Economic Viewpoint
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Would an entry in bear market territory be justified for the U.S. equity market?

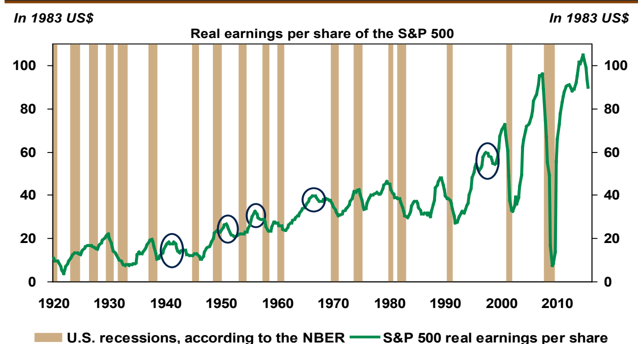
The beginning of the year was a particularly turbulent one for financial markets and equity markets in Japan and Europe have recently entered into bear-market territory. The U.S. stock market was also ruffled by the spike in risk aversion, in addition to being bothered by a downturn in profits and concerns about the health of the U.S. industrial sector. While the S&P 500 has recovered a bit recently, the climate remains volatile and it would not take much more by way of additional declines to also lead it into bear-market[1] territory. However, a bear market also implies that investors discount a high probability of recession in the United States. In this *Economic Viewpoint*, we analyze the causes of investor pessimism and weigh in on the question of whether the major fall in the S&P 500 is fully justified from a fundamental standpoint. Our conclusion is that investor bearishness is overdone and that the U.S. stock market is poised to soon constitute an attractive opportunity.

WHAT BOTHERS EQUITY INVESTORS?

There are many motivations behind the current stock market rout. One of the most commonly cited factors is the peak reached in the U.S. earnings' cycle last year. According to Bloomberg data, in the fourth quarter, S&P 500 earnings fell 6.5%, marking a third consecutive contraction. Profits in the U.S. equity market are thus in recession, prompting some to posit that an outright recession might be around the corner. The large body of empirical research that has fleshed out the variables that reliably predict U.S. recessions, has seldom come across company earnings. Turning points in profits are in fact a dime a dozen, and while recessions are almost invariably accompanied by profit contractions, the opposite is not necessarily true. There have been numerous instances of so-called real profit recession, without a macroeconomic recession (graph 1).

Furthermore, the current turn in profits is no generalized event. To a meaningful degree, energy and materials are responsible for the overall contraction (graph 2 on page 2). As of Q4, overall operating profits are down 0.3% on a year-over-year basis but profits excluding these two sectors are in fact up 10.4%. The same can be said about revenues, which are down 2.4% year-over-year for the S&P 500 as a whole, as of Q4. This decline is largely concentrated in energy and materials, which exhibit respective revenue declines of 35% and 10%.

Graph 1 There have been many profit turnarounds without an economic recession



Sources: Robert J. Shiller, National Bureau of Economic Research and Desjardins, Economic Studies

We should also point out that beyond commodities and the impact of the stronger U.S. dollar for U.S. businesses with international exposure, rising labour costs constitute another impediment to profits. In 2015, unit labour costs boasted their highest pace of growth post-recession (graph 3).

[1] In this analysis, a correction is defined as a drop of more than 10% in the index, while a bear market is defined as a decline of more than 20%.

