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AGF MARKET INSIGHT

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From the desk of...

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U.S. Equity Outlook

STILL EXPECTING A LONGER CYCLE DESPITE RECENT VOLATILITY

Our stance on the U.S. stock market continues to be a bullish one. Notwithstanding the third-quarter correction and some of the resurfacing risk factors, it is our expectation that the current uptrend in equity prices will be similar in duration to other periods where there has been a prolonged economic cycle. The most recent experience analogous to the current cycle is what occurred in the 1990s. During that decade, the economic expansion and the associated rise in equity prices lasted about 10 years. The current cycle has witnessed an economic expansion having a duration thus far of six and a quarter years with the rising trend in stock prices in place for the past six and a half years.

While the current economic expansion has been rather subdued by historical measures, with average calendar year real GDP growth of 2.1% more than a full point below the 3.2% average since 1945, the United States has had the highest growth rate among the industrialized countries. The muted economic backdrop has not significantly deterred corporate profits from recording healthy gains from the trough levels associated with the last downturn. The recent deceleration in earnings growth can be primarily be attributed to the significant drop in the profitability of the Energy sector. To illustrate this, the second-quarter 2015 S&P 500 Index earnings per share growth moves up from a 0.3% gain to an 7.3% increase on an ex-Energy basis. A strong U.S. dollar and sluggish international growth were additional factors inhibiting earnings and revenue growth during this period.

Looking ahead, we remain optimistic as we expect corporate profits to accelerate for the balance of this year and into 2016 as the aforementioned factors hindering growth diminish over time. Since the stock market is more closely correlated with earnings growth than any other single variable, we feel confident stocks will move upward to record highs over the course of the next 12 months.

STILL ROOM TO GO FROM A ‘PEAK TO PEAK’ PERSPECTIVE

When analyzing the length and duration of the current bull market, it is interesting to note that up until March 2013, the S&P 500 was simply recovering lost ground from the 2008 financial crisis. Thus, one could reason that strictly comparing the duration of the current bull market to past bulls ignores the fact that the 2008 financial crisis was one of the worst and deepest troughs the S&P 500 has ever experienced.

This gave us the impetus to look at the current bull market from a ‘peak to peak’ perspective – that is, how much progress beyond the previous highs has the current expansion made relative to past cycles, both from an equity market and broader economic perspective, and how does the current expansion compare to historical ‘peak to peak’ moves?

What we found supported the view that there is still considerable scope in this cycle for further upside to economic growth and for further appreciation potential of stock prices. In the current cycle, both the economy and the stock market are not up nearly as much from the previous peak as what has occurred in past cycles. As illustrated in the tables below, U.S. GDP is only 9% higher than its peak level recorded in June 2008, and this is materially below the average gain of 23% from peak to peak. Using the same framework, we can see stock prices still have substantial upside, since the current 24% advance from the last market peak is markedly below the 85% average peak-to-peak gain.

Peak To Peak Moves

S&P 500 - Peak to Peak

Peaks:	S&P 500 Level	% Gain from prev peak:
Aug-29	31.7	n/a
Jul-56	49.4	56%
Dec-61	71.6	45%
Nov-68	108.4	51%
Dec-72	118.1	9%
Nov-80	140.5	19%
Aug-87	329.8	135%
Aug-00	1517.7	360%
Oct-07	1549.4	2%
Sep-15	1920.0	24%
Average gain from previous peak		**85%**
Current gain from previous peak		**24%**

U.S. Real GDP - Peak to Peak

Peaks:	% Real GDP Cumulative gain from prev peak:
Dec-48	n/a
Jun-53	27%
Sep-57	11%
Mar-60	9%
Sep-69	51%
Dec-73	15%
Mar-80	19%
Sep-81	2%
Sep-90	35%
Dec-00	41%
Dec-07	18%
Jun-15	9%
Average gain from previous peak	**23%**
Current gain from previous peak	**9%**

Source: Bloomberg, National Bureau of Economic Research. Uses monthly observations. S&P 500 peak defined as: a) level higher than previous peak, b) no retest of peak for two years, or c) peak followed by trough of 20% or more. U.S. Real GDP peaks defined by business cycles determined by the NBER. As at September 30, 2015.

POTENTIAL RISKS TO OUR VIEW

There are several risk factors that we continue to monitor. Among them, there is the ongoing volatility associated with the coming interest rate hikes by the U.S. Federal Reserve Board (Fed). With respect to rate hikes, we have said in our previous publications that historically, initial rate hikes have typically been accompanied by volatility shortly before the hike but have not derailed the bull market for the following 12 months. With that in mind, the current stock market correction has not surprised us, and all things being equal, we would expect a resumption in the bull market after uncertainty around monetary policy dissipates.

Global growth concerns, including further deceleration in China's growth as well as disruption in the recovery of the European economy, could also pose as material risks, though the United States – being the most consumer-driven economy in the world – continues to show resiliency.

CONCLUSION

We remain optimistic for the current bull market to register new highs in the coming 12 months. There have been 13 corrections of 5% or more since the current uptrend in equity prices began 6 ½ years ago. We view the current correction as being no different in that it represents a buying opportunity.

For more information on U.S. equities, please visit AGF.com/US and contact your financial advisor.

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