The Correction: Just Valuations, or Earnings Too?

If the downturn reflects just a valuation reset and not an earnings problem, the market may be close to fair value.

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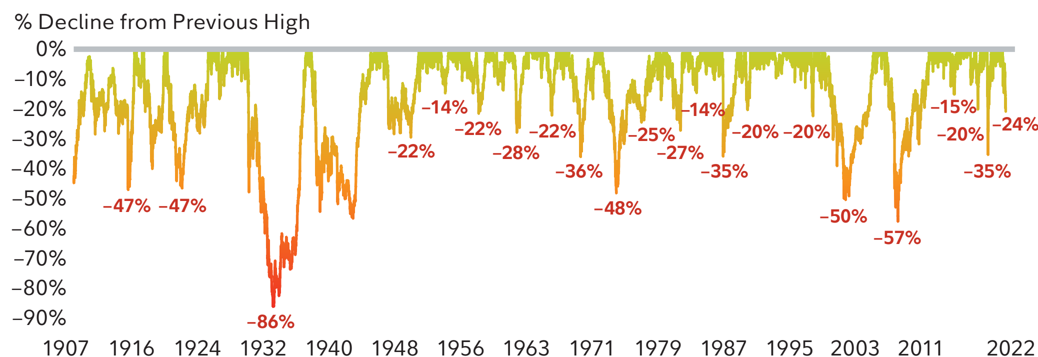
KEY TAKEAWAYS

- Serious bear markets get hit by a double whammy: lower valuations and falling earnings.
- So far in this correction, stock-market valuations have come down considerably due to tighter financial conditions, but earnings estimates have held up.
- Inflation expectations have declined, but headline inflation data has remained very high, forcing the Federal Reserve (Fed) into a more hawkish stance.
- This liquidity cycle has been a moving target of ever changing perceptions of how restrictive the Fed will get, leaving the stock and bond markets in limbo.

The market's wild ride has brought us to what I think is an important crossroads. I consider the correction a valuation reset driven by tightening liquidity. If I'm right, then after a 24% decline in the S&P 500 (using intraday values), the stock market may be close to—but not quite yet at—fair value. If I'm wrong, and the market also has an earnings problem, then this reset is not over.

EXHIBIT 1: Bears of this size are common, historically.

S&P 500 Drawdowns from Two-Year Highs, 1900–Present



Past performance is no guarantee of future results. Drawdowns are based on intraday data. Source: Bloomberg Finance LLC, as of June 16, 2022.

