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A rosy scenario for stock market, but will it last?

Investors watch job numbers and the Fed after pushing Dow to record high this week.

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America's stock market has been buoyant, even though credit markets are still creaky and an outright recession grips the housing market, a sector that often gives early warning of wider economic slumps.

What has fueled a run-up of stock prices that set a new record high for one key index this week?

The answer, to borrow a phrase from the cold war, may be "containment."

Many investors have gauged that the overall economy is mostly insulated from housing and credit troubles – thanks in part to the Federal Reserve's willingness to provide a monetary nudge as needed.

Similarly, investment strategists are confident that even if the US hits a slow patch, a strong world economy will bolster earnings for the biggest US companies. The world is more insulated from a slowdown in the US than it used to be.

"We haven't seen the end of the impact of the credit crunch," and the housing downturn "has further to go," says David Kudla, chief executive officer and strategist at Mainstay Capital Management in Grand Blanc, Mich. But "we don't expect that it has the ripple effect ...such that it causes a recession or a significant market decline."

If this benign scenario holds true, the stock market could provide some comfort to Main Street as well as Wall Street. It would imply healthy profits at corporations, which could inspire more job-creating investments. And, while not every homeowner owns stocks, it could also help consumer confidence.

At the very least, a resilient stock market would mean that capital gains on stocks would help offset any continuing drop in home prices on America's collective household balance sheet.

In general, the stock market can be a leading indicator of where the economy is headed – since investors are pricing shares based on expected future earnings.

This week, the Dow Jones Industrial Average hit a new record high of 14087.55.

Ironically, the rally came on bad news. Citigroup said its third-quarter profits would be sharply lower, due to markdowns related to the recent credit turmoil. But it said it expected conditions to be improving.

Investors took that, and a similar writing off of credit losses at the investment bank UBS, as a sign that the worst for financial firms may be behind them.

"What was encouraging this week was the transparency coming out of a couple of major financial institutions," Mr. Kudla says. Uncertainty had been holding the stock market back.

All uncertainty isn't over. A key hurdle for bull-market spirits comes Friday, when the Labor Department releases employment numbers for September.

If more jobs are lost than created, fears of recession could grow. Last month saw the first net loss of jobs in several years.

Big job growth could also shake investors. A reading above 100,000 new jobs could spoil hopes that the Federal Reserve will cut interest rates.

The Fed eased credit conditions last month by lowering its short-term interest rate. That helped restore confidence after an August panic. The plunging value of subprime mortgage loans – a facet of the US housing slump – sparked a freeze-up in credit markets, which spread even beyond US shores.

While a hot jobs number could spook Wall Street, some analysts say the stock market and economy can muddle upward even without further rate cuts by the Fed.

"We're probably going to slide through here without a recession," says Michael Cosgrove, who publishes the EconoClast, a market newsletter based in Dallas.

He says that's the case despite the past precedent for economic downturns to be foreshadowed by slowdowns in residential real estate.

"This may be different, because the global economy is much stronger," he says. "The market could probably end the year higher than what it is now."

Ahead of the jobs report, the Dow Industrials opened Thursday up slightly, but still below the peak reached at the beginning of the week.

Not every analyst is bullish on this fall's outlook.

"The euphoria in the market is a temporary phenomenon," predicts Komal Sri-Kumar, managing director and chief global strategist at Trust Company of the West. "I think the Fed is reluctant, in terms of doing what the market wants."

As he sees it, higher stock prices could signal to the Fed that more rate cuts aren't needed.

Still, he sees exports and global operations helping the earnings of large multinational companies – the kind that dominate the Dow and the Standard & Poor's 500 index.

After some dips this fall, he expects the Dow to be back at 14000 by January.

So far this year, the most global sectors of the S&P have led the way: high-tech firms, industrial producers, and the energy and raw-materials firms that benefit from rapid growth in developing nations.

But the general pace of earnings growth is slowing. After years of double-digit gains for the S&P 500, third-quarter profits for these companies are expected to be up just 2 percent from the same period last year, according to estimates compiled by Thomson Financial this week. They forecast a rise of 2 percent in S&P profits from the same period a year ago. As recently as July, Wall Street had been expecting a 6 percent jump in third-quarter profits.

The market isn't a foolproof barometer of the economic outlook. According to economist David Rosenberg at Merrill Lynch, recessions began in 1980 and 1990 just as the S&P 500 index hit a peak.
