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Recession risks warn of ‘severe’ drop in the stock market

Most S&P 500 stocks could fall 50% or more if a ‘worst-case’ recession unfolds

By Tomi Kilgore

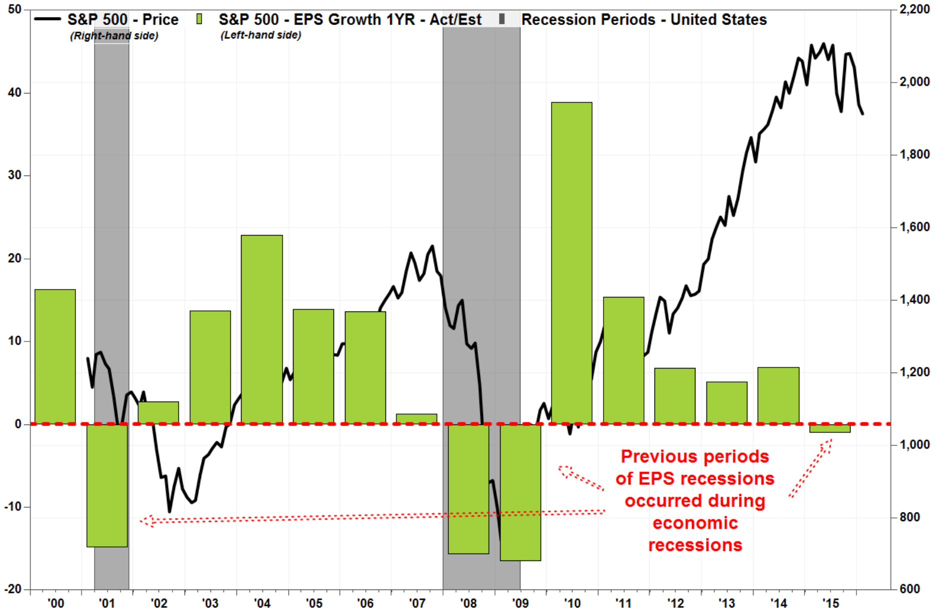
Another brokerage firm has used the “R” word on Tuesday, warning investors to wake up to the idea that rising risks of a recession could send the stock market over a steep cliff.

Based on current valuations, the prices of most stocks don’t appear to have factored in a recession scenario, “hence the downside should we see a recession could be rather severe,” RBC Capital Markets’ global equity team wrote in a research note to clients.

Applying a stress test to their coverage universe, using worst-case, price-to-earnings valuations seen during the 2008-to-2009 recession, RBC analysts said they believe the shares of most companies could still fall another 50% or more from current levels.

The concern for RBC analysts stems from the recently volatility in the stock market, caused by macro weakness, softness in China and commodity market challenges.

On Monday, Deutsche Bank strategist David Bianco said the second-half of 2015 was “clearly a profit recession” for S&P 500 companies, and suggested it probably won’t be until the second half of this year that “healthy” growth returns.



Nearly half of S&P 500 companies have now reported fourth-quarter results through Tuesday morning, and earnings-per-share is headed for a 5.8% decline on the year, according to FactSet, compared with an estimated 5.7% decline as of Friday. That’s the data provider’s blended growth rate, which combines those companies that have reported with the estimates for the rest.

That would be the third-straight quarter of an EPS decline, the longest such streak since the Great Recession.

Among Tuesday’s culprits for the earnings decline, Exxon Mobil Corp. reported a 58% profit plunge and Pfizer Inc. reported a 50% earnings drop. Royal Caribbean Cruises Ltd. reported earnings that nearly doubled, but the stock plunged 16% after the company provided a weak first-quarter outlook.

Deutsche Bank fixed income analysts said last week that given dollar strength, the selloff in stocks and the widening of credit spreads so far this year, their financial conditions index “is now firmly at levels consistent with recession,” and is likely to continue to deteriorate as global liquidity declines.

Based on their analysis of Treasury yield spreads, adjusted for current artificially low yields, they place the probability of a recession in the next 12 months at 46%. That’s well above the Federal Reserve’s model, which estimates a 4% probability of recession.

Also last week, Goldman Sachs gave investors a blueprint to follow if the economy suffered a recession in 2016, and Credit Suisse revisited lessons learned from past recessions.

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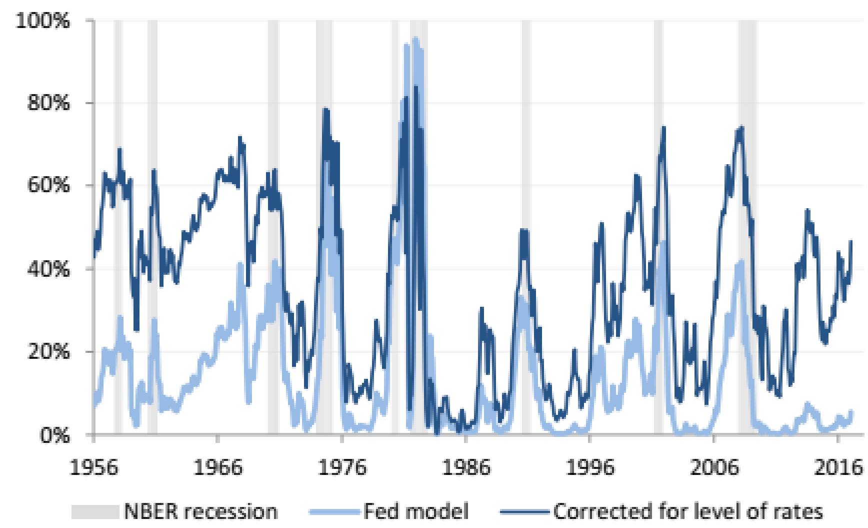
Probability of a recession in the next 12 months predicted by the 3m10y slope



Source: Deutsche Bank