Some Reflections on Inflections

Where do we go from here?

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KEY TAKEAWAYS

- While many economies have transitioned to mid cycle, we likely still have much mid-cycle benefit to look forward to.
- Although this cycle's earnings may be less stellar than in recent quarters past—and their growth rate may have peaked—I think future earnings could still be positive.
- Possible disruptors to the traditional market progression include the Federal Reserve's tapering and Congress's fiscal largesse awaiting approval.
- Now may be a time to consider a market transition, whether from growth to value or from U.S. to non-U.S. stocks.
- At the same time, stock analysts might want to wait for a clear inflection of relative earnings before considering any large-scale change to asset allocation.

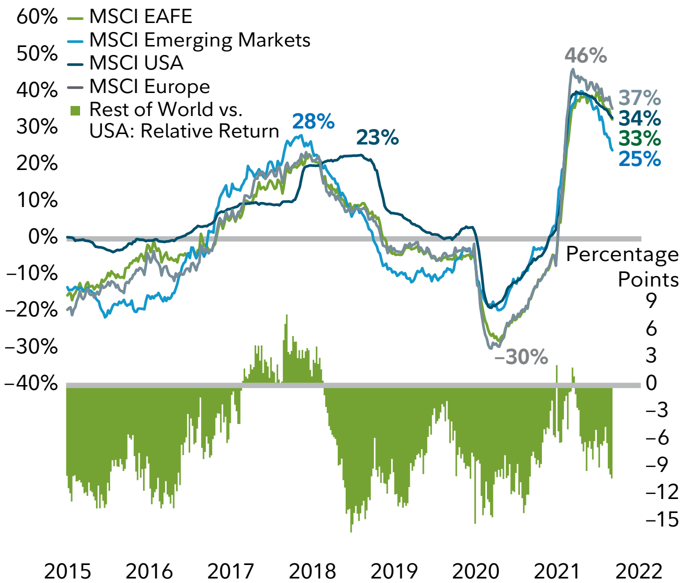
Earnings season is nearly over, and this round may turn out to be pivotal. After several quarters of earnings reports coming in well above expectations, I think this time around the growth rate could be less stellar, albeit still positive. After gains of 54% in Q1 and 96% in Q2, the expected growth rate for Q3 earnings per share (EPS) is 28%. While earnings growth overall may yet surprise to the upside, I, for one, doubt it will be by the 30 percentage points of the past two quarters.

Here is what I know: First, historically speaking, price typically has followed earnings except at the tails. Very negative earnings growth has tended to produce positive returns—because negative earnings growth usually occurs at a market bottom—whereas very positive earnings growth does not seem significantly correlated to returns. Historically, when earnings growth has exceeded 30%, the regression of earnings versus price has plateaued. In other words, investors typically haven't rewarded extremely high earnings growth because it has tended to be unsustainable. We saw this in 2018 following the Trump tax cuts.

Second, I think the growth rate of earnings estimates has peaked for this cycle. This isn't a bad thing per se, but I consider it a strong indicator that growth is likely to moderate from here. The global earnings trajectory looks to me like a classic transition from early cycle to mid cycle (Exhibit 1).

EXHIBIT 1: So far, earnings appear to be sticking to the business cycle script.

Global Earnings Growth: Change in Forward EPS Estimates and Relative Return



EPS: earnings per share. Forward estimates are NTM, or next 12 months, measured year-over-year. MSCI EAFE represents developed markets excluding the U.S. and Canada. Lower panel: USA represented by MSCI USA Index and Rest of the World by MSCI All Country World Index (ACWI) ex USA Index. Relative return calculated as MSCI ACWI ex USA total return minus MSCI USA total return year over year, week by week.See appendix for index definitions. Source: Fidelity Investments, Bloomberg Finance LP; weekly data through Oct. 31, 2021.

