Special

INVESTING

Outlook: Volatility masks opportunity in U.S. economic renaissance

With extreme volatility, U.S. markets reaching new highs despite a reduced earnings forecast, and global markets reaching levels not seen since 2007, investors are understandably cautious. Are stocks overvalued?

Clément Gignac, chief economist at Industrial Alliance, has been a market observer for more than five decades. He shares his informed views in this Q&A.

Based on your analysis, are U.S. stocks overvalued?

We have a number of measures we apply to determine if markets are undervalued, overvalued or fairly valued. It's not always easy for people on Main Street to follow the various analytical approaches, so let's start with a simple, 5,000-feet view. The stock market is usually driven by earnings growth and interest rates; it's linked to GDP growth. That is the main reason that equities generally provide a better return than bonds over the long run.

However, there are also economic, business and stock market cycles. Market sentiment may shift from greed – the "irrational exuberance" of the late 1990s – to the fear of 2008 and 2009. This is the reality of the market, and the reason it's so important to have a long-term view.

If we use history as our guide, as well as research conducted by Credit Suisse and other international firms, we find that when you have inflation rates of between one and three per cent as we do today, stock markets generally trade at around 17 or 18 times profits. In early April, the S&P 500, the most commonly used benchmark for the entire U.S. market, traded at around 16 times the next 12 months' profit. From that angle, we can assess that it is probably close to being fairly valued, but it's not in an overvalue zone.

What is your response to those investors who see reduced corporate earnings forecasts and the return of high volatility as evidence that there are rocky times ahead?

To succeed in the equity markets, it's crucial to look further ahead than this quarter. If you see a recession around the corner, a market that is trading at 17 times earnings is not good news. But if you have confidence, as we do, that the U.S. economy is in renaissance mode – with a resilient economy, good consumer and business balance sheets, government that is addressing its fiscal mess and an energy revolution underway – it is reasonable to expect three, four or five years of continued economic expansion ahead.

With that outlook – along with, very importantly, low inflation – we expect the U.S. market to remain attractive for some time. Earnings growth expectations are still around six to eight per cent per year. At the same time, the 10-year bond yield in Canada is around 2.5 per cent; the U.S. 10-year bond yield is 2.75. There are no significant attractive alternatives to the stock market.

Given that, what is your longer-term outlook for U.S. equity returns?

The market will not always provide double-digit returns as it did last year, of course. But if earnings continue to grow at six to eight per cent per year, valuations remain fair, and share buybacks offer an additional two per cent, as we think they will, it is reasonable to expect that the market will deliver between eight per cent and 10 per cent returns on average (including dividends) for the next three to four years.

There will likely be some fireworks, years with double-digit returns, and other years with low single-digit and possibly negative returns, because we have not seen any large corrections in the last three years. It is probable the Federal Reserve will increase interest rates over the next two or three years, meaning return from fixed income of two or three per cent, compared to an eight to 10 per cent return on U.S. equities.

What is your view on the Canadian market?

We feel it has good potential over the long run, but given that financial and resource companies comprise two-thirds of the Canadian market, we see two primary risk factors.

The first is the behaviour of the real estate market over the next two to four years; any significant slowdown will affect the earnings growth of Canadian banks. The second is China's economic deceleration. It's not impossible that the next three to five years will be a bumpy road for commodities due to potential slowing demand from China, despite the reforms they've implemented.

In addition, technology is always the enemy of commodities over the long run. Shale oil, for example, was largely unheard of a decade ago. Now, because of shale oil, oil is not at the predicted $150 or $200 per barrel. It's around $100 per barrel, and the U.S. is expected to become the world's biggest oil producer in 2016.

The Canadian stock market's valuation is lower than the U.S. market. It is not overvalued, but given these risks and the Canadian market's lack of diversity, we see that lower valuation as reasonable.

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THE 20 RULE

In the 1960s, the "20 Rule" was a commonly used rule-of-thumb for market valuation, says Clément Gignac, chief economist at Industrial Alliance. Under the rule, "if the earnings ratio plus the rate of inflation is below 20, markets are considered fairly valued. If the market earnings ratio is 15 times earnings, with inflation at one per cent, the total is 16, significantly below the 20 Rule. If the market is at 20 times earnings with inflation at around two or three per cent, it means it is expensive, around 23.

"At 20 or less, it's probably a good idea to stay the course and remain invested. At 23, it's probably a yellow flag – consider reducing equity exposure and increasing fixed income exposure."

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