After the Comeback

What's next after the V-shaped reversal?

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Key takeaways

- The S&P 500® index's 14% gain in Q1 2019 following the 14% loss in Q4 2018 is another example that sometimes the best action for an investor to take is: nothing.
- Context is everything, and the four lenses of earnings, liquidity, valuation, and sentiment remain moderately constructive for risk assets, in my view.
- The main risk at this point is that the expected "V-shaped" earnings recovery turns into a "U" or an "L."
- If that happens, I think the Federal Reserve will need to cut rates several times, and that doesn't seem likely anytime soon.
- But with China reflating, an L-shaped earnings curve also seems unlikely; indeed, if earnings rebound as expected, new highs may not be far behind.

Well, that was quick: Following a 14% decline in Q4 2018, the S&P 500® (total return) index gained nearly all of it back in the first quarter of 2019. Stocks put the "V" into "V-shaped," although a 60/40 portfolio combining the S&P 500 with investment-grade bonds did even better, gaining 9% after losing 8%. It's a good reminder that sometimes when the market is going through a correction, the best action to take is: nothing. Selling just because the market is headed down is not always a winning strategy for investors, as many recently found out the hard way. To wit, investors redeemed $89 billion worth of U.S. equity funds and ETFs in Q4, and they kept right on selling in Q1—to the tune of at least another $66 billion—despite the market's strong rebound.

I have updated my "periodic table" of asset class returns (Exhibit 1) through Q1 2019. While the first quarter does not a year yet make, you can see the reversals from last year. Most notably, cash plunged from first to worst.

Will it continue? As always, context is everything. As investors, we have to make assumptions as to where we are in the business cycle and beyond; otherwise, most indicators become a coin toss. Exhibit 2 illustrates how the market historically has performed following a 20% decline. The odds of a strong gain are roughly equal to the odds of a further sharp decline. Again, context is key. For me, that context comes through the four lenses of sentiment, rates, earnings, and valuation. So, let's take a look.

Sentiment

As noted above, I think sentiment remains oversold. Despite the rally, investors continue to sell at a record pace. According to EPFR Global, since Q3 2018 through Q1 2019 investors have sold a staggering $147 billion of equity funds and ETFs. That's pretty amazing considering that this bull market is now 10 years old and the S&P 500 has so far charted a nearly five-fold increase. Usually everybody loves the market after a long advance, in my experience, but that is not the case today.

Perhaps this is how things will continue, or perhaps at some point the public jumps back in. Maybe the world's aging demographics play a role here in terms of investor preference for income-producing assets instead of straight equities. Or maybe investors have been getting their equity exposure through solutions-based funds instead of pure equity products (the data I look at considers only pure equity vehicles).

EXHIBIT 1: Cash fell from first to worst in Q1

Annual Returns for 20 Major Asset Classes Ranked in Order of Performance (1988–2018 and 1Q2019)

