

VIEWPOINT

Correction Territory: Assessing the Current Equity Environment

MICHAEL P. REILLY | AUGUST 21, 2015

Friday's stock market decline pushed the Dow Jones Industrial Average into "correction" territory, down 10.1% from its mid-May peak, with the S&P 500 Index now 7.5% below its record high. While the most immediate impact of China's recent surprise devaluation of the yuan was to exacerbate the rout in emerging markets currencies and stock markets, as well as commodity prices, the heightened risk of a synchronized slowdown in global growth provided the catalyst for the U.S. stock market sell-off.

During bouts of equity market volatility such as the present one, it is instructive to assess the fundamentals – specifically the outlook for corporate earnings. U.S. stocks have proven tremendously resilient during the bull market of the past six-plus years, buoyed by the Fed's extraordinarily accommodative monetary policy as well as the relatively steady progression of corporate earnings growth. The Fed has clearly signaled its intent to attempt lift-off from its zero-rate policy, although its task has just become more complicated due to macroeconomic events abroad and their reverberations across the capital markets. Up to this point, U.S. stocks have been able to digest the headwinds faced by corporate earnings due to persistently anemic GDP growth (i.e., around 2.0-2.5%), a strong dollar, and the evisceration of energy sector earnings due to the plunge in energy prices. With 94% of S&P 500 companies having reported 2Q15 earnings, RBC Capital Markets calculates that earnings growth, which was flat on a year-over-year basis, would have been up 7.3% excluding the energy sector. However, consensus earnings growth estimates that presently point to 5% year-over-year growth are at risk to the downside should the slowdown in global growth intensify. Thus, while the S&P 500's current price-earnings ratio of 16.7 times this year's consensus earnings expectations is close to the three-decade average and, on the surface, not particularly expensive nor cheap, the present market volatility reflects the uncertainty associated with the denominator – namely, the resilience of corporate earnings.

During a typical year, the stock market experiences several pullbacks on the order of 5%, and after nearly four years without a stock market correction, the current weakness has been all the more noteworthy and may persist with both the Fed and investors in "data dependent" mode. Yet, barring a Fed policy "error" that tips the U.S. economy into recession, we believe that U.S. corporate fundamentals remain solid given generally deleveraged corporate balance sheets, high cash balances, and near-record profit margins, while valuation ratios are consistent with their long-term averages, supported by continued robust M&A activity.

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