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Lower Stock Valuations May Be a Trade-Off of Higher Trade Tariffs

Although stock valuations may fall, strong earnings growth could mitigate any decline in equity prices.

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Key Takeaways

- Recently proposed trade tariffs—in conjunction with tightening interest rates and financial conditions—could threaten to squeeze stock valuations in the coming months.
- Historically, tariffs levied on trade have been inflationary, and rising inflation can pressure price-to-earnings (P/E) ratios.
- Nevertheless, a continuation of the strong earnings growth of the past several quarters could help alleviate or moderate any stock market decline.
- There have been a number of periods in market history when P/E levels trended lower but stock prices did not.
- Given its current strength, the market appears able to withstand some tightening of financial conditions and not unravel in the process.

With recent headlines regarding trade policy, it's worth taking a step back to get a sense of where the market stands in terms of valuations and what could lie ahead if trade policy around the world turns more protectionist.

The stock market has reached an important crossroads, as tightening financial conditions from a more hawkish Federal Reserve (Fed) and potentially higher tariffs could start to offset the earnings boom that's currently under way. The question is whether this can happen without triggering a decline for stocks.

Equities really have had the best of all worlds these past few years, with earnings growth in the double digits and financial conditions (as measured by the Goldman Sachs Financial Conditions Index) remaining very accommodative despite the rise in both short- and long-term interest rates. The combination of rising earnings growth and benign financial conditions is a powerful set of tailwinds and usually drives stock valuations higher. Indeed, the forward price-to-earnings (P/E) ratio has risen from 14 times earnings (14x) in early 2016 to 19x in February 2018 (the highest since 1999).

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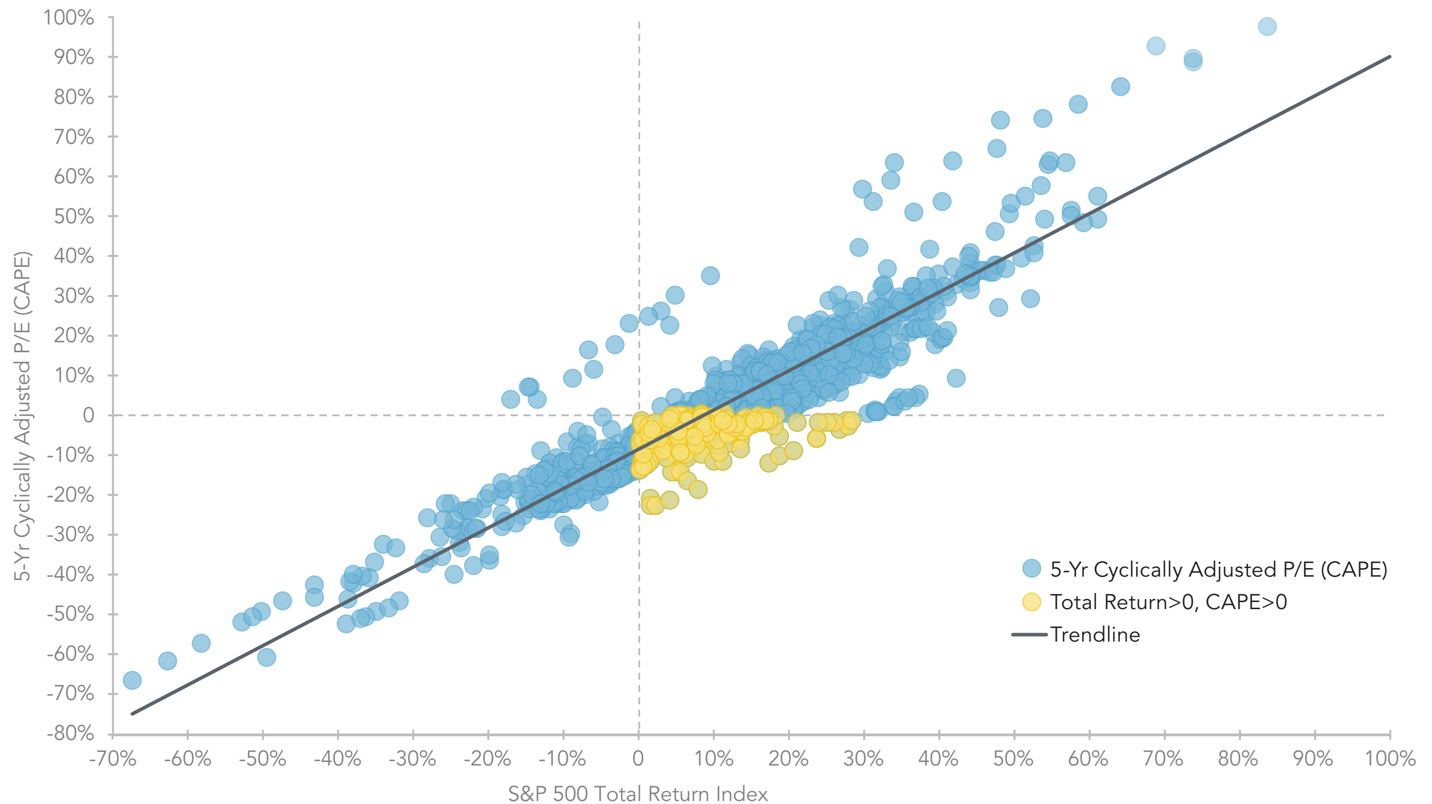
Not only that, the equity risk premium has fallen to a very low 1.8%, more than offsetting the recent rise in the risk-free rate (10-year Treasury yield). That combination seems hard to justify under any backdrop, even the nearly perfect one of the past few years.