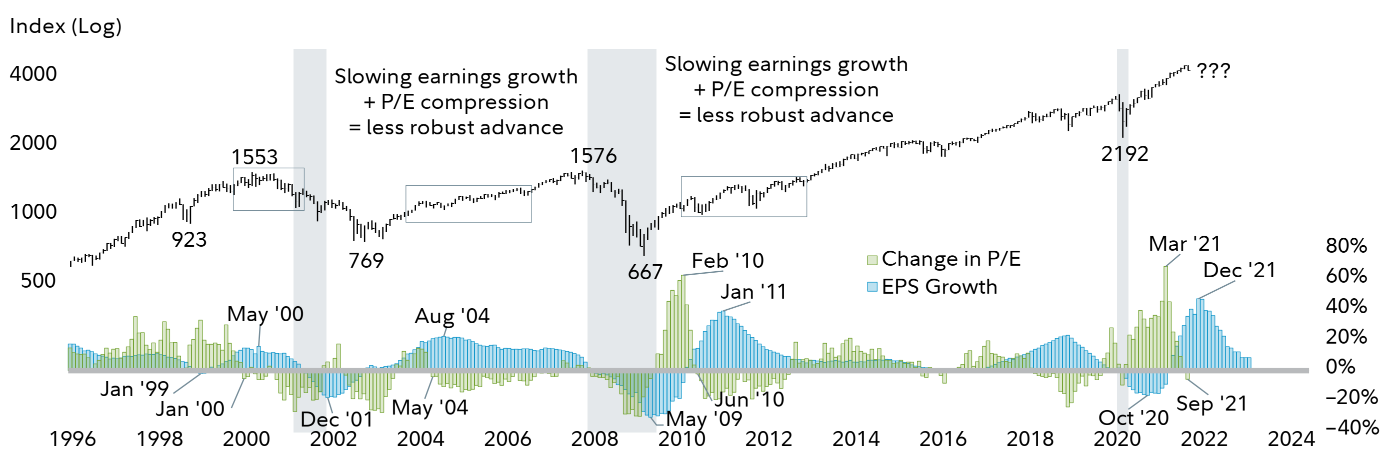
Third, valuations have been coming down. The forward S&P 500's price-earnings (P/E) ratio has already compressed by three points as of this writing, moving down from 23x to 20x, and I think more is likely on the way.

In my experience, this combination of developments is typical for the mid-cycle phase. Looking back over the past few decades, the stock market has described a fairly clear sequence of events around early-cycle recoveries (Exhibit 2). Speaking in historical generalities: First, the market bottoms, then earnings bottom a few quarters later. In the exhibit below, earnings growth is represented by the blue bars, which extend into 2022 because they include current estimates. Between those two inflection points, the P/E multiple (green bars) usually undergoes substantial expansion. After the P/E ratio has peaked on a rate-of-change basis, earnings growth goes positive, then the change in the P/E ratio turns negative, followed by a peak in earnings growth.

After this sequence has usually come a period of slower—but still positive—earnings growth, combined with P/E multiple compression. The result: The equity market loses its steep upward slope as the bull market transitions from its early-cycle V shape to a more trend-line mid-cycle phase.

EXHIBIT 2: Broadly speaking, the market often seems to repeat a series of steps.

Forward Earnings Estimates versus Valuation: Global Developed Markets



Shaded areas represent recessions. Global developed markets represented by MSCI World Index. EPS: earnings per share. Forward EPS estimates are NTM, or next 12 months. P/E: price-earnings ratio. Source: Fidelity Investments, Bloomberg Finance LP; monthly data through Oct. 31, 2021.

But with this transition comes the occasional wobble. Exhibit 2 also shows that off-script drawdowns occurred in 2010 as well as 2004, although it turns out these events were just temporary (if uncomfortably long) corrections in a cyclical bull market. Further, it appears to me that, seasonally speaking, we may be in the zone for such a wobble. The S&P 500 took a correction in mid-October, but I think the seasonal window has improved from there, so perhaps we have already seen the worst of it. Either way, based on market sequence described above, the advance from here may be decidedly less robust than it has been these past 18 months or so (but past performance is no guarantee of future results).

