Stock Market Outlook

Our market view remains unchanged. While there always has been, and continues to be, the risk of a 5-10% correction from recent highs, a “bear market” is unlikely. After the extreme market volatility of the past few days, we reiterate, and expand upon, the following points that we made in our recent Investment Policy report, It’s always darkest Before the dawn (July 14, 1996):

- Concerns in the stock market about slowing current earnings as well as concerns in the bond market about accelerating future economic growth have resulted in the worst of both worlds for stocks: downward pressure on both P/E and earnings.
- However, with rates having backed up sharply this year (and with the Fed’s expected August, or earlier, tightening now already reflected in rates), U.S. economic growth should slow, inflationary concerns should dissipate and, so, P/Es should stabilize.
- For over a year now our forecast has been for down S&P 500 operating earnings in Q2 and Q3 1996—the first down earnings since 1991. While Q2 and Q3 should see moderate declines in S&P 500 operating EPS, close to double-digit gains should reappear late this year/early next year, partly driven by a rebound in global economic activity.
- This year’s flat earnings are next year’s easy comparisons. A key reason why we expect earnings to rise 9% next year is that by the end of 1996, nearly all cyclical sectors will have experienced an earnings decline and should be flat or up in 1997. If no sector is down a lot and many sectors are up (including consumer durables, consumer non-durables, healthcare, telecommunications, many financials, and multi-national conglomerates), then S&P earnings should register a solid gain. Synchronized GDP growth in Asia, Europe and the U.S. is another major plus for 1997 earnings.
- The “window of vulnerability” for the stock market should close after Q3. Weakness in stocks could continue until after Q3 earnings reports or, in other words, until investors start to focus on the close to double-digit earnings gains. However, renewed earnings growth and a little help from lower interest rates would support a DJIA of 6,000+ by year-end 1996; 6,400+ by year-end 1997—the DJIA could rise 1,000 points over the next 18 months.
- As we have repeatedly said (most recently in In a Tight Spot, June 2, 1996), the risk has been of a 5-10% correction but not of a bear market. From its May 24 high, after hitting down 10% midday Tuesday, the S&P is now down 6.5%. While a correction of another 5% from current levels is always possible, a more substantial further correction still seems unlikely because in an absolute sense (i.e., on a P/E basis) stocks are not expensive. Now at 91% of normal P/E valuation, stocks would fall meaningfully below 90% of fair value if there were a further correction of much more than 5%.

The DJIA certainly should not break below the 5,000 level. Against a background of modest inflation and strong corporate profits, stocks have not sold below 90% of normal P/E valuation since January 1991— and then it took the conflict in the Middle East to push stocks that low. Since 1985 stocks have sold below 90% of normal value for only one extended period of time—October 1989 through January 1991, and that was against a background of collapsing earnings.

- From an asset allocation perspective, the major disequilibrium in the capital markets continues to be the relatively high bond yields. Of stocks and bonds, bonds today offer the best risk/reward.
- The probability that stocks outperform bonds is 30%; the probability that stocks outperform cash is 35%. Our current asset allocation is: Stocks 51%, Bonds 39%, Cash 10%.