EM	EM	TIPS	EM	SV	EM	com	LV	EMD	LV	LG	EM	REIT	REIT	com	EM	REIT	EM	REIT	EM	LT	EM	SG	LT	EUR	SG	REIT	JPN	SV	EM	cash	SG	U.S. Small Cap Growth Stocks
JPN	LG	IGB	SG	LV	EAF	JPN	SPX	REIT	SPX	EUR	JPN	SV	SV	gold	SG	EM	JPN	EUR	gold	IGB	HY	REIT	TIPS	EM	SC	LT	LG	SC	LG	LG	REIT	Real Estate Investment Trusts
SV	SPX	cash	EMD	SC	EUR	EAF	LG	LG	SV	SPX	SG	com	HFs	TIPS	SC	SV	com	EM	EUR	cash	gold	SC	gold	EMD	SV	SPX	REIT	LV	EUR	IGB	SC	U.S. Small Cap Equity
EAF	LV	LT	HY	HY	SV	cash	LT	SPX	LG	EAF	LG	LT	IGB	LT	SV	EUR	gold	EAF	TIPS	gold	LG	SV	REIT	SV	LG	LV	SPX	HY	EAF	gold	SPX	S&P 500
LV	EUR	LG	SC	EMD	HFs	EUR	SG	LV	EUR	LV	EAF	EMD	TIPS	EMD	EAF	EAF	EAF	gold	LG	TIPS	EUR	gold	EMD	EAF	LV	LG	EMD	SPX	JPN	LT	SV	U.S. Small Cap Value Stocks
SC	SG	com	LG	REIT	SC	LG	SC	EUR	SC	LT	HFs	HFs	HY	IGB	EUR	SC	REIT	SV	EAF	EMD	SG	EM	IGB	REIT	SPX	TIPS	IGB	EM	SPX	HY	LG	U.S. Large Cap Growth Stocks
SPX	TIPS	SPX	SV	EM	LV	SPX	EMD	SV	REIT	HFs	EMD	TIPS	LT	REIT	REIT	LV	EMD	LV	LT	HFs	EAF	LG	HY	LV	JPN	IGB	cash	com	SG	LV	EUR	Developed Europe Equity
SG	LT	EUR	REIT	LT	REIT	REIT	TIPS	HFs	HFs	IGB	SC	IGB	cash	HFs	JPN	JPN	EUR	SC	com	HY	REIT	JPN	LG	SC	EUR	SG	EAF	SG	SC	SPX	EAF	Foreign DM Equity
EUR	JPN	gold	SPX	SPX	LT	HFs	SV	com	LT	cash	SPX	LV	SC	cash	LV	SG	LV	SPX	SG	SV	EMD	LV	SPX	SPX	EAF	EMD	LT	EMD	LV	REIT	EM	EM Equity
REIT	SC	HY	LV	IGB	HY	HY	EUR	SC	SG	TIPS	com	cash	gold	HY	LG	TIPS	LT	SG	IGB	JPN	SC	HY	LV	HY	HY	SC	SG	REIT	gold	EMD	LV	U.S. Large Cap Value Stocks
HY	SV	EMD	LT	LG	EMD	gold	HY	HY	HY	HY	EUR	SC	EMD	EM	HY	EMD	TIPS	HY	EMD	SC	SPX	SPX	cash	LG	HFs	SV	EUR	LG	EMD	com	HY	High-Yield Debt
EMD	IGB	EM	TIPS	SG	gold	SV	IGB	SG	EMD	SG	LV	gold	EM	JPN	SPX	HY	LG	EMD	SPX	LV	com	com	SG	SG	REIT	HY	HFs	gold	SV	TIPS	JPN	Japan Equity
LG	EAF	LV	IGB	TIPS	SG	SC	REIT	EAF	IGB	gold	cash	HY	LV	SV	EMD	SPX	SPX	HFs	cash	SPX	SV	EMD	SC	TIPS	cash	cash	LV	TIPS	LT	HFs	EMD	EM Debt
com	REIT	REIT	EUR	cash	JPN	LV	HFs	EM	cash	SC	TIPS	EUR	SG	LV	com	gold	SV	LG	HFs	com	LV	LT	SV	JPN	IGB	HFs	SC	JPN	TIPS	SG	TIPS	TIPS
TIPS	cash	SG	EAF	com	TIPS	SG	EAF	cash	EMD	SV	HY	SPX	SPX	EAF	gold	com	SC	JPN	HY	REIT	HFs	TIPS	HFs	IGB	EM	gold	HY	IGB	HY	SC	LT	U.S. Long-Term Treasury
LT	EMD	SC	cash	EUR	SPX	IGB	com	IGB	EAF	JPN	IGB	EAF	EUR	EUR	HFs	LT	SG	cash	LV	LG	TIPS	EAF	com	LT	EMD	EM	TIPS	HFs	HFs	JPN	gold	Gold
IGB	HY	EAF	JPN	gold	IGB	TIPS	cash	TIPS	com	EMD	SV	LG	LG	SC	TIPS	LG	cash	IGB	SC	SG	JPN	IGB	EUR	HFs	com	JPN	SV	EAF	REIT	SV	IGB	Investment-Grade Bonds
cash	gold	SV	gold	EAF	cash	EM	JPN	LT	EM	REIT	gold	SG	com	SPX	IGB	IGB	HY	LT	JPN	EAF	IGB	HFs	EAF	gold	LT	EAF	gold	LT	IGB	EAF	HFs	Hedge Funds
gold	com	JPN	com	JPN	LG	LT	gold	JPN	JPN	EM	REIT	JPN	EAF	LG	LT	HFs	HFs	TIPS	SV	EUR	cash	EUR	JPN	cash	TIPS	EUR	EM	cash	cash	EM	com	Commodities
—	—	—	—	—	com	EMD	EM	gold	gold	com	LT	EM	JPN	SG	cash	cash	IGB	com	REIT	EM	LT	cash	EM	com	gold	com	com	EUR	com	EUR	cash	Cash
'88	'89	'90	'91	'92	'93	'94	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09	'10	'11	'12	'13	'14	'15	'16	'17	'18	'19	

