Nowhere To Go But Sideways?

Strong earnings are providing a much-needed tailwind for stocks as valuations decline.

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Key Takeaways

- Since late January the stock market has traded sideways, a condition that could persist for weeks to come.
- Robust earnings growth has allowed the market to undergo a "benign valuation reset."
- With the market inching closer toward the late cycle, valuation pressures will likely remain an obstacle for stocks.
- Currently, it's difficult to envision a near-term catalyst for the start of a bear market or a resumption of the bull market.

Stocks remain stuck in a two-and-a-half-month trading range, loosely defined as 2,600 to 2,800 for the Standard & Poor's 500 Index (S&P 500®), with few catalysts in place to drive the market to higher highs or lower lows. The choppy trading began in late January, after stocks climbed roughly 52% in almost two years against record low volatility.[1]

Interestingly, the S&P 500 continues to pretty much follow the textbook script of a bull-market correction: an unsustainable surge to the upside, followed by a brief, violent decline (more than 10% in nine trading days from Jan. 29 through Feb. 8), then a swift recovery but to a lower high, followed by another down leg but to a higher low.

Now the market is at a moment of truth, at least technically speaking. In other words, have stocks successfully retested their early February low and launched the next up-leg in this epic nine-year-old bull market? Or is the market just killing time, churning around on its way to a new bearish down-leg? Nobody knows of course, but in my view the market is not ready to declare itself in either direction. Here's why.

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Not buying the bear

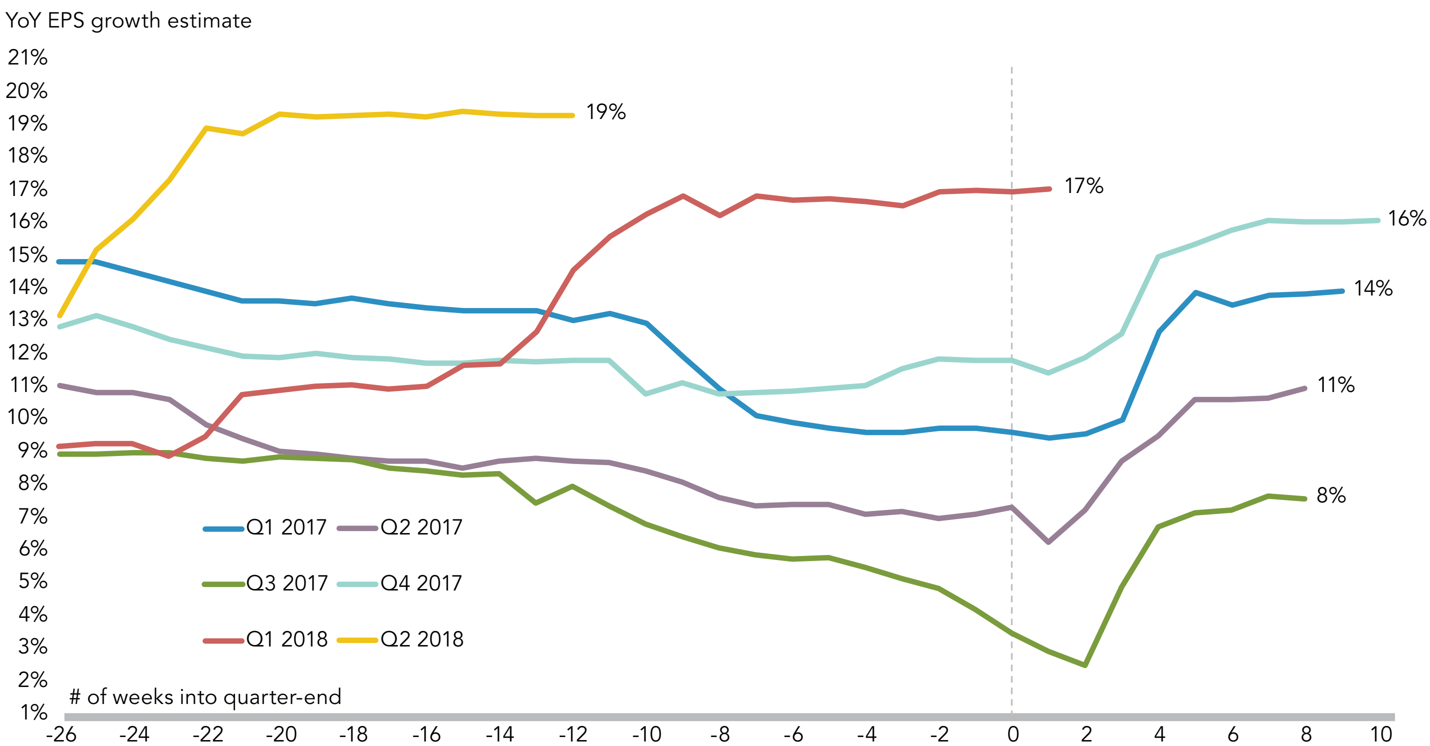
I can't buy into the bearish scenario at this time. With corporate earnings growth estimates near 20% (year-over-year) for Q1, Q2, and for calendar-year 2018 overall (see Exhibit 1 below), it's difficult to envision a catalyst that could knock this market down by the 20% required to be called a bear market. Strong earnings growth should be able to offset a multitude of problems, including rich stock valuations, tighter monetary policy, and even trade tariffs.