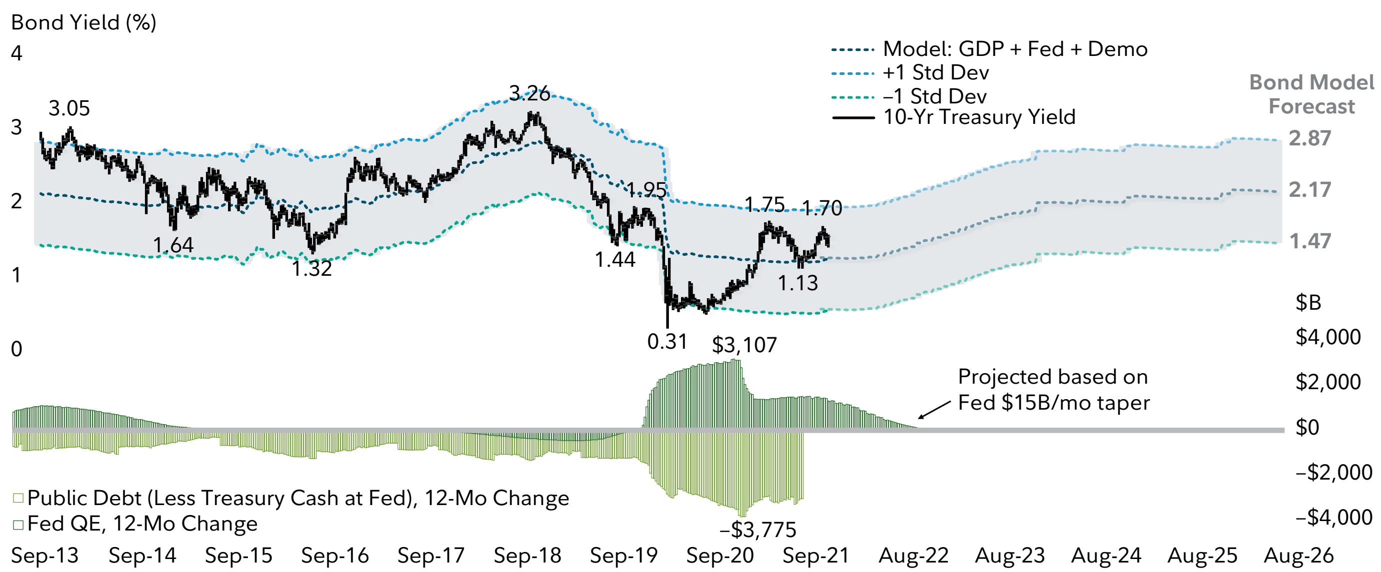
One big question for stocks here is whether market leadership will shift back to the value side, now that rates are on the move again. History has shown that long-duration growth stocks can be quite convex to interest rates, and the performance of cyclicals (especially the financials and energy sectors) relative to value stocks has been historically positively correlated to rising yields. So, in theory, if bond yields rose to a new equilibrium—say, 2% on the 10-year Treasury—then value perhaps could take over.

The Department of Labor's October jobs report did nothing to dissuade the Federal Reserve from embarking on the taper it advertised at November's meeting of the Federal Open Market Committee. This suggests to me that the 2022 bond market could face a supply/demand dynamic opposite to what we've seen this past year (Exhibit 3). In 2021, the Treasury issued less paper than has become usual—because it was running down its cash balance at the Fed—while the Fed continued to buy $120 billion per month of government debt to keep the economy chugging along. In 2022, the next two rounds of Congress's fiscal spending could receive funding right as the Fed tapers its quantitative easing down to zero.

A related question for the stock market is whether a rotation from growth to value would benefit non-U.S. equities. In principle it should, but a look at the earnings picture for non-U.S. developed and emerging markets (especially China) suggests to me a need for some caution.

EXHIBIT 3: For the Fed (and the fixed income market), turnabout is fair play.

