MAR 6, 2017 @ 12:02 PM

What Might Derail This 'Trump Rally'

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Despite incredible political acrimony, mudslinging, and some seeming chaos in the new administration, the Dow Jones Industrial Average ("the Dow") managed to rise about 14% from Election Day to February 28. While there have been gradual increases to the underlying economy and corporate profits that pre-date the election, three possible reasons for the recent stock market spike may be:

1. A more relaxed regulatory environment—which should help companies lower costs associated with complying with government rules.

2. Anticipated infrastructure spending—which would stimulate the overall economy and put people to work while boosting the materials and construction sectors.

3. Proposed cuts to personal and corporate tax rates—which could boost profits and lead to higher stock valuations.

Since the election, some sectors, like financials have moved even higher than the Dow. This reflects the strong belief that regulatory reform, particularly of banks, will not require bi-partisan action by Congress and that the executive branch can accomplish a large portion of regulatory change. In other words, there is minimal risk to the stock market that the Trump administration won't be able to reform regulations.

Infrastructure spending and tax reform, on the other hand, require Congressional action, and therein lies some of the risk to this recent U.S. stock market rally. In order to pass a meaningful infrastructure spending bill, President Trump has to win over conservative Republicans who have been concerned with government spending and deficits. If these Republican deficit hawks stick to their belief system, they will want any increased spending to be paid for by cuts in other areas. But significant budget cuts are not very likely, as Trump has said that the biggest parts of the budget are either off limits to cuts (Social Security and Medicare) or targeted for increase (defense).

Especially if there are reticent Republicans, Trump will need to garner Democrat support to pass any meaningful infrastructure legislation. The question then becomes whether Democrat lawmakers are willing to potentially give Trump a political victory and help him reward a lot of his voters—particularly blue collar union voters and tradespeople who were in large part once staunch Democrats.

But who knows what will happen in politics. Maybe we will have a political "kumbaya" orchestrated by self-proclaimed master of negotiation President Trump. Trump has surprised many people thus far, and maybe he can win over enough Democrats. If that happens, we will get a huge infrastructure spending bill, our country will get long-awaited improvements to roads, bridges, tunnels, airports and other areas, and the stock market's ebullience will be justified. If we don't get this spending, there could be disappointment in the markets.

Tax reform is a bit trickier. Although conservative Republicans may worry that the proposed tax reforms will increase the national deficit, they will likely fall in line and be supportive. However, if Democrat votes are needed to pass tax reform, then Democrats have their traditional arguments on their side. Unlike with infrastructure spending—which Democrats have long supported—few Democrats support lower corporate tax rates. To be sure, a lot of this recent stock market rally has been driven by the belief that corporate tax rates—and possibly personal tax rates—are coming down. Not delivering on a sizable tax cut would send a shiver through the stock market.

Another risk to the stock market rally could be significantly higher interest rates, but this doesn't seem likely in the near term. The global economy isn't strong enough to support the Fed's dramatically raising rates—especially when our major trading partners are still in a near-zero-percent policy. However, if this were to happen, a stronger dollar could result, which would hurt the earnings of U.S. exporters and multi-national corporations—which in turn could hurt the stock market.

The wild card, and not something that is likely to happen soon, is the extent that any protectionist legislation starts to work its way through Congress. Protectionism is rarely good for capitalism and the global economy. Retaliation is just too easy, particularly for nations that would be targeted by the U.S. At this point, it seems that protectionist talk, border taxes, and nationalism are more posturing than reality.

But if these policies come to the fore, then this would be perhaps the biggest impediment to the stock market rally.

For now, there is joy in Mudville. Plenty of dirt is being slung around, and the stock market is enjoying—or ignoring—every minute of it. What may cause the rally to stop is anyone's guess; but a stalemate on Capitol Hill, protectionism, or an unexpected event such as a terrorist attack would be some of the risks investors need to be wary of.

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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