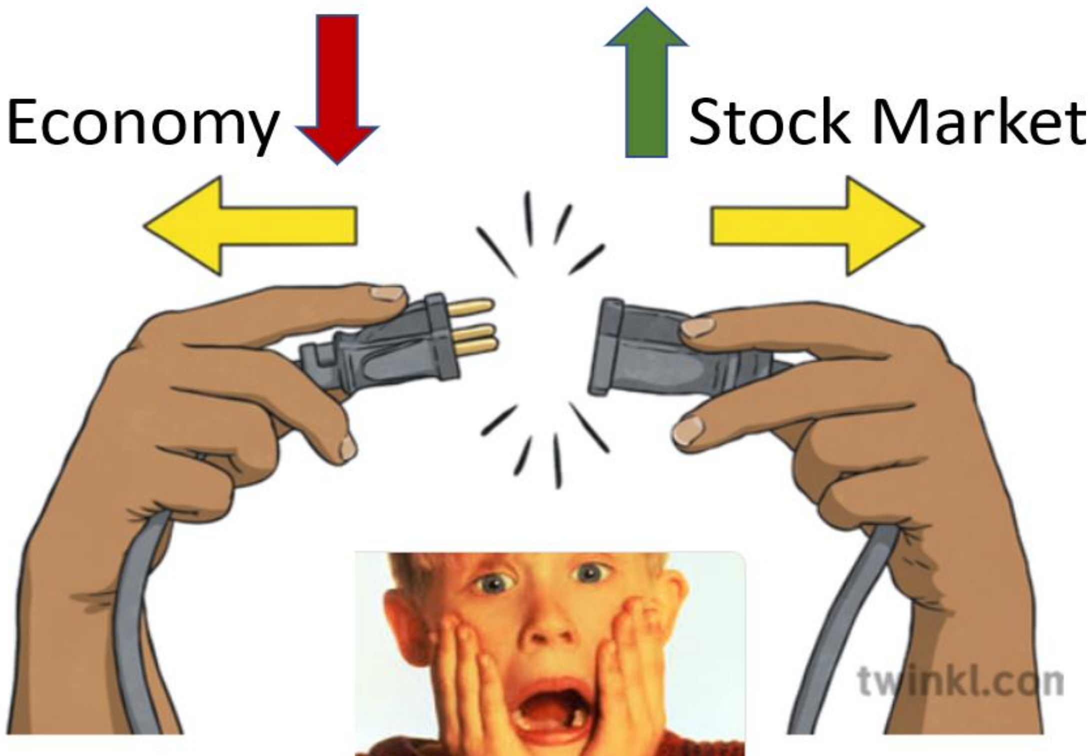
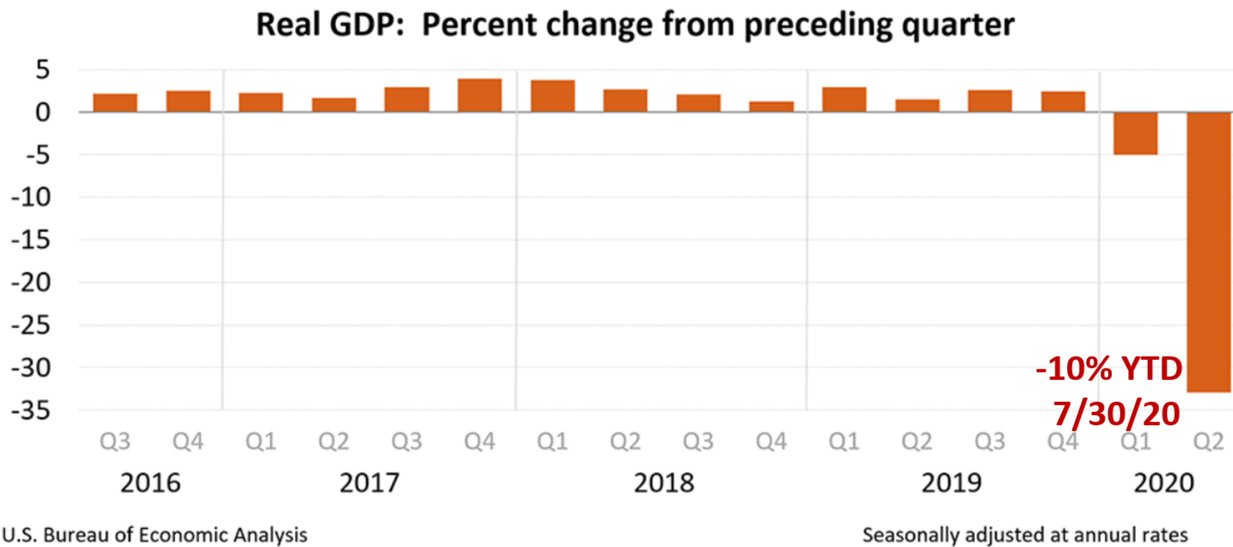
The Stock Market Will Reconnect with the Economy. Then what?