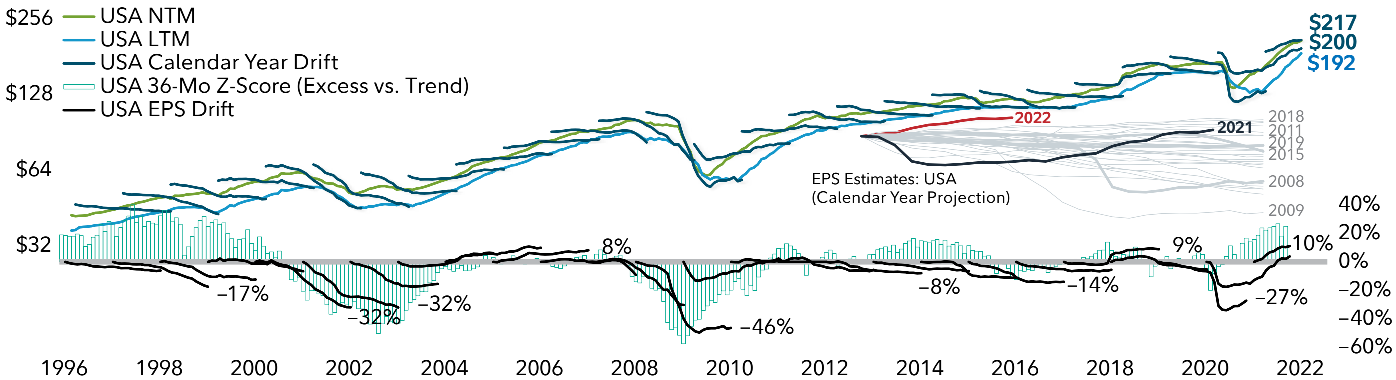
U.S. Bond Market Performance and Monetary Policy



QE: Quantitative easing. GDP: Gross domestic product. Std dev: Standard deviation, a measure of the dispersion of a dataset relative to its mean. In a normal distribution, 68% of a dataset's values fall within ±1 standard deviation of the mean. Source: Fidelity Investments; weekly data through Sept. 30, 2021.

EXHIBIT 4: U.S. earnings estimates follow a fairly familiar pattern.

EPS Estimates, Calendar Year Progression: United States



EPS: earnings per share. USA: MSCI USA Total Return Index. NTM: next 12 months. LTM: last 12 months. Z-scores: A ranked list accounting for the distribution of values relative to the mean within the universe, measured in standard deviation units. The Z-score is positive (negative) if the value lies above (below) the mean. Source, Datastream, MSCI; monthly data. Special thanks to Fidelity senior market data analyst Sam Houston-Read.

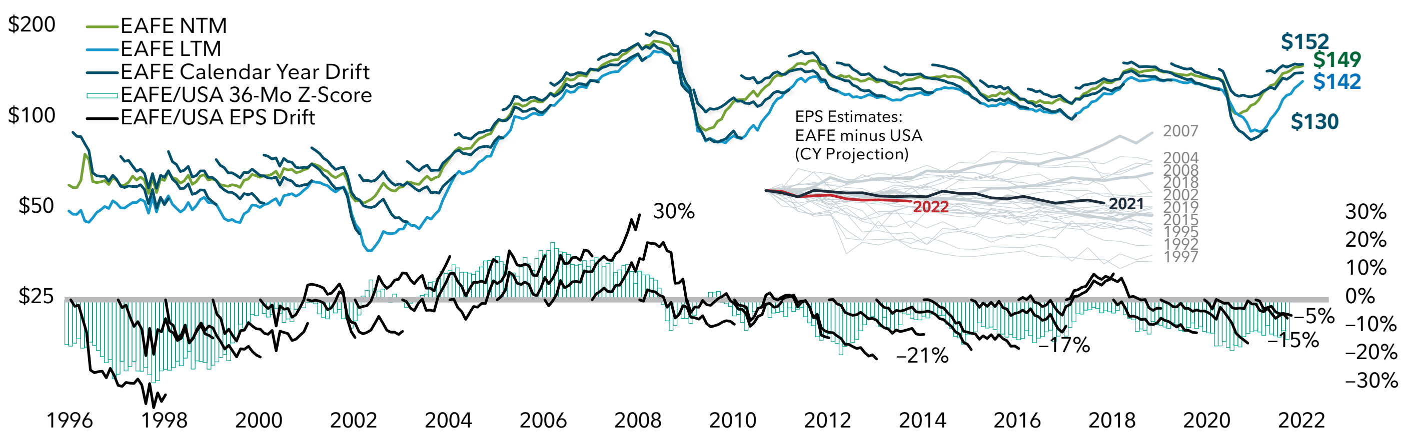
Exhibit 4 (above) shows the historical month-by-month progression of consensus earnings estimates by calendar year for the United States. The estimates run from the February before the calendar year to the February after. The top panel shows the dollar-value estimates, and the bottom panel shows the progression from the start of each "squiggle." The green bars show the 36-month Z-score of the MSCI USA Index (a Z-score indicates the standard deviation of a particular value relative to the mean of a dataset).

