4 Risks To The Current Stock Market Rally

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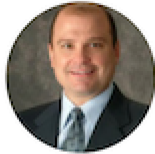

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I help people on their path to Financial Freedom. FULL BIO
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Thus far in 2020, the U.S. stock market is off to a virtually uninterrupted, positive start. There are legitimate reasons for stock investors to be optimistic, including an expected increase in corporate earnings as well as continued strength from the U.S. consumer fueled by strong wage growth and low unemployment. The economy is also benefitting from low interest rates, low oil prices, a relaxed regulatory environment, and a favorable corporate tax structure that recently passed in the Tax Cut and Jobs Act. In addition, we have newly signed trade deals that should lead to firming global growth.

Even with all these typically positive factors, Wall Street remains a two-way street: the risk of negative movement in the stock market is ever present. This risk is especially true when stock prices have run up; so it may be prudent to look out for potential causes of a stock price correction. Here are four risks investors might see in 2020.

Disappointing earnings. Corporate earnings are a primary driver of stock prices, and based on how investors are valuing stocks, the market is expecting good earnings in 2020. The forward Price Earnings ratio—which is the 'multiple' that stocks sell for in relation to their earnings—is above historical average. When this occurs, there are generally two results: (1), earnings are strong and the high level of stock prices

are justified, or (2), earnings disappoint and stocks decline. Jittery investors, stock traders, or (near) retirees who may be over allocated to stocks, may want to pay attention to earnings reports and company guidance.

A hawkish Federal Reserve Bank. In 2018, The Federal Reserve Bank (The Fed) started to tighten money supply and raise interest rates. The result was a sharp drop in stock prices of almost 20%. However, The Fed quickly reversed course and expanded the money supply by being an active buyer of bonds in the open market. These more recent Fed actions, for a variety of reasons, encourage stock investment. With asset prices now spiraling upward, The Fed may want to discourage speculation. While we do not expect The Fed to reverse course again by either raising rates or tightening money supply, they may only need to mention a potential tightening to send the stock market into a tailspin.

Trade uncertainty returns. For the past few years, there has been an overcast of uncertainty regarding global trade. In large part, this was due to the U.S.-China trade spat, but there were also tensions with Canada, Mexico and Europe. Fortunately, with the signing of Phase I of the China Trade Deal and the U.S.-Canada-Mexico Agreement (the USMCA), most of these concerns have been allayed. However, European issues remain and potential enforcement of the China trade pact could return tension to the global markets. In the near term, trade uncertainty reduces capital investment and global growth. It seems likely that prior to the November election, President Trump would avoid trade disruptions, as they could slow the economy and hurt his re-election chances. However, if the market sees renewed trade tension as a post-election possibility, it could impact stock prices.

A weakening bond market. As a result of accommodative Fed policy and other factors, there is a lot of corporate debt outstanding. Much of the debt, notably in the energy sector, is rated non-investment grade. An economic downturn would weaken the cash flow of debtors, which could spiral into defaults. For example, a prolonged drop in oil prices could reduce the debt service capability of many issuers which could spread to bank debt being downgraded. In addition, lower prices could slow production and negatively impact the economies of a number of U.S. energy producing regions.

These are just four of the potential risks to an otherwise robust economic climate. There are also the ever-present risks of an unexpected global event, the global recovery leading to higher inflation and added risks from the presidential election. To be sure, several market-friendly Democrats remain in the race for the White House; but there are some whose policies would likely not be favorable to stock prices. In addition, there is the possibility that both houses of Congress could swing to Democrat control; if this results, we will likely see a shift in tax policy and regulation—which in the short run may not favor shareholders.

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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