- There are two reasons that the stock market is disconnected from the economy. Both have a high price tag.
- Ideally the economy will snap back, and the connection will be re-established that way, but it will still need to absorb an exorbitant amount of new money.
- The other way to reconnect is a market crash. Are you prepared?
- After the reconnect, be prepared for tax increases and inflation.

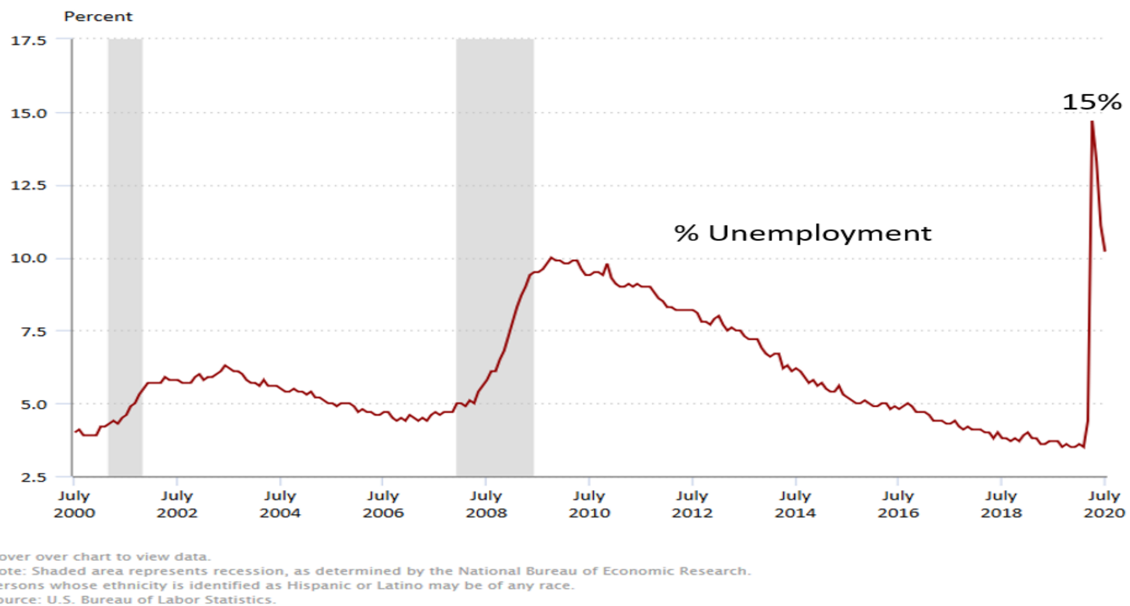


The following thoughts will be discussed in our upcoming Video scheduled for release August 18. You'll feel our concerns.

There's no doubt about it. Economies around the world are in a COVID-induced recession. In the US, GDP has declined 10% through July. A recession is defined as a decline of 10% or more. In the following picture, changes are annualized; the unannualized decline is 10% so far this year.

