TD Economics

An Equity Market Check-Up

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Highlights

- Equity market momentum has come off the boil. While corporate earnings continue to improve, a high bar has been set. At the same time, economic data surprises have become fewer and farther between. Investors are patiently waiting for the path forward to become clear.
- Though downside risks are always present, the economic recovery is likely to be supportive of corporate earnings and financial conditions should continue to support investor sentiment. This provides a favorable backdrop for risk assets.

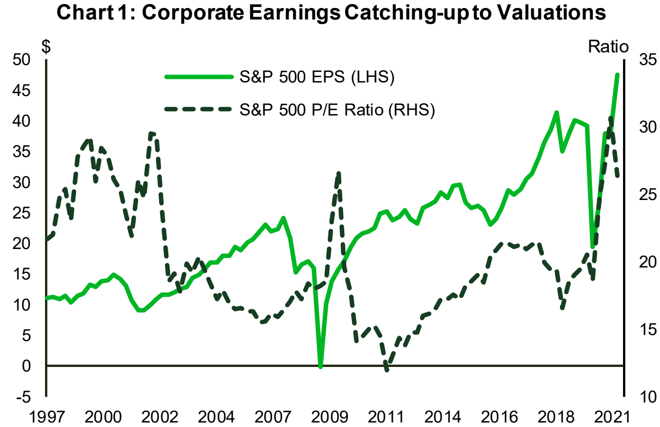
With the price of everything from running shoes to washing machines rising on high sales volumes, the profits of large corporations are surging. This has resulted in the earnings per share of S&P 500 companies reaching new all-time highs, more than double what they were a year ago. At the same time, the equity price advance witnessed over the last year has slowed. The S&P 500 and the Global Dow (ex-US) indexes have leveled out over the last two months, though they are still up approximately 10% over 2021. The trend is even more apparent in the NASDAQ Composite, which has been range-bound for all of 2021, after outperforming in 2020. Though investors might bemoan the relative stability in equities, this has allowed earnings to catch-up to high equity prices. This dynamic has led to an improvement in equity valuations (Chart 1).

The long-term driver of equity prices is corporate earnings. With a robust economic recovery, the outlook for corporate profits is encouraging. The consensus call for earnings per share of the S&P 500 is expected to be 50% higher by the end of 2022 than it was at the end of 2020. That suggests the growth rate in profits could be triple that of nominal GDP growth over the same time period.

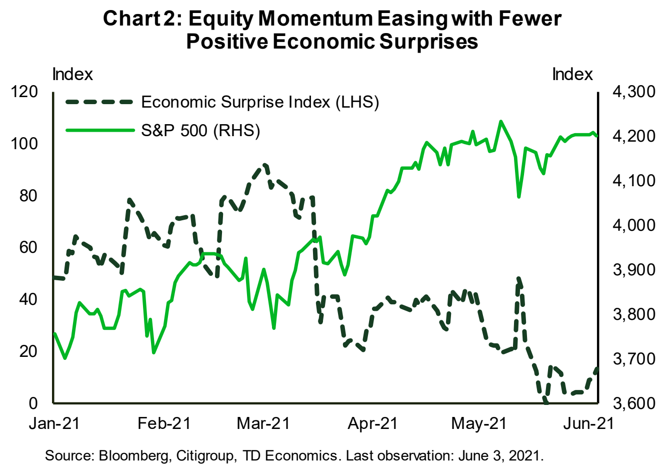
The economic narrative is compelling, but stock prices have largely priced this outcome. In other words, the bar for profits has been raised. A significant move higher in equities will require expectations for corporate earnings to move even higher. Though earnings for the first quarter have been solid, real-time economic data has been more settled, and largely come in at or below admittedly buoyant expectations (Chart 2).

This has resulted in a number of clients voicing concern about the vulnerability of equities. They wonder whether flat equities are in for a Wile E. Coyote moment – waiting to fall once investors realize that the economic growth narrative is crumbling beneath their feet. To that point, equities typically drop 10% to 15% once a year

Chart 1: Corporate Earnings Catching-up to Valuations



Source: S&P, TD Economics. Last observation: April 2021.



and it has been a solid 16 months without a retracement. There is always a risk of a correction, but it is unlikely to persist for long. Today's employment report, which showed strong wage gains, along with the beat in ISM manufacturing and services this week, should assuage fears on this front.

The bottom line is that the current economic recovery is in its early innings and has a long way to run. The economy is set to grow well above its trend-pace over the next two years, supporting even stronger growth in earnings. Additionally, loose monetary policy is still in place and will be for some time. In spite of the risks and recent slowing in equity momentum, the fundamental backdrop still favors equities and risk assets in general.