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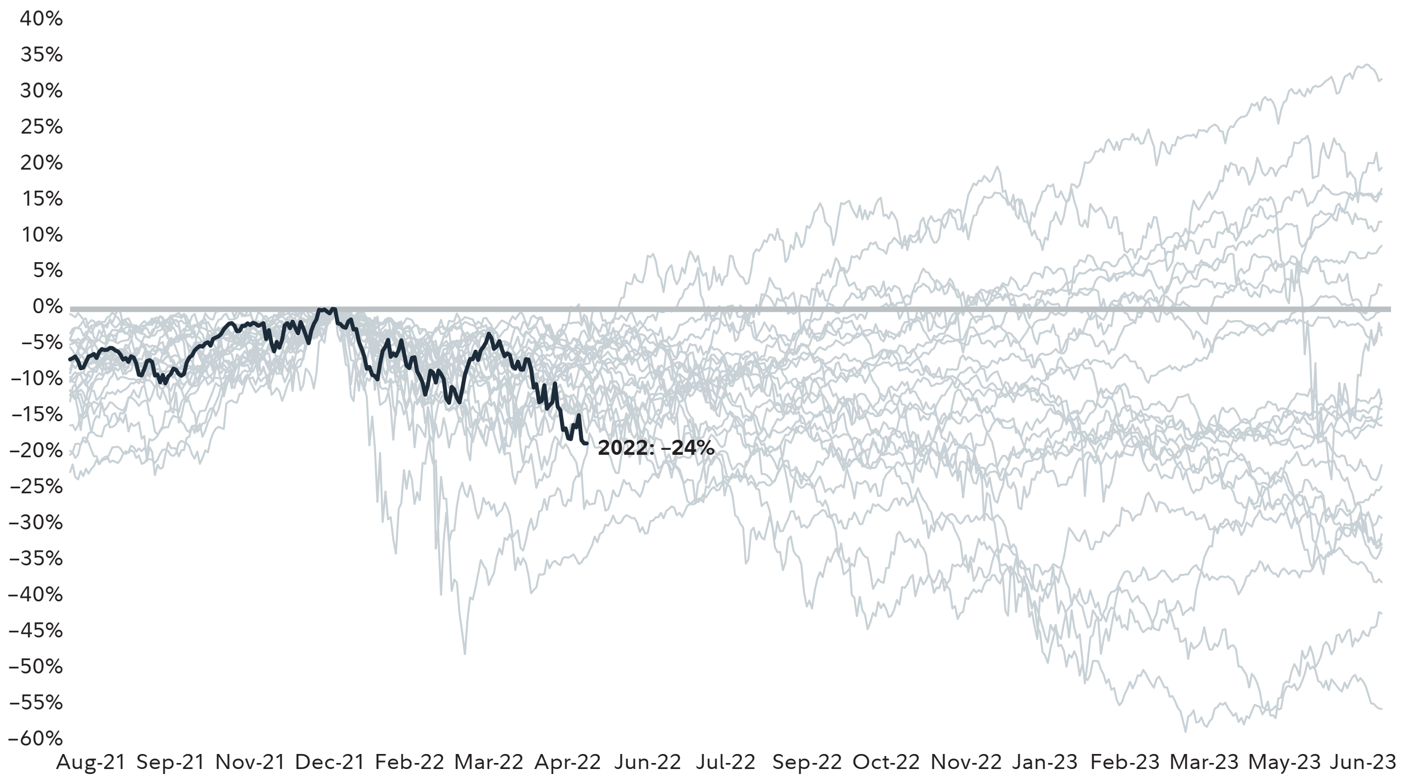
Serious bear markets tend to be hit by a double whammy: a valuation derating and an earnings recession. So far, this bear reflects only a correction in price-to-earnings (P/E) ratios, caused by the rising cost of capital and an outgoing liquidity tide. Its magnitude is on par with past non-recessionary drawdowns, such as 1994 (–10%), 1998 (–21%), 2011 (–21%), 2015–16 (–15%), and 2018 (–20%) (Exhibit 2).

EXHIBIT 2: So far, this correction is around the middle of the pack.

S&P 500 Corrections, 1926–Present



A correction is a decline of 10 percent or more from an asset's most recent high. Past performance is no guarantee of future results. Returns are based on prices of stocks in the S&P 500 and do not include dividends. Daily data since 1928. Source: Fidelity Investments, FactSet, as of June 16, 2022.

Exhibit 3 offers greater context. As the bottom rows of the table demonstrate, the current downturn looks similar to the median of non-recessionary bear markets and serious corrections since the 1870s.

EXHIBIT 3: For perspective on today's downturn, consider the historical context.