Past performance is no guarantee of future results. Diversification/asset allocation does not ensure a profit or guarantee against loss. It is not possible to invest directly in an index. All indices are unmanaged. Asset classes represented by: cash—Bloomberg Barclays 3-month Treasury Bellwether Index; U.S. large cap growth stocks—Russell 1000 Growth Index; investment-grade bonds—Bloomberg Barclays U.S. Aggregate Bond Index; gold—Handy & Harman gold price; U.S. long-term Treasury—Bloomberg Barclays U.S. Long-term Treasury Index; high-yield debt—Bloomberg Barclays High Yield Index; U.S. large cap value stocks—Russell 1000 Value Index; SPX—S&P 500 index; real estate investment trusts—MSCI US REIT Index; emerging-market debt—JPM EMBI Global Index; commodities—Bloomberg Commodity Index Total Return; TIPS (Treasury inflation-protected securities)—Bloomberg Barclays U.S. TIPS Index; hedge funds—HFRX® data; U.S. small cap growth stocks—Russell 2000® Growth Index; U.S. small cap equity—Russell 2000® Index; Japan equity—MSCI Japan Index; small cap value stocks—Russell 2000® Value Index; foreign developed-market (DM) equity—MSCI EAFE Index; emerging-market (EM) equity—MSCI Emerging Markets Index; developed Europe equity—MSCI Europe Index. Sources: MSCI, Bloomberg, Standard & Poor's, Haver Analytics, HFRX®, Handy & Harman, Fidelity Investments, as of March 31, 2019.

But it may also be that even after 10 years investors remain traumatized by the 2007–2008 financial crisis and don't trust the stock market with their money. And if they do invest, they have an itchy trigger finger, as the recent outflows illustrate. When I am out talking with other investors and financial pundits, the questions generally still center on what can go wrong rather than what can go right.

This skeptical sentiment likely is compounded by the fact that the stock-market gains since 2008 were at least in part catalyzed and compounded by the Fed's quantitative easing and policy of zero interest rates, as well as by companies' financial engineering. It's a fair enough argument. I also think that there's a behavioral aspect going on here: People fear financial losses more than they desire gains, and now that the cycle is so advanced, many just assume (perhaps correctly) that the next big move is more likely to be down than up.

