Economic Viewpoint

Desjardins Economic Studies
www.desjardins.com/economics

September 26, 2016

Some optimism still seems appropriate regarding North America's stock markets

A few years ago, we tried to forecast the returns of the main asset classes from 2013 to 2022. The U.S. stock market has wildly exceeded our expectations since then, recording annual growth of more than 15%, despite the lacklustre increase in profits. The last few years have been tougher for Canada's stock market, pummelled by the drop in commodity prices. Now that the worst of the impact from the oil shock seems to be behind us, and given that price/earnings ratios could remain relatively high, North American stock markets still seem to be able to deliver attractive returns over the medium term, especially if compared with the bond market's weak outlook. Investors should however be aware that stock markets are still likely to know some difficult periods, including when central banks will normalize their monetary policy or when the long expansion of the U.S. economy will come to an end.

HAVE RETURNS BEEN CLOSE TO OUR EXPECTATIONS?

In the fall of 2013, we published a study on the historic returns yielded by the major asset classes, and the outlook for the next ten years.[1] Our main conclusions were that, after getting the millennium off to a very difficult start, North American stock markets seemed to be well positioned to deliver an attractive average return of about 7.5% a year. Conversely, after 30 years of remarkable performance, the bond market seemed slated to post much smaller returns.

Without repeating the entire exercise, we thought it would be interesting to compare the performance of asset classes over the 2013–2015 period to our projections, and examine the relevance of revisiting our return assumptions for the coming years.

THE U.S. STOCK MARKET STOLE THE SHOW

The U.S. stock market has delivered an especially strong performance in recent years, with the rebound that started in 2009 continuing. Factoring in dividends, the S&P 500 delivered an annual average return of 15.8% from 2013 to 2015 (table 1 on page 2). This performance was inflated by a return of over 30% in 2013; last year, it only rose 1.4%. As forecast, the U.S. bond market's strong gains gave way to much smaller returns, with the Barclays U.S. Universal index only yielding an annual 1.55%.

The situation was otherwise in Canada, where the tumble in commodity prices pulled the S&P/TSX index down sharply in 2015, and prompted the Bank of Canada to further lower its key rates. Including dividends, the Canadian stock market still delivered an annual return of 5.1% from 2013 to 2015, slightly beating the bond market's 3.7% return.

An investor with a portfolio made up of 15% U.S. equity, 35% Canadian equity, 45% Canadian bonds and 5% Canadian 3-month T-bills would thus have earned an average annual return of 5.86% over the 2013–2015 period. This result is quite close to our initial forecast, which was for an average return of 5.40% for the 2013–2022 period. The U.S. stock market grew twice as fast as anticipated, however, making up for the Canadian stock market's difficulties. Expressed in Canadian dollars, the U.S. stock market's performance is even more impressive, posting average annual growth of 25% from 2013 to 2015.

THE U.S. MARKET'S SURGE WAS NOT BASED ON EARNINGS

A stock index's increase can be broken down into the earnings growth of the companies that make up the index,

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "Long-term major asset class returns – After a lost decade, the stock market seems to offer better opportunities," September 25, 2013, www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv130925.pdf.

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Table 1
Assumptions and forecast returns

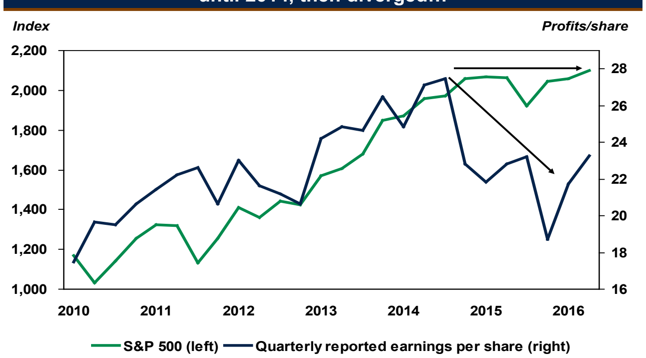
Average annual growth in %	*Original forecast for 2013–2022* United States	Canada	*2013–2015 results* United States	Canada	*New forecast for 2016–2022* United States	Canada
Main assumptions						
Nominal GDP	4.75	4.00	3.57	2.91	3.75	3.40
Profits	4.75	4.25	0.84	-12.16	7.00	14.00
Price/earnings ratio*	16	15	24	36	20	20
Dividends	2.75	3.25	2.40	3.11	2.50	3.00
10-year yield*	5.00	5.00	2.27	1.40	2.75	2.25
Results						
Stock markets	7.50	7.50	15.82	5.08	7.00	8.00
Bonds	3.00	3.25	1.55	3.71	2.75	2.25
Canadian portfolio**	---	5.40	---	5.86	---	5.00

* End of the period; ** 15% U.S equity, 35% Canadian equity, 45% Canadian bonds and 5% Canadian 3-month T-bills.
Source: Desjardins, Economic Studies

and the change in the index's valuation, i.e. movement of the price/earnings ratio.