Bear Markets and Serious Corrections, 1872–Present

Top	Bottom	Months	Δ Nominal SPX	Δ Real SPX	P/E High	P/E Low	Δ P/E	Δ CPI (Annual)	Δ Fed	Δ Nominal EPS	Δ Real EPS	Return to Prior High	Months to Prior High	NBER
Jun-1872	Jun-1877	61	-47%	-31%	12.4	9.4	-24%	-5%	-190	-30%	-13%	Mar-1880	95	Recession
Jun-1881	Jan-1885	44	-36%	-26%	14.1	13.8	-2%	-4%	+120	-37%	-26%	Jan-1899	215	Recession
May-1887	Aug-1896	113	-35%	-17%	17.2	17.1	-1%	-3%	+260	-39%	-25%	Jan-1899	143	Recession
Jun-1901	Nov-1903	29	-26%	-31%	17.3	11.7	-33%	+3%	+210	+7%	-5%	May-1905	48	Recession
Jan-1906	Nov-1907	22	-37%	-40%	14.6	9.4	-36%	+3%	+220	-8%	-9%	Nov-1909	46	Recession
Nov-1909	Dec-1914	62	-28%	-29%	13.7	14.1	+3%	+0%	-70	-24%	-29%	Oct-1916	84	Recession
Nov-1919	Aug-1921	22	-35%	-36%	10.1	13.6	+35%	+1%	+60	-52%	-87%	Feb-1925	65	Recession
Sep-1929	Jun-1932	33	-87%	-82%	20.5	8.6	-58%	-8%	-330	-73%	-64%	Dec-1954	308	Recession
Mar-1937	Apr-1942	63	-60%	-65%	16.8	7.3	-56%	+2%	-10	-20%	-30%	Feb-1946	109	Recession
May-1946	Jun-1949	37	-30%	-46%	22.4	5.6	-75%	+9%	+79	+172%	+110%	May-1950	48	Recession
Aug-1956	Oct-1957	15	-23%	-24%	14.3	11.8	-18%	+3%	+98	-8%	-12%	Sep-1958	26	Recession
Dec-1961	Jun-1962	7	-30%	-28%	21.6	14.0	-35%	+1%	+13	+10%	+9%	Oct-1963	22	Recession
Feb-1966	Oct-1966	8	-24%	-24%	18.2	12.3	-33%	+4%	+70	+2%	+0%	Nov-1968	34	
Nov-1968	May-1970	18	-37%	-41%	18.0	12.3	-32%	+6%	+139	-7%	-12%	Nov-1972	48	Recession
Jan-1973	Oct-1974	21	-50%	-57%	19.9	6.7	-66%	+11%	+205	+27%	+2%	Dec-1982	121	Recession
Sep-1976	Mar-1978	18	-20%	-27%	11.8	8.0	-32%	+7%	+121	+2%	+5%	Apr-1981	55	Recession
Nov-1980	Aug-1982	21	-29%	-36%	9.1	6.3	-31%	+8%	-473	-8%	-20%	Oct-1982	23	Recession
Aug-1987	Oct-1987	2	-36%	-36%	24.0	14.3	-40%	+5%	+12	+11%	+10%	Jul-1989	23	
Jul-1990	Oct-1990	3	-20%	-22%	16.0	13.4	-16%	+10%	-47	-32%	-35%	Feb-1991	7	Recession
Jan-1994	Nov-1994	9	-8%	-10%	22.8	14.8	-35%	+3%	+272	+41%	+38%	Feb-1995	13	
Jul-1998	Oct-1998	3	-22%	-23%	27.1	21.1	-22%	+2%	-102	0%	-1%	Dec-1998	5	
Mar-2000	Oct-2002	31	-51%	-53%	30.0	16.8	-44%	+2%	-425	-24%	-26%	Jul-2007	89	Recession
Oct-2007	Mar-2009	17	-58%	-58%	17.6	12.1	-31%	+1%	-378	-50%	-51%	Apr-2013	67	Recession
May-2011	Oct-2011	5	-21%	-22%	15.8	12.0	-24%	+3%	-4	+7%	+6%	Feb-2012	10	
Sep-2018	Dec-2018	3	-20%	-20%	20.0	15.6	-22%	+0%	+24	+8%	+8%	Apr-2019	7	
Feb-2020	Mar-2020	1	-35%	-35%	21.9	14.9	-32%	-3%	-124	-17%	-17%	Aug-2020	6	Recession
Jan-2022	?	5	-20%	-27%	24.8	17.8	-28%	+6%	+110	+3%	+1%	Jan-2022		
Median: All Cycles		19	-33%	-31%	17.5	12.3	-32%	+3%	+19	-8%	-12%		48	
Non-Recession		4	-22%	-22%	21.4	14.6	-28%	+3%	+18	+8%	+7%		11	