The chart illustrates how consensus earnings estimates typically have started too high and then progressed downward. Looking back over more than 25 years, we can see, the market usually has been unfazed by this "drift," except at cyclical inflection points.

Things look a little different for non-U.S. developed markets, especially when viewed relative to the United States (Exhibit 5). Using the same kind of earnings data as we did in the previous exhibit, Exhibit 5's top panel

EXHIBIT 5: Non-U.S. earnings and performance influenced by U.S. results?

EPS Estimates, Calendar Year Progression: Non-U.S. Developed versus U.S. Markets



EPS: earnings per share. EAFE: MSCI EAFE Total Return Index. USA: MSCI USA Total Return Index. CY: calendar year. Z-scores: a ranked list accounting for the distribution of values relative to the mean within the universe, measured in standard deviation units. The z-score is positive (negative) if the value lies above (below) the mean. Source, Datastream, MSCI; monthly data.

shows a similar progression. The bottom panel, though, shows an earnings progression for the MSCI EAFE Index similar to what we observed for MSCI USA. The bottom panel, though, shows *relative* drift, that is, MSCI EAFE earnings estimates as a percentage of those for MSCI USA, here overlaid against the Z-score of relative returns (MSCI EAFE returns as a percentage of MSCI USA returns). As noted, a Z score shows how far a particular value differs from the mean of a set of values (measured in terms of standard deviation). Given the historical experience of mean reversion among indexes, here a low (negative) Z score in Exhibit 5 may suggest an attractive relative valuation, and vice versa. More to the point, by combining relative drift with relative Z scores, I think the data in Exhibit 5 shows a strong correlation between relative earnings and relative performance. For stock analysts, in other words: Get the earnings right, and the performance will follow.

I don't show it here, but in terms of earnings revisions and relative performance vis-à-vis the U.S. market, emerging markets have on the whole experienced a relationship similar to that of their developed-market counterparts, meaning a very clear connection between relative earnings and relative performance. Moreover, both developed- and emerging-market U.S. dollar-based EPS estimates remain close to or below the peak levels reached in 2010. I think these correlations show just what an earnings machine the U.S. has been over the years.

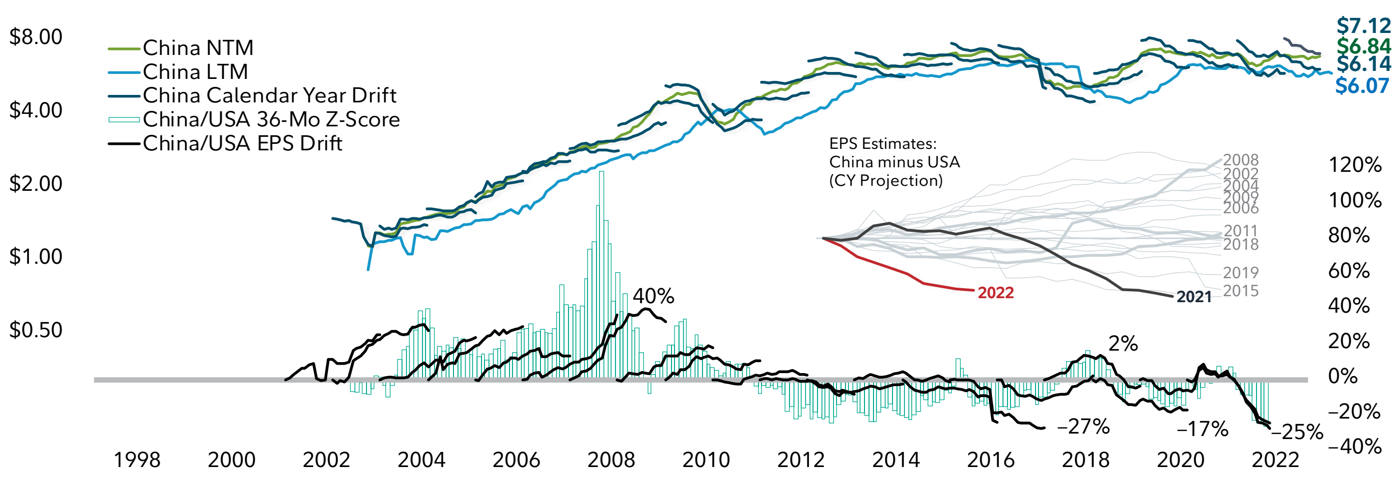
And then there's China (Exhibit 6). The MSCI China Index's earnings progression has imploded relative to the United States. The inset shows that 2021 and 2022 are among the worst years ever for relative revisions for the Chinese market.