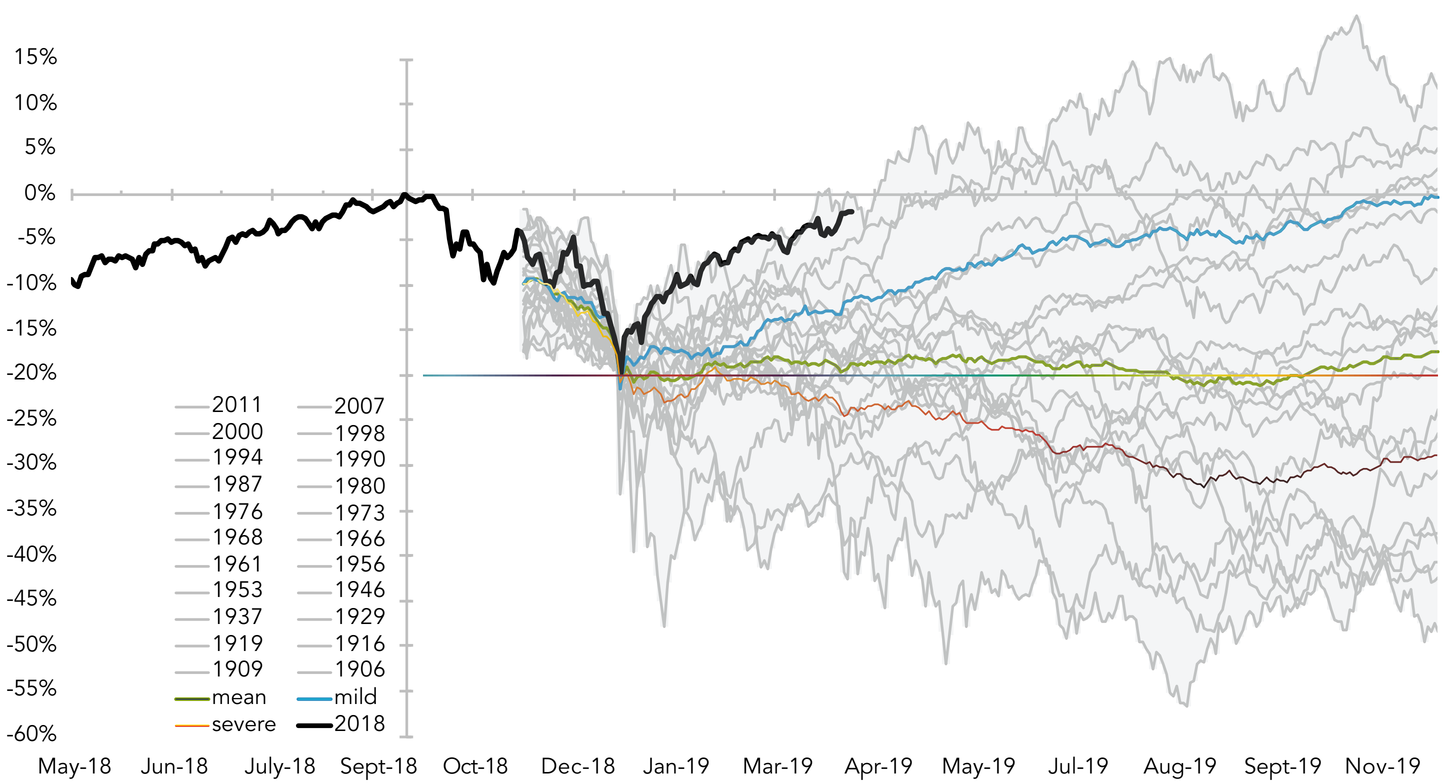
All in all, though, the sentiment lens still paints a fairly constructive picture, in my view.

Liquidity conditions

What about interest rates and financial conditions? According to the March Federal Open Market Committee (FOMC) meeting, the current Fed tightening cycle is a wrap. After nine hikes totaling 225 basis points—plus

EXHIBIT 2: The market is about as likely to rise as it is to fall following a sharp decline

S&P 500 Percentage Price Movement Following a 20% Drawdown



The exhibit above displays an undifferentiated historical view of cyclical tops followed by a significant decline to develop mean, mild, and severe reference lines.
Source: FactSet, Fidelity Investments; daily data since 1928, monthly prior.