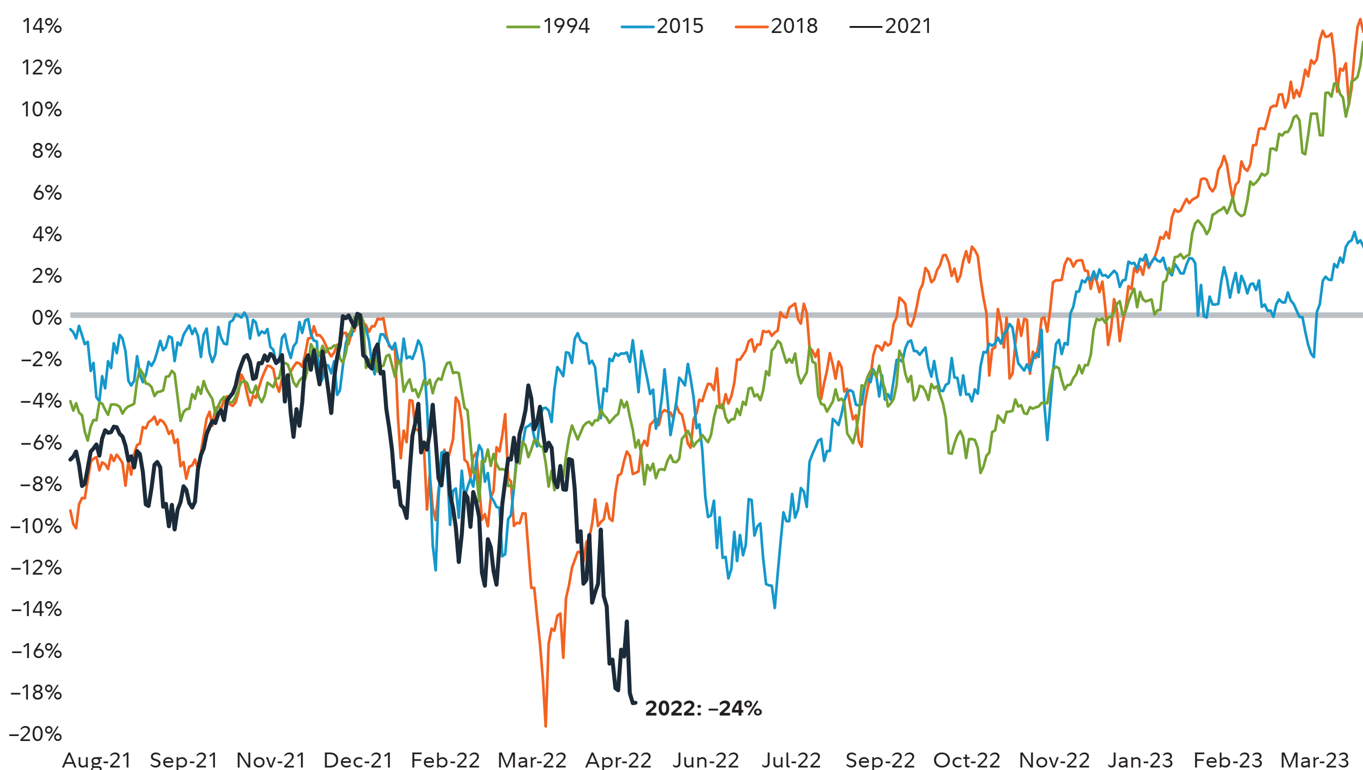
Past performance is no guarantee of future results. Table columns, from left to right: Date of market high, date of market low, number of months between high and low, decline in S&P 500 (SPX) price index in nominal (before inflation) and real (after inflation) terms, price-to-earnings ratio high, low, and change, annualized change in the inflation rate (Consumer Price Index, or CPI) during market decline, change in Federal Reserve policy rate (basis points), change in nominal and real earnings per share, date at which S&P 500 price index returned to previous high with number of months to previous high, and whether the National Bureau of Economic Research (NBER) declared a recession during the period. Real prices are nominal prices adjusted by the CPI. Source: NBER, FactSet, Bloomberg Finance LLC, Haver Analytics, as of May 20, 2022.

The market's current forward P/E is 15.8x (as of June 16) and fair value is 14.8x—a haircut from its cycle high of 22.7x last year. The market may fall farther, but in my book this is close enough.

I think the 1994, 2015-2016, and 2018 tightening cycles offer a good road map (Exhibit 4). All had a lot of sideways churn with the occasional sharp drawdown.

