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# Market Shakeup: What's next?

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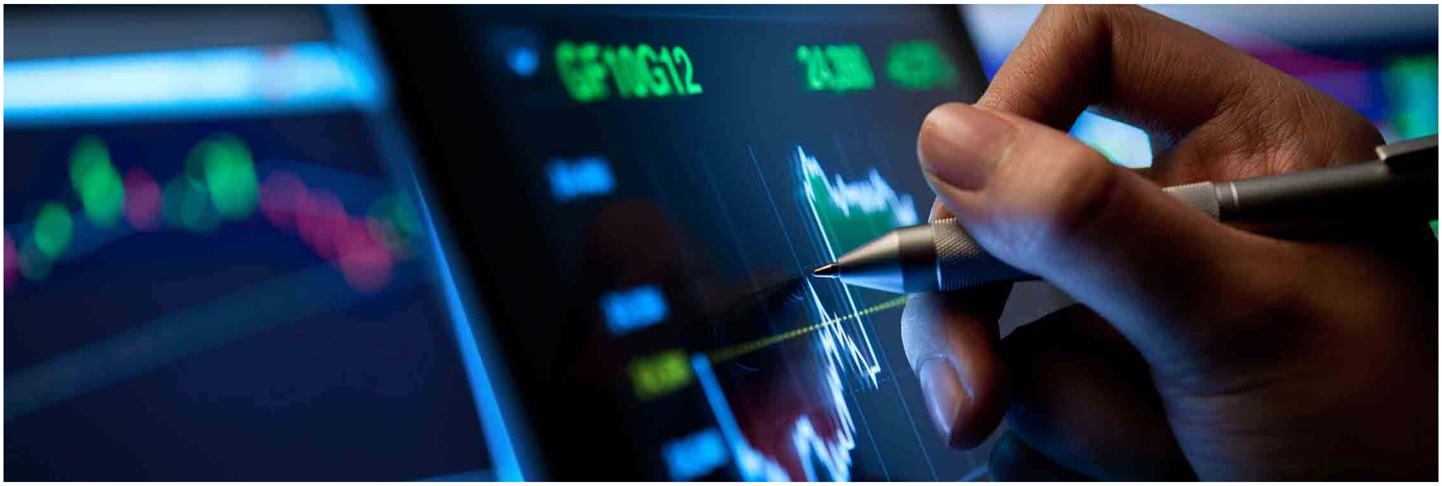
## With valuations down and earnings strong, the bull run is likely not over yet.



## Key Takeaways

- Behind the recent market pullback were 2 imbalances: investors' seeming disregard for rising bond yields, and stock valuations that were high by historical standards.
- I see the market as now being in much better balance, with strong earnings growth pushing the market higher, but rising rates acting as a valuation headwind.
- I believe this is still a bull market scenario, albeit a more late cycle one than before.

After a record run of very strong gains and very low volatility, the stock market correction of the past 2 weeks has been swift and violent, with stocks getting hit by various liquidity air pockets as levered positions in various corners of the market were liquidated.

At its worst point last Friday, the S&P 500 index had fallen 11.8% from its intraday high of 2873 on January 26.

## How did we get here?

In my view, the stock market decline was the inevitable correction of 2 imbalances that have accumulated since last August. One imbalance resulted from the stock market's apparent lack of attention to the sharp rise in bond yields (even bringing with it memories of 1987 when the market plummeted in the face of rising rates). The other imbalance was the product of the stock market gaining twice as much as I can justify by the recent tax cut and its resulting sharp rise in earnings estimates.

Last August was a pivotal time because that's when the probability of tax cuts started to get priced into the market again. From that point on, the S&P 500 has rallied 457 points to its recent high.

