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What's Driving The Stock Market Surge?

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The Covid-19 pandemic has had a devastating impact on the physical and financial well-being of millions of Americans, and the forecast for the next several months is increasingly grim despite recent good news about the approval and efficacy of several different vaccines.

During the week of December 14, for example, the country's average number of daily cases rose to a record high of 216,674—which is more than three times what the daily case average was during the summer peak in July. The U.S. averaged 2,633 Covid-19 deaths on a daily basis that week, and total reported deaths of 3,270 on that Thursday was the third-highest daily total yet. Experts predict that 562,000 people in the U.S. will have died from Covid-19 by the end of March 2021, and that more than 3,750 deaths could be reported daily in mid-January 2021. Despite all of this doom and gloom, the Dow Jones Industrial Average rose 148.83 points on December 18 to reach an all-time closing high of 30,303.37.

When the Covid-19 pandemic first struck, markets performed as expected as they declined dramatically. The Dow Jones, for example, fell from 28,992 on February 21 to 18,951 on March 23. The S&P 500 dropped from 3,373 on February 20 to 2,238 on March 23. Anticipating massive investment losses, PIABA attorneys—i.e., attorneys who sue financial advisors and financial institutions on behalf of customers and are part of the Public Investors Arbitration Bar Association—began to aggressively advertise for cases where customers had lost money in the market and began to create narratives on their websites blaming financial advisors for failing to anticipate the market downturn and for failing to protect their clients from unwanted exposure to risk.

Much to everyone's surprise, however, over the following months markets rebounded and continued to do so even as the news about Covid-19 worsened. On November 24, at a time when many Americans faced the prospect of being unable to see family members for Thanksgiving—and several weeks before news that the first Covid vaccine in the U.S. had been approved—the Dow Jones reached a new high of 30,046.

One reason why market indices like the Dow Jones and S&P 500 have soared is because they comprise the stocks of large companies like Home Depot, Apple, Microsoft and Amazon that have adapted their business lines during the pandemic and prospered. Financial advisors should be cognizant, however, that much of the financial pain caused by the pandemic has been felt by smaller businesses and other types of businesses that have been less able to adapt to a post-pandemic world.

Another factor behind the market gains is that massive amounts of stimulus money from the CARES Act and similar federal programs have clearly played a role in ongoing investor optimism and (at least temporarily) in alleviating some of the economic fallout from the Covid-19 pandemic in certain sectors.

In addition, aggressive monetary policy from the Federal Reserve Bank and signals from Fed Chairman Jerome Powell that interest rates will remain at historic lows for the foreseeable future have bolstered markets and investor confidence. On the other hand, with markets already at historic highs and with employment numbers getting closer to pre-pandemic levels, there is a real concern that this influx of federal funds, coupled with aggressive monetary policy, could eventually lead to inflation and a long-term decline in financial markets. Elevated equity valuations, after all, rest on the assumption that inflation will stay low even with historically low interest rates.

Finally, no one seems to be talking about the fact that the U.S. had a federal budget deficit of $984 billion in 2019 (4.6% of gross domestic product) and that this federal budget deficit has now exploded to over $3 trillion (nearly 19% of gross domestic product.) It is not clear how the Federal Reserve could raise rates in a meaningful way to combat inflation down the road without dramatically increasing the amount of interest to be paid on this already massive federal budget deficit. All of this could make for a roller coaster ride for the stock market in 2021.

The good news for financial advisors is that, much to the dismay of Public Investors Advocate Bar Association attorneys, financial markets have not been devastated by the pandemic and there has not been an influx of new case filings where investors lost money by *remaining invested in the market.*

According to statistics from FINRA Dispute Resolution Services, new case filings by customers were actually down this year with a total of 1,716 customer cases filed through October versus 2,048 customer case filings through October 2019. New case filings involving common stock and mutual funds were down significantly as compared to 2019, suggesting that many retail investors stayed in the market and enjoyed the resurgence since March.

On the other hand, new case filings involving REITs increased from 187 in 2019 to 316 in 2020; new case filings involving limited partnerships increased from 96 in 2019 to 132 in 2020 and new case filings involving business development companies increased from 19 in 2019 to 132 in 2020.

Despite the current good news about financial markets, financial advisors should be aware that they are operating in uncharted territory, that the risk/return landscape has changed dramatically and that it is far from clear that markets will remain at their current highs. Financial advisors also need to be aware that certain clients may have encountered unforeseen financial difficulties as a result of the pandemic, and that the risk of customer complaints can increase when customers encounter financial problems due to extrinsic factors.

In light of all of this uncertainty, financial advisors should meet with their clients, talk about what is going on in the markets and have documented discussions with clients about how much risk they want to take. Documenting these types of discussions and updating official client profile information to include the most current information about a client's risk tolerance, investment objectives and current financial situation will not only help to ensure that client accounts are being invested appropriately, but will also limit the artistic license that PIABA attorneys can take down the road if one of these customers were to lose money and blame his or her financial advisor for unwanted exposure to risk.

To a certain extent, it seems hard to stay out of the stock market these days. And in this type of environment it is not clear where investors can find safety as well as a competitive return. For example, even traditionally safe fixed-income investments may be more of a risky proposition these days insofar as any increase in interest rates will undo current high prices of long-term bonds. However, financial advisors with clients who are unwilling to stay in the market indefinitely and who can ill afford to take a hit on their equity portfolios should, at a minimum, watch for a change in market psychology from "risk on" to "risk off" and be ready to reallocate client portfolios to short-term government money market funds.