Is a Stock Market Correction Looming?

Description

Stock markets, including the TSX, raced to record highs in the wake of Trump's surprise victory, contrary to the predictions of many pundits at the time. This occurred because of a massive outpouring of optimism over the outlook for the economy because of his planned tax cuts, trillion-dollar investment in infrastructure, and regulatory rollback.

Nonetheless, it is becoming increasingly obvious that the tremendous surge in stock valuations is approaching the absurd. Not only are markets higher than they were at the peak of the Dot Com and U.S. housing bubbles, which ended in some of the worst market corrections in history, but they have disconnected from economic reality.

It is this disassociation from fundamentals that should have investors deeply concerned.

Now what?

Earlier this week, global stock markets led by the U.S. retreated sharply. All three of the major U.S. indices — the S&P 500, Dow Jones Industrial, and Nasdaq — plummeted by just under 2%. Even the TSX was not immune, plunging by 1.8% and wiping out roughly $39 billion in recent gains.

There are signs that this carnage could very well continue.

According to a recent survey conducted by Bank of America Merrill Lynch, fund managers believe that stocks are now the most overvalued they have been since the Dot Com bubble of 17 years ago. When taking a closer look at the TSX, it becomes clear that it is overvalued because stock valuations have significantly outstripped underlying fundamentals.

Corporate earnings have failed to keep pace with company valuations. Fourth-quarter 2016 net earnings for Canadian companies were down by 6.5% compared to the previous quarter. Based on these earnings, the S&P/TSX Composite Index is now trading with a trailing stratospheric price of 52 times earnings — well above the historical average.

While some pundits expect earnings to improve drastically over the course of 2017, which will cause this ratio to fall, this is difficult to accept.

Canada's economic growth remains muted; the 2016 GDP only expanded by 1.4% compared to 2015, which is below the historical average. There are signs that this trend will continue, despite analysts predicting that the 2017 GDP will grow by 2%. The recent pullback in crude doesn't bode well for any significant uptick in economic growth. Canada's energy patch is responsible for over 6% of GDP, and crude as well as other petroleum products make up over 18% of all exports.

Meanwhile, business investment remains weak, and the manufacturing sector is under pressure. This state of affairs could worsen if Trump implements his protectionist trade policies.

For these reasons, the extreme gap between GDP and stock valuations, as evidenced by the market-cap-to-GDP ratio standing at 113%, or one-and-a-half times the long-term average, will only close if there is a sharp market correction.

So what?

Normally, if a market slump is expected, investors would hedge against it by boosting their exposure to gold, which is widely recognized as the ultimate safe-haven asset.

However, I believe that utilities such as **Algonquin Power & Utilities Corp.** (TSX:AQN)(NYSE:AQN) offer a far better defensive hedge.

You see, steep barriers to entry endow their businesses with wide economic moats, which, in conjunction with the inelastic demand for water and electricity, means that earnings are virtually guaranteed. As a result, they have relatively low levels of volatility compared to other stocks.

Algonquin's diversified business, encompassing renewable electricity generation, power transmission, and water, as well as gas distribution, makes it the ideal defensive hedge. While investors weather any market downturn, they will be rewarded by its juicy 5% yield.

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