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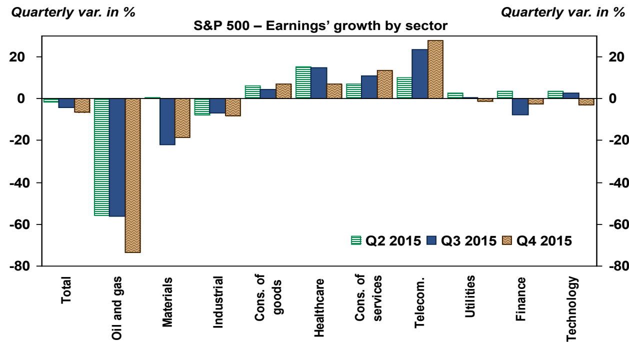
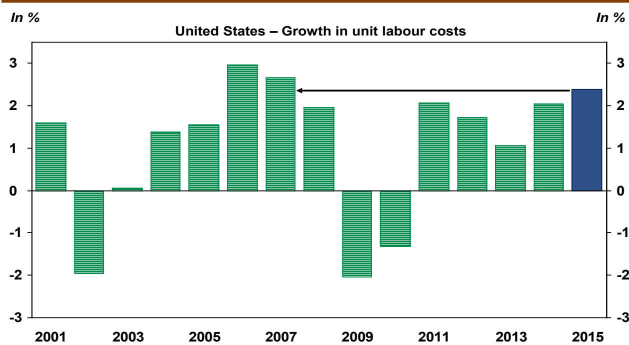
Graph 2 Commodity related sectors are the ones struggling the most



Sources: Bloomberg and Desjardins, Economic Studies

However, this situation has its advantages. With rising wages and strong employment dynamics, U.S. consumers benefit from a renewed capacity to spend. Whether they elect to use this capacity currently or to spread it out over time (implying a higher saving rate in the near term) should not be all that consequential. The key point is that sooner or later, corporations should get their redemption via stronger top lines, if one assumes that the macroeconomic cycle still has legs. We will expand on this further.

Graph 3 Strongest growth in unit labour costs in the last eight years

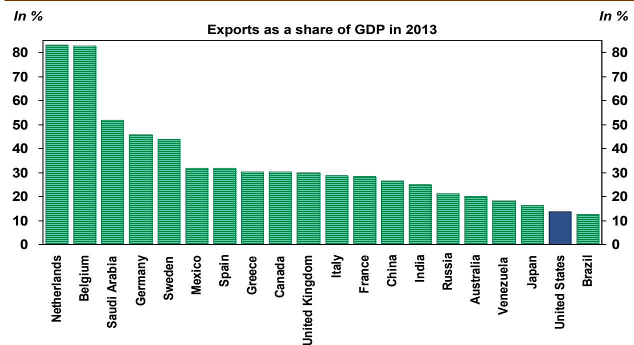


Sources: Datastream and Desjardins, Economic Studies

Another source of preoccupation for the equity market has been the mess in China. The Shanghai stock index is off nearly 50% since last June and Chinese authorities have been at pains, trying to simultaneously stabilize equities and the renminbi. But should it matter all that much for the United States? The Chinese stock market is less than a tenth of the size of the S&P 500 and foreign exposure has been limited by restrictions on capital inflows.

There is nonetheless a growing belief that China's attempts to sustain its currency in the face of pervasive capital outflows is doomed to fail, and that the inevitable tumble in the renminbi will send a disinflationary impulse globally. All else equal, this would imply an even stronger U.S. dollar (especially with some abatement in the liquidation of Chinese official reserves), and provide for an even more powerful headwind to U.S. exports. Even if this "endgame" scenario came to fruition, the U.S. economy is one of the most capable of tolerating weakness in its trade sector. Relatively speaking, exports account for a small fraction of GDP (graph 4). The U.S. economy managed to grow at a respectable pace of 2.4% last year, despite net exports penalizing growth in the order of 0.7 percentage points.

Graph 4 The weight of exports in U.S. GDP is relatively small



Sources: World Bank and Desjardins, Economic Studies

Thirdly, we cannot omit the puzzling oil-equity nexus that has characterized market action in recent months. The correlation between crude oil has approached the level of perfection, despite lower fuel prices providing a meaningful boost to economic activity. The United States just recorded its best year of vehicle sales since 2000, driven by some rekindled appetite for large, albeit less fuel-efficient types of vehicles. Vehicle miles-driven, which were flat ever since 2009, are suddenly growing again. Even though weak oil prices raise the specter of bankruptcies and defaults in the energy sector, there is no too-big-to-fail in the energy sector. Loans extended to the oil and gas sector account for less than 5% of U.S. major banks' lending books. We thus fail to see how the slide in oil prices is negative for the U.S. economy on net.

WOULD A BEAR MARKET BE JUSTIFIED FROM A FUNDAMENTAL STANDPOINT?