EXHIBIT 4: This tightening cycle looks familiar.

S&P 500 Price Returns in the 1994, 2015, 2018, and Current Fed Tightening Cycles



Past performance is no guarantee of future results. Returns are based on prices of stocks in the S&P 500 and do not include dividends. Daily data since 1928. Source: Fidelity Investments, FactSet, as of June 15, 2022.

The downturn has brought market technicals to oversold levels similar to the other mid-cycle corrections that have occurred since the March 2020 low. Flows into equity mutual funds and ETFs have reversed after two years of inflows, margin debt is shrinking again after spiking in 2020, and corporate insiders are nibbling again, albeit less so than earlier this year. Sentiment is gloomy—no surprise with price down 20% and valuation down 25%–30%—a development that historically has been positive for future returns.

Financial conditions have now tightened across the board, with the stock market declining 24%, rates rising, credit spreads widening, and the dollar rallying. If the downturn is mainly a valuation correction brought about by tighter financial conditions, it seems like this is a good time to ask: Are we there yet?

Expectations for how much the Fed will tighten have come down slightly, with the Secured Overnight Funding Rate (SOFR) curve now pricing in a terminal rate of approximately 4%.[1] (The terminal rate represents the Fed's assessment of the neutral rate at which it is neither stimulative nor restrictive). Much of the decline likely stems from falling inflation expectations. Even though the last CPI report came in hotter than expected, there seems to be a growing consensus that the rate of change in inflation has peaked for this cycle.

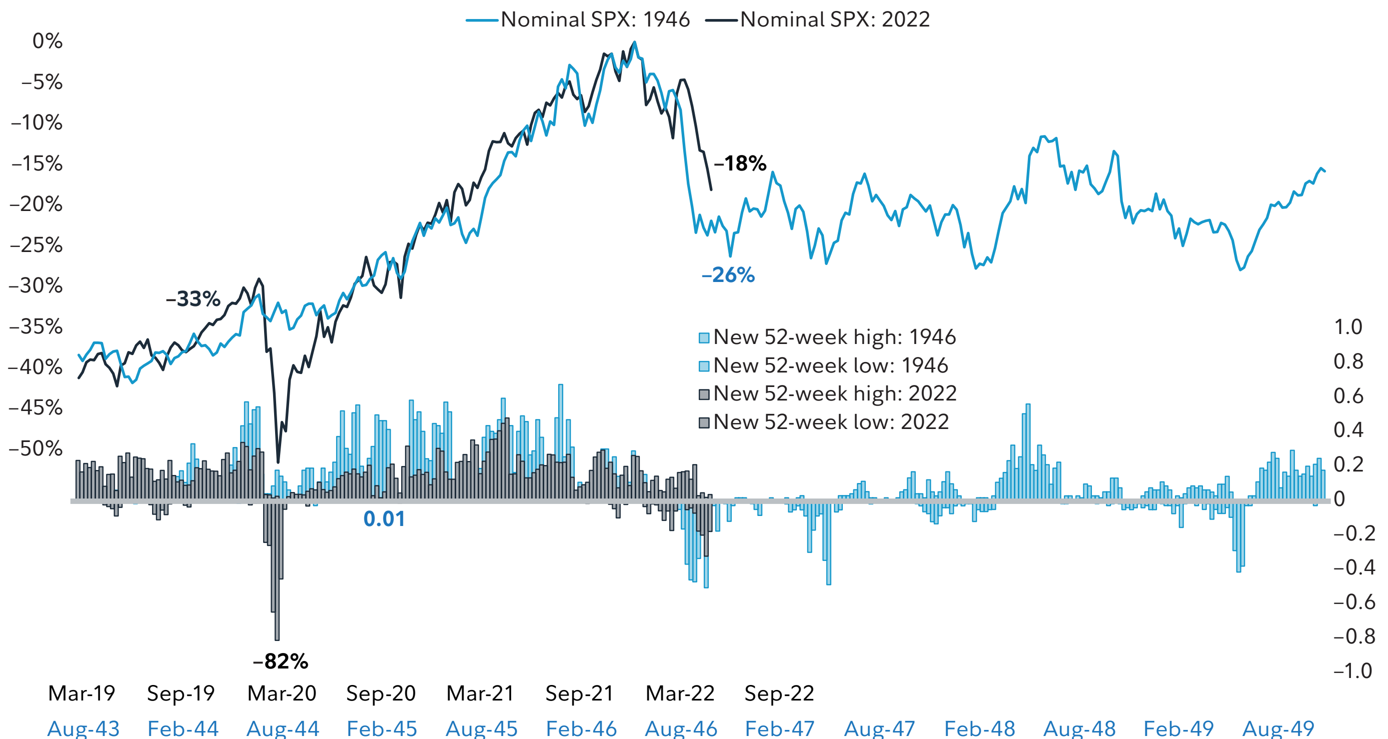
Both the 10-year and 5-year 5-year (5y5y) forward TIPS break-even spreads have slid, to 3% and 2.35%, respectively. The latter is at roughly the same level as it was a year ago, suggesting long-term inflation expectations remain contained. This is a critical nuance for the Fed, as it decides how far above the neutral level of 2.5% it needs to get in order to tame the inflation beast. Meanwhile, lower TIPS break-evens could allow the Fed to complete its campaign to boost real rates sooner.