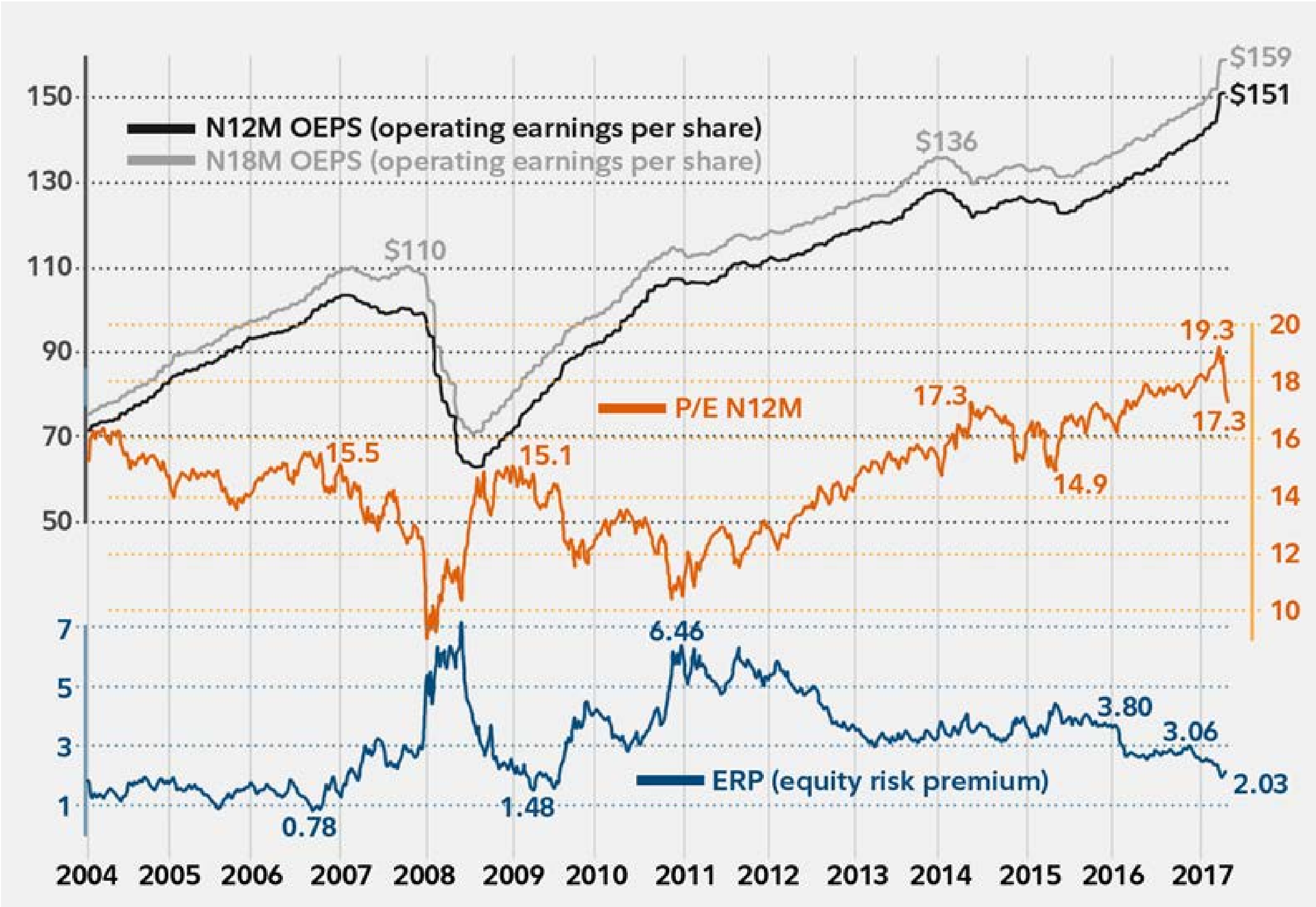
The problem with that rally was that only half of it was justified, based on consensus analysis, by the earnings windfall from the tax cuts. The conventional wisdom on the street has been that the corporate tax cuts are worth around $2/share per percentage point in the effective tax rate, or $10/share in total if the effective tax rate declines from 26% to 21%. So at a P/E ratio of 20x that equates to around 200 S&P points ($10 x 20 = 200 points). But the rally was good for 450 points, with the other 250 points coming from P/E expansion.