From a fundamental perspective, the bearish view on U.S. stocks finds most validation in the industrial sector. The combination of a strong currency, weak emerging market growth, and an unravelling energy sector has inflicted material damage to industrial activity, exacting a heavy toll on the manufacturing sector. The ISM manufacturing index has been in contraction for four consecutive months (i.e. from October through January). Historically, there is a fairly close link between the equity market cycle and the

Of bear markets and corrections...

Entry into bear market for the U.S. equity market would signal that elevated recession probabilities are being priced in. Looking back to 1970, there has been six bear markets. Bear markets span over 491 days on average, and the recovery to the previous peak typically takes well over 1000 days, from the moment a bottom has been formed (table 1).

Table 1
Entry into bear market

Beginning	End	Magnitude of the contraction	Length of the contraction	Length of the recovery	Recession
		in %	in days	in days	
January 1970	May 1970	25.90	141	238	x
August 1973	March 1974	48.00	633	2,111	x
November 1980	August 1982	26.90	623	83	x
August 1987	December 1987	33.30	105	600	
March 2000	October 2002	49.00	926	1,685	x
October 2007	March 2009	56.50	515	1,463	x
Average		**39.90**	**491**	**1,030**	

Source: Desjardins, Economic Studies

By contrast, there have been eight non-bear-market corrections, and only two were accompanied by a recession (in the early 1990s) (table 2). Corrections last an average 145 days and the subsequent recovery to the previous peak takes only 100 days. Currently, the correction runs slightly over 200 days, but it must be noted that the length of correction phases has been historically highly dispersed, going from 42 days (in 1998) to 398 (in 1983 and 1984). Naturally, the past is not prologue, and these experiences can only serve as a guideline. But if one believes that a recession/bear market scenario is implausible, U.S. equities might be able to find their footing.

Table 2
Non-bear-market corrections

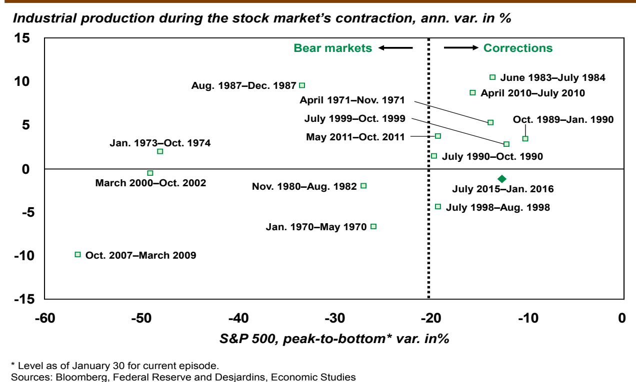
Beginning	End	Magnitude of the contraction	Length of the contraction	Length of the recovery	Recession
		in %	in days	in days	
April 1971	November 1971	13.80	208	71	
June 1983	July 1984	13.60	398	176	
October 1989	January 1990	10.20	113	119	x
July 1990	October 1990	19.60	86	123	x
July 1998	August 1998	19.20	41	84	
July 1999	October 1999	12.10	91	32	
April 2010	July 2010	15.60	67	120	
May 2011	October 2011	19.20	154	120	
Average		**15.41**	**145**	**106**	

Source: Desjardins, Economic Studies

manufacturing cycle. From the perspective of the decline in industrial production since July, the current correction could in fact be construed as justified. In fact, in all the market corrections since 1970 that were accompanied by industrial production contractions, a bear market was avoided in only one instance (graph 5).

