BUSINESS

Road to Retirement: The market only needs one thing

How long can investors rely on the Federal Reserve?

By **CHARLIE FARRELL** | cfarrell@northstarinvest.com | Special to The Denver Post
September 6, 2020 at 6:00 a.m.

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If you've been a student of the stock market, then you probably believe that the stock market is supposed to reflect the underlying fundamentals of the economy and corporate profitability. When those things look good and are growing, stock values go up. When those things look bad and are shrinking, stock values go down. That is basically how it has worked for the last 120 years.

But that's not how it's working today. Right now, the market does not need the economy, corporate profits or dividends to grow. It's going up despite all those things getting worse. It seems to only need one thing, and that is massive support from the Federal Reserve. The big question for investors is how long they can rely on that support.

I know issues surrounding the Fed can be confusing. It's hard to understand what they do and how they do it. But the main thing to understand is that the Fed has gone from primarily being a referee to being a player in the markets. And it is now the most powerful player in the world.

Why is that? It's because the Fed can create money. Usually, we rely on the productive capacity of people working in the economy to generate money and profits. That growth then makes its way back into the economy through new investments and increased employment, and the cycle repeats. Without growth, the cycle stalls. That's why investors spend countless hours assessing growth prospects.

But that game changes if suddenly an entity shows up that can create money without any link to economic activity, profits or employment. This is essentially what the Fed is doing. They are creating trillions of dollars and pushing those dollars into the economy. Because the amount of money is so enormous, it is overwhelming the "real economy" and changing the way investors value stocks.

Photograph by Ellen Jaskol

Charlie Farrell

So how much money are they creating? Consider that in 2019, total profits generated by companies in the S&P 500 were about $1.3 trillion. The Fed just spent $3.5 trillion in five months, with more likely to come. So which number is currently more important to the economy: corporate profits or Fed spending? Fed spending clearly dwarfs corporate profits.

Here is another number to consider: The economy is trending toward roughly an 8% decline for the 12-month period since the COVID-19 crisis started. That equates to about $1.7 trillion of lost capacity in the economy. But again, the Fed just spent $3.5 trillion in a few months, more than double the GDP decline we are likely to see.

Fed and congressional support this year are overwhelming the economy with dollars (about $5.5 trillion in total between the two), and the amount is multiples of what's needed to address the actual contraction in the economy. If the U.S. economy loses $1.7 trillion in output but gains $5.5 trillion from spending, even in a recession, things can look good.

On a side note, while spending has come from both the Fed and Congress, investors are more focused on the Fed because it can unilaterally spend an unlimited amount. Congress can't do that.

I won't get into whether it makes sense to spend all this money. Everyone's got a different opinion. As an investor, you just need to recognize it's happening and then figure out what it means.

From a strictly investment standpoint, it's clearly a positive when you consider the value of your retirement accounts. But investors also feel a bit of trepidation, wondering if their portfolio values are sustainable. Can they fundamentally rely on this Fed support?

At this point, I think it's rational to rely on it. Why? Because the Fed has explicitly stated that they will continue to provide whatever support is needed for the markets. That type of support has never been a part of our financial system before. And since they can create money to fulfill this promise, it is rational to rely on it.

But just know that it makes markets more unstable. With so much Fed support, market values are primarily dependent on the policies of a few folks in Washington. And if those policies change or don't work, then market values can change rapidly.

As an investor, you basically have three choices today. You can either decide to join the Fed party, sit it out and wait for a day of reckoning, or do a little of both. Since I don't think anyone can accurately assess the odds of where this is all going, it makes sense to spread your bets.

The amount you have in diversified stocks is a bet on the party continuing. The amount you have in cash, CDs or high-quality bonds is a bet on a day of reckoning. If you think it's a toss-up between these two outcomes, then consider splitting your money 50/50. If you feel more strongly about one outcome versus another, then weight your portfolio toward that outcome. For instance, if you think Fed support can continue to float markets, then maybe you go 60/40.

But I'd be careful about betting aggressively one way or another. With the markets riding on this "one thing," you don't want to make the wrong bet with a sizable amount of your retirement money.

Charlie Farrell is a CEO of Northstar Investment Advisors LLC. This article is for information and education purposes only. Past performance is no guarantee of future returns, and all investing involves the permanent risk of loss. Consult your individual financial adviser for guidance specific to your circumstances.