We often focus on valuation discounts when choosing whether to invest more in non-U.S. equities versus U.S. equities, but these charts show me that, as usual, earnings are what analysts should solve for. As I see it, price follows earnings, period.

Another way to visualize the U.S. and non-U.S. earnings progression is to stack them side by side. (Exhibit 7). U.S. estimates track much smoothly than non-U.S. developed-market estimates, perhaps indicating a more efficient market here. (Comparing U.S. and EM markets tells a similar story.) Also, note how the progression over the years is generally more positive for the United States—upward and onward—whereas EAFE earnings have spent a number of years making very little progress. And even though a comparison with China appears on its surface to show something different (lower panel), a closer look shows more or less the same story.

EXHIBIT 6: Big trouble in little China?

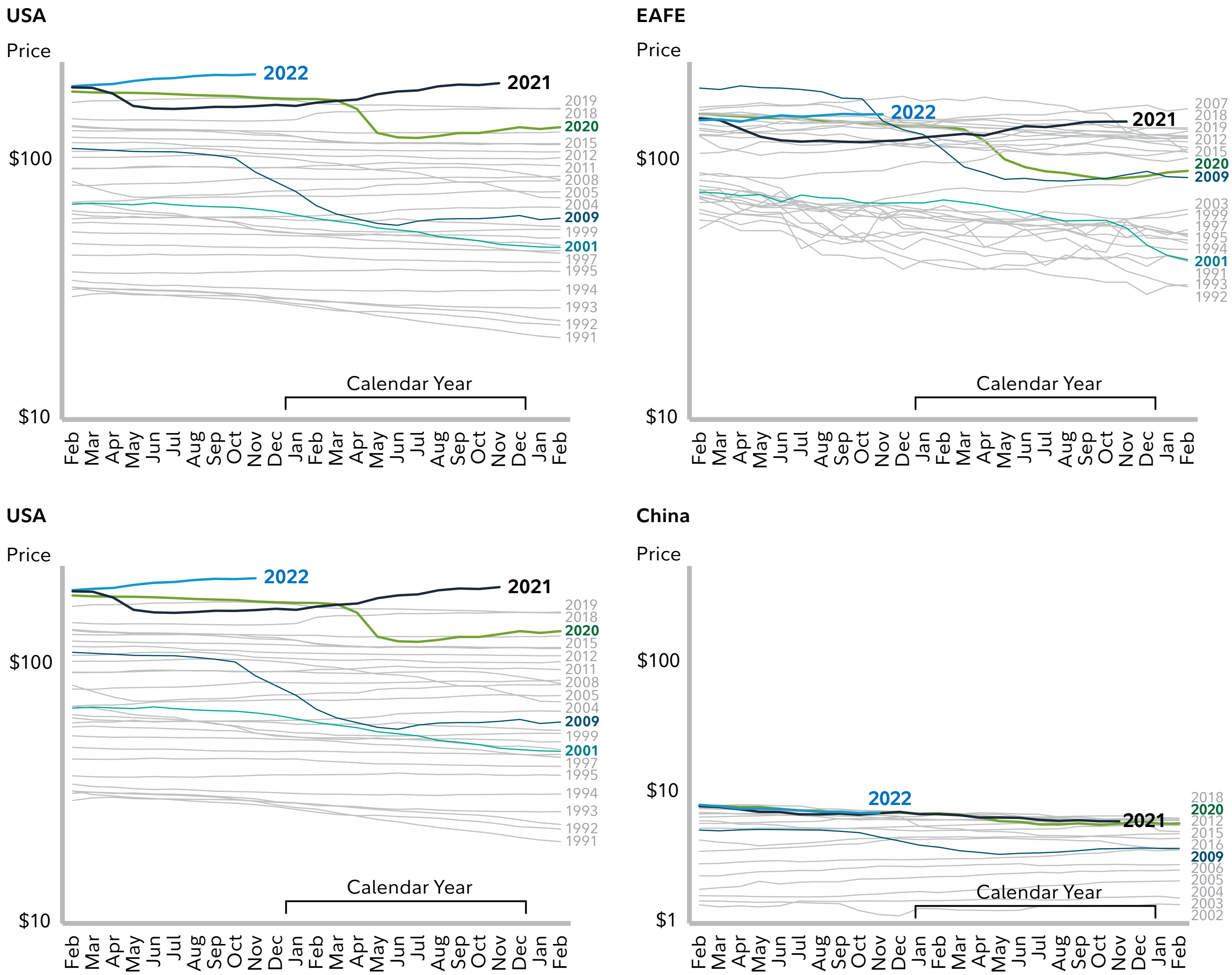
EPS Estimates, Calendar Year Progression: China versus the United States