But those halcyon days may be coming to an end, with the recent correction in stock prices being only the first salvo of what might be an extensive period of market chop. Historically, tariffs levied on trade have been inflationary, and there is a consistent inverse relationship between P/E ratios and inflation. Therefore, it seems reasonable to assume that if the inflation rate were to rise as a result of changes in trade policy, this could contribute to a tightening of financial conditions. With the big tax-induced earnings gains now presumably discounted by the market, any hawkish tilt from the Fed could be enough to start knocking the market's P/E ratio down a few notches, while bringing the risk premium back in line in with historical norms.

The question then becomes whether we can have what I would call a "benign valuation-compression regime." In other words, can valuations come down without stock prices following suit? The answer is yes, but it will require strong earnings growth. The chart below (Exhibit 1) shows a scatterplot of the year-over-year change in the Standard & Poor's 500 (S&P 500®) Total Return Index,

EXHIBIT 1: Can stocks go up while P/Es come down?

S&P 500® Total Return Index vs. 5-Year Cyclically Adjusted P/E (CAPE)



Source: Bloomberg Finance L.P., Haver Analytics, Fidelity Investments, as of March 9, 2018.
Past performance is no guarantee of future results.

versus its five-year cyclically adjusted P/E (CAPE) ratio. The yellow dots show those months during which the benchmark's year-over-year total return was positive but the P/E ratio was lower than the year prior. It has happened 22% of the time over the past 100 years or so. It is clearly not the most common scenario (usually the P/E ratio rises as the market rallies and vice versa), but it does happen. It's a bit like threading a needle.

That brings me to the next question: How similar were these past market regimes compared to where we are today? The following periods stand out as benign valuation-compression regimes:

- **Early 1950s:** The 1950s were boom times that kept on booming (following the Great Depression and World War II). It goes to show that when earnings are skyrocketing, it doesn't really matter what happens to interest rates and financial conditions. The early 1950s also had ultra-low interest rates and very low equity valuations, so there were practically nothing but tailwinds. Today's low interest rate environment is similar to that of the early 1950s, but the same cannot be said for valuations or the risk premium.
- **Late 1960s and late 1970s:** An inflationary boom in the late 1960s ultimately led to the 1970 recession, while the late 1970s was a period of stagflation with high inflation and low valuations. During both periods, however, there was plenty of inflation to at least create the illusion that the stock market was just fine. Notably, dividends were a huge part of the return stream back then.
- **1994:** A benign tightening cycle in 1994 was followed by a massive boom in 1995.
- **2005–2007:** Strong earnings growth and reasonable valuations (but followed by the Great Financial Crisis in 2008).
- **2014–2016:** Monetary policy divergence led to a strong U.S. dollar and tightening financial conditions. The 1994 and 2015 cycles were totally different from the earlier ones, with little inflation and far less earnings growth. Those were basically sideways trading ranges where the market just needed to pause for a while to let the fundamentals catch up. During each cycle the S&P 500 had a few drawdowns of 10%–15%. Not the end of the world by any means, and they were followed by big bull markets.

What's the conclusion? Historically, periods of valuation compression have often coincided with late cycles, and there has been some evidence of late-cycle indicators increasing. But what happens to stock prices during the late cycle is not a cookie-cutter certainty. It may ultimately come down to the juxtaposition of earnings growth relative to financial conditions, not to mention the prevailing level of PEs. Expect a tug-of-war between these sides of the equation.

Right now with earnings growth very strong and the bond market already reflecting a fair amount of Fed tightening (pricing in five rate hikes over the coming two years), my sense is that the market is in OK shape to withstand some tightening of financial conditions and not unravel in the process. So, maybe a prolonged sideways chop with the occasional 10%–15% drop is where we are headed for now.

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Endnotes
[1] Equity risk premium is the difference between returns on stocks and the risk-free rate of return, which is typically benchmarked to longer-term government bonds (such as U.S. Treasuries), assuming zero default risk by the government.

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