



Why U.S. Stocks Could Be Headed for a Correction (and What it Means for Canadians)

Description

With all three major U.S. indices recently reaching all-time highs, the number one question on investors' minds is simple: How much higher can the rally progress? In response, there have been no shortage of prominent investors and analysts (ranging from George Soros and Stan Druckenmiller to Prem Wetsa) warning that a material correction is overdue.

These investors should not be ignored. **Goldman Sachs** equity analyst David Kostin indicated in a recent note that the forward price-to-earnings ratio of the S&P 500 has grown from 10 to 18 since 2011 (a 75% increase). Such a significant increase in P/E has only been observed two times in history (the period preceding Black Monday and the period preceding the tech bubble popping), and the end results were historic crashes.

Of course, it not impossible that today's markets are significantly different due to historically low interest rates, but with nearly every valuation measure indicating overvaluation—and the gap between the fundamentals and asset prices continuing to diverge—investors should be cautious.

This applies equally to Canadian investors, given the strong correlation between the S&P 500 and the TSX.

The S&P is overdue for a correction

Historically, the length of the current bull market is nearly unrivaled. The current bull market is 89.5 months old as of writing, which would make it the second-longest bull market in U.S. history (only falling behind the tech bubble of the 1990s, which lasted 118 months). The average U.S. bull market lasts 51 months, which puts this bull market 75% above average.

Of course, a prolonged bull market by historical standards would be justified if the underlying fundamentals supported it, but according to a whole slew of valuation metrics, they simply do not. The S&P currently trades at about 18 times next year's earnings, which is higher than it has been for 88% of its history. Similarly, the Shiller P/E ratio, which divides the total market capitalization by the average

previous 10 years of inflation adjusted earnings, is 27. This is compared to the mean of 16.6, and once again can only be rivaled by the bubble conditions of the late 90s.

Markets are supposed to reflect future earnings-growth potential, and if current multiples are justified, then some of the best days for U.S. earnings must be ahead. This does not seem to be the case, however. Earnings expectations for 2016 have been steadily declining throughout the year as the index has been rising, and adjusted EPS growth expectations have been flat for the past three years.

In fact, billionaire Stan Druckenmiller revealed that among U.S. non-financial firms, operating cash flow growth actually peaked five years ago; the growth rate has been steadily declining and has actually turned negative recently. This has occurred as the growth rate for net debt has been accelerating, and the gap between debt and cash flow growth is the largest it has ever been in U.S. history, according to Druckenmiller.

With debt levels rising (very close to record highs) and earnings and cash flow growth declining, it does not make sense that the market is trading at an extremely expensive P/E ratio.

What this means for Canadians

Does this mean a crash is coming for U.S. stocks? It is impossible to say, and the current state of overvaluation has been driven by falling interest rates. What is clear is that the risk level is high, and should there be a large pullback in U.S. stocks, the Canadian market would likely feel it since the S&P 500 and the TSX have shown a very tight correlation historically. Periods where U.S. stocks fall and Canadian stocks rise are rare.

What should Canadians do? Stan Druckenmiller is responding to the risk (as is George Soros) by increasing his exposure to gold. With the current level of risk being high, gold is a smart play, and **Barrick Gold Corp.** ([TSX:ABX](#))(NYSE:ABX) is a fairly low-risk way to gain this exposure.

Barrick is focused on debt reduction and quality production versus quantity. This should give Barrick good exposure to any rise in gold prices that could come from a stock pullback.

CATEGORY

1. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:B (Barrick Mining)
2. TSX:ABX (Barrick Mining)

Category

1. Investing

Tags

1. Editor's Choice

Date

2025/08/07

Date Created

2016/08/18

Author

amancini

default watermark

default watermark