We must conclude that the U.S. stock market's excellent performance from 2013 to 2015 is not based on profit growth. After the strong advance that took it to a historic high in the third quarter of 2014, the S&P 500's earnings per share plunged over 30%, ending 2015 very close to where they were at the end of 2012 (graph 1).

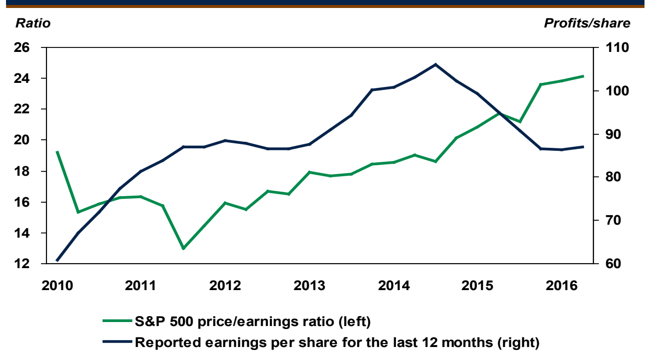
Graph 1 The S&P 500 and its earnings had strong growth until 2014, then diverged…



Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies

Accordingly, the U.S. stock market's excellent performance since the end of 2012 is essentially due to an increase in price/earnings ratios. The ratio, which is based on the earnings for the last 12 months, went from 16.5 at the end of 2012, a relatively normal level, to 23.6 at the end of 2015 (graph 2). A rise this fast by price/earnings ratios could raise concerns for investors.

Graph 2 … leading to a notable increase in price/earnings ratios

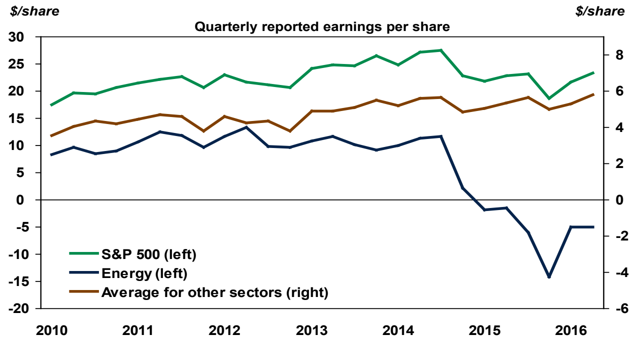


Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies

THE EARNINGS CORRECTION SEEMS TO BE OVER

Profit growth is determinant for the stock market's medium-term performance. It would thus be hard to stay optimistic about this asset class if we thought the recent earnings downtrend would persist. The disappointing profit growth since the end of 2012 can, however, largely be explained by the problems of the energy sector, which has had to grapple with a spectacular tumble in oil prices since mid-2014. The earnings per share of the S&P 500's energy component went from $9.59 at the end of 2012 to a loss of $14.21 at the end of 2015. Conversely, an index representing an unweighted average of earnings per share in the other sectors shows growth of 32% over the same period (graph 3 on page 3).

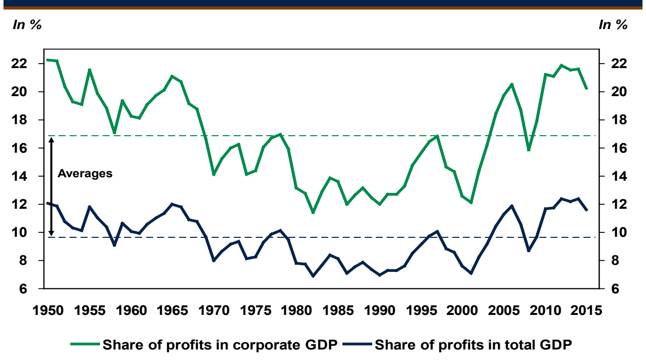
Graph 3 Decrease in profits stems mainly from the energy sector



Sources: Datastream and Desjardins, Economic Studies

In addition to the problems in the energy sector, profit growth is slowing somewhat in other sectors. The strong greenback has, of course, contributed to the difficulties in some sectors, including manufacturing. Beyond the currency effect, slowing profit growth is not surprising. The surge in profits after 2009 pushed profit margins and the proportion of profits in GDP to very high levels (graph 4). For this reason, our 2013 study anticipated that profit growth would slow, nearing GDP growth. The signs of wage acceleration in the United States are another reason to look for a fairly subdued rise in earnings. We therefore find it reasonable to look for profit growth that is similar to nominal GDP growth once the effects generated by the oil price collapse have dissipated.

