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My "Best-Estimate" Scenario For The U.S. Stock Market For The Next 60 Days

Let us start with a perhaps less obvious question: Why 60 days?

Because that will take us through the historically volatile months of September and October (when fear can beget fear) to the middle of November, which historically tends to mark a turn in the markets toward an end of the year rally.

Because, over these 60 days, we are looking at some "scheduled" events that could well drive this stage of the market–the September 26 meeting of the Federal Reserve (and another likely interest rate increase), the next stages in the U.S.-China tariff war with tariffs on a projected total of $460 billion in Chinese goods, the November 4 deadline set by the United States for its allies to join in on new sanctions on Iran, and an election that could shift power in Washington with unsettling effects.

Set against those potential developments over the next 60 days, I think we have got constants that include continued strength in the U.S. dollar and continued weakness in emerging markets, continued strength in the U.S. economy (although probably not with GDP growth as strong as in the second quarter), better than solid growth in earnings for the third quarter (which could be, according to some estimates, slightly higher than earnings growth in the second quarter) and the likelihood that inflation will keep moving, slowly, higher.

Putting all these elements together is a challenge but here is what I think the next 60 days are likely to bring:

● Continued weakness in emerging markets because of the strong dollar and because of fears that the Trump administration's tariff policies are going to slow global growth. Emerging markets have been on the edge of a full-fledged 20% bear market recently. My rule of thumb, though, is that due to the greater volatility of these markets, they do not enter corrections or bear markets at the standard level that developed markets do (that is 10% for corrections and 20% for bear markets.) I think emerging markets have further to slip over the next 60 days before they enter a true emerging markets bear market and start to look cheap enough to enough traders and investors so that they are willing to put money into these assets in spite of the risks. How much further down? I am looking for a bottom somewhere around a total drop in emerging markets of 30% or so. That is another 10 percentage points from here.

● Relative outperformance of U.S. markets–with lots of volatility, though. The troubles in emerging markets (and the uncertainties in Europe) will keep cash flows headed in the direction of U.S. assets. We will get the same effect from rising interest rates and a stronger dollar. Also, projections from Wall Street analysts for 21.5% earnings growth in the third quarter will keep money in U.S. stocks through the October earnings season. If we get the normal 2 to 3 percentage point bump to actual earnings from projected earnings, earnings for this quarter will come in just slightly below the bumper growth of 25.9% for the second quarter. Nobody will want to walk away from that kind of earnings growth rate–especially because the second and third quarters look to be the peak in earnings growth for this cycle (thanks to the December 2017 tax cuts.) Earnings growth in the fourth quarter is now projected to drop back to a still very strong 18.6%. My best estimate is that we could see the Standard & Poor's climb another 5% by the end of this 60-day period, which would push that index over 3000 to a new historic high.

● However, that gain for U.S. stocks will not come without impressive volatility. (a) Fear that the emerging market crisis will spread from emerging to developed markets. We have already seen that. (b) Fear that U.S. tariff moves will indeed take a bite out of U.S. growth. (c) Fear that the Federal Reserve will once again put an end to an economic recovery. (d) Fear of the usual suspects among geopolitical events: war in the Korean peninsula or in the Middle East, for example. (e) Fear that U.S. stocks have to sell off (fear of fear itself.) I don't think we are looking at some extended market break but I would be very surprised if we don't see a spike in the VIX (the CBOE S&P 500 Volatility Index) fear to 22 or 23 (which is not especially high by historical standards) or a plunge back to a VIX of 10 or so. (The VIX dropped 6.64% today to 13.22.)

● In this environment some traditional risk hedges, such as the Japanese yen, should do reasonably well. Others, such as gold, will continue to lag. A strong dollar and rising interest rates even with slowly climbing inflation just is not a good environment for gold. I would expect oil prices to climb modestly because of worries over the November 4 deadline for U.S. sanctions and continued bottlenecks in U.S. production out of the Permian Basin. But supply seems abundant enough and growth in the global economy iffy enough to keep West Texas Intermediate below $75 a barrel in this period and Brent at less than $85–absent a shooting event in the Persian Gulf. (West Texas Intermediate closed at $69.84 a barrel today and Brent at $79.37.)

Can't do a best estimate scenario like this without a list of wildcards, of course.

● The biggest of those in the next 60 days is China and the U.S.-China trade war. To me it does not look like China is about to fold on the tariff war. I think restricting the influence of overseas companies in China's economy accomplishes enough of Beijing's policy goals (as I wrote yesterday, September 10) to keep China from making the kind of major policy concessions that the Trump administration is looking for. I could be wrong–and a big settlement of the trade war issue would mean a big bump to global financial markets.

● China gets a second mention on my list of wildcards. It looks like economic growth in China is slowing enough so that the People's Bank and the government could still announce stimulus efforts within this 60-day period. In the short run, such an announcement would lead to a bounce in emerging market assets–more growth in China means more sales of emerging market goods and commodities to China. But, over a slightly longer run, any stimulus, especially any stimulus which overtly weakened the Chinese yuan, would lead to more selling in emerging markets as emerging market currencies felt more pressure and as investors and traders worried about the effects of cheaper Chinese goods competing with emerging market products.

● Investors and traders have to keep in mind, too, the possibility that the November 4 deadline for new U.S. sanctions could lead to some event that might destabilize global oil markets. So far the consensus among economists is that slightly higher oil prices are not going to take very much away from global growth. But a spike in the price of oil would be a different question entirely.

● Finally, there is the possibility that the Fed with new and relatively untested leadership might say something to raise fears that the U.S. central bank will more aggressively raise interest rates in 2019 than the markets now anticipate. Market participants are very aware that the Fed has a track record of killing economic expansions with interest rate increases that are intended to head off inflation. The assumption, I think, in the markets is that the Fed will do it again in this cycle–that indeed the U.S. central bank has to if it is to bring monetary policy back to something like neutral and reduce the size of its balance sheet. But, markets would like to see that happen later rather than sooner.

If you look out more than 60 days there are plenty of reasons to worry about the continued longevity of this bull market and this economic boom. There is the worry that I just mentioned about the Fed. There is the huge debt overhang created during the boom and that has, in recent years, added a considerable amount of questionable–and dollar denominated–debt to corporate balance sheets in overseas markets. We are very late in the credit cycle and it is not hard to argue that we are headed to a Minsky Moment of reckoning sometime in the next three years or so.

That is the back-ground for the next 60 days–and it explains much of the nervousness and volatility of this market. But I don't think we are about to see a day of reckoning quite yet.

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BW: See "About the Author" on the next page.

About the Author

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Web sites: www.jubakpicks.com; http://jubakfund.com/; http://jubakam.com/

BW: here is an excerpt from Jim's WELCOME message on his website

After twelve years with MSN Money, I am excited at being on my own. The move gives me a chance to bring you, my readers, more and better ideas for profitable investing. Each week the folks at the MoneyShow.com and MSN Money will publish seven of my posts from this blog on their sites. That is already an increase in your weekly dose of Jubak from the days when I wrote Jubak's Journal twice a week. But you will also find another 18 or so posts a week on my JubakPicks.com blog that do not appear on either of those two sites. (Although they have appeared as much as three days ago and as little as a few minutes ago, if they are really important) on my new subscription site at http://jubakam.com/)

Here I am aiming for five posts a day five days a week. I won't always get to those numbers. Some posts just take longer to research and write and sometimes, like everyone else, I run out of gas and need to take a break. But my goal isn't some arbitrary number of posts, anyway. The goal is to bring you the best market intelligence that I can on a schedule that keeps you at least one step ahead of the market.

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