Opinion: 3 powerful reasons the stock market is heading even higher

By Howard Gold
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Start with the Federal Reserve and the trade war

What summer doldrums?

The S&P 500 index SPX, -0.34% jumped to close just above 3,000 on Wednesday, its eighth gain in the last 10 sessions, and the Dow Jones Industrial Average DJIA, -0.48% rose for the sixth straight session to end solidly above 27,000. Both are now less than 1% off their July all-time highs. The Nasdaq Composite index COMP, -0.30% is less than 2% off its record peak, and the small-cap Russell 2000 index RUT, +0.76% and the bellwether Dow Jones Transportation Average DJT, -0.45% , which lagged the other averages, have rallied sharply in recent weeks.

This comes amid worries about yield curve inversions, recession (60% of Americans think one’s coming in the next 12 months, according to the latest ABC News/Washington Post poll), trade tensions, negative interest rates in Europe and Japan, and slumping global economies.

But U.S. traders and investors never got the memo. That stocks can stay so strong even before we enter the historically best six months for stocks (November through April) of the calendar year tells me they’re poised to move higher, at least in the months ahead, for three reasons:

1. Recession may be coming, but it isn’t right around the corner. A few weeks ago, when the yield on the 10-year Treasury note TMUBMUSD10Y, -2.54% dropped below the yield on the two-year Treasury TMUBMUSD02Y, -2.03% for about 6½ minutes, the media covered this momentous event as if it were the Normandy invasion. But it lasted only three trading days, according to Treasury Department data, signifying nothing.
What the media missed (except for this column) was that the real yield curve inversion, discovered by Duke University Professor Campbell Harvey, is the spread between the three-month Treasury bill and the 10-year note, a measure that has correctly "called" the last seven recessions. Since that yield curve was inverted for the entire second quarter of 2019, Harvey has now put out a recession "red alert," meaning that the chances of recession are now 40% or higher.

But the average lag between a full inversion and recession is 11 to 12 months, meaning any U.S. recession probably won’t hit until the second half of 2020. Meanwhile, consumer confidence remains strong and GDP growth is OK, at about 2% in the second quarter. Looser monetary policy or any respite from the trade war (see below) might stave off the inevitable until 2021, giving stocks some breathing room to move higher.

2. The Federal Reserve will keep cutting interest rates whether it wants to or not. President Trump just tweeted that he wants the Fed to cut rates to zero or lower. That’s ridiculous, of course — do we really want to have negative rates like Europe or Japan? — and Fed officials will do everything they can to look as if they’re independent of the president’s moods and whims.

Read: Dear Mr. President, why is it a good thing if a 10-year Treasury note is worth less than a bag of dirt?

But the overwhelming logic of Fed policy is to keep cutting rates, even as it tries to control the pace and the narrative. The weakness in the global economy and efforts by other central banks to fight it — Lawrence McDonald of Bear Traps Report says there have been 32 rate cuts this year by central banks globally (prior to Thursday’s rate cut by the European Central Bank), and markets have priced in 58 more rate cuts — will keep the heat on the Fed as Chairman Jay Powell starts worrying more about falling "behind the curve."

Whatever the reason, rate cuts are bullish for stocks and investors are looking for more of them.

Read: ECB cuts key rate, restarts quantitative easing as it attempts to revive eurozone economy

3. Investors expect Trump to fold on trade. Algorithms may cause stock markets to sell off when the president puts out bellicose tweets, but investors have taken their measure of the man and they think that rather than risk re-election, he’s going to ultimately cave into China and end the trade war. Why? Because he’s folded on so many things before — from threatening “fire and fury” against North Korea to embracing bromance buddy Kim Jong Un even as “Little Rocket Man” has tested at least 18 missiles since May; from indirectly boasting he could kill 10 million people in Afghanistan to planning to meet the Taliban at Camp David days before the anniversary of the Sept. 11 terrorist attacks. He’s already caved in to China so much it’s hard to take the Capitulator-in-Chief’s threats seriously.

That’s why the smart money is looking for a cosmetic trade deal some time next year that includes some modest Chinese concessions but no major givebacks on critical issues like technology policy, which China views as a vital national interest. The president will declare any agreement a great victory, and traders will just wink as stocks move higher.

Read: Trump delays tariff hikes against China until Oct. 15

At least that’s what they’re counting on, especially as the president’s approval ratings slip and the economy weakens as we head into the 2020 election year.

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