Graph 4 Share of profits in U.S. GDP remains high



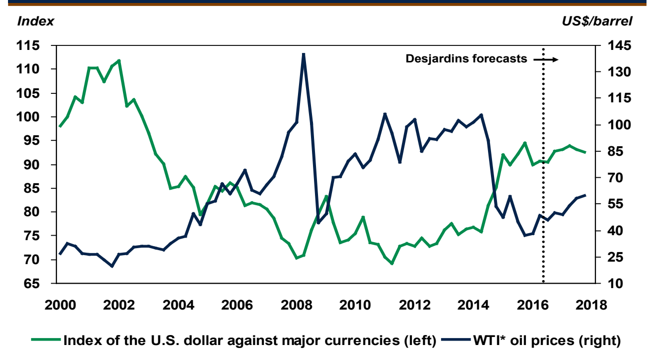
Sources: Datastream and Desjardins, Economic Studies

IS THERE REASON TO WORRY THAT PRICE/EARNINGS RATIOS WILL FALL?

In our 2013 analysis, we assumed that price/earnings ratios would remain stable, at around 16 for the S&P 500. In the end, they have jumped in recent years, hitting relatively high levels. A relapse in price/earnings ratios would have a big impact on the stock market's performance. This certainly represents one of the major risks for the stock markets. For example, if the ratio based on past earnings had ended 2015 at 16 rather than 24, the S&P 500 would have been at just 1,384 instead of 2,044.

There are, however, good reasons not to worry too much about the fact that this ratio is currently relatively high. Firstly, an increase in ratios that are based on past earnings is fully justified after earnings temporarily drop, if we expect them to then go back up. With the major surpluses in the global oil market having made way for a balanced market, oil prices have gone up substantially in the last few months and we expect them to return to around US$65 a barrel in a few years. This price rebound, combined with major productivity gains, should result in a substantial increase in profits in the U.S. energy sector. The greenback's movement also promises to be less unfavourable to U.S. corporate profits in the coming quarters (graph 5).

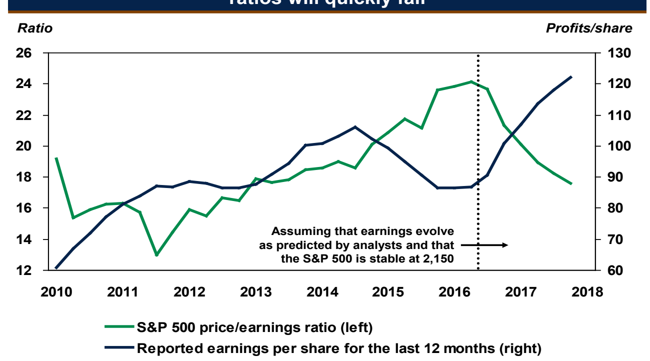
Graph 5 Changes in oil prices and the U.S. dollar looking more favourable



* West Texas Intermediate.
Sources: Datastream and Desjardins, Economic Studies

In this context, we have already seen the earnings of S&P 500 corporations go up since the beginning of 2016; analysts expect this trend to pick up speed in the next few months, taking profits to a new quarterly peak at the end of the year (graph 6). The profit increase forecast by analysts would

Graph 6 If earnings rebound as analysts expect, price/earnings ratios will quickly fall



Sources: S&P Dow Jones Indices, Datastream and Desjardins, Economic Studies be enough to take the price/earnings ratio to around 21 at the end of 2016 and 18 at the end of 2017. These earnings forecasts seem a little too optimistic to us, but it does seem appropriate to expect earnings to rise substantially in the coming quarters as the temporary effects that had dragged them down since mid-2014 gradually dissipate. After that, profit growth should be in line with economic growth.

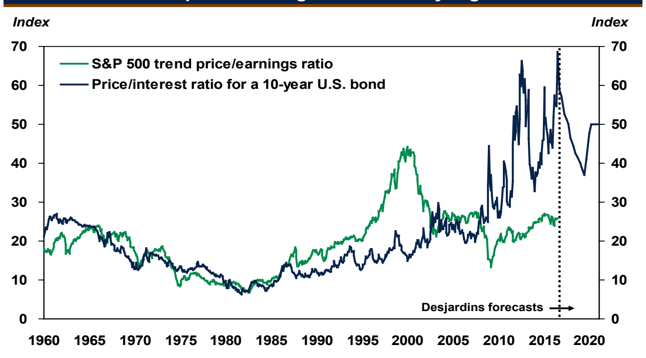
ONGOING LOW BOND YIELDS ARE GOOD FOR THE STOCK MARKETS

When our study of returns was released in 2013, we assumed that North American bond yields would rise slowly in the years to come, eventually getting close to their historic average: about 5% for federal 10-year yields. In the end, U.S. yields have been relatively stable to date instead, at around 2% for the federal 10-year bond, with Canadian yields falling to new lows. This allowed the Canadian bond market to post a slightly higher return than we expected. The problem for the bond market is that while a drop in yields is positive for short-term returns, it reduces the potential for future returns. Over a long period, the bond market's returns thus essentially reflect the bond yield at the start of the period, not the subsequent movement in yields.