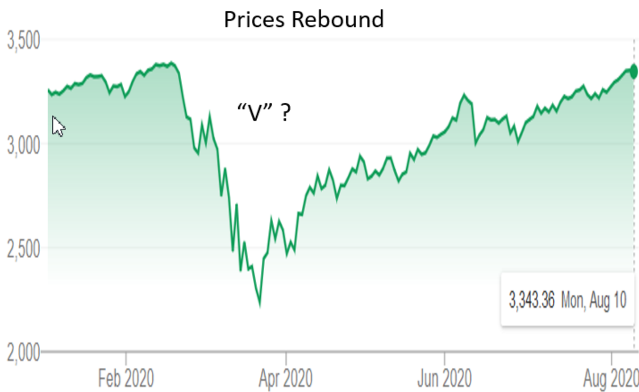


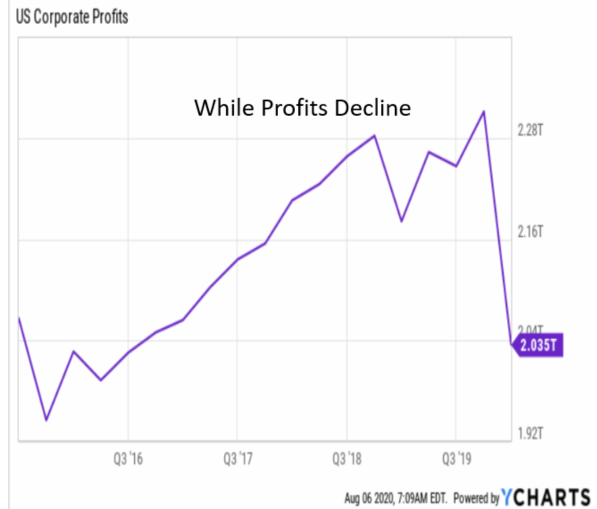
Furthermore, unemployment soared to 15% but has corrected back down to 10%. Although this is far from the 25% unemployment suffered in the Great Depression, the pandemic has not ended yet.



But despite these problems, the US stock market is climbing the infamous wall of worry and it's doing so in the face of declining corporate profits.

