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What the stock market tells us about the post-COVID-19 world

The stock market provides a view of what investors expect for the future. It is precisely in complex situations such as the COVID-19 outbreak that the prescience of the market is particularly valuable, argues Alexander F. Wagner.

Many people do not have much sympathy for the stock market; they associate it with greed, scandals and speculation. Yet the stock market can be a powerful tool for society. It provides a unique view of the expected future of a company and the economy. That is because the value of a firm derives from all future expected cash flows, discounted to the present to adjust for time and uncertainty. In the financial markets, all kinds of individuals meet, sophisticated and naïve, opinionated and without convictions, to play a high-stakes game: the pricing game. Through a mix of fundamental value-drivers and simple demand-and-supply dynamics, asset prices emerge. Effectively, the stock market is an incentivized survey of future expected outcomes. It is precisely in complex and fast-evolving situations that the stock market provides particularly useful information.

The outbreak of COVID-19 is bringing about epochal changes to our lives. A few months ago, daily life today would have been unthinkable to most. Managers, politicians and academic economists focused on traditional business risks or, at most, on the pressing issue of climate change. In just a few weeks, attention has shifted dramatically. Governments around the world are trying to stem the tide with increasingly strong measures. Uncertainty is extreme. We do not know how deadly the disease really is, whether there will be a vaccine and when it will be available, what effects policies will have, how people will respond, and so on.

In such a moment of collective confusion, what do we learn from the stock market? One might be tempted to say 'not much'. The recent wild swings may suggest the market went 'crazy': on March 16, the Chicago Board Option Exchange's Volatility Index, known as the VIX, surged past the prior all-time peak (reached in the financial crisis more than a decade ago). The second-worst day ever of the Dow Jones Industrial Index happened on March 16; three of the 15 worst days ever of the US market occurred between March 9 and 16. But one of the top 10 surges ever in the market also took place in this time period.

Such events are an opportunity to learn something about investor psychology and human behaviour. On some days, individual investors appear to have begun speculating on the direction the market would take that day, or speculating on what others would speculate that the market would do that day, and so on. Keynes developed his famous 'beauty contest' metaphor for this type of behaviour. Indeed, as financial markets are driven by humans (or algorithms designed by humans), they are always behavioural.

But digging deeper, one recognizes additional, arguably more important patterns. Specifically, even as the aggregate market experiences feverish fluctuations or falls strongly, the relative stock price moves of different stocks reveal which sectors and companies will be better off in the future than others.

Recent research reported in a working paper (https://ssrn.com/abstract=3550274) studies three phases of investor behaviour. First, in the incubation phase (which started in early January after cases of pneumonia detected in Wuhan, China, were first reported to the World Health Organization (WHO)), well-informed and sophisticated investors started partially anticipating what was to come in the future weeks and months. Their investment behaviour resulted, for example, in a decline for the transportation industry during this early phase.

In the second phase, outbreak (after January 20, when the WHO issued its first situation report), attention of investors grew. Analysts and companies started talking about the virus on conference calls, and Google search intensity for 'coronavirus' surged. Internationally oriented stocks began suffering strongly, indicating that global trade would be hampered for a while if the virus outbreak was not contained soon. From the strong performance of the telecom industry, we learn that investors expected the demand for services supporting work at home to skyrocket, suggesting that this mode of work will be highly relevant in the future.

Third, the fever phase began on February 24, after Italy implemented a strict lockdown in its most productive region, Lombardy. Markets started to oscillate wildly, and people suddenly realized that the virus could affect them directly. Panic selling in the stock market went hand-in-hand with panic buying in supermarkets. But, critically, in this phase, too, we learn something about the expected medium and long-term from the relative stock price moves. Internationally oriented US stocks actually had a comeback as the outlook for the situation in China brightened relatively to the US outlook. Importantly, however, companies with a lot of debt and a shortage of cash started to suffer disproportionally. This suggests that the health crisis has morphed into a possible financial crisis.

COVID-19 represents a fearsome and novel risk. As such, it stirred feverish behaviour by investors. Yet despite the volatility, despite the panic, reasonable economic expectations underlay movements in the stock prices of individual companies. Society can thus learn about the nature of the challenge we are facing in these trying times. The stock price reactions suggest that broad actions, including fiscal policy interventions, are required to avoid further negative outcomes and propagations of the COVID-19 shock. The crystal ball of the market foretells a different economic landscape than the one we have gotten used to. Such changes bring potentially massive social and political upheavals. Hopefully, we can avoid the inherent dangers and benefit from the opportunities. ❐

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