The parallels to monetary policy during the 1940s remain intriguing (Exhibit 5). After WWII ended in 1945, there was a serious fiscal and inflation overhang, much like there is today. The 1940s were an era of financial repression; in 1948 the Fed tightened policy (but only slightly), while maintaining a cap on yields until 1951.

If the Fed's terminal rate doesn't change much from the expected 3%, then amid falling inflation expectations the bond market is starting to look more and more attractive. Conditions may be favorable when the 10-year Treasury yield is above 3%.

EXHIBIT 5: Does the post-WWII era offer a roadmap for the present?

Nominal S&P 500 (SPX) Returns, August 1945–August 1949 and March 2019–Present



Past performance is no guarantee of future results. Returns are based on prices of stocks in the S&P 500 and do not include dividends. Nominal returns are before inflation is taken into account. Source: Fidelity Investments, Bloomberg Finance LLC, FactSet, as of May 22, 2022.

The stock market is balancing price, earnings, and valuation. Prices rose much faster than earnings from March 2020 through 2021, causing valuations to climb. Those trends were bound to revert to the mean—either slowly, with prices languishing until earnings caught up, or suddenly, with prices falling to come down to earnings.

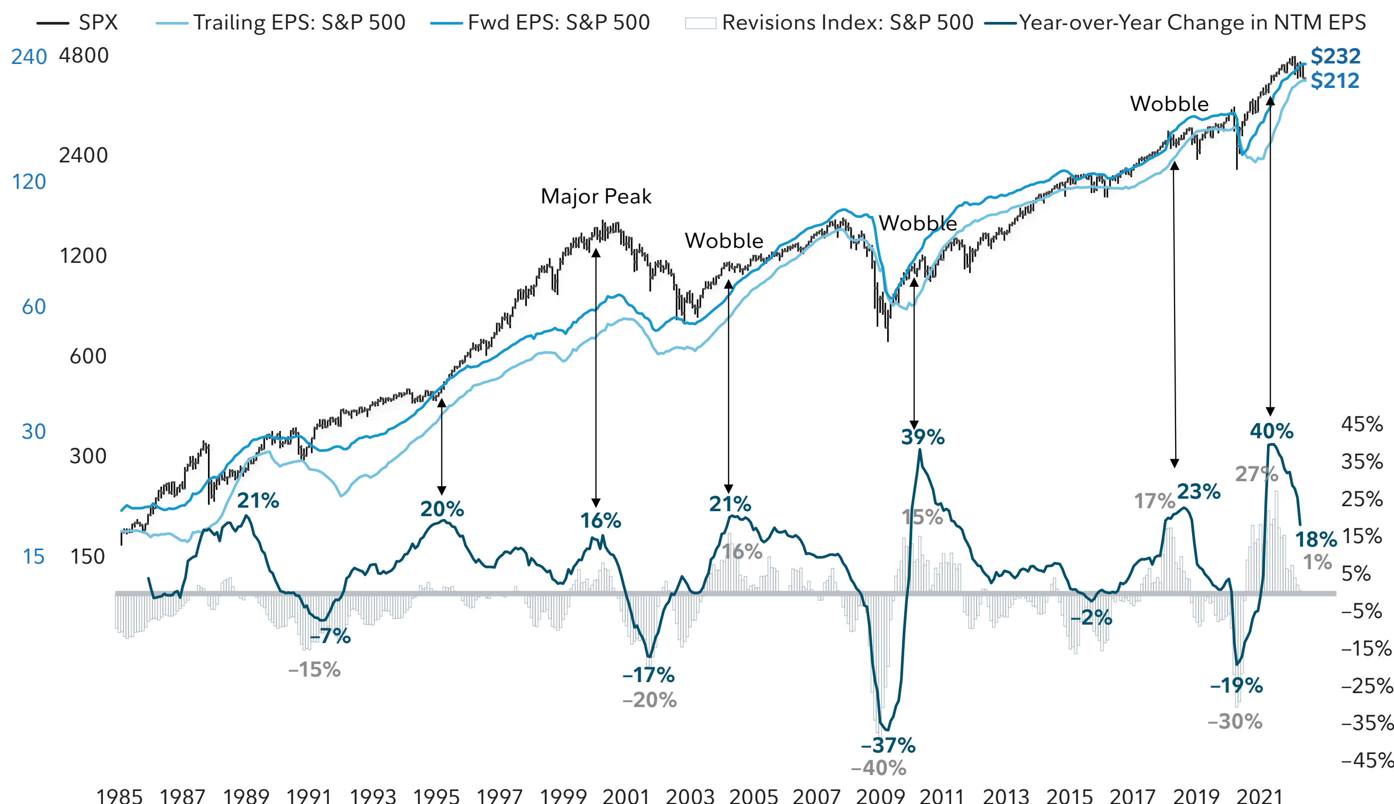
We now know that the reset happened slowly, then all at once. There is still a gap between the 65% gain in the S&P 500 monthly total return index since March 2020 and the 54% gain in EPS. But if earnings match 2023 estimates, they will be up 68% since March 2020, and the reset could be considered complete. That take on the market rests on a couple assumptions, however: that the market has a lot more sideways churn left in it, and the earnings growth narrative remains intact.