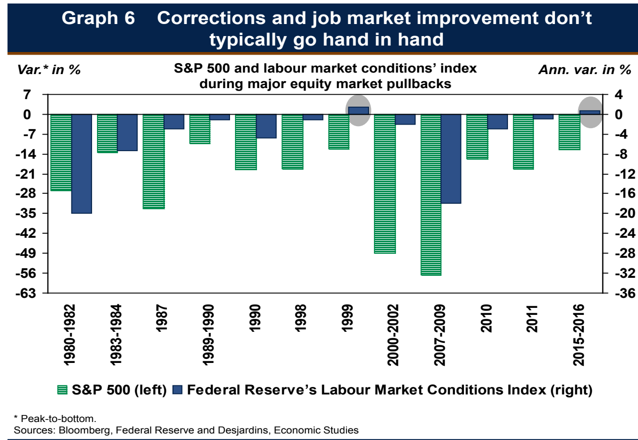
The current context nonetheless stands out relative to prior episodes. Traditionally, a slowdown in manufacturing is accompanied by a weaker job market, which reinforces equity market pessimism. In the present case, the manufacturing sector is weakening while the job market continues to improve. The Federal Reserve's Labor Market Conditions Index has kept on a rising trend since last July,

Graph 5 Bear markets are more frequent in situations where industrial production is in contraction



* Level as of January 30 for current episode.
Sources: Bloomberg, Federal Reserve and Desjardins, Economic Studies

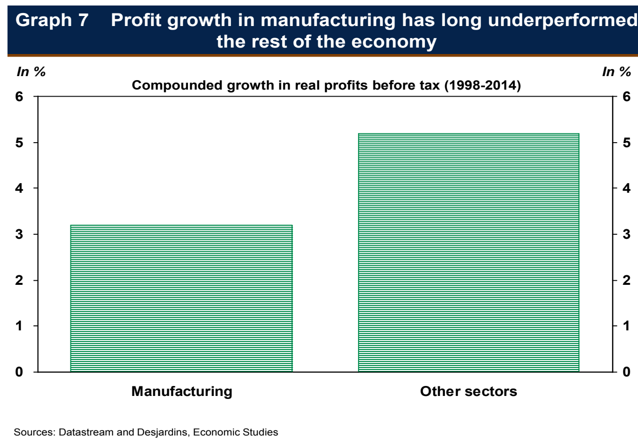
all while the S&P 500 experienced a decline of nearly 15%[2]. To put this in context, in the history of stock market corrections and bear markets going back to 1976, only once before did stock markets sell off sharply despite an improving job market. It was during the tech bubble of the late 1990s (graph 6).



Graph 6 Corrections and job market improvement don't typically go hand in hand

* Peak-to-bottom.
Sources: Bloomberg, Federal Reserve and Desjardins, Economic Studies

What to make of these two conflicting signals? We tend to believe that the manufacturing cycle is a less potent determinant of overall returns than in the past. This is simply because the manufacturing sector's share of the U.S. economy is fundamentally smaller than it was a few decades ago. Only two of the ten largest companies by market capitalization on the S&P 500 are pure traditional manufacturers (Johnson & Johnson and General Electric). Real manufacturing profits have been growing at a slower pace than that of earnings in other sectors since the late 1990s (graph 7), without preventing the S&P 500 from generating a total return of 7.1% on an annual basis since then.



Graph 7 Profit growth in manufacturing has long underperformed the rest of the economy

Sources: Datastream and Desjardins, Economic Studies

By contrast, the job market remains a central pillar, particularly in an economy for which personal consumption expenditures and residential investment account for a combined 71% of GDP. If we rely more on the job market to assess the fundamental context, there is little justification for an entry into bear market for U.S. stocks.

OUR VIEW

At the time of writing, the S&P 500 has recovered above 1,900 points, which tends to confirm our scenario of a correction episode, like many others. Given the magnitude of daily movements since the beginning of the year, one should not overlook the probability that a new phase of risk aversion drives the market lower again, perhaps even into bear-market territory. But a bear market would not be justified economically speaking. Our models currently place the odds of a U.S. recession at about 20%.

At 3.1% in 2015, growth in U.S. consumer spending was healthy. The hiring rate stands at its highest level since 2007. So far, consumer confidence has proven impervious to current market turmoil and spending capacity is enhanced by quickening real personal disposable income growth and savings on fuel expenditures. The S&P 500 is currently priced at 15.4 times 12-month forward earnings, only fractionally above its average of the last 30 years.

As volatility continues ro recede, U.S. equities should present some attractive opportunities. Our total return target stands at 7.0% for the S&P 500.

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[2] Between July 20, 2015 and January 20, 2016.