S&P500

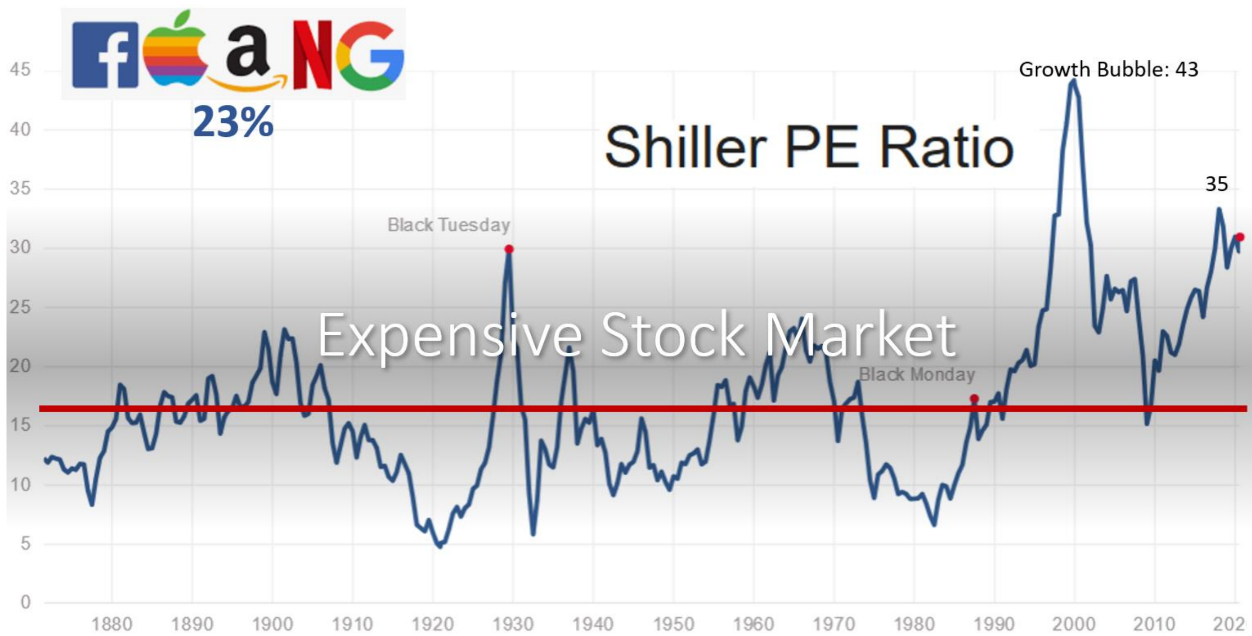




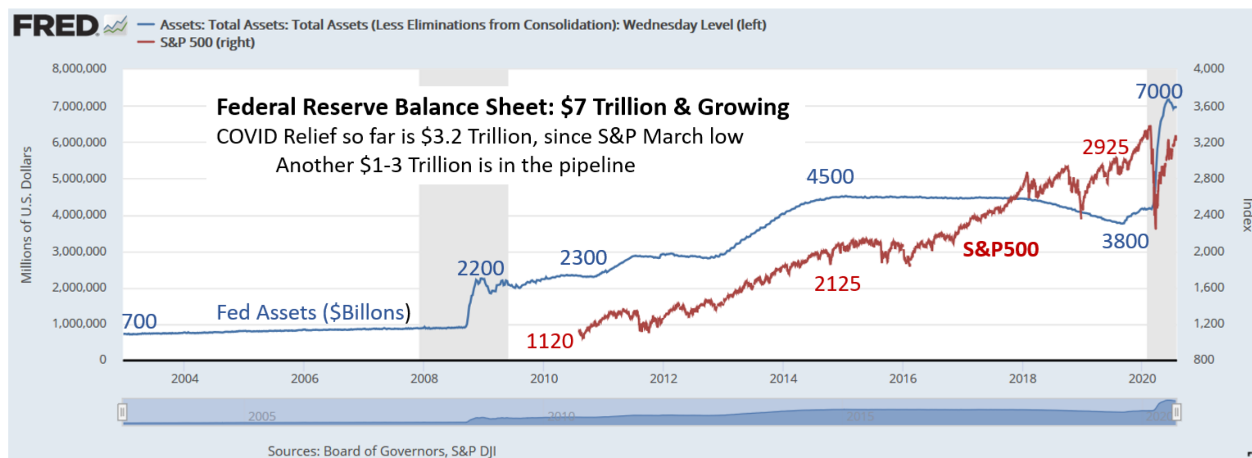
This disconnect between the stock market and the economy is extremely unusual. The two will reconnect again. Either the economy will recover, as the stock market predicts, or the stock market will reprice and crash. In the following we discuss the causes of the disconnect, and what investors should be concerned about as the disconnect corrects.

Causes of the disconnect

Hopium and Federal intervention are buoying up the stock market. “Hopium” is the wishful thinking that makes investors believe that the economy will not only recover quickly, it will snap back with vigor as the virus is quickly vanquished. The reality is that the stock market was extremely expensive coming into the pandemic, and it’s become even more expensive. Some explain the phenomenon with the fact that FAANG stocks are 23% of the S&P500, and these stocks have benefited from the pandemic. We’ve heard these rationalizations before. In the 1960s it was the Nifty Fifty. In the growth bubble of the 1990s it was “trees can grow to the sky.”



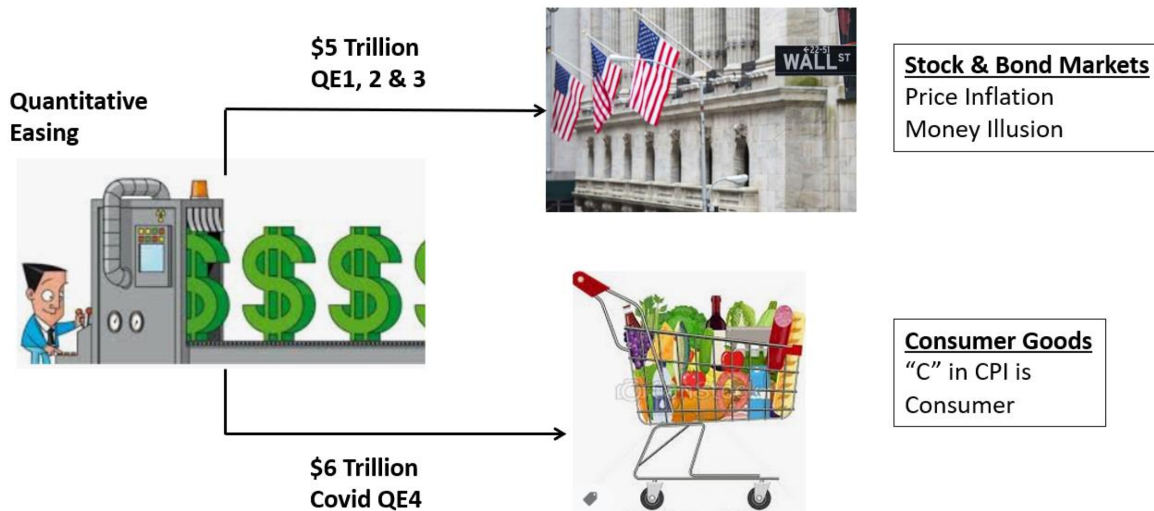
The other reason for the disconnect is Federal intervention. Coming into the pandemic, the Fed had injected $5 trillion in Quantitative Easing (QE) from the 2008 recession. Now it has added another $3 trillion in the first round of COVID relief and will likely add at least another $2 trillion, bringing the total to a whopping $10 trillion.



