Why a Sustained Market Correction Is Due and How to Beat it

Description

There are growing fears of a sustained market correction with the TSX now on a five-day losing streak and signs of worse to come, with Canadian stocks still appearing overvalued as whole. Furthermore, there are a range of macroeconomic indicators, which portend poorly for the performance of the global economy with a number of major economies showing significant weakness.

Let's take a closer look at why a sustained market correction is due and how investors can beat it.

Stocks are overvalued in the context of the overall economic outlook

Only last week the **Dow Jones Industrial Average** hit a new record high with investors continuing to plow their funds into stocks, despite signs of growing global macroeconomic instability. This instability has the potential to significantly disrupt global economic growth, highlighting the growing disconnect between stock valuations and economic reality.

China continues to be gripped by bad news, with August industrial activity slowing further, housing prices falling for the fourth consecutive month, and retail sales slipping to a four-month low. These facts clearly indicate that the government's stimulus measures are failing to gain traction, causing many economists to revise their outlook for the world's second largest economy. Many expect China's 2014 GDP to come in well under the government's 7.5% target.

The fragile economic recovery in the Eurozone has come to an end, with August 2014 industrial activity in its three largest economies, Germany, France, and Italy slowing, while for the second quarter, Germany and Italy's economies contracted with France's stagnating. This declining economic growth and increasing stagnation is creating a perfect storm for the emergence of deflation, with the August inflation rate hitting a five-year low and unemployment remaining worryingly high. While some would argue deflation is a good thing, it will lead to consumers delaying purchases as the real value of existing debt spirals and hard assets fall, causing further economic contraction.

Of even greater concern is the Eurozone is yet to feel the full impact of the broad-based sanctions taken against Russia as a result of that country's intervention in the conflict in the Ukraine, pointing to further pain to come for its member states. The impact of these sanctions could be even more severe than originally thought, with the Kremlin now retaliating with its own, further sapping market confidence.

For these reasons, it is clear there has been a growing disconnect between stock prices, which are being driven by investor exuberance rather than solid economic fundamentals. It's also likely there will be further economic bad news ahead, which can only drive stock prices lower increasing the severity of the correction, with miners, oil producers and consumer stocks among those most likely hardest hit.

How to beat a sustained market correction

Despite the doom and gloom surrounding the market and the likelihood of a deeper correction, investors can beat it by investing in quality stock that have wide economic moats, low debt, and limited earnings volatility.

One industry that stands out in this respect is Canada's banks, with the **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS), **Toronto Dominion Bank** (TSX: TD)(NYSE: TD) and **Royal Bank of Canada** (TSX RY)(NYSE: RY), my preferred picks. All three operate in a heavily regulated industry and hold dominant market share, giving them a wide economic moat.

They also have a track record of strong earnings growth, relatively low levels of leverage and appear attractively priced with low forward PEs of 10, 10.6, and 11 respectively. Furthermore, all three will continue to reward patient investors while they wait for markets to recover, with juicy yet sustainable dividend yields in excess of 3%.

CATEGORY

1. Bank Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:BNS (The Bank of Nova Scotia)
2. NYSE:RY (Royal Bank of Canada)
3. NYSE:TD (The Toronto-Dominion Bank)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:RY (Royal Bank of Canada)
6. TSX:TD (The Toronto-Dominion Bank)

Category

1. Bank Stocks
2. Investing

Date
2025/10/02
Date Created
2014/09/26
Author
mattdsmith