warned against complacency: "most people globally are still susceptible to the infection. (…) More than six months into this pandemic, this is not the time for any country to take its foot off the pedal".

On the very same day, the US stock market began its fourth consecutive week of rally. The S&P 500 index is back to where it was at the beginning of 2020, erasing the historic plunge (one-third of its value) that took place between 20 February and 23 March 2020, as if nothing had ever happened. Is there anything strange about the stock market behaviour during this time? As the world suffered from the worst economic crisis since the Great Depression (Baldwin and Weder di

Mauro 2020a, 2020b, Bénassy-Quéré and Weder di Mauro 2020, Coibon et al. 2020), the reaction of stock markets raises serious concerns. Since the beginning of the crisis, stock prices seem to be running wild.

At first, they ignored the pandemic, then panicked when Europe became its epicentre. Now, they are behaving as if the millions of people infected, the 400,000 deaths and the containment of half the world's population will have no economic impact after all.

What new insights on stock markets behaviour can be drawn from the Covid-19 crisis?

In one of his influential New York Times columns, Paul Krugman (2020) said out loud what many people were thinking: "Whenever you consider the economic implications of stock prices, you want to remember three rules.

First, the stock market is not the economy. Second, the stock market is not the economy. Third, the stock market is not the economy (...). The relationship between stock performance – largely driven by the oscillation between greed and fear – and real economic growth has always been somewhere between loose and nonexistent".

The no less famous Malkiel and Shiller (2020) have also discussed the seemingly odd behaviour of stock markets in the face of the pandemic. According to Malkiel, the alleged stock market irrationality is only "apparent", and the Covid-19 crisis does not "impl[y] that markets are inefficient" in as much as there are no arbitrage opportunities, and stock markets remain hard to beat. Shiller is more nuanced: "Speculative prices may indeed statistically resemble a random walk, but they are not so tied to genuine information (...). The contagious stories about the coronavirus had their own internal dynamics only loosely related to the information about the actual truth".

A key quote from the article:

"Do stock markets incorporate all available information? Actually, it transpires that we can see the glass as half-full or half-empty.

On the one hand, the dynamic of stock markets during the COVID-19 pandemic is not completely accidental. In particular, our study suggests that it was not the situation of countries before the crisis that influenced the reaction of stock markets, but rather the health policies implemented during the crisis to limit the transmission of the virus and the macroeconomic policies aiming to support companies. On the other hand, fundamentals only explain a (very) small part of the stock market variations.

Just like Krugman and Shiller have claimed, it is hard to deny that the link between stock prices and fundamentals have been anything other than loose."

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