Aging Bull

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Global equity markets have roared back from last year's depths with a rally for the ages, which has exceeded the hopes of even the most wild-eyed optimist. The 60%-to-80% sprint in the major averages has been the strongest post-recession rally of the post-war era, pushing the Dow above 11,000, the S&P 500 above 1,200, and the TSX above 12,000 (*Chart 1*). Has the market come too far too fast given the still-fragile U.S. recovery, and the still-many hurdles the global economy faces? We would again assert that the answer is no. While the bull market is starting to mature, and the abundance of risks certainly counsel some caution—as vividly highlighted by Friday's selloff on the Goldman news—we still believe that equities remain the most attractive asset class on a one-year basis.

We stated last summer (in "The Market's Message", Focus, August 14, 2009): *"We do not see the market rebound as particularly overdone. Most valuation measures are far from stretched, the stage of the cycle is friendly for equities and, after one of the most vicious bear markets on record, the scope of the* (equity market) *recovery is hardly shocking. However, further advances will have to be earned the old-fashioned way—through a solid recovery in earnings."* While these factors have all matured, they still point to a pro-equity bias, even if more modest returns lie ahead.

CHART 1
COMPARING THE RECOVERIES
S&P 500 (trough = 100)

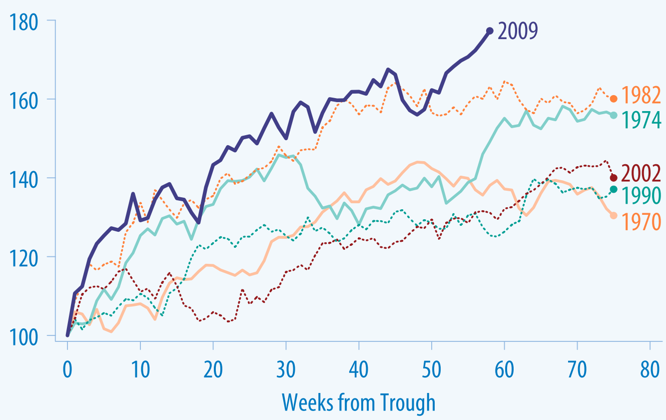
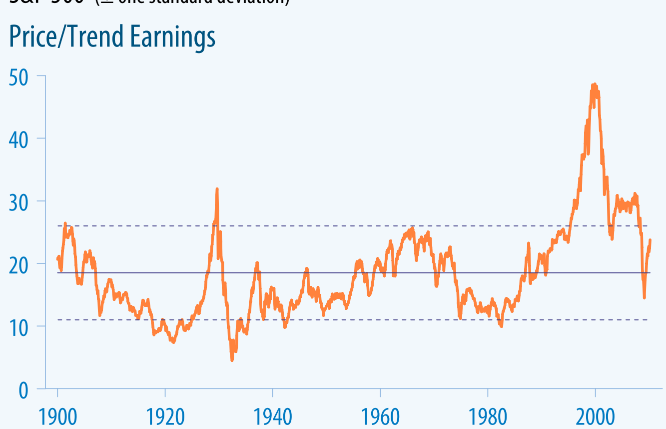


CHART 2
VALUATIONS ON THE RISE
S&P 500 (± one standard deviation)



Valuations have crept back above their long-run norms by most metrics. The purest measure, price-to-trend earnings, now sits at 24.2 for the S&P 500, up from a low of 13.2 in March and above the long-run average of 18 (*Chart 2*). This doesn't leave much more room for valuation expansion—it's about fair given our forecasts for inflation and the unemployment rate. However, other measures like the forward earnings yield remain attractive, especially when stacked up against other asset classes such as government bonds. Indeed, one factor that could add further support to stock prices is the distinct lack of compelling alternatives. Cash still carries a near-zero yield, government bonds are burdened with sovereign risk and corporate bonds have seen a huge rally. The 6.5% forward earnings yield on the S&P 500 is not only well above the 10-year Treasury yield, but is also higher than that on BAA-rated corporate bonds. And, in the outside chance of an inflation flare-up, stocks are a better hiding place. Valuation expansion will likely slow markedly in the year ahead, but raw earnings growth and relative value should carry stocks higher still.