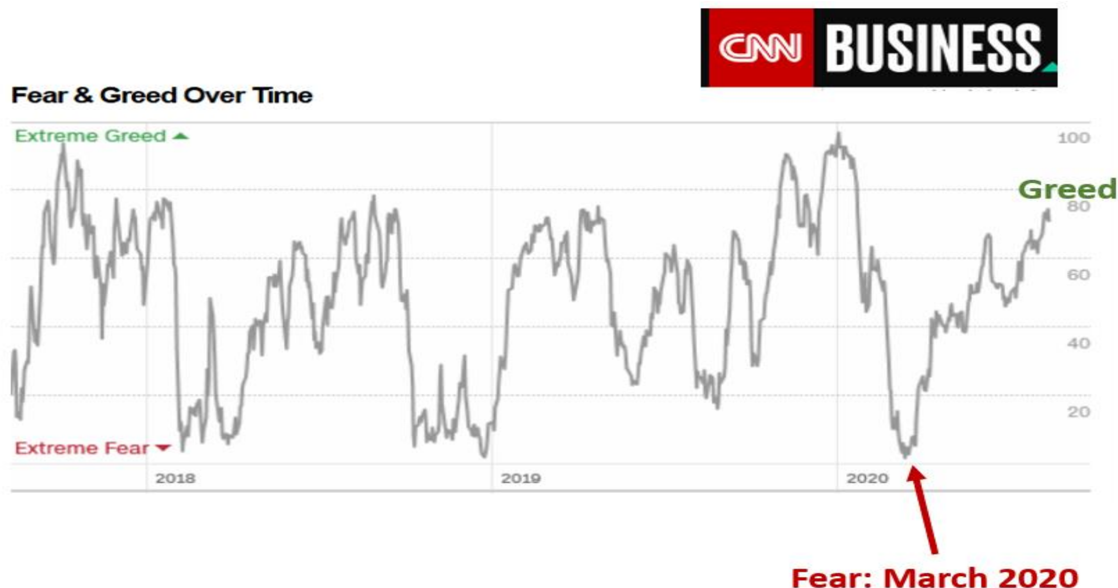
Much of this new money has been invested in the stock market as wealthy individuals buy stocks and companies buy back their own shares. Make no mistake. We have had serious inflation, but not in the traditional way of higher commodity prices. Stock and bond prices are highly inflated, resulting in what economists called money illusion.

What happens when the stock market reconnects with the economy

Regardless of the reasons for a reconnect, the economy will have $10 trillion of new money to absorb. The economy is $22 trillion in GDP. It will have to deal with both money illusion in the markets and inflated commodity prices because the new money is flowing into both.



If the reconnect happens because investors run out of Hopium, the stock market will crash. Investors are driven by greed and fear, in alternating sequences as shown in the following.



Being prepared

Investors should expect a stock market correction. Greed will give way to fear. FOMO (fear of missing out) will become FOLO (fear of losing out). Also, there are plenty of other threats to the economy and stock market.

We continue to specifically warn baby boomers because they are invested 60/40 stocks/bonds on average in the Risk Zone spanning the transition from working life to retirement. Boomers cannot afford this risk, regardless of market conditions. They should be no more than 30% in risky assets at this critical time in their lives. Importantly, most target date funds are 85% in risky assets at the target date, with 55% in equities and 30% in risky long-term bonds. Boomers in TDFs should get out now unless they are in one of the few safe ones.

Younger investors should protect themselves too, but they will probably recover if they don't. That said, no one likes the pain of losing money.

Then after the reconnect investors should be concerned about protecting their savings from inflation by investing in TIPS and real assets like precious metals and real estate. Also be prepared for tax increases necessitated by inflation. The economic effects of COVID will continue long after a vaccine is found. Forewarned is forearmed.

Ronald Surz is co-host of the Baby Boomer Investing Show sponsored by Age Sage Robo and President of Target Date Solutions, sub-advisor of the SMART Target Date Fund Index suite of collective investment funds (CIFs). He deigned the patented Safe Landing Glide Path followed by SMART and union 401(k)s.
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