Waiting for the End Game

The market is looking for the interest rate cycle's next inflection point.

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Key Takeaways

- As of late June, the stock market is in a five-month-long trading range of about +/-10%.
- Tightening financial conditions are pulling stock valuations lower, but in the U.S. this has been offset by a well-timed earnings boom.
- Emerging-market equities are in the eye of the storm, in part because they feel the full brunt of tighter financial conditions but don't have an earnings boom to offset it.
- Ultimately, the way in which the market's stalemate resolves itself may come down to the timing and magnitude of the Federal Reserve's rate-hike cycle.

The U.S. stock market's "benign valuation reset," in which price-to-earnings (P/E) ratios fall while stock prices more or less stay up, is now well into its fifth month. From its January 2018 peak through late June, the Standard & Poor's 500 Index (S&P 500®) has been stuck in a trading range of roughly +/-10%, resulting in a modest 5% drop. That's basically nothing in the grand scheme of things, especially following the massive 50+% gain over the two years that preceded the January peak.

Beneath this relatively quiet surface, however, a storm has been brewing. With the Fed recently raising interest rates for the seventh time since December 2015 and hinting at six more hikes through the end of 2020, liquidity (i.e. financial conditions, meaning the availability of credit and level of interest rates) has begun to weaken in recent months. As you can see in Exhibit 1 (page 2), the Goldman Sachs Financial Conditions Index had performed pretty much in lockstep with global stock markets (as represented by the MSCI ACWI Index)

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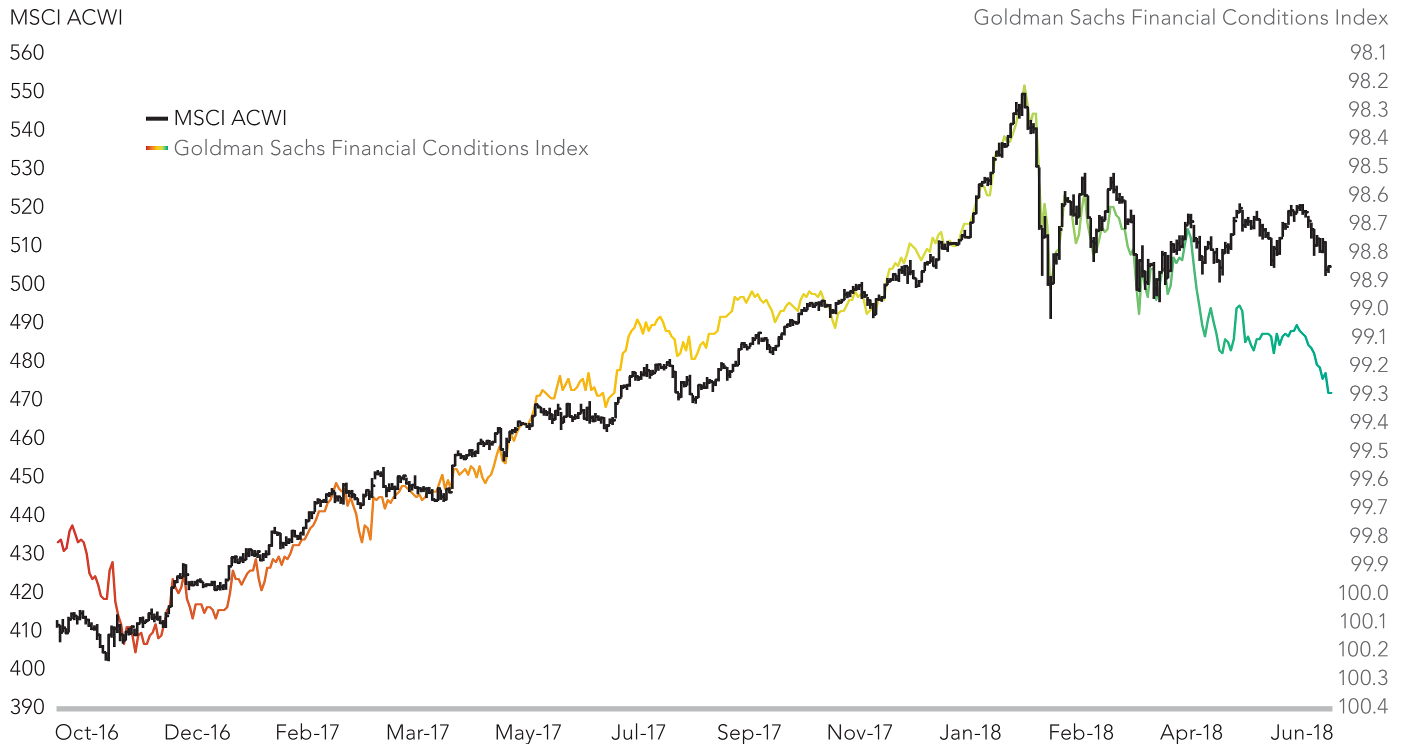
from October 2016 until the early spring of this year. The U.S. economy looks like it may be approaching its late cycle phase, which is typically when growth slows, inflation rises, the Fed is tightening and the yield curve is flattening, meaning the gap between short- and long-term rates is narrowing. This is usually a recipe for P/E compression for the stock market, which is exactly what has been happening in recent months. The market's P/E ratio using expected earnings peaked at 19.5x in January, and is currently down three points to a more normal but still above average 16.7x.

So, are we in late cycle? I don't think so, at least not yet. Typically, by the time the economy has entered the late cycle, earnings growth is slowing and profit margins are declining. This hasn't happened yet, compliments of the serendipitously timed tax cuts.