So far, earnings projections support that narrative (Exhibit 6). Estimates for 2022 and beyond continue to rise, with 2022 projections now at 10.9% for 2022. That said, we are clearly past peak earnings growth. The growth rate for trailing EPS topped out at 40% last year, is down to 18%, and appears on its way to around 10% by the end of 2022. And earnings downgrades are now nearly as common as upgrades, with only the energy sector sustaining any momentum for positive estimate revisions. None of this is particularly surprising at this point in the business cycle.

For me, the bottom line is that the stock market now looks like it may be approaching fair value, though it could always fall farther. Declining inflation expectations may help contain the amount the Fed has to increase rates from here. Those dynamics could give investors a better handle on what to expect—and could help lower the risk of the market suffering an earnings decline on top of a valuation haircut.

EXHIBIT 6: Earnings growth is past its peak but solidly positive.

Consensus Earnings Estimates for S&P 500 Companies, 1985–Present



NTM: Next 12 Months. Past performance is no guarantee of future results. Monthly data. Revisions Index: The percentage of earnings revision upgrades minus the percentage of earnings revision downgrades. Source: Refinitiv, as of May 22, 2022.

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Jurrien Timmer is the director of Global Macro at Fidelity Investments. In this role, Mr. Timmer specializes in asset allocation and global macro strategy. Additionally, he is responsible for analyzing market trends and synthesizing investment perspectives across Asset Management to generate market strategy insights for the media, as well as for Fidelity's clients.

Fidelity Thought Leadership Vice President Martine Costello Duffy provided editorial direction for this article.

Endnote

[1] Bloomberg Finance LLC, as of June 15, 2022.

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