Given the highly aggressive measures instituted by numerous central banks and the fact that economic agents seem less and less able to cope with a substantial interest rate hike, we have substantially downgraded our forecast for bond yields. We still expect them to climb slowly, but North American 10-year yields should top out below 3% over the medium term.

Bond yields will therefore remain very low, historically speaking; in other words, the bond market will stay expensive. The price/interest ratio for a U.S. 10-year bond, which is similar to the price/earnings ratio for equity, should therefore stay above 30 over the medium term, compared with a historical average that is closer to 20 (graph 7). Low interest rates also suggest that prices for other assets will stay relatively high, for example, real estate. In a very low interest rate environment, it is normal for all assets that offer some form of income to be relatively expensive. This situation suggests that price/earnings ratios could also stay above their historic average over the medium term. Rather than expecting the ratio based on past earnings to be at 16 over the medium term, it now seems appropriate to look for a ratio of 20.

Graph 7 In a world of low interest rates, it would be normal for price/earnings ratios to stay high



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

ECONOMIC OUTLOOKS MAY BE SLIGHTLY LESS FAVOURABLE

The global economy has continued to deliver a mixed performance in recent years, and the tumble taken by oil prices had put inflation below central banks' target levels. Nominal GDP thus grew an average of just 3.6% in the United States and 2.9% in Canada from 2013 to 2016; in our previous study, we were forecasting average respective growth of 4.75% and 4.00%. This slightly disappointing growth had a hand in the subdued advance of corporate profits. Given the late stage in the economic cycle, we now look for growth of 3.75% for U.S. nominal GDP, and 3.40% for Canada's nominal GDP through 2022.

RETURN OUTLOOKS HAVE NOT CHANGED MUCH

It is completely normal for the returns on asset classes to temporarily diverge from their medium-term trend. This is especially true in the event of a major shock, such as the recent oil price correction. Beyond the shock's impacts, which could still be felt for some time, the outlook for medium-term returns of the major asset classes have not changed much from what we found in our 2013 study (table 1 on page 2).

In particular, we are still convinced that North America's stock markets offer better return prospects than the bond market. Ongoing very low interest rates over the medium term could even justify higher price/earnings ratios than we previously anticipated. Despite the strong performance seen in the last few years, we therefore still expect an attractive annual return of about 7% for the U.S. stock market to 2022.

The weaker outlook for oil prices could have a longer-term impact on the Canadian stock market, as profitability of the oil sands sector could remain much lower on a permanent basis. In this context, it seems that the S&P/TSX will have trouble reaching the levels suggested by our 2013 study at the end of 2022. Nonetheless, after the 2015 decline, the return outlook for the S&P/TSX is fairly good for the years to come. The comeback by commodity prices has already generated an increase of over 10% in the Canadian stock market since the start of 2016, and we should continue to see some catching up in the next few years as oil prices keep rising gradually. For the 2016–2022 period as a whole, we therefore expect the S&P/TSX to return 8%, including dividends.

Given the further drop in interest rates since the end of 2012, the return outlook for Canada's bond market seems even lower over the 2016–2022 period, with annual growth of 2.25% for the FTSE TMX Universe index.

THE END OF THE ECONOMIC EXPANSION CYCLE COULD CURB RETURNS

Overall, the medium-term outlooks thus remain fairly good for the stock markets. As we have seen in Canada since mid-2014, some events could however create more difficult periods for the markets. As we noted earlier, low interest rate is an important favorable factor for stock markets. Any sign that central banks, especially the Federal Reserve (Fed) in the United States, could tighten monetary policy faster than expected, and thus drive up interest rates, would thus likely cause a temporary stock market declines. Investors' nervousness at the approach of the September meeting of the Fed has illustrated this phenomenon. Our return forecasts already assume, however, a gradual rise, albeit limited, of interest rates.

Another event for investors to keep an eye on is certainly the potential end to the U.S. expansion cycle within a few years. The U.S. economy's recovery after the last recession was not spectacular, but it has now lasted about seven years. Since 1945, expansion periods have lasted an average of just under five years, according to the National Bureau of Economic Research (NBER). It therefore seems likely that the U.S. economy will see a recession before 2022, although, at this point, nothing suggests that the cycle is ending. A recession in the United States could pull down profits and the stock markets for several years. It could therefore be advantageous for investors with fairly short investment horizons to reduce their exposure to the equity markets when a U.S. recession seems to be coming. However, adjusting a portfolio at the right time is very difficult to do. Investors with a long investment horizon and do not want to take tactical positions would, in our opinion, do better to accept the risk of a temporary drop in the stock markets and bank on the rebound that usually comes after a recession.

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