Volatility May Remain High, but the Stock Markets Could Bounce Back

The bull market that began after the 2008 financial crisis is nearly ten years old in the United States. However, recent months have been difficult for investors. While the U.S. stock market may appear to be expensive according to some indicators, those based on earnings and interest rates seem to indicate that it is still attractive. The Canadian stock market, meanwhile, looks like a bargain where things currently stand. Since the economic environment should remain favourable for a while yet, the indexes still have some potential for gains. The episodes of volatility, such as those seen in February and since early October, could end up being frequent, however, as investors will continue to try to anticipate the next recession.

A Second Stock Market Correction in 2018
The past two months have not been easy for investors, with major stock markets taking a nosedive. Even the U.S. market, one of the few to make significant advances in the first nine months of 2018, has seen virtually all these gains wiped out since the beginning of the fourth quarter (graph 1).

GRAPH 1
A second stock market correction in 2018

![Graph showing the S&P 500 and S&P/TSX indices]

This second S&P 500 correction in 2018, a decline of more than 10%, is reminiscent in many respects of the one that occurred in February. First, these corrections were preceded by a stock market upswing, with the S&P 500 jumping more than 7% in the first few weeks of 2018 and making a similar leap in the third quarter of the year. The surge in technology stocks, which has been particularly strong in recent months, was also a vulnerability, and it comes as no surprise that the fall was especially sharp for this sector (graph 2). Furthermore, in February as well as October, the stock market correction was triggered by signs of wage acceleration and a significant rise in bond yields. Fears about the robustness of the global economy gradually won out, however, over concerns about the increase in bond yields in recent weeks.

GRAPH 2
The upswing in technology stocks may have been exaggerated

![Graph showing the S&P 500 and NASDAQ indices]

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In any event, it is not unusual to see periods of high volatility on stock markets. Rather, it is the straight-line climb by the S&P 500 in 2017 that is the exception from a historical standpoint (graph 3). As a number of central bank leaders noted recently, the return of higher volatility on financial markets is a predictable consequence of the normalization of monetary policies, as investors can no longer count on monetary authorities to keep injecting liquidity to prop up asset values.

Are the Stock Markets Very Expensive?

While central banks seem to be determined to continue the gradual normalization of their monetary policy, fairly high volatility should be expected on the markets in the coming quarters. Investors could also continue to worry about rising interest rates, which are reducing the present value of future corporate dividends and profits, and about the possibility of a recession since the growth cycle has had a long run (graph 4).

In this context, it is important for the value of stock markets to be based on solid fundamentals to prevent an exodus of investors and a long downward trend. Highly overvalued stock markets, like in the late 1990s, would be in a very poor position to handle this type of environment.

Fears of market overvaluation relate mainly to the U.S. stock market, which is currently experiencing a particularly long bull period. The S&P 500 has not seen a decline of more than 20% and has more than quadrupled since its March 2009 low. It is not unusual for such performance to raise doubts about U.S. market valuation. What’s more, some indicators, especially the ratio of U.S. market capitalization to nominal GDP, seem to point to a significant overvaluation (graph 5).

However, the ratio between market capitalization and GDP does not take into account interest rates and corporate earnings. These two variables underlie every serious fundamental stock market valuation, as the main characteristic of a share is to provide an entitlement to a company’s future profits.

The cyclically adjusted price-to-earnings (CAPE) ratio developed by Robert Shiller also shows that the S&P 500 is expensive from a historical perspective, but that unlike the tech bubble episode, it does not appear to be overvalued relative to the bond market (graph 6 on page 3). It is also important to understand that the CAPE ratio uses average real profits for the past ten years to valuate the S&P 500 (graph 7 on page 3). As the financial crisis is still pulling this average down considerably, one might wonder whether using a 10-year average is the best approach right now. An alternative CAPE ratio based on earnings for the past five years would be significantly lower and only slightly above its 30-year average.

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1 For example, see the [address](http://example.com) delivered by the Bank of Canada Governor Stephen Poloz before the Canada–UK Chamber of Commerce on November 5, 2018, entitled “Making Sense of Markets.”
Current Earnings Provide Solid Support

In our opinion, very high corporate profits mean that the U.S. stock market is not all that expensive today (graph 8). After the January surge of the S&P 500, the price/earnings ratio based on earnings for the past 12 months was fairly high at around 21; however, it has dropped recently to about 17, slightly below its average since 1987 (graph 9). A decline in this ratio is not surprising, as stock market indexes are stumbling and the spectacular surge in earnings is continuing. Companies comprising the S&P 500 are therefore headed for more than a 25% increase in profits in 2018. The U.S. tax reform certainly contributed to this excellent result, but a strong uptrend buoyed by record profit margins and robust sales growth was already noted last year (graph 10). Canadian companies are also posting quite remarkable profit growth, which drove the S&P/TSX price/earnings ratio down quite low.

An Interesting Opportunity for Investors with Strong Nerves

It is understandable for investors to be worried about the normalization of monetary policies and the potential end to the growth cycle. We should also expect the clearer rise in wages and interest rates to soon start putting the brakes on the spectacular earnings growth.
However, there is a big difference between a slowdown in profit growth and a drop in earnings that would justify a real bear market. Since a recession does not appear to be imminent, the recent decline in stock indexes and price/earnings ratios strike us as exaggerated and could be a good purchasing opportunity for investors ready to stomach some volatility. In buying the U.S. stock market at a time when it appears to be valued fairly correctly from a fundamental point of view, an investor can expect to make a pretty normal return of about 7% annually in nominal terms. The gains could be even bigger on the Canadian stock market, which seems downright affordable. With interest rates rising but staying very low, we would be hard-pressed to find more attractive assets at the moment. Some more pessimistic analysts recommend turning to the money market, but this option sentences investors to very limited returns. A number of international stock indexes are also an interesting option after many challenging quarters, but the economic and political risks appear much higher on the international stage, particularly in Europe and emerging countries.

Investors who today opt for the stock market must nevertheless be aware that a true bear market could occur once the growth cycle ends. However, in the long term, this type of fluctuation has little effect, as such corrections are often followed by an equally strong rebound when growth begins to accelerate again.

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