Four Key Drivers for Stocks in 2018

Earnings, liquidity, Fed policy, and China may be the biggest market movers in the new year

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Key Takeaways

- 2018 could produce a more two-sided risk-return dynamic as corporate earnings growth moderates back to trend and liquidity conditions start to tighten.
- With the global economy growing again, the conversation in 2018 will likely continue to focus on monetary policy, particularly the speed and magnitude of the Fed's planned normalization path.
- While the prospects and impact of tax legislation in the U.S. have taken center stage, investors should keep a close eye on China in terms of the policy tightening that's under way there.
- All of this may well leave the market in 2018 somewhere between the strong mid-cycle returns of 2017 and the possibility of a more turbulent dynamic in 2019.

Setting the stage

What a year 2017 was for investors.

The U.S. stock market enjoyed a nearly unparalleled combination of high returns and low volatility in 2017. In fact, the risk-adjusted return of the Standard & Poor's 500 Index (S&P 500) through November is at the 99th percentile since 1926. In other words, during the past 91 years, the stock market's annual risk-adjusted return was higher than 2017's only 1% of the time.

The driving forces behind 2017's spectacular risk-return dynamic were strong earnings growth and easy liquidity conditions, juxtaposed against low investor expectations. Double-digit earnings growth (11% in 2017) and easing financial conditions—despite five interest-rate hikes in the past two years—created a strong tailwind for equity valuations. As a result, the trailing price-to-earnings (P/E) ratio[1] for the S&P 500 has risen by three points since the 2016 election, from 18.5 to 21.7.

This illustrates how stock market math almost always comes down to three pillars: earnings, valuation, and liquidity. Those are the moving parts that are continually in flux to produce different market regimes over time. As shown in Exhibit 1 (see page 2), the performance of the U.S. stock market (as measured by the S&P 500) is for the most part directly correlated to the direction of earnings growth and of liquidity (as measured by the Goldman Sachs Financial Conditions Index).

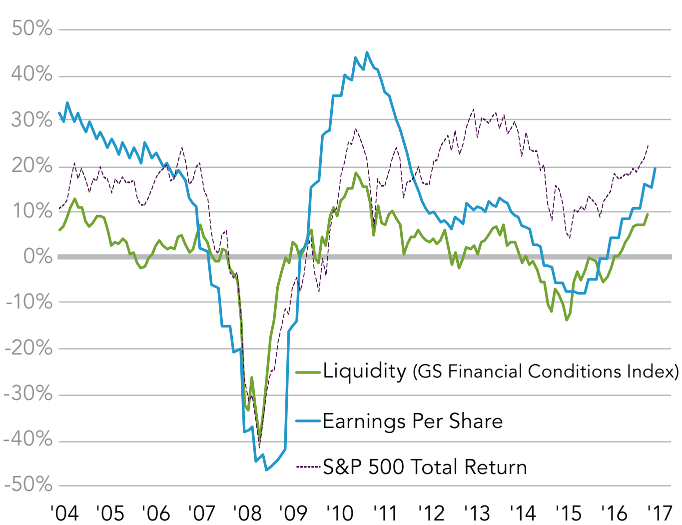
Part of 2017's strong return was also due to the fact that few investors were positioned for this rally. This has been a relatively unloved bull market, even after an eight-year run in which the S&P 500 has gained a cumulative 334%. Think back to what sentiment was like a year ago. Prior to the U.S. election, the consensus was that if the Democrats won there would more secular stagnation (low economic growth = low returns), while a Republican win would cause the market to fall due to increased protectionism.[2] It seemed like a lose-lose situation for stocks based on conventional wisdom, so few investors were correctly positioned for the epic rally that was about to ensue.

Four key drivers in 2018

The big question today, of course, is whether the recent Goldilocks environment can continue in 2018. While I remain constructive on the stock market, it's unlikely it will be able to replicate the ideal conditions of 2017. Here are four key drivers that I believe may have the biggest effect on stocks in 2018.