EPS: earnings per share. CY: calendar year. China: MSCI China Total Return Index. USA: MSCI USA Total Return Index. Z-scores: a ranked list accounting for the distribution of values relative to the mean within the universe, measured in standard deviation units. The z-score is positive (negative) if the value lies above (below) the mean. LTM: last 12 months. Source, Datastream, MSCI; monthly data.

EXHIBIT 7: Famous last words, "This time it's different."

Comparative EPS Estimate Progressions



EPS: earnings per share. USA: MSCI USA Total Return Index. EAFE: MSCI EAFE Total Return Index. China: MSCI China Total Return Index. Source: Datastream, Factset; monthly data.

To sum, some questions: Could Fed action catalyze a rotation from growth to value in the U.S. equity market? I think so. Could such a rotation benefit non-U.S. equities? In principle they could, but a look at the earnings picture for developed and emerging markets—especially China—suggests some caution. I think the bottom line for all these charts is that analysts might want to wait for a clear inflection of relative earnings between U.S. and non-U.S. markets before considering large-scale asset allocation changes. I think valuation discounts help, but I don't think they are enough.

Definitions

Cyclicals: Stocks issued by companies whose business prospects are tied to economic cycles. For example, steel companies often do poorly in a recession, when consumers are buying fewer large items such as cars and refrigerators.

Value: Stocks that are considered undervalued based upon such ratios as price-to-book (P/B) or price-to-earnings (P/E). These stocks generally have lower P/B and P/E ratios, higher dividend yields, and lower forecasted growth rates than growth stocks.

Growth: Stocks of companies that have shown or are expected to show rapid earnings and revenue growth. Growth stocks are riskier investments than most other stocks and usually make little or no dividend payments to shareholders.

Index definitions

S&P 500® 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.

MSCI USA Index is a market capitalization-weighted index designed to measure the performance of the large- and mid-cap segments of the U.S. equity market.

MSCI ACWI (All Country World Index) ex USA Index is a market capitalization-weighted index designed to measure investable equity market performance for global investors of large and mid cap stocks in developed and emerging markets, excluding the United States.

MSCI World Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors of developed markets.

MSCI Europe Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors of the developed markets in Europe.

MSCI Europe, Australasia, Far East (EAFE) Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors in developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets (EM) Index is a market capitalization-weighted index designed to measure the investable equity market performance for global investors in emerging markets.

MSCI China Index is a free float-adjusted market capitalization-weighted index of Chinese equities that includes China-affiliated corporations and H shares listed on the Hong Kong exchange and B shares listed on the Shanghai and Shenzhen exchanges.

Bloomberg U.S. Aggregate Bond Index is a broad-based, market value-weighted benchmark that measures the performance of the investment-grade, U.S. dollar-denominated, fixed rate taxable bond market.

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He specializes in global macro strategy and tactical asset allocation. He joined Fidelity in 1995 as a technical research analyst.

Fidelity Thought Leadership Director David Risgin, CFA, provided editorial direction for this article.

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