Il Sole 24 ORE

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PERSPECTIVES

The Wall Street Race now has to contend with reality

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The risk is that, without corporate profits, the market may decline again

If economic reality does not move in the direction of the stock exchanges, will it be the stock exchanges that will crash against economic reality? Yesterday's fall in prices of about 2% (leading to 6% and 4% drops for European and US stock exchanges since 11 May), puts investors face to face with this brutal question. Was it normal for stock exchanges up to a few days ago to race ahead despite the greatest economic crisis of the century? And above all, will the drop in prices of the last few days (even though Wall Street made a recovery yesterday) lead to the realisation that the preceding exuberance was turning into a bubble?

It was the market figures that indicated there was something strange about that rally. A graph prepared by Amundi demonstrates that, on Wall Street, the gap between corporate profits (in free fall) and share prices (rising up to a few days ago) has never been so wide since the time of the Internet bubble in the year 2000. Stock valuations are high everywhere. If you look at the share price to earnings ratio in the last 30 years, according to calculations made by Amundi's Monica Defend, Wall Street is in the 85th percentile, global prices (MSCI World Local) at the 70th and Europe (MSCI Europe Local) at the 65th. percentile. Nonetheless, the economy is collapsing and many companies have closed.

So why were stock exchanges racing ahead so much? There are two reasons. The first is related to the unprecedented scale of monetary and fiscal stimuli. Citigroup's Matt King estimates that global central banks will buy 5 trillion dollars' worth of various types of securities by the end of the year, injecting a huge amount of liquidity into the markets. This has a shattering effect; investors, who are loaded with money, have to put their money somewhere. And so they invest, even though they do not have much faith in future recovery.

This leads to the second reason for the rally. Having to choose what to buy, investors will either buy the same securities as central banks (government bonds, corporate bonds and so on) or else resort to the stock exchange and invest in those companies that benefit most from the crisis. Therefore, everybody ends up buying the big US technology or pharmaceutical companies, leaving behind the sectors that are most penalised by COVID-19. It is not a coincidence that the stock exchange rally in the US, to a great extent, involved only 6 companies: Facebook, Apple, Alphabet, Amazon, Netflix and Microsoft.

Clearly, this is so not just from today. Minack Advisors calculates that, out of the 6 trillion dollars in capitalisation that Wall Street added since 2015, as much as 4 trillion is due to just those 6 companies. But in Covid times, the phenomenon is accentuated. As Banor Capital's Francesco Castelli observed, "In difficult times, investors always tend to take refuge in a few more protected sectors". But, whereas this behaviour is clearly rational, the fear is that, should it be adopted *en masse*, it could create a bubble. Indeed, what makes you wonder is the fact that even companies like Google and Facebook, which derive most of their revenue from advertising (which certainly does not enjoy great prospects during a recession), are flying high.

Until, at a certain point, the alarm goes off. Federal Reserve President Jerome Powell reminded us on Wednesday that this is the worst recession since the Second World War. No joke. The ECB bulletin reports an unprecedented deterioration in consumption. The number of workers in the US who have applied for unemployment benefits since the beginning of the crisis has reached 36 million. And so, even in a stock exchange that is inebriated with liquidity, one begins to ask questions. Optimists wonder if indices can still rise in this environment, and pessimists whether the bubble is bursting.

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Recession. On Wednesday Fed President Jerome Powell warned the markets, defining the current recession as the worst since World War II