Economic News

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UNITED STATES

The stock market has nothing to fear from a gradual increase in interest rates

Excellent U.S. job market data released in early November and the comments of several Federal Reserve (Fed) leaders suggest that key rates will start rising at the December 16 meeting. Should we fear that a start in monetary firming heralds the end of a long bull market in the United States?

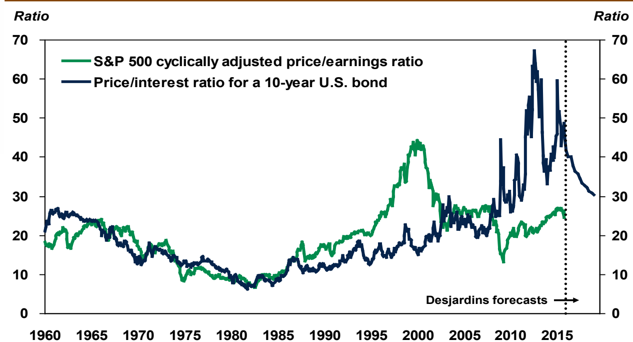
S&P 500 price/earnings ratios are now relatively high from a historic standpoint, particularly the cyclically adjusted measure based on earnings over the past 10 years. Yet, this increase is small compared with the spectacular surge in the cost of bonds. Note that 2% on a 10-year bond means the investors agree to pay 50 times the interest promised.

The large positive gap between what investors demand from shares and corporate bonds also contradicts the idea that shares are strongly overvalued. Under current conditions of extremely low interest rates, high global savings and reaching for yields, we can even question why price/earnings ratios are not higher. One explanation could be that buyers of shares never counted on bond yields staying near zero.

Even though they seem ready to start monetary firming, Fed leaders are being careful to signal that rates will be raised gradually. While the outlook for economic growth seems to be more limited than in the past, we can expect interest rates to remain significantly lower in the medium term than what was observed prior to the 2008 financial crisis.

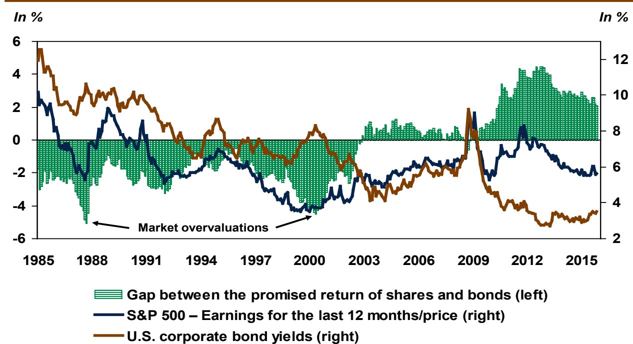
Implications: The start of U.S. monetary firming could trigger some market volatility. However, this alone should not justify a lasting decrease in U.S. stock market valuation measures. As long as investors expect interest rates to stay relatively low in the medium term, prices/earnings ratios could remain higher than in the past. Of course, other factors, including disappointing earnings or a surge in concerns, could harm stock markets.

The rise in price/earnings ratios does not appear excessive, especially compared to what happened with bonds



Sources: Global Financial Data, Robert Shiller, Datastream and Desjardins, Economic Studies

Difficult to argue that the U.S. stock market is currently overvalued compared to bonds



Sources: Institutional Brokers' Estimate System, BofA Merrill Lynch, Datastream and Desjardins, Economic Studies

Mathieu D'Anjou
Senior Economist

François Dupuis
Vice-President and Chief Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Mathieu D'Anjou Senior Economist
Benoit P. Durocher Senior Economist
Francis Généreux Senior Economist
Jimmy Jean Senior Economist
Hendrix Vachon Senior Economist

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