

U.S. Stock Market Outlook

June 2009

An early sixteenth century globe contains the legend “hic sunt dracones” (here be dragons) in the uncharted seas off the east coast of Asia. This legend is a good description for the uncharted waters in which investors in the U.S. stock market now find themselves. Despite a 25.1% rise in the S&P 500 index from the end of February through 30 June, the recession continues, recovery is not clearly in sight, and concern is increasing about the post-recovery impact of the fiscal and monetary measures taken to spur a recovery. Beyond this point, there may be dragons.

We have just entered the nineteenth month of the Great Recession. While economic news continues to be bad, it is generally less bad than it has been, which has both lifted consumer sentiment and fueled investor expectations that the trough of the recession and the start of the recovery are not far off. Opinions on when we will reach this point are varied, from we are already there, to later this year, to some time in 2010.

When the recovery starts and how rapid and strong it will be are critical issues for charting expected returns from the U.S. stock market. Despite the uncertainty around these issues, one thing is clear—we have entered the anticipatory stage of the recovery. If the collective wisdom of the market is correct, the recovery is not far off.

The first signal of a recovery in past recessions has typically been the stock market. In the typical recession, stock prices start increasing well before earnings reach their trough and lead to a significant increase in valuation multiples. Stock prices are low, valuations multiples are low, and investors buy in before improved economics change the picture.

We are at or beyond this point right now. Figure 1 shows that the price of the S&P 500 has increased significantly since the end of February while earnings have continued to decline. Price to earnings ratios (P/E), on a trailing twelve month basis, have increased from a trough of 10.9 at the end of February to 14.6 at the end of June—down marginally from 15.1 at the end of May. Of course, investors buy future earnings, not past earnings. Valuations of estimated earnings have also increased from a trough of 11.4 in November 2008 to 15.6 as of the end of May, even as estimated earnings are projected to decline to approximately \$59.00 per equivalent share of the index compared to \$63.00 per share as of the end of June (and excluding extra-ordinary items). Note that earnings have declined 29.8% from their peak of nearly \$90.00 per share in August 2007 (see Figure 2).

Investors have bought in and are waiting for the recovery. How long will U.S. equity investors have to wait? This analyst finds the case made by those who project a later recovery more convincing than those (including the Fed) who project a nearer start to the recovery or those who say the recovery has started already. Whatever the case, the timing, speed, and strength of the recovery will largely determine the scale of near-to-mid-term returns from the U.S. stock market, with average compound returns ranging from 4.8% to 20.8% depending on the nature of the recovery and investor sentiment.

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