I view a rally in the stock market because of stronger earnings growth as completely justified since stock prices tend to follow earnings. And, according to the discounted cash flow model (DCF), even an expansion of the P/E multiple makes sense if the increase in earnings growth is sustained (which it presumably would be in this scenario since the corporate tax cuts are permanent). The key market in a DCF model is the discount rate. One way to think about determining an appropriate discount rate is how much should you pay today for an asset that will pay you back in the future.

But the problem is that valuation multiples are already elevated as a result of the unconventional monetary policy of the post-2008 era. That has pushed down interest rates and, in turn, has pushed up the valuation of pretty much all asset classes, including equities. On top of that, the equity risk premium (the excess return that investing in the stock market provides over a risk-free rate) has fallen to 2.0%, which is by no means a record low but well below the long term average of about 4%.

So, between a suppressed risk-free rate and a below-average risk premium, the overall discount rate that is used to calculate the present value of future earnings growth is quite low at 4.8%, which in turn has led to rich valuations for equities. If the discount rate was a more typical 6%-7%, we would be looking at a P/E ratio several points lower.

## Earnings & valuation




Source: FMRCo, Bloomberg, St. Loius Fed. Weekly data.
N12M and N18M stands for next 12 months and next 18 months.

At the recent high, the P/E ratio (using 12-month trailing earnings) had climbed to 22x and the forward P/E (using expected earnings) had reached 19.3x. Those were the highest levels since 1999 and more than 2 P/E points above the levels from last August, when this latest rally kicked off.

In my view, to argue that P/E ratios should expand even further because of the tax cuts is technically correct but hard to justify given how elevated valuation levels already are.

The other imbalance was just a simple matter of the stock market ignoring the bond market.

Interest rates—and liquidity conditions in general—are an essential piece of the equity valuation puzzle, along with earnings. The combination of earnings growth and liquidity conditions tend to drive valuations higher or lower, and since early 2016 the stock market has enjoyed a simultaneous surge in earnings growth and a sharp easing of financial conditions (i.e., more liquidity).

That easing of financial conditions occurred despite the Fed tightening 5 times with another 6 signaled, in addition to a gradual reduction in the Fed's balance sheet. The yield on the 10-year Treasury has now more than doubled off its historic low of 1.32% in July 2016. As of last week, the 10-year has now climbed to 2.88%, which is up 87 basis points since last August's 2.01% low.

Amid the euphoria of the explosive re-rating in corporate earnings it has been clear that the markets were too complacent about the other side of that trade, which is that adding fiscal stimulus to an economy that is operating at full capacity 9 years into an expansion might just create a classic late cycle overheating phase, with all the implications therein for the Fed, interest rates, the yield curve, and risk premium. In retrospect, a yield of 2.0% last August didn't make much sense.

