GLOBAL MARKETS UPDATE

8th Jul. 2010

CAPITAL ECONOMICS

Is the worst over for the US stock market?

- **The US stock market has rebounded a little this week. We don't expect a much stronger showing over the remainder of 2010 and are sticking with our view that the S&P 500 will end the year at around 1075, a little above where it is now. We do, however, think a fresh slump is unlikely for three reasons.**
- **First, the economic outlook is not as bad as many now seem to assume.** True, there have been signs that the recovery has shifted into a lower gear. (See our *US Economics Weekly*, 5th July.) Yet we still think GDP growth is likely to top 3.5% at an annualised rate in the second half of 2010, and come in around 2.5% in 2011. This would be less impressive than the second quarter of this year, during which we think the economy grew at an annualised rate of 4-5%. But it would be a far cry from a renewed slide into recession. What's more, we have been expecting the economy to slow. The fact that this is now happening does not give us a reason to alter our forecast for the stock market.
- Of course, what really matters to investors is the outlook for profits. All eyes will be on the second quarter earnings season, which is scheduled to get underway today. While the Q2 numbers will undoubtedly have an impact on the near-term direction of the stock market, we think it is more important to focus on where earnings are heading. The domestic profits of US non-financial companies – as reported in the National Income and Product Accounts – have rebounded over the past year or so as firms' costs have fallen more quickly than their selling prices. However, the growth rate has begun to slow. We think earnings could continue to grow for one or two more quarters as margins edge slightly higher. However, we suspect that profit growth will grind to a halt and turn slightly negative later this year. Again, though, this is something that we have already assumed will happen.
- **Second, we doubt that investors' appetite for risk is likely to wane a great deal more in the near term.** Although Europe's fiscal crisis has been – and should remain – a legitimate source of worry, things are unlikely to reach a head for a year or two. Meanwhile, concerns about China should ease as it becomes clear that its economy is not heading for a hard landing. Finally, central banks in the major developed economies are still providing huge amounts of liquidity and are unlikely to raise interest rates for the foreseeable future. The risk premium attached to equities is not something that can be observed directly. However, it ought to mirror broadly the risk premium attached to corporate bonds. The spread of BBB-rated 7-10 year US corporate bonds over Treasuries of an equivalent maturity has already increased by nearly 70bp since late April. While the spread was a lot bigger at the height of the financial crisis, it is now well above its average of the last decade. (See Chart 1.)
- **Third, the stock market does not appear to be *dramatically* overvalued by historical standards.** Admittedly, the cyclically-adjusted price/earnings ratio of the S&P 500 and Tobin's Equity Q for the US non-financial corporate sector are still well above their long-run averages. (See Chart 2.) But the market has been much more overvalued at times in the past. The obvious example is before the dot com bubble burst in 2000. The fact that the stock market is not in a similar bubble today does not preclude a sharp fall, but it ~~does provide some comfort.~~

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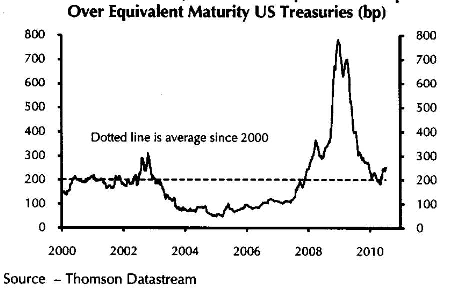
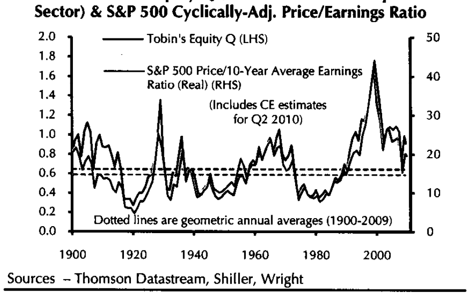
Chart 1: US BBB-Rated, 7-10 Year Corporate Bond Spread Over Equivalent Maturity US Treasuries (bp)



Source – Thomson Datastream

Chart 2: Tobin's Equity Q (US Non-Financial Corporate Sector) & S&P 500 Cyclically-Adj. Price/Earnings Ratio



Sources – Thomson Datastream, Shiller, Wright