Equities

Perspectives on prices, policy and profits

Inflation sits at a 40-year high, a harsh reality with serious implications for the economy, policymakers and markets. As a Fed rate hike cycle looms, we discuss what can be gleaned from previous tightening episodes, and outline three key tenets for equity investors during this precarious time.

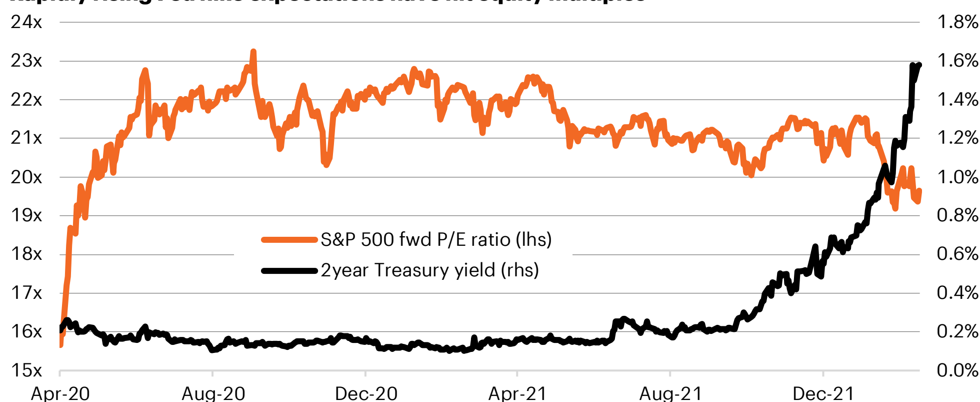
Key takeaways

- The magnitude of Fed-induced equity valuation declines has been fairly consistent throughout history, though timing has varied.
- With equity markets having internalized a rapid hiking cycle, the durability of growth and earnings has taken center stage.
- The economy appears well-positioned to weather higher rates, although current levels of inflation make the distribution of outcomes exceptionally wide.
- Investors should prioritize flexibility and cash flow during this precarious period.

Rapidly rising inflation has quickly shifted the backdrop for markets. After accommodative policy aided in driving a robust economic recovery from the depths of the COVID-19 crisis, policy is primed to make a U-turn as inflation has become the political and economic Public Enemy No. 1. While significant disagreements exist around the nature of inflation and by extension the appropriate response for combatting it, the reality is that the Federal Reserve is set to tighten policy, likely quite rapidly and materially. At this writing, futures markets are implying expectations for the initial rate hike in March (with the possibility of a 50 bp move), followed by 5–6 additional hikes throughout 2022.[1]

Markets have already felt the impacts of policy tightening. Treasury yields have risen across the curve, with short-term rates rising more rapidly than long-term yields. The 2-year yield has risen by nearly 1.40% over the past 100 trading days, an occurrence last seen in the early 1980s—fittingly, the last time the Fed was faced with similar levels of inflation.[1] Over that time the S&P 500 Index has returned 1.79% but has seen its P/E ratio decline by around three times.[1] This represents yet another illustration of the remarkable speed with which the current market cycle has progressed. With policy expectations having shifted so rapidly, we believe it is now market fundamentals that will take center stage.

Rapidly rising Fed hike expectations have hit equity multiples



Source: Bloomberg Finance L.P., as of February 15, 2022.

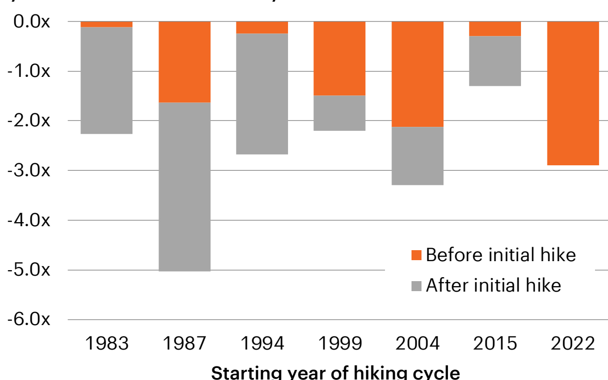
[1] Bloomberg Finance L.P., as of February 18, 2022.

Markets internalize tighter policy

The recent market reaction to expectations for Fed tightening has followed historical precedent. As a higher policy rate is priced in, the yield curve tends to bear flatten, with short-term rates rising more than long-term rates. We have also typically seen real yields—the nominal yield minus inflation expectations—drive most of the uptick in yields. For equity markets, this tends to be felt in valuations. Rising rates put upward pressure on discount rates, usually weighing on P/E ratios, especially for high-duration growth stocks whose value is disproportionately embedded years into the future.[1]

We looked at historical declines in S&P 500 valuations over the past six rate hike cycles, dating back to the 1980s. The below chart shows the maximum drawdown in the P/E ratio from one year before the first hike to one year after, and how much of it occurred before and after the initial rate hike.