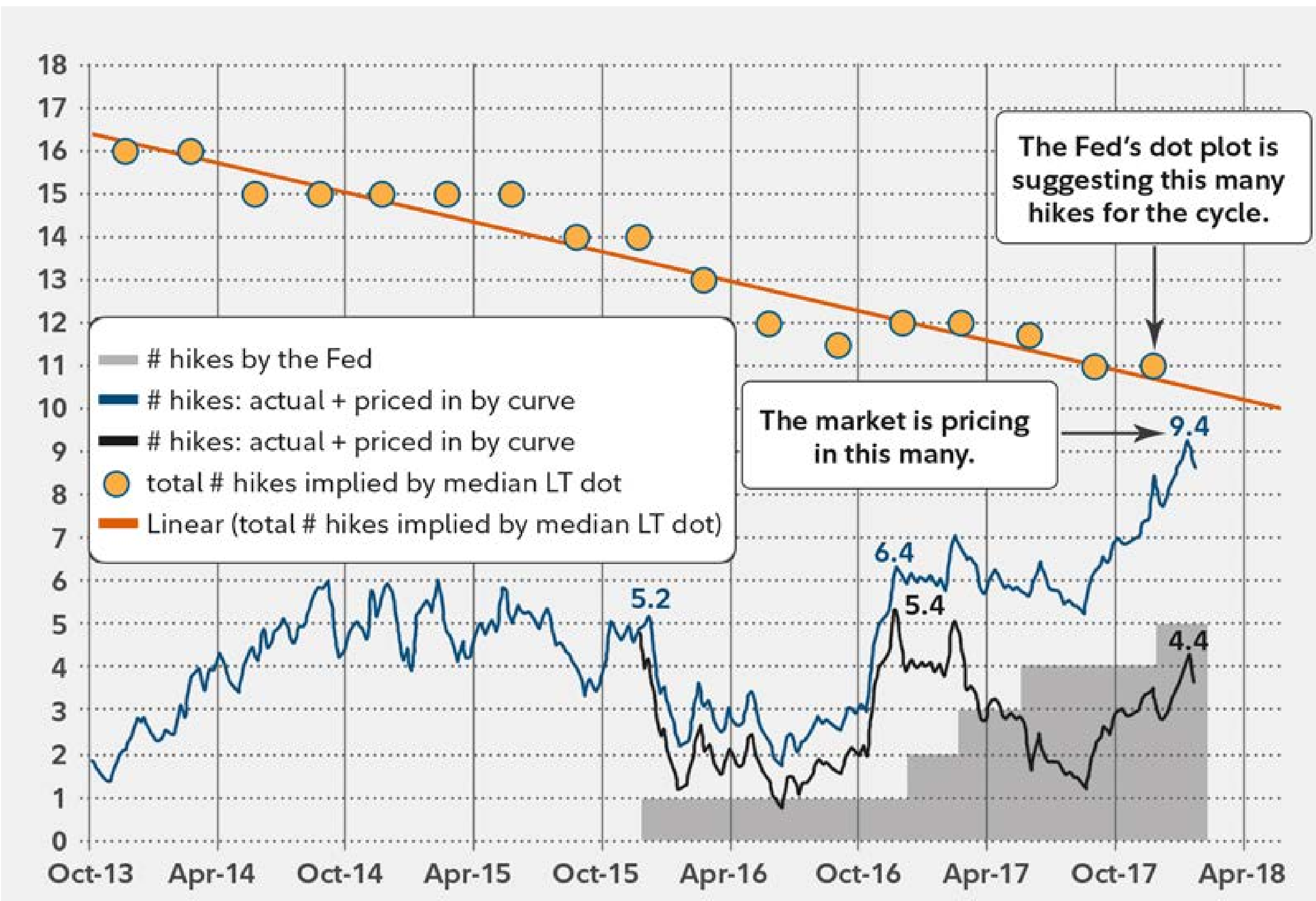
## Problems solved?

So where does this leave us now? The good news from my perspective is that these 2 imbalances—rising rates being ignored by the stock market and valuation multiples rising beyond what I think can be justified—have now mostly corrected.

For one, the market has completely given back the 2-point valuation boost since last August. The trailing P/E is now back to 20x and the forward P/E is back to 17x. Second, the bond market has now gone from pricing in one more Fed rate hike over the next 2 years to pricing in over 4 more hikes. Predicting interest rates is a notoriously difficult exercise, but my guess is that at a yield of near 3% the 10-year is a lot closer to some sort of equilibrium than it has been in several years. At 3% or so, bond yields are consistent with another 4 or 5 Fed hikes and that seems to me like a reasonable bet for this Fed cycle.

So, between these 2 adjustments, I see the stock market as now being in much better balance, with strong earnings growth pushing the market higher but rising rates acting as a valuation headwind. This is a market regime wherein stock prices should rise less than earnings growth, not more than earnings, as has been the case for several years. With earnings up strongly, this is still a bull market scenario, albeit a more late cycle one than before.

The market vs. the Fed




Source: Bloomberg, FMRCo. Weekly Data.

## What's ahead?

Whether last week's correction ended on Friday or continues for several more weeks or months to come is of course unknowable. But the good news is that (a) bond yields are now in much better synch with the Fed, (b) the stock market has given back its (in my opinion unjustified) valuation bump from last August, and (c) it is paying attention to the bond market again (as well it should). And of course we have (d) double digit earnings growth.

All in all, that makes me feel a lot more comfortable about where the market is at and where it is likely to go.

## ABOUT THE EXPERT

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