CHART 3

SURPRISE ME

S&P 500 (% of companies vs. historical norm)

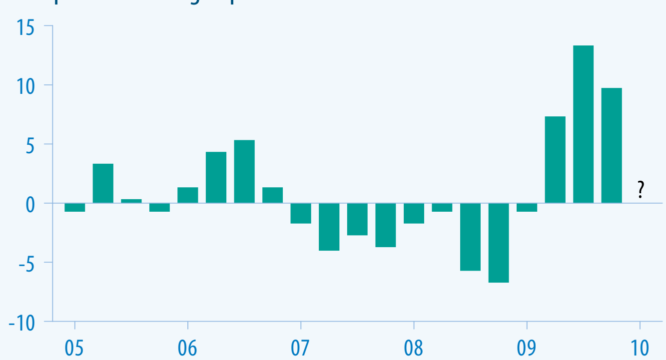


CHART 4

OECD LEADING INDICATOR – EXPANSION

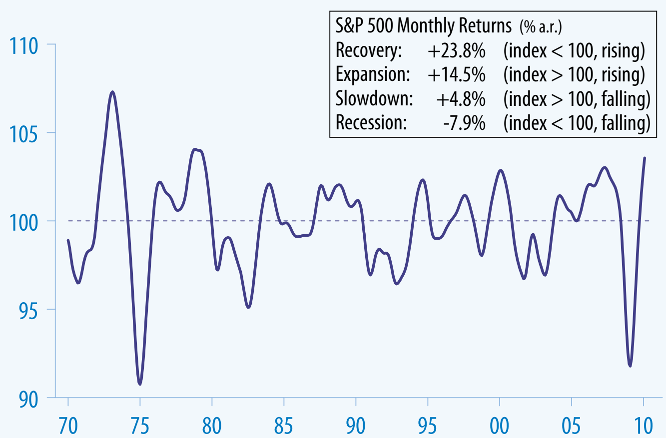


TABLE 1

AS THE CYCLES TURN

(average monthly return * : % : a.r.)

Fed Cycle	All Months	Easing	On Hold After Easing	1st Third of Tightening
S&P 500	8.5	8.7	18.1	10.2
Employment Cycle	**All Months**	**1st Half of Jobs Recession**	**2nd Half of Jobs Recession**	**1st Year of Jobs Recovery**
S&P 500	8.5	-12.7	21.5	13.1

* since 1970, excluding current cycle

The earnings environment remains very positive, with the consensus view on U.S. and Canadian GDP growth climbing steadily and profit margins still expanding. The U.S. business sector went on a cost-cutting rampage during the recession, slashing total compensation as much as 6.4% y/y in Q3. We've long suggested that this would set up a levered profit recovery, which is exactly what has unfolded since corporate earnings troughed in 2008Q4. Importantly for stock prices, however, expectations have slowly begun to catch up with the reality that this earnings recovery has quite a bit of muscle. While a record 79% of S&P 500 companies beat expectations in Q3 of last year (*Chart 3*), that was likely the high-water mark of the cycle, and fewer upside surprises would slow the pace of stock price appreciation.

As the economic recovery matures, so too will the bull market. Unquestionably, the sweet spot of the cycle for stocks is the earliest part of the recovery stage, when depressed markets start to discount a rebound in corporate profits—we've witnessed that during the past year. Lying ahead is the expansion phase which, while not nearly as bountiful, still tends to produce above-average equity market returns. Using the OECD leading indicator as a rough guide, we have indeed moved into this part of the cycle (*Chart 4*), where historical returns have remained above average despite moderating from the recovery phase. Similarly, equity market returns tend to decelerate as the job market moves into the recovery phase, which we've seen the first signs of in the U.S., and as the Federal Reserve begins to tighten monetary policy, which remains some time away (*Table 1*). Indeed, average returns during the last half of the jobs recession have almost doubled those seen in the first year of the jobs recovery thanks to the market's forward-looking nature. Taken together, the economic, employment and monetary policy cycles point to a more mature bull market, but one that is hardly too old to keep rewarding equity investors.

The Bottom Line: The bull market in equities has matured. However, thanks to a still-favourable stage of the economic cycle and still-attractive relative value, stocks should be able to grind higher and outperform most other asset classes in the coming year.