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CANADA

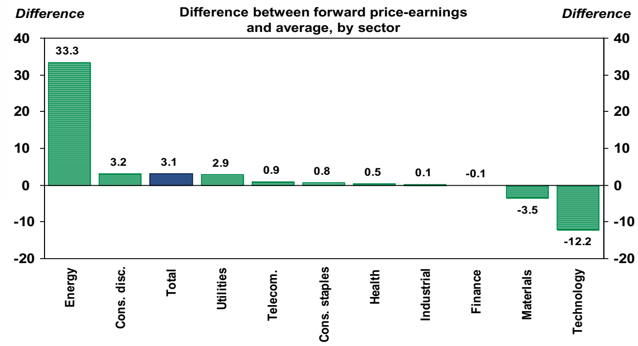
Is the Canadian stock market overvalued?

Given the adverse implications of the oil price tumble on profitability within the heavy-weight energy sector of the Canadian stock market, a relatively subdued performance of the S&P/TSX index might have been expected in 2015. However, the index is currently around 300 points away from its peak of September 2014, even boasting better performance than the U.S. stock market since January. Analysts have largely shaved their earnings' growth forecasts for the Canadian stock market, currently expecting a fall of 9% for 2015, which would correspond to the worst year since the recession. Hence, the recent improvement in the Canadian stock index, in a context of declining earnings' expectations, has led to an expansion of the 12-month forward price-earnings ratio. This ratio currently stands above 17 against an average of 14 since the end of 2002, leaving to suggest that the Canadian market could be somewhat overvalued.

Care should be taken not to jump too quickly to conclusions, especially as it can be observed that the energy sector is by far the one showing the largest price-earnings discrepancy. The majority of other sectors show multiples faithfully aligned with their respective averages, while materials and information technology remain in a situation of undervaluation from a historical perspective. The explosion of the price-earnings multiple in energy can be ascribed to expectations for sharp profit contractions over the next few months, rather than meaningfully bullish sentiment on energy stocks. Corporate results published so far have validated the lowered expectations on earnings. However, positing that oil prices will remain relatively stable, and with the drastic spending cutbacks under way in the oil industry, profit growth expectations, and in turn the price-earnings ratio, should gradually converge towards somewhat more standard levels.

Implications: The price-earnings ratio indicates that the Canadian market could be overvalued, and therefore at risk of correction. However, several factors suggest caution before making such a prognosis. First, as discussed, the ratio is currently heavily distorted by the energy sector. Other sectors do not seem outrageously overpriced. Second, other multiples, such as the cyclically-adjusted price-earnings (Shiller PE) or the forward price-to-book, do not corroborate the signal offered by the price-earnings ratio. Third, even if the Canadian stock market has made good progress so far this year, its performance remains far more modest than those of equity markets in Europe, or in China where authorities are attempting to temper investor exuberance. Finally, we must acknowledge that where it is question of overvaluation, the Canadian stock market has nothing to envy to sovereign bonds these days.

The energy sector is a major reason behind the above-average S&P/TSX price-earnings ratio



* Average from October 2002 to April 2015.
Sources : Datastream and Desjardins, Economic Studies

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