All about the liquidity

Strong earnings are bailing out high valuations, but it's all about financial conditions from here.

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Key Takeaways

- An earnings boom is providing a much-needed bailout for an expensive market.
- This earnings strength is helping the market grow out of its high valuation.
- However, with strong earnings now fully discounted, attention will likely switch to how quickly financial conditions will tighten from here.
- Financial conditions tend to move the needle more than earnings during this phase of the market cycle.
- At this point, it looks like the Fed can tighten policy further without triggering a recession.

Four months after the market peak in January, the Standard & Poor's 500 (S&P 500®) Index remains stuck in a trading range of around 2,600–2,800. What's next? More of the same, if you ask me.

From here, it's all about earnings and liquidity (i.e., the level of interest rates and availability of credit), which together drive stock valuations in the form of price-to earnings (P/E) ratios. These three factors then determine stock prices. It's simple math, really: If earnings go up and liquidity stays low, the P/E goes up. Therefore, if the P/E rises within the context of expanding earnings, then by definition price has to go up more than earnings.

That's what happened from 2009 until last January, when earnings doubled and the P/E doubled and, therefore, the S&P 500 price index quadrupled. Now we have a regime where earnings are going up a lot but liquidity is tightening. Therefore, they offset each other, which puts pressure on P/Es. That leaves prices somewhere in limbo, which is what has been happening since January. The result is a trading range of about 10%–15%, which could continue for some time.

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Consider both sides of the earnings boom

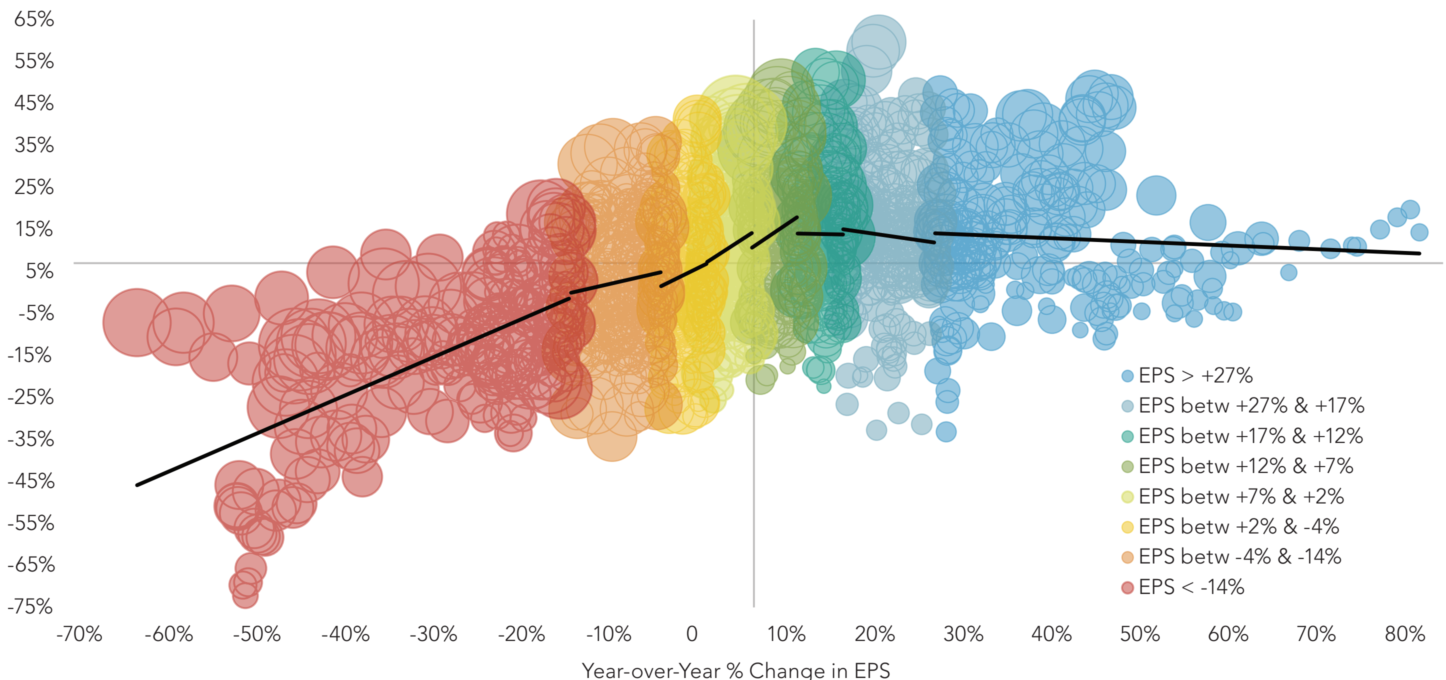
Earnings have been booming, of course. Q1 earnings season is wrapping up now, and as high as the expectations were going into the reporting season, they weren't high enough. To wit, Q1 earnings growth is clocking in at a warp speed of 24% (year over year). That's pretty amazing nine years into a bull market. And the expectations for Q2 and Q3 are 20% and 22%, respectively. After that, earnings growth is expected to moderate to a still-healthy 10%.[1]

That's really bullish, right? Well, yes and no. It's certainly helpful that this earnings boom is providing a much-needed bailout for the market's high valuation (at least it was high back in January). Super strong earnings growth allows P/Es to come down without triggering a bear market. Indeed, the S&P 500's forward P/E ratio peaked at 19.5x in January and has already fallen to 16.1x in just three months, before rising to 16.9x for the week ending May 11.