EXHIBIT 1: Historically, earnings and liquidity drive stock prices over the long term.

S&P 500 Return Relative to Earnings and Liquidity (%), 2004 to 2017



Source: Bloomberg Finance L.P., Fidelity Investments, as of Dec. 8, 2017.

Earnings

I think 2018 will be a year in which the "P" (price) in P/E goes up only as much as the "E" (earnings).

For one, it appears that earnings growth has begun to moderate back to its long-term growth rate of 7%. This is a normal development two years after a cyclical bottom. A more moderate earnings growth environment is still a positive prop for the markets, but it should be less of a tailwind for stock valuations than the double-digit growth we've seen since the first quarter of 2016.

It is possible that earnings growth would get a boost from a cut in the corporate tax rate (if enacted), but how much of a boost remains to be seen. Some experts believe the effective tax rate (not the statutory rate) will only decline by a few percentage points.[3] Ultimately, if tax reform lowers corporate taxes it could improve earnings for U.S. companies, particularly for some domestically oriented sectors, and for small-cap stocks, which pay higher taxes today relative to large multinationals. Nevertheless, I think that the overall impact of the cuts may be smaller than previous efforts at fiscal stimulus.

Liquidity

In my opinion, the bigger factor that could limit the upside for risk-adjusted returns is the liquidity environment. It's impressive that financial conditions (which are affected by the dollar, interest rates, credit spreads, and stocks) have eased substantially since early 2016. This is despite multiple rate hikes by the Federal Reserve Board (Fed), which has also now begun to shrink its balance sheet. Fed rate hikes are called "tightening" for a reason—it's what the Fed aims to do to financial conditions when it sees the threat of rising inflation.

It's possible the Fed will need to tighten further—and perhaps a lot further—if and when inflation finally starts to show up. At this point, the market is only pricing in two and a half more hikes after its just-executed fifth hike since December 2015. That seems too low to me, and it's well below the six more hikes that the Fed is signaling via its dot plot. As long as inflation remains well below the Fed's 2% target as it did in 2017, perhaps the market will be proven correct. But the risk is that the Fed tightens more and faster than the market is pricing in. If that happens, it could send both the dollar and real rates higher, which could lead to tighter financial conditions and less support for equities.

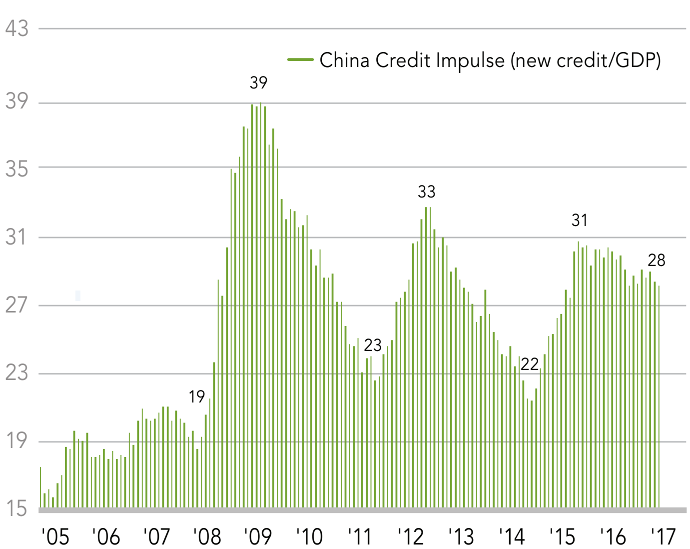
Fed policy

That being said, I disagree with some of the more dire views out there, which claim the Fed is on the cusp of committing a policy error that will invert the yield curve sometime in 2018. An inversion of the yield curve (when short rates rise above long rates) historically has been one of the most reliable predictors of a recession and bear market. But with the overnight rate at 1.375% and the 10-year Treasury yield at 2.38%, there's still about 100 basis points of room left before the yield curve inverts. It would require five additional quarter-point rate hikes from the Fed before the curve inverts, assuming long rates stay where they are. In all likelihood, the Fed would only raise rates that aggressively if inflation forced it to. And if that happened, long rates should rise instead of fall, deterring a curve inversion in the process.

