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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

A rough ride back to normal

While volatility came roaring out of hibernation, the market correction is unlikely to alter the encouraging economic and earnings outlook. Look for the bull market to get back in gear later in the year.

Jim Allworth

For important and required non-U.S. analyst disclosures, see page 7

All values in U.S. dollars and priced as of February 28, 2018, market close, unless otherwise noted.

RBC Wealth Management

A rough ride back to normal

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Equity markets had been so calm for so long, so investors can be forgiven for forgetting how a "normal" stock market behaves. The rough ride of the past few weeks has taken some excessive valuation and investor complacency out of the mix. But it is unlikely to have any noticeable effect on the global economy or on the encouraging corporate earnings outlook. The correction may have further to run, but we expect new highs and a resumption of the long-term bull market later in the year.

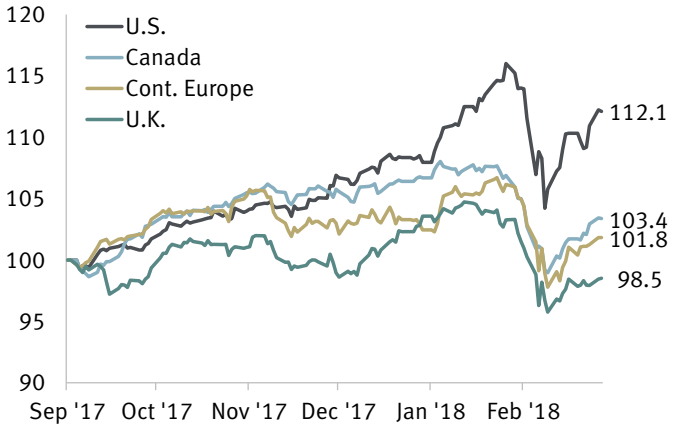
Equity investors have been taken on a wild ride. The wildest has been in the U.S., where starting from just before the tax cut deal was struck in early December, the S&P 500 stormed higher to a peak of 2970, a very fat gain of 7.8% in just seven weeks. And then, abruptly, the market gave that back and a whole lot more, falling at its worst moment by 11% back to where it had been in September, just before Congress had begun to believe tax cuts were even possible.

What produced all that upside into the January high? Back in September, when tax cuts seemed remote, consensus estimates had S&P 500 earnings rising to $142 per share in 2018, fueled by faster U.S. and global GDP growth and largely confirmed by management guidance—a nice improvement on the $132 expected for 2017.

Once the possibility of a big corporate tax reduction began to gain traction, that $142 estimate started to rise week by week, reaching $156 per share not long after the cuts were signed into law. That's a jump of about 10% in expected earnings for 2018; however, between September and the market peak in January the index powered higher by a startling 16%, pushing up the forward price-to-earnings (P/E) multiple to 18.4x from 17.4x.

And then the tide turned abruptly. The major indexes plummeted in just two tumultuous weeks back to where they had been four months earlier in September

A tale of four indexes



A painful pullback felt around the world.

Source - RBC Wealth Management, Bloomberg; data as of 10:30 am CST 2/27/18

of last year. The severity of the drop was exacerbated by the unwinding of several large volatility-linked investment funds whose particular structure forced the accelerated selling of stocks as prices fell and market volatility surged higher. Eventually selling was exhausted and buyers arrived, attracted by lower valuations than had been available for more than a year—16x forward earnings at the February low.

Dissecting the correction

But what triggered the downturn? And was the sharp advance in the market's P/E multiple up into the January peak justified? Probably not is the answer to the second question, at least not over so short an interval.

The most widely cited trigger for the stock market downturn was a U.S. Labor Department report that showed average hourly earnings in the manufacturing sector had unexpectedly surged, raising the spectre of an increase in inflation and even higher bond yields and therefore lower P/Es. As we have noted, the resulting market decline quickly became self-reinforcing and self-fulfilling, despite the fact the hourly earnings surge was quickly assessed by some as an extreme-weather aberration.

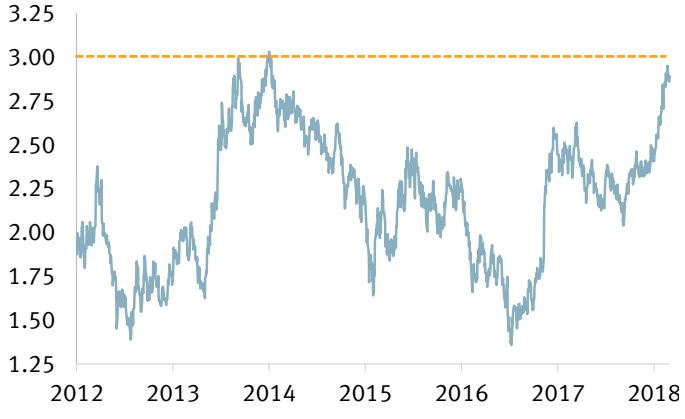
P/Es pushed down by rising yields, but pulled higher by earnings growth.

We think there is more to the story.

Two things are usually pointed to as factors that can provoke a change in P/E multiples. One would be a change in the discount rate (the 10-year U.S. Treasury yield) used to calculate the present value of future earnings—the lower the discount rate the more future earnings are worth today, justifying a higher P/E ratio. So, when the 10-year yield moved sharply higher from a depressed 2.06% in September to a chunky 2.70% in January, one would have expected the P/E multiple to move down. Instead, it moved higher, from 17.4x to 18.4x 2018 estimated earnings.