According to the discounted cash flow model, the two primary variables driving valuations are earnings and liquidity. When earnings growth is strong and financial conditions are benign (as is typically the case during the mid-cycle), it generally pushes valuations higher. To wit, since the 2009 bull market, earnings have more than doubled and so has the P/E. As a result, stock prices have quadrupled. But as night follows day, the late cycle tends to follow the mid-cycle, and falling P/Es by definition means that equity prices are falling, or at least going up less than earnings.

EXHIBIT 1: As interest rates continue to rise, financial conditions have begun to trend lower.

Financial Conditions



Period shown is Oct. 1, 2016 to June 22, 2018. Financial conditions are shown on reverse scale. Source: Factset, Fidelity Investments, as of 6/22/18.

The great earnings bailout

In the first quarter of 2018, earnings-per-share (EPS) growth was up 24% versus Q1 2017, exceeding what were already high expectations. Meanwhile, the consensus estimates for the next three quarters are all around 20%. Taken together, the earnings picture has provided a strong antidote to what otherwise would be a less-friendly scenario.

In recent years the stock market has been highly correlated to financial conditions, but over the past few months a gap has opened up (as was illustrated in Exhibit 1). The fact that financial conditions continue to deteriorate suggests that the path of least resistance for stocks is down, not up. Nevertheless, equities have been resilient, at least in the U.S. Basically, an expensive market is getting bailed out by an earnings boom. In that regard, the tax cuts couldn't have come at a better time.

But the same cannot be said for markets overseas, which are being weighed down by a deceleration in earnings growth, a strengthening U.S. dollar, and a simultaneous tightening of liquidity conditions. You can especially see the relationship between liquidity conditions and stock prices play out in emerging markets. EM markets tend to benefit when liquidity is ample but suffer when liquidity is tight, as is currently the case.

The dollar has been on a tear in recent months as a result of a widening policy divergence between the Fed and the European Central Bank (ECB), and that strength is hurting emerging markets, because they generally fund themselves in dollars. The spread between the two-year German bund yield and two-year Treasury yield seems to be especially moving the needle for the dollar these days. It has been steadily widening in recent months, as the ECB has signaled that it won't be raising rates until mid-2019, while the Fed continues to go full steam ahead.

Waiting for the Fed to blink

The way I see it, the market needs to get to the point where it can see the light at the end of the tunnel in terms of how many more rate hikes to expect from the Fed, in relation to when and by how much the ECB will conduct its exit from global easing. Once markets can see the end game, the dollar may ease off and financial conditions could start easing again, which should relieve the downside pressure on P/Es in the U.S. At that point, emerging markets may start to rally again.

But when is that point? The bond market (as represented by the fed funds curve) is pricing in three more hikes in the next two years (to 2.75%), but the Fed is signaling several more than that (two more in 2018, three more in 2019, and one more in 2020), to a 2020 median dot of 3.38%. If the Fed's dots are to be believed, chances are that the yield curve could invert sometime in 2019.[1]

The pressure on emerging markets is reminiscent of the 2014–2016 cycle, when there was a similar tightening in liquidity conditions. Back then, the problems in China and other emerging markets got so bad that the Fed had to ease off its hawkish forward guidance. That had almost the same effect as a rate cut and helped kick start a synchronous global recovery.

In late 2014, the dollar began to strengthen as the Fed was both tapering quantitative easing (QE) and signaling a normalization in short rates, while the ECB was just about to launch its version of QE called the Asset Purchase Program. That created a massive policy divergence resulting in a very strong dollar and an increasingly overvalued Chinese yuan. This led to capital flight and eventually a devaluation of the yuan.

Many investors are wondering if we are getting to the same point now, where the Fed slows its tightening path. Remember, markets are always discounting the future, so when the Fed tightens less than the market had priced in,

it has the same effect as an easing of monetary policy. As illogical as it sounds, in a flow-based world the Fed can be tightening and easing at the same time. Right now the markets are waiting for the Fed to "ease" again by raising rates more slowly.

I have my doubts as to whether the Fed is anywhere close to blinking at this stage. For one, the current cycle doesn't have the systemic importance of China in its crosshairs like it did in 2015. China is slowing for sure, but it is hardly at a crisis point. Instead, the hot spots today are Turkey, Argentina and Venezuela, all important countries but likely not systemic to the global economy the way China is.

Second, I get the sense that the Fed feels it doesn't have the luxury to pause its tightening efforts like it did two and a half years ago, before the sub-4% unemployment rate and before the fiscal stimulus. Back then the Fed had little opportunity cost in waiting. But not today.

So, my guess is that the Fed will keep raising rates, the dollar will keep strengthening, and financial conditions will continue to tighten. As long as U.S. earnings growth continues to boom, that still paints a relatively benign picture for the U.S. equity market.

What's next?

What happens when the reprieve from the earnings boom wears off, which is expected to happen in 2019? In my view, it will all come down to where the Fed is in the rate-hike cycle at that time. If by then the Fed is signaling that it's close to the end of the cycle, then the markets will likely be fine. We could be looking at a market dynamic in which earnings are growing at their historical trend (7%), liquidity conditions are easing again, and valuations are attractive.

But if earnings growth peaks and the Fed is still signaling that there are many more hikes to come, it's quite possible that earnings would no longer be strong enough to offset rising rates and tightening liquidity conditions. If by that time the Fed has tightened so much that the yield curve has inverted, we could be confronting a potential recession.

For now, it comes down to when earnings growth starts decelerating (2019?) and when the Fed ends its tightening campaign (2020?). We won't know for a while, which tells me that the major stock market averages in the U.S. may remain stuck in their trading range. That leaves non-U.S. stocks, especially emerging markets, in the eye of the storm.

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Endnote

[1] Market Realist, "Understanding the Changes to the FOMC's June Dot Plot, June 14, 2018. https://marketrealist.com/2018/06/understanding-the-changes-to-the-fomcs-june-dot-plot

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