One additional caveat is that it is still unclear how the shrinkage of the Fed's balance sheet will affect financial conditions. The Fed's balance sheet reduction will remove some liquidity from the financial markets, but so far investors have not reacted negatively to the news. Whether this reflects complacency, a delayed reaction, or simply a non-event remains to be seen. In any case, it's an added dimension to the Fed's monetary policy discussion, and one that could play an important role in 2018 and beyond.

EXHIBIT 2: China and global markets tend to benefit when China's credit impulse is near or above 30%.

China's Credit Impulse (%), 2005 to 2017



GDP: gross domestic product. Source: Bloomberg Finance L.P., as of Dec. 8, 2017.

China

Another key player for the market will be China. A lot of the gains in global equities since early 2016 can be attributed to China's reflation[4] in late 2015 and early 2016. China produced what we call a "credit impulse" (new credit as a percentage of GDP) of 31% in early 2016. That credit reflation produced ripple effects throughout the emerging markets as well as the developed markets.

Now the question is how China's recent policy tightening (in an attempt to rein in speculative lending practices) will affect its economy and the global markets. In the past, the "hangover" phase of these credit impulses ended up causing enough strain to require a renewed credit impulse a few years later. It was a constant roller coaster, with new credit as a percent of GDP swinging from 19% in 2008 to 39% in 2009, back to 23% in 2011 then up to 33% in 2013, and then back down to 22% in 2015 before rising to 31% in 2016 (see Exhibit 2).

Through mid-December 2017, China's new-credit-as-a-percent-of-GDP metric is at 28%, which shows that the Chinese leadership is keeping things running at a high level. If that continues, it should continue to provide a tailwind for global earnings. However, if the credit pendulum swings back to the low 20's as it has in the past, we could see some real pressure on earnings in 2018.

From 2017 to 2018: a tough act to follow

In trying to envision 2018 through my "three pillars" lens (earnings, valuation, liquidity), I just don't see a continuation of the 2017 scenario, in which rising earnings growth and easing liquidity conditions push valuations higher—a situation where prices increase more than earnings, which are also rising. A more likely scenario for 2018 seems to be one in which earnings continue to climb but at a more moderate pace, while with the removal of the liquidity tailwind creates a scenario in which stock prices rise equal to or more slowly than earnings.

I also sense that 2018 will produce a more balanced two-way dynamic between equity market returns and volatility, as 2017 did for bonds. In other words, stocks will likely have less-positive returns and more volatility in 2018. Historically, the S&P 500 has produced an annual return of 11% against a volatility of 15.[5] Since February 2016, however, it has been a 20% return against a volatility of 6. This is not normal and not something that investors should ever count on.

On the whole, I believe the stock market in 2018 may end up somewhere between the strong mid-cycle returns of 2017 and the possibility of a more turbulent late-cycle dynamic in 2019. All in all, that's not a bad outcome after the run the market's been on.

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Endnotes

[1] Trailing P/E is the current price of a stock divided by the previous year's earnings per share.

[2] Protectionism: Government actions/policies that restrain international trade in order to protect local businesses and jobs from foreign competition.

[3] The effective tax rate for a corporation is the average rate at which its pre-tax profits are taxed. The statutory tax rate is the rate imposed on taxable income of corporations after deductions for labor costs, materials, and depreciation of capital assets.

[4] A fiscal or monetary policy, such as lowering interest rates or reducing taxes, intended to designed to expand a country's output.

[5] As determined by the S&P 500's Sharpe ratio, a measure that indicates the average return minus the risk-free return divided by the standard deviation of return on an investment.

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. Third-party marks are the property of their respective owners; all other marks are the property of FMR LLC.

Goldman Sachs Financial Conditions Index tracks changes in interest rates, credit spreads, equity prices, and the value of the U.S. dollar. A decrease in the index indicates an easing of financial conditions, while an increase indicates tightening.

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