Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

3 Things that May Move the Market this Year

By Mitch Zacks
Portfolio Manager

We're now halfway through 2019, and the stock market has delivered solid performance year-to-date. It's difficult to believe that the S&P 500 is up nearly +20% in the first six months, but investors must remember that the market's stout performance is coming off a miserable Q4 2018 where the S&P 500 flirted with bear market territory.[1] Much of the gains in 2019 have been the market simply retracing losses endured at the end of 2018. As I write, the market is still only a few basis points above its all-time high.

The trillion-dollar question, then, is where does the market go from here? What can we expect in the back half of 2019? Below I'll take a look at three events that could shape the equity market in 2019.

Event #1: Escalating Geopolitical Tensions Resulting in War

Last week saw tensions escalate between the U.S. and Iran, with the U.S. just moments away from a retaliatory strike on Iran before it was called off at the last minute. Tensions rose when the U.S. accused Iran of using mines to attack commercial ships in the Strait of Hormuz, which is a key shipping lane for the world's crude oil supply. Days later, Iran shot down a U.S. drone it claimed had entered Iranian airspace.

Whether or not the tension will escalate from here is a critical uncertainty. An analysis of several geopolitical crises since 1900 found that the Dow Jones Industrial Average often had knee-jerk reactions to escalations, falling an average of -6.8% within a month of a crisis. However, the Dow also quickly recovered – six months after the post-crisis low, the Dow was trading, on average, 1.6% higher than before the crisis erupted.

The other historical reference that could be valuable here is what happened during the Arab Oil Embargo, when OPEC nations cut off oil supplies to the U.S. and other countries. Oil prices jumped nearly 4x in five months, and U.S. stocks suffered a correction – falling more than 10% – that lasted throughout the embargo.[2]

This event is very much a "wait-and-see" for investors, given we have very little information about negotiations or talks between the two nations. On the energy front, however, the global economy is awash in oil supply and the U.S. is capable of ramping up production very quickly, making prices less of a concern.

Event #2: A Trade Breakthrough or Breakdown with China

Last week kicked off a set of hearings in the U.S. trade representative's office so that consumers and corporations could voice concerns on trade. On the agenda: consumer and corporate grievances related to the planned 25% of additional tariffs on $300 billion of Chinese imports.

To date, the consumer has largely been shielded from direct impact of tariffs, as many consumer goods have not yet been taxed. *The Wall St. Journal* analyzed some of the goods that would get caught up in this latest round of tariffs – 273 categories in total – and found that there were few comparable alternatives produced domestically or elsewhere for many of the goods. Items like fireworks, fishing poles, and electric blankets almost exclusively get imported from China, to the tune of $66.3 billion in 2018.

Many companies have voiced concern over the latest round of tariffs, as they have not been able to find substitute suppliers to tide them over until a broad agreement is reached. President Trump and Chinese President Xi Jinping agreed to have an extended meeting in Japan next week at the G-20 Summit, but neither side has indicated that the purpose of the meeting is to reach an agreement.[3] Stocks have had a difficult time breaking through to new all-time highs, in my view, because of uncertainty over the U.S. – China trade issue. Until some resolution is reached, I believe stocks will struggle to move materially higher.

Event #3: An Interest Rate Cut

The stock market has been particularly receptive to the Fed's shifting stance on monetary policy, in my view. I think the Fed's announcement at the turn of the year to effectively pause interest rate increases in favor of a "patient" approach was and is a key catalyst to the current market rally.

Market participants now appear to be convinced that the Federal Reserve is actually going to cut interest rates sometime in 2019, a move that I think could give the bull market more runway by increasing investor confidence and nudging investors into equity markets (since fixed income markets offer relatively low yields).

But there's another side to this story, and that is what happens if the Fed *does not* cut interest rates as the market is hoping. I think in that scenario you could see a volatile back half of 2019.

Bottom Line for Investors: Don't

Forget About the Wall of Worry

In any given year, the market is faced with fairly consequential events and 'concerns' that keep investors on edge. But you should remember that the U.S. economy is resilient and that stocks have a long, storied history of climbing the "wall of worry." Often times, the more concerned investors are about stories or events that could shake up the markets, the more upside stocks potentially have – it creates a scenario where low expectations set a low bar, and stocks can surprise to the upside with good news and good outcomes.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Yahoo Finance, June 25, 2019. SNP - SNP Real Time Price. Currency in USD.
[2] Barron's, June 21, 2019. https://www.barrons.com/articles/iran-war-stock-market-51559052028
[3] The Wall Street Journal, June 16, 2019. https://www.wsj.com/articles/as-china-tariffs-loom-some-u-s-companies-say-buying-american-isnt-an-option-11560677402?mod=djem10point