Treasury yields surged near the 2014 high-water mark

10-year Treasury yield (%)



Rising yields should have depressed P/Es.

Source - RBC Wealth Management, Bloomberg; data through 2/28/18

The other factor that could argue for a change in the market's P/E ratio would be a shift in the long-term average growth rate of S&P 500 earnings per share. In this case, many investors believe that tax cuts have unleashed an increase in these long-term growth prospects. We are not convinced.

So far, what we know for sure is that the reduced tax rate should boost after-tax margins by an amount equal to the tax savings in 2018 and that American companies should be able to sustain that improvement through 2019—corporate managements have said as much.

Beyond that it is much murkier. Will companies choose to reinvest these extra cash flows in their businesses or instead, distribute them as increased dividends and/or buybacks, neither of which would justify a sustained higher P/E? If they do plow the tax savings back into their businesses will those companies earn as high a return on this new addition to shareholders' capital as on their existing capital stock? Maybe eventually, but probably not at once.

Might some of this improved margin be sacrificed to more intense competition, given U.S. consumers are getting only a very modest lift from the personal tax changes? Or, alternatively, in a very tight labor market could wage increases take away from the corporate bottom line much of what the new tax legislation has given?

For now, we know about as much as we can know about what earnings should be reported this year and next. CEOs in the U.S. have given forthright guidance about what effect tax cuts will have on the bottom line and about their enthusiasm for the business outlook. We expect it will be at least six months, probably longer, before events could conspire to seriously challenge RBC Capital Markets' upbeat view that has S&P 500 earnings per share rising by 17% this year to $155, and by a further 7% to $167 in 2019.

Fallout shelter

Worries that recent market volatility will produce economic fallout are misplaced, in our view, and in the view of Fed Chairman Jerome Powell, who stated in his recent congressional testimony that the Fed believes the market gyrations will have little or no effect on the course of economic growth. Our recession indicators,

No sign of a U.S. recession on the horizon.

Recession scorecard

Start of recession	Yield curve	Inflation trends	Labor market	Credit performance	ISM Mfg.	Earnings quality	Housing market
Nov '73	↓	↓	↓	↓	↓	–	↓
Jan '80	↓	↓	↓	↓	↓	–	↓
Jul '81	↓	↑	↑	↓	↓	–	↓
Jul '90	↓	↓	↓	↓	↓	↓	↓
Mar '01	↓	↓	↓	↓	↓	↓	↔
Dec '07	↓	↓	↔	↓	↓	↓	↓
Present	↑	↑	↑	↑	↑	↑	↑

Key: ↓ Recessionary ↑ Expansionary ↔ Neutral

Note: Past performance is not indicative of future performance
Source - RBC Wealth Management's national research correspondent as of 3/1/18

several of which typically give long advance warning of an impending economic downturn, are all still giving firmly positive readings.

Outside of the U.S., German business confidence is at a 30-year high. Confidence across most of the eurozone is similarly elevated. Japan, China, and India all seem to be thriving, as is Canada despite concerns about the potential for adverse trade and NAFTA outcomes.

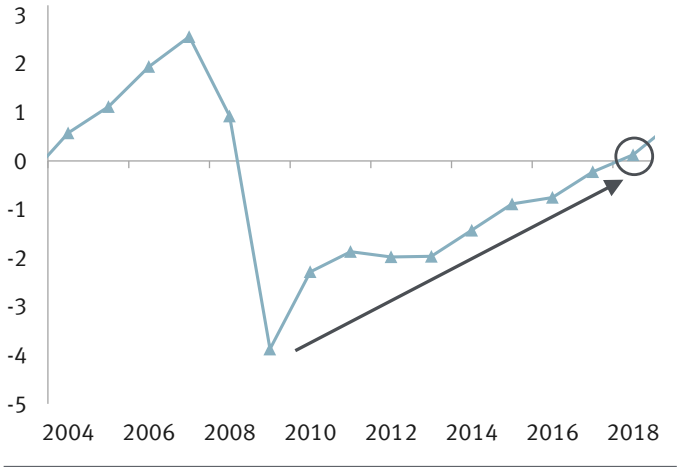
Economic fundamentals remain solid and are likely to be unaffected by market volatility.

With the economic and earnings underpinnings as firm as they are and with no recession in sight, we are comfortable with our modest Overweight in global equity portfolios and expect the major averages will achieve new highs later in the year. But this correction could have further to run before a sustainable turn higher can get underway. Very often, market downturns that feature some panic selling, as this one did, go on to rally for a while before subsiding into a retest of the lows over some weeks or months—enough time to allow complacent optimism to give way to pessimism and concern.

That may or may not be the course the market follows this time, but when the longer-term uptrend does eventually get re-established, we expect the slope of the advance will be somewhat shallower and less of a straight line than what investors have become used to over the past two-and-a-half years.

Economic slack finally gone in developed world

Output gap for developed economies (% of potential GDP)



Tight capacity usually a harbinger of rising inflation.

Note: International Monetary Fund (IMF) estimate for 2018
Source - IMF, Haver Analytics, RBC Global Asset Management

Much of the policy good news is on the table, but markets will have to contend with strengthening headwinds over the next couple of years, including: gradually tightening monetary policies from the Fed and other central banks, capacity constraints, upward pressures on wages and inflation, and some normalization of bond market spreads.

As long as the U.S. and global economies continue to grow, we expect equity markets will be able to navigate past these more challenging conditions.

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