Stock Market Outlook: Should Investors Buy Now or Wait?

Description

The stock market doesn't look as rosy as it did six months ago. In fact, it's been in a dip or correction, depending on if you're looking at the Canadian or U.S. stock market. When will the market downturn be over?

To begin to understand which direction the stock market may take over the next months, investors should observe what happened in the last little while. The recession during the pandemic wasn't so bad. One could say that the economy recovered at lightning speed. There are reasons for the economic recovery and stock market rally that happened before the current dip.

During the pandemic, governments around the world continued to pump money into the economy, aiming to put cash into the hands of people and businesses that were abruptly impacted by economic shutdowns due to the unforeseen COVID-19 pandemic. This led to an earnings decline (across the economy) that wasn't as bad as anticipated. Government aid also helped support consumer spending during a highly uncertain time. This eventually led to a relieving stock market rally after a flash market crash during the pandemic.

The U.S. stock market traded as high as a normal price-to-earnings ratio of about 23 at the end of 2021, whereas its long-term normal valuation is closer to 18 times earnings. Some investors would argue that the high multiple was reasonable given the exceptional rebound of earnings (a growth rate of 49%) of the U.S. stock market (using **S&P 500** as a proxy) in 2021.

However, it didn't stop the valuation contraction that's happening now, as the growth rate is estimated to slow to about 5% over the next two years. Partly, the slower growth rate has to do with the waning pandemic government programs that are no longer needed. And partly, it has to do with liquidity tightening post-pandemic. Additionally, there are also other factors like the Russia invasion into Ukraine, higher prices in energy and raw material, rising interest rates, and global supply chain issues.

The U.S. stock market trades at about 19 times earnings today. If it retreats to its long-term normal valuation, it'd be another drop of about 7% or so. However, sometimes the market overshoots to the downside, which could lead to a multiple of about 15 times earnings. If that happens, it'll be a decline of 21% or so from current levels.

The Canadian economy has close ties with the U.S. economy, which is why when the U.S. goes into a recession or experiences a market downturn, we will experience something similar here up north as well. So, while the U.S. stock market is in correction mode, even though it's not nearly as bad for the Canadian stock market, I would remain cautious on the Canadian stock market.

The Foolish investor takeaway

While investors will surely try to guess the bottom of the current market downturn, it's important to focus on the long run. Long-term stock market returns have outperformed other asset classes and that's not going to change as long as you're buying quality businesses at reasonably valuations. Of course, since the market could still have some ways to fall, there could be increased opportunities to *buy at a greater discount*, which is most welcome.

Investors should continue buying over the next months as long as the market continues to provide attractive opportunities. That said, if you find yourself short on cash all the time, you might want to be more frugal with your cash and keep more dry powder on hand.

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