If the consensus estimates for earnings growth end up being too high, or nearing an inflection point (e.g., a cyclical high or low), then that would be a different story. But so far, there is no evidence that this is the case.

When examining the typical progression of consensus earnings estimates, they tend to start high and then drift lower as earnings season approaches. But that is not happening so far this year. Initially, the corporate tax cuts caused the estimates for coming quarters to soar (as one would expect). However, instead of trending lower as is usually the case, earnings-per-share (EPS) estimates for the past three months have remained rock solid. With Q1 earnings season now under way, there are so far no signs that EPS estimates are too high for either Q1 or Q2, or even for 2018 overall. This suggests that Wall Street had it right and that the market did not overestimate the impact of recent tax-cut legislation. If anything, it's possible that the Street is too conservative on earnings.

EXHIBIT 1: EPS estimates for the first and second quarters of 2018 have remained robust despite historical earnings trends and extreme volatility.

Earnings Estimate Progression



Source: Bloomberg Finance L.P., as of 4/13/18.

This strength in earnings is allowing the stock market to (so far) undergo what I call a "benign valuation reset," in which price-to-earning (P/E) ratios come down while stock prices more or less stay up. Now, it's unlikely that the market will go straight up while P/Es come down. But, with earnings growth providing such a powerful tailwind, stocks have been able to hang in there with only a 10% drawdown[2] while the S&P 500's forward P/E ratio[3] has declined three full points (or 17% in percentage terms), from 19.4x to 16.1x at the recent low. While a 10% drawdown is never pleasant, I would describe this one as a win considering the alternative, which is that the market declines as much as or more than the P/E ratio.

Is the bull run done?

So does the recent correction mean the stock market is out of the woods and ready to resume its bull run? I don't believe so. While earnings growth is providing a valuable antidote to the decline in valuations, the fact is that we are likely approaching the phase of the market cycle when P/Es start to contract.

We are not officially in the late cycle yet, but it is probably where we are eventually heading. The mid-cycle phase is the sweet spot, because that's when earnings growth is robust and liquidity conditions are benign. I tend to frame market dynamics through the lens of the discounted cash flow model, which states that equity valuations are driven by two factors: earnings growth and interest rates. When earnings are growing and interest rates are either declining or at least not getting in the way, it's all systems go for higher valuations (i.e., a higher P/E).

During the late cycle, earnings growth is typically slowing (but still positive) while the Fed raises interest rates—a combination that usually results in lower stock valuations. But while rates have been rising, earnings growth remains strong (and, in fact, has gotten stronger in recent months). That's why I believe we're not in the late cycle yet: The two drivers for valuations are now offsetting each other, leaving the fair value P/E in somewhat of a holding pattern. Call it purgatory I guess, but that's where we are—stuck somewhere in the middle. After an epic two-year run, that may seem like harsh medicine, but compared to a bear market I think it's a pretty good outcome.

From volatility to buying opportunity

Of course there is no lack of other things to worry about, from the Fed's rate-hike policy to trade tariffs to the constant barrage of market-moving "tape bombs" emanating from Washington, DC. But all these things are already reflected in a P/E that's down three points since late January. Maybe it should go lower still. Regardless, from here on it will be all about the earnings. As long as earnings can offset the valuation drag, the benign reset can continue.

For me, though, the high valuation across all asset classes is and will likely remain a big headwind for the markets for the foreseeable future. Since the end of the financial crisis in 2008, companies have bought back $4.0 trillion of their own shares.[4] These "buybacks" lower the number of shares a company has available for trading, which inflates the earnings per share and, in turn, understates the P/E. Meanwhile, the Fed has bought $3.7 trillion worth of bonds since 2008.[5] Thus, it's easy to conclude that this form of "non-economic" demand for financial assets has elevated stock valuations and suppressed their volatility.

For now, though, with the positives and negatives somewhat offsetting each other, I don't see the ingredients for an imminent resumption of the bull market or the beginning of a bear market. Perhaps the truth will be somewhere in between, where the S&P 500 makes a new low (say, to 2,450 or so), but then quickly reverses itself. Even a 15% correction is not that big of a deal, statistically speaking, and it is certainly a possibility. But against the backdrop of robust earnings growth and a tightening-but-not-too-fast Fed, I would view that as an attractive buying opportunity.

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Endnotes

1 Source: FactSet, as of 1/31/18.

2 A drawdown is the peak-to-trough decline of a particular investment during a specific time frame, and is typically quoted as the percentage between the peak and the subsequent trough.

3 Forward P/E reflects earnings growth forecasted for the next 12 months.

4 Bloomberg.com, "Stocks Lose Critical Buyer at Worst Time," 4/2/18.

5 https://www.cnbc.com/2017/04/06/fed-balance-sheet-what-happens-why-it-matters-what-could-go-wrong.html.

Index definitions

Standard & Poor's 500 (S&P 500®) Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of the McGraw-Hill Companies, Inc., and has been licensed for use by Fidelity Distributors Corporation and its affiliates.

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