



Is the Risk of a Market Correction Rising?

Description

Recent research conducted by global investment manager Vanguard Group, which manages over US\$4.4 trillion in assets, indicates that there is a 70% chance of a U.S. stock market correction. That data indicates that the risk of a correction is now 30% higher than it has been over the last 60 years.

The flattening of the yield curve, which indicates that investors are concerned about the long-term macroeconomic outlook, is a key reason for Vanguard's claims. There are also fears that stock valuations have outstripped corporate earnings and economic fundamentals. Because of the close correlation between U.S. and Canadian financial markets, any U.S. stock market correction would certainly spill over into Canada.

Now what?

Since Trump's stunning electoral victory, the **Dow Jones Industrial Average** keeps hitting record high after record high, recently breaking through the 24,000-point mark for the first time ever to have gained 25% over the last year. While the rise of the **S&P/TSX Composite Index** has not been as dramatic, it broke through the 16,000-point barrier earlier this month to hit a record of 16,131 points before pulling back to be just over 16,040, returning 7% for the same period.

There is considerable consternation that these record heights see stock valuations having well and truly exceeded the underlying fundamentals — notably, corporate earnings. That is a potential indicator of a market bubble forming primarily because of the considerable optimism surrounding Trump's tax reform and other fiscal stimulus.

An important indicator to consider when attempting to determine if stocks are overvalued is the price-to-earnings ratio (PE).

According to the *Wall Street Journal*, the Dow Jones has a PE of 21.37. While that's above the long-term historical average of 16, it is well below the ratio of 40 reached at the height of dot.com boom.

Meanwhile, independent research shows that the S&P/TSX Composite has a PE ratio of over 23, which is higher than that of the Dow Jones and well above the historical average, indicating that it

could be overvalued.

What is even more concerning is that data from Statistics Canada indicates corporate profits have been steadily declining over the first three quarters of 2017. Third-quarter corporate profits before taxes fell by 6% compared to the previous quarter, but they were still an impressive 16% higher than the same period in 2016 when the index had a PE ratio of almost 29. This indicates that the gap between stock valuations and corporate earnings is closing and it should narrow further.

You see, the S&P/TSX Composite is heavily weighted to financials as well as commodities stocks, making up 34.5% and 31.5% of the index, respectively. That means the solid results being reported by Canada's banks and miners will cause collective corporate earnings to rise.

Canada's banks just capped off another solid reporting system. **Bank of Nova Scotia** reported some outstanding results because of stronger earnings from its Latin American operations.

Miners are also benefiting from the [rally in commodities](#) with many reporting significantly higher third-quarter earnings. **Teck Resources Ltd.'s** ([TSX:TECK.B](#))([NYSE:TECK](#)) gross profit for the third quarter surged by a healthy 36% year over year because of firmer coking coal and base metal. That trend should continue into 2018 for because of the positive outlook for steel-making coal, copper, and zinc.

So what?

Nevertheless, for those investors concerned about a market crash, one of the best means of hedging against the growing uncertainty is by investing in **Brookfield Infrastructure Partners L.P.** ([TSX:BIP.UN](#))([NYSE:BIP](#)). Not only does it benefit from stronger economic growth because it is the owner of infrastructure critical to economic activity, but it also possesses many [defensive characteristics](#), including an almost insurmountable economic moat, making it virtually immune to market downturns.

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