Back to Fundamentals 2.0

Welcome to 2019!

On October 12th, 2018, I sent out a macro piece called "Back to Fundamentals for a Moment." In that analysis, I urged caution regarding the valuation of the U.S. stock market. Below is an updated chart from that research piece.

As you can see, the U.S. stock market has further corrected. In fact, the S&P 500 price to sales ratio has fallen from 2.16 (October 12th, 2018) to a current level of 2.01 – for an 8% decline. The bad news is that to get back to historical averages, the S&P 500 (price) would still have to decline 25% from the current level of 2642. Fortunately, markets do not move in straight lines up or down, but this provides some guidance as to what I think is possible over the next 3-5 years.

So the next question is why?...

In a nutshell, the U.S. Federal Reserve (Fed) is signaling that they would like to continue quantitative tightening despite the recent adverse price reaction. Chairman Powell indicated that the Fed is willing to be “patient”, which has been a terrific catalyst for the current market rally. However as long as the Fed is quantitative tightening, liquidity is being drained from risk assets which has the effect of depressing prices and increasing volatility. Also, the U.S. treasury is forecasted to issue over $1 trillion of new bonds – and somebody will need to buy them. In recent months foreign central banks have been reducing their treasury bond purchases which means the U.S. will need to finance their deficits internally – again, that money must come from somewhere. Likely, it will be squeezed from risk assets including the stock market.

As it stands, I do expect selling to resume once the current rally has run its course. Sorry! I must reiterate my view that U.S. stocks generally have poor risk/reward at current valuation levels.

So Where do Canadian Stocks Stand?

The previous chart is derived by taking the price of the TSX Composite and dividing it by the price of the S&P 500. The resulting graph shows the relative price of Canadian stocks compared to U.S. stocks over a 20 year period (white line). I have also superimposed the Goldman Sachs Commodity Index (yellow line) over the same time frame. As you can see, the TSX is trading at 20 year lows relative to the S&P 500. The yellow line demonstrates why. . . Canadian stocks are relatively cheap because commodity prices are low. Additionally, funds created by quantitative easing (by the Fed) found their way into the U.S. stock market. The cycle is beginning to unwind which should lead to underperformance of U.S. stocks relative to Canadian stocks in the years to come.

Furthermore, when commodity prices fell off a cliff in 2008, Canadian stocks underperformed U.S. stocks from 2011 to present. One explanation for this phenomenon is that the U.S. central bank undertook quantitative easing while the Canadian central bank did not. The aggressive money printing in the U.S. clearly propped up the U.S. stocks but did not have the same effect on Canadian stocks or commodities.

In summary, U.S. stocks look historically expensive relative to their revenues, their Canadian piers, and to commodity prices. Continued quantitative tightening by the U.S. Federal Reserve will likely put further downward pressure on U.S. share prices and growing U.S. government deficits may prove challenging to finance going forward.

Please stay tuned…