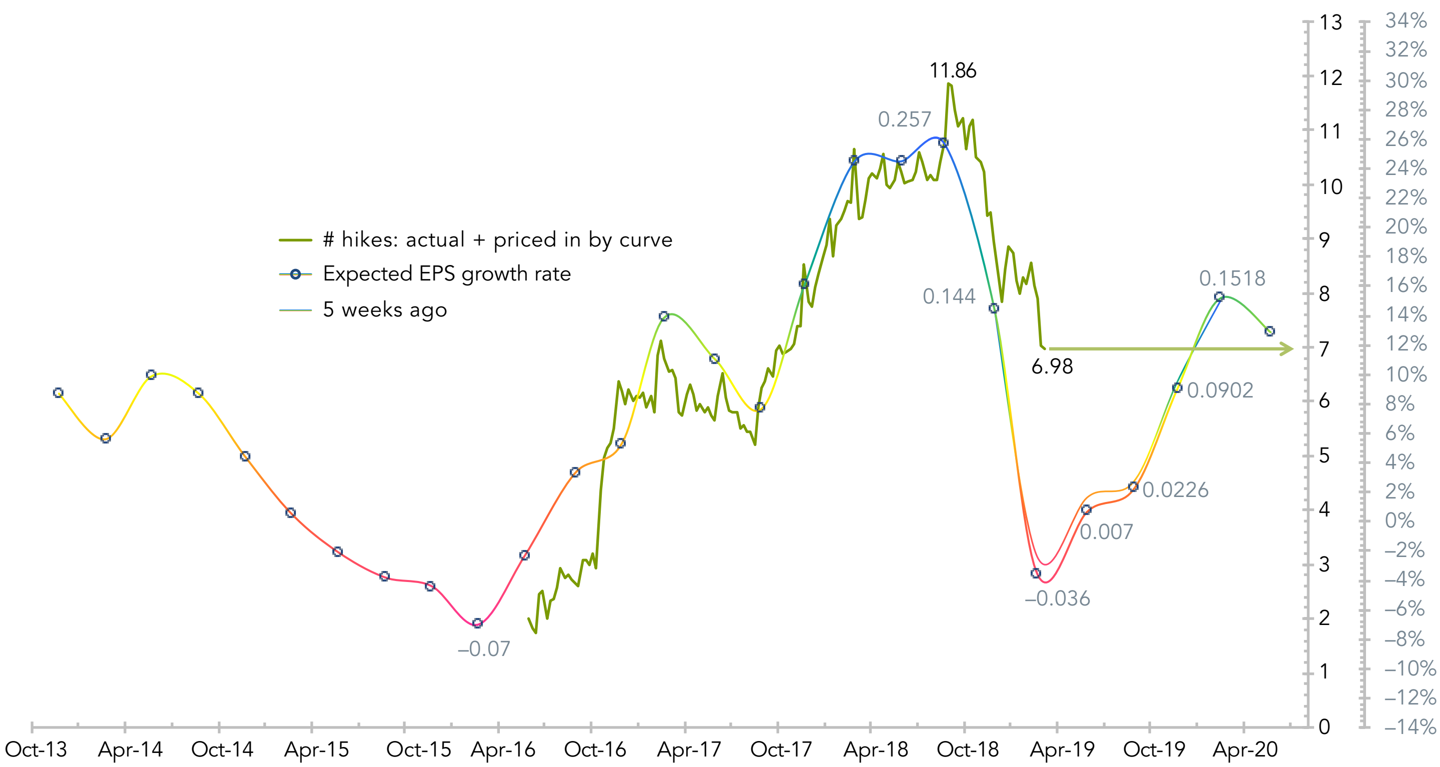
around $800 billion in balance-sheet reductions—the Federal Reserve apparently is ending its policy-normalization campaign (Exhibit 3). Hard to believe how fast the narrative has changed from six months ago, when the Fed was raising expectations for five more hikes through 2020.

If estimates for the so-called neutral rate, or "R-Star," are to be believed, the Fed has ended its policy-normalization campaign just below neutral. If we add in the effects of balance-sheet reduction, I would argue that the "shadow" policy rate (i.e., adjusted for the Fed's balance sheet) will end just shy of +1.0% later this year. That's still right around neutral—and also well shy of previous Fed tightening highs, which saw inflation-adjusted policy rates peak at 3.3% in 2007, 4.8% in 1999, and 5.4% in 1989. Makes me wonder where the next cycle peak will be—or the next trough for that matter. The last three troughs in real rates were +0.1% in 1993, -1.1% in 2004, and -2.0% in 2012. Are we looking at -3% in 2022? To me, that's a scary thought.

