What's Next for the Stock Market?

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- The U.S. stock market performed well last year and has continued that streak into the second quarter of 2013.
- Though COMPASS would not be surprised to see a correction on the order of 5 - 10%, which is a common and natural occurrence, we continue to believe that the U.S. economy will continue to plod along and a correction should not cause clients to abandon their strategy.

Following a 16% total return last year, the S&P 500 Index, considered to be a good yardstick for the U.S. stock market, increased another 10.6% during the first quarter, ending at a record high. The year-to-date gain is better than many had expected for all of 2013. Consequently, what's next for the U.S. stock market given its recent appreciation and the risks it faces?

Market Environment

Despite several head winds facing the stock market, it has not suffered from a correction of more than 3% since November 2012. These head winds have included a deceleration in corporate earnings growth and anemic economic growth, the fiscal cliff at year end, a payroll tax increase of 2%, as well as higher rates for higher earners, the ongoing European debt crisis as witnessed by recent challenges in Cyprus, and geopolitical concerns, especially Iran and North Korea.

On the other hand, the Federal Reserve's ongoing purchase of Treasury and mortgage-backed securities has helped keep interest rates near all-time record lows. Low interest rates have allowed for the recovery of the housing market, which has seen declining inventory levels and rising prices. A rebounding housing market should aid economic growth this year.

Market Valuation

Although the stock market has enjoyed a meaningful rally recently and more significantly since the market bottom in March 2009, from a valuation perspective the stock market is not expensive. Whether viewed from a price-earnings multiple, dividend yield, or other valuation metrics, the S&P 500 is currently trading near its long-term historical average on these measures. Given the low interest rate environment, it could be argued that the stock market should be trading at meaningfully higher levels, especially if some of the uncertainty from U.S. fiscal policy and the European debt crisis were to clear.

Alternatives

When viewed from the perspective of other types of common investments, stocks remain a compelling choice. For example, the safest type of investments, such as cash equivalents like money market accounts and certificates of deposit, pay minimal rates of interest, generally far below the current rate of inflation. Bonds too are suffering from low levels of interest income, but also are susceptible to a decline in value if interest rates increase should economic activity improve and the Federal Reserve reduce its bond purchases.

Market Outlook

So while the U.S. stock market has performed well recently, it is still not expensive from an historical valuation perspective. However, given the lack of a meaningful correction over the past four months and the uncertainties facing market participants, a correction on the order of at least 5 – 10 percent should not be a surprise. In fact, based on data compiled by J.P. Morgan Asset Management, intra-year corrections are commonplace. Over the past 33 calendar years, the S&P 500 has experienced 14.7% intra-year declines on average, though many are between 5 – 10% (the average is dragged down by infrequent, larger declines like those seen in 1987, 2001 – 2002, and 2008). The challenge for investors will be to maintain composure during a market sell-off given the heightened nervousness felt by many over the past several years.