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The Market-Economy Disconnect

Submitted by Walid L Petiri on Fri, 04/19/2013 - 9:00am

The conventional wisdom that the stock market is an indicator of the economy's direction is not valid this time. Especially after this winter's broad stock rally, it is obvious that stock performance is divorced from economic growth. On the contrary, investors should have a strategy prepared for a potential economic downturn.

The Dow Jones Industrial Average strung together a series of all-time highs in March and April. Many commentators seized on this as a real sign that the economy has shaken off the Great Recession and financial crisis. I wouldn't read so much into it for several reasons. I think that the Dow's impressive winter signals nothing more than emotion-driven bullish enthusiasm in spite of a shaky economy.

Remember that the Dow only includes 30 very large company stocks. In industrial post-war America, those 30 blue chips were a representative slice of the economy.

"There was less national inequality, and everyone's income tended to move in the same direction," [writes Adam Davidson](#) in the *New York Times* about the years right after World War II. "What was good for GM really was good for the country."

That isn't the case today. Today, the Dow is less representative of the broad stock market. In 2007, **Kraft** ([KRFT](#)), **Citigroup** ([C](#)) and **General Motors** ([GM](#)) were among the 30. Since then, Dow Jones replaced them and the index is now far more tech-laden. The Dow still represents the major sectors, but the world is much more interconnected now and stock prices have less to do with the fortunes of everyday Americans. The Standard & Poor's 500, with its 500 components, is a better measure of the market, although it is focused on the largest U.S. companies.

Inflation and Weighting

SMART ADVICE



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By Larry Light, Editor-in-Chief

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The DJIA isn't indexed to inflation, so hitting 14,198 in 2013 isn't quite like hitting 14,198 in 2007, its previous peak, which the benchmark finally passed on March 5. The index's price in 2007 and 2013 is not an apples-to-apples comparison.

It is a price-weighted index. Each Dow component represents a fraction of the index proportional to its stock price. The index, whose fluctuations are news the world over, comes from adding the prices of the 30 stocks and dividing the sum by what's called the [Dow Divisor](#). The divisor, which currently stands at 0.130216081, accounts for stock splits, changes to the index components and other factors that disrupt historical continuity of the Dow.

So if **International Business Machines (IBM)** has an amazing quarter thanks to strong sales in China, and its stock trades up 10%, the Dow rises about 150 points, or just over 1%. This reflects nothing apart from IBM's luck in China, and unless you own IBM stock, it means little to you or the U.S. economy as a whole.

The S&P 500 is market-capitalization weighted, which more accurately measures the market's valuation of a company than the price of one share. More valuable companies, rather than those with high share prices, have more sway on the S&P 500.

What the Stock Rally Really Means

So what is driving the rally, and why should you be concerned? Two perceptions are moving the market higher. One is the belief that the economy is improving. The other is the assumption that the Federal Reserve will sustain aggressive monetary stimulus for a year or more. Pair those thoughts together, and you have grounds for sustained bullish sentiment. Take one or both away, and you have problems.

While the market soared in the first quarter, with the [Dow up 11%](#), the economy grew just 0.1% in 2012's fourth quarter by the federal government's most recent estimate. (The [first-quarter economic growth report](#) comes out Friday, April 26.) That weak growth should make investors concerned. America's economy is producing more goods and services than before the recession began, but that gain comes with an asterisk, because the population has grown. Viewed on a per capita basis, gross domestic product at the end of 2012 remained 1.5% *below* its pre-recession peak.

If the improving economy inspires investors, then attribute the market highs to a resurgent housing market, strong expansion in the manufacturing and service sectors, an encouraging employment report and, of course, record corporate profits.

Yet all of these pale in comparison to the most influential factor: central bank policy. The Federal Reserve's ongoing bond-buying stimulated the real estate industry, the stock market and the overall economy. Additionally, the open-ended money-printing effort of the European Central Bank takes some of the edge off the anxiety over the future of

the euro and expands global liquidity. We can now add the Bank of Japan to the list as their new central bank chief pumps 1.4 trillion yen into the economy to escape deflation.

What's an Investor to Do?

Whenever the Dow flirts with or reaches a new record high, bears come out of hibernation and exclaim that a pullback is imminent. Of course, other analysts feel stocks are fairly valued or even undervalued at the moment.

Individual investors notoriously underperform stock indexes because they make emotional decisions to jump in and out of the market at inopportune times. Evidence the *recent New York Times* article citing Dalbar Inc. data from the 20-year period ending December 2013, which showed the S&P 500 had a 8.21% annual return while the average stock mutual fund investor got 4.25%. Over 20 years, \$10,000 invested at 4.25% is worth \$22,989, yet invested at 8.25% you get \$48,456.

Though fees are clearly a part of the underperformance the bigger reason is the investor themselves: "They get excited or they panic, and they hurt themselves," Dalbar President Louis S. Harvey said. Avoid listening and following all of the chatter, market calls and sales pitches. Your best bet for long-term investing is a disciplined, well thought strategy that constantly considers risk.

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