Is This Stock Market Rally Putting Investors At Risk?

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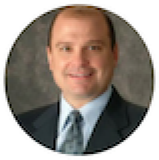

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I help people on their path to Financial Freedom. FULL BIO
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Rarely in my career have I seen such polarizing views on the direction of stocks. One view anticipates a slow recovery due to the extremely high levels of unemployment and the uncertain future of a vaccine for Covid-19. The countering view forecasts one of the most rapid financial comebacks in history, largely due to the historical levels of monetary and fiscal support.

What concerns me in the near term, is how the narrative is changing. For years, most market watchers were saying that earnings were the biggest drivers to stock prices. Now, there is little clarity on the future of corporate earnings—except for the tech sector and other areas benefitting from the Covid-19 crisis. Yes, many of these technology, communication, and stay-at-home stocks are delivering strong profits, optimistic outlooks, and some investment opportunities. But these sectors are not the entirety of the U.S. economy, and they are not immune to a decline of the overall economy. Finance, energy, industry, transportation, travel, leisure, real estate, retail (sans Amazon, Target and Wal-Mart), and other sectors continue to struggle. Many of these companies have pulled their profit forecasts and are no longer giving visibility into their future earnings. This should be a concern as corporate earnings were always considered the biggest factor in stock valuations. After all, isn't the 'P/E' ratio (Price to Earnings ratio) one of the biggest metrics used in stock valuation?

The narrative of recent years has also held that the stock market hates uncertainty. Now, the market is ignoring that just about everything is uncertain including, for example, the following:

- whether we get an effective Covid-19 treatment in the near term
- whether we get an effective vaccine
- when and how we will reopen outdoor venues and restaurants
- when overall corporate earnings will rebound
- how severe the pandemic will be in foreign nations
- if oil prices will stabilize for a prolonged period
- if U.S.-China tensions will elevate
- how the banking sector can manage through low rates, a flat yield curve, and large number of defaults and bankruptcies
- how the U.S. consumer will react when unemployment remains high
- fiscal troubles at the state and local government level

On top of all these Covid-19 related questions, what impact will the November elections have on the markets? A defeat of President Trump will result in the slowdown or reversal of the trend to less regulation. Whether or not you are in favor of more regulation, the simple corollary is that lower regulation lowers costs and, thereby, increases profits. Furthermore, corporate income taxes and capital-gains taxes are hot topics of debate. An increase in the corporate tax rate lowers after-tax earnings, and an increase in the capital-gains tax rate impacts investment returns and, hence, stock prices. Yet there is virtually no discussion of these risks, despite President Trump trailing badly in several major polls.
So, against this backdrop of potentially lower corporate earnings, uncertainty in numerous areas, and the risk of political change that is unfavorable to Wall Street, from where is the optimism coming? The answer points to two factors: (1), The Federal Reserve Bank ("The Fed") policy of virtually unlimited monetary stimulus and (2), Congressional support of the economy by spending at a previously unseen pace. Of course, a lot of that spending has been compassionate and necessary—that is not my debate. What I am asking is "why are investors are willing to put capital at risk when there is so much economic pain, uncertainty, and risk?"

Have we fully moved into a 'TINA' (there is no alternative) market? Has The Fed's action made interest rates so low on cash and bonds that investors are virtually forced into investing in stocks? And if so, what are the risks of this behavior? Have sub-zero-percent interest rates worked well for the Japanese investment markets these past decades? And have European stock markets and especially European bank stocks significantly benefitted from lower rates? The answer, when looking at the data, is a resounding "No."

For now, it seems studying finance and the markets isn't necessary. The primary skills a money manager seems to need right now are the ability to follow the herd into large-cap tech and 'stay at home' stocks, to listen to Federal Reserve Chair Jerome Powell, and to watch what legislation comes out of Congress. As long as The Fed and Congress are supporting financial markets and providing liquidity, investors may feel comfortable continuing to bid up stock prices. But for those of us who also like robust earnings and market clarity to go along with central bank intervention and government support, this isn't as rosy an investment landscape as we would like.

Contributor's Bio

Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publications.

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