While the Fed looks like it panicked in December—giving the appearance that it is beholden to the market or to political pressures—when you consider the pivot in the context of the tightening in financial conditions, the persistent undershooting of inflation targets (despite rising labor costs), the proximity to the neutral rate, and the unknown consequences of balance-sheet reduction, the Fed's decision to stop tightening appears prudent, in my view.

EXHIBIT 3: The Fed signals an end to its policy-normalization campaign

Earnings Growth Estimates and the Fed Rate-Setting Cycle, 2013–2019



EPS: Earnings per share. Sources: Bloomberg Finance, L.P., Fidelity Investments; weekly data through March 31, 2019.

But as we can see from the action in the yield curve in recent weeks, the conversation seems to be quickly switching gears again, this time towards an even bigger pivot. First it was about tightening less than advertised via the dot plot (the graph showing FOMC members' expectations of future policy rates), then it was about not tightening at all. Now it's about easing. Indeed, the money-market curve is now pricing in several rate cuts by 2021. That's not my base-case scenario at all, and I suspect the prospect of rate cuts may be a bridge too far for this Fed, or at least too soon.

How quickly the Fed may or may not follow the market's lead towards rate cuts could end up making a big difference for stocks. For instance, during the 1994 and 1998 market cycles, the Fed started cutting rates in just a matter of weeks following their respective stock-market corrections, and in both cases the market responded with a "melt up" in stock prices. But in 2007, the market's signal for the Fed to cut rates went unheeded for many months. We all know what happened next. I don't think today's conditions are anything like 2008, but the example does highlight that the Fed's response to the bond market matters.

Earnings and Valuation

As for valuation, the price-earnings (P/E) ratio for the S&P 500 is in the neutral zone at 16.7x expected earnings. The January 2018 valuation peak found the P/E was at a "nosebleed" level of 19.5x, only for the P/E to fall six points to the low of 13.7x in December 2018. In 2019, it's lately back to middle ground. As I see it, with the Fed on hold, valuation all comes down to earnings. If earnings growth stages the V-shaped recovery that the market expects, the current valuation makes sense; if not, it's probably too high.

The year-over-year annual earnings growth rate peaked in Q3 2018 at +26% (Exhibit 3 again). It decelerated to +14.5% in Q4 and, with quarterly earnings season around the corner, is expected to decline to -3.9% in Q1. For calendar year 2019, Wall Street's estimate is for +4.6% growth (following +22% growth in 2018). I still see some downside risk to the 2019 estimate given recent downward drifts in estimates, but mostly I think we'll see at least a little growth in 2019 before earnings presumably return to trend in 2020.

The Street is betting on a V-shaped earnings recovery to begin in the second half of 2019, to match the V-shaped stock-price recovery. If that happens, I think the Fed can probably afford to do nothing—neither easing nor tightening—for the next few quarters. The downside risk, as I see it, is that the V turns into a U or even an L, in which case the Fed will need to heed the bond market's warnings evidenced via the recent brief inversion in the yield curve.

But the upside is that the global earnings picture could get a shot in the arm, especially now that China is reflating again. So far the results have been muted, but China's latest PMI (purchasing managers' index) reading above 50, indicating an economy in expansion mode, suggests that maybe China's various stimulus measures are gaining some traction. If so, that could boost global GDP and earnings outlooks.

Conclusion

All in all, the four lenses suggest to me a continued risk-on stance. I think markets will be hard pressed to repeat Q1's performance, but at this point we are pretty close to the S&P 500's old highs of 2940. If earnings stabilize in the second half of 2019 and revert to trend in 2020, new highs for the major averages may not be far behind.

My sense is that without an inflation shock forcing the Fed into a policy error (i.e., tightening too much), and without the kind of financial imbalances (excess leverage) that we saw in 2008, little stands in the way of further gains. Yes, we could get a recession, but absent these two components any recession could well be short-lived, in my view. If we indeed end up in a bear market, that too could prove to be short and shallow, similar to the previous two brief 20% drawdowns, in 2011 and 2018.

All of this serves to return me to the secular road map and my impression that the past 10 years have been very similar to the two preceding secular bulls: 1949–1968 and 1982–2000. We'll see whether this one, too, proves one of the greats; so far it's still on track, despite all the naysayers.

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