Historically, however, the market has rewarded normal-but-sustained earnings growth (7%–12%) much more than super-high 20%-plus earnings growth, as shown in Exhibit 1, which compares changes in the earnings growth to changes in its price return. The further to the right you look, the lower the slope. This illustrates that booming earnings growth is generally not sustainable (certainly not nine years into an expansion) because investors are not willing to pay for those earnings. Thus, with earnings now a known factor and presumably priced in, attention is shifting more broadly to liquidity or financial conditions.

EXHIBIT 1: Historically, stocks have performed better when earnings are at a sustainable level.

Earnings Growth vs. Price Return



EPS: Earnings per share. Black lines represent the trend for each color. Monthly data. Source: Haver Analytics, Fidelity Investments, as of May 11, 2018. Past performance is no guarantee of future results.

While we're arguably still in the mid cycle, Exhibit 2 suggests we may be entering an "inflation boom" stage. You can see this from the fact that the ISM Manufacturing Index[2] data points have been edging closer to the upper right-hand quadrant in recent months (i.e., higher growth and higher inflation). To the extent that continues, the more likely it is that the late cycle would begin. When (or if) that happens is an open question, but it's not unreasonable to envision it occurring later this year.

For now, we're not there yet because earnings growth is accelerating rather than decelerating, while inflation is rising and the Fed is tightening. So we don't have all the makings yet of a late cycle during which growth typically slows as inflation rises, eating into profit margins.

This is when financial conditions tend to tighten up, leading to P/E compression, and this could be why the market has been in an extended trading range. If strong earnings are already known but rising prices are next, why pay up for earnings anymore?

Liquidity—a close correlation

Looking at the relationship of financial conditions and earnings relative to the S&P 500 shows that, historically, the Goldman Sachs Financial Conditions Index has a 79% correlation[3] with the S&P 500, while 12-month trailing and 12-month forward earnings have only a 23% and 16% correlation, respectively. At the end of April, the Goldman Sachs Financial Conditions Index had a 94% correlation (12 months) with the S&P 500 index, while trailing and expected earnings had a 48% and 32% correlation, respectively.

EXHIBIT 2: The U.S. economy may be heading toward an "inflation boom" regime.

Growth & Inflation

Source: ISM, Haver Analytics, Fidelity Investments, as of May 11, 2018. Past performance is no guarantee of future results.

My point is that now that the earnings boom is a known thing, changes in liquidity conditions are going to drive the bus here, as they have since January. So the tension continues, with earnings supportive of higher prices and higher valuations, but with liquidity conditions acting as a drag on both. The question is, who wins the battle?

This was not an issue earlier in the mid-cycle when earnings and financial conditions were tailwinds that drove valuations higher, and it could be a big issue someday if earnings and financial conditions both become headwinds (driving valuations way down). For now, though, it remains a tug of war. As long as the earnings estimates pan out (which so far they are, and then some), the market will soon be quite reasonably priced again at 15 times forward earnings (15x).

But remember what I mentioned earlier: As important as strong earnings are for the market's ability to grow out of its high P/E, very strong earnings growth tends to be unsustainable. Therefore, very high earnings are usually a weaker predictor of returns than more normal trend-like earnings growth.

How tight is too tight?

All in all, current conditions spell "extended trading range" to me, at least until the Fed cycle is complete. Then it will be a matter of whether the Fed has successfully engineered a soft landing or whether it will be something more negative. It all comes down to, "how tight is too tight?" Right now the real Fed funds rate is right on top of the so-called natural rate[4] of interest. So Fed policy is neither too loose nor too tight. Even if the Fed hikes rates another four or five times over the coming two years, as is priced in by the forward curve, it will probably still not be too tight (depending on what the natural rate and inflation are at the time).

So, at this point, it looks like the Fed can tighten policy further without triggering a recession. But monetary policy is always a moving target, and the risk is that the Fed tightens beyond what the bond market is expecting. There would have to be a clear increase in inflation to force the Fed's hand, and in recent speeches the Fed has already hinted that its inflation target is symmetric, meaning that it will allow core inflation to rise above 2% without prompting the central bank to ratchet up its tightening path.

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Endnotes

[1] Source of all earnings growth and estimates in this report: Bloomberg Finance L.P., as of 5/11/18.

[2] A monthly index released by the Institute of Supply Management (ISM) which tracks the amount of manufacturing activity that occurred in the previous month to measure economic activity. A sustained value below 50 tends to indicate an economic recession; a value substantially above 50 indicates a time of economic growth.

[3] As measured by the rolling 12-month correlation of 36-month standard deviations, which measures the variability about the mean of a data set: the closer to the mean, the lower the standard deviation.

[4] The rate at which real GDP is growing at its trend rate, and inflation is stable.

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Index definitions

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