Changes in S&P 500 P/E in rate hike cycles
Max decline in fwd P/E ratio during the period from 1 year before the first hike to 1 year after



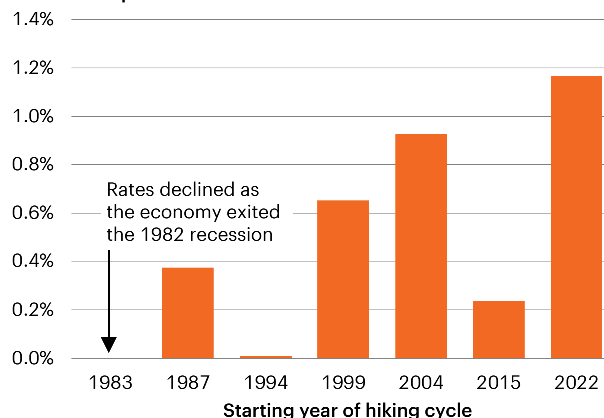
Source: Bloomberg Finance L.P., as of February 18, 2022.

The first point to note is the consistency across rate hike cycles in terms of the total drawdown in valuations. In most cases, the S&P 500 P/E ratio has declined by between 2.0x and 3.2x from peak to trough in the two-year period surrounding the first hike. The outliers here are the late 1980s cycle, which encompasses the Black Monday crash of October 1987, and the cycle starting in 2015, which saw the Fed pause for a year following the initial hike before resuming hiking in late 2016.

The second observation is that the composition of declines in P/E ratio is highly *inconsistent*. In some cycles, such as those that began in 1983 and 1994, most of the P/E decline occurred *after* the first hike; in the case of the 1999 and 2004 cycles, most of the decline came before the Fed had hiked even once.

The logical explanation for this discrepancy would be differences in the timing and magnitude of the market's forecast of future rate hikes. Indeed, the next chart shows the changes in 12-month LIBOR—a decent proxy for the market's expectation of the Fed funds rate over the next year—in the 6 months leading up to the first Fed rate hike.

Change in 12-month LIBOR
In 6 months prior to date of initial rate hike



Source: Bloomberg Finance L.P., as of February 18, 2022.

The more foresight that markets had in forecasting a Fed hiking cycle, the earlier equity markets reacted. This shows us that the speed with which markets priced in Fed rate hikes—here estimated by the change in 12-month LIBOR—correlates quite strongly with the portion of the decline in valuations that occurred before the initial rate hike. Importantly, just because the majority of the valuation correction may occur before the first hike does not mean that valuations are set to become a tailwind for market; in fact, P/E ratios have consistently been flat to slightly lower as the Fed has implemented hikes.

From all of this, we draw three conclusions. First, valuations tend to decline by around 2.0x–3.2x around the early stages of a Fed hiking cycle. Second, the timing of the valuation drawdown depends on the market's anticipation of the hikes; and third, even when markets anticipate the hikes and equities react early, there is no precedent for valuations to *increase* meaningfully as the Fed hikes.

These inferences may seem rather intuitive. Higher discount rates should put downward pressure on valuations, and the sooner markets anticipate hikes, the sooner it should price them into equity markets. But they also have important implications for the current environment. As we can see, the magnitude of rate hikes priced into the market over the past 6 months is unprecedented in the past four decades.

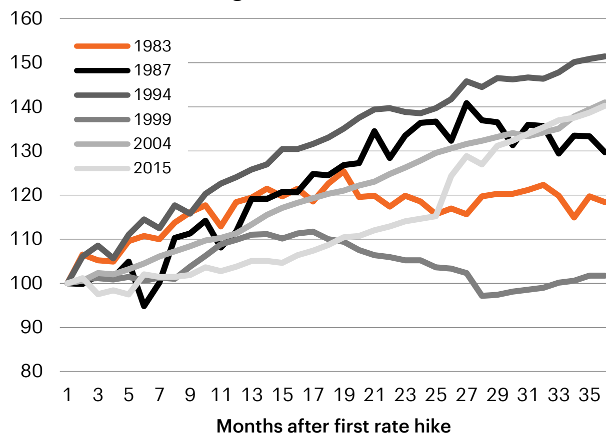
Relatedly, the pre-hike drawdown in valuations has been the sharpest the market has seen over that time horizon. If history is a guide, it is possible that equity markets have seen the worst of the hiking cycle-related valuation impact.

There are important caveats to this conclusion. First, the level of inflation being experienced right now is unique and presents a much wider distribution of policy outcomes than investors have become accustomed to. Second, the Fed is also likely to begin shrinking its balance sheet this year, a process known as quantitative tightening. This adds an additional policy factor that cycles before 2010 did not contend with. Finally, geopolitical tensions may introduce a significant element of uncertainty for markets that could weigh further on risk sentiment and valuations.

Earnings can take a hike

If we use the above conclusion as our base case, the logical next question will revolve around fundamentals. Assuming little room for improvement in valuations in the first year of a rate hike cycle, the source of positive equity returns will likely need to be earnings growth.

S&P 500 EPS following the first rate hike



Source: Bloomberg Finance L.P., as of February 18, 2022.

The above chart plots the path of S&P 500 earnings in the three years following the first Fed rate hike, indexed to 100 on the date of the initial rate hike. Importantly, tighter monetary policy does not inevitably dictate a slowdown or outright decline in corporate earnings. Indeed, in 50% of the past six rate hike cycles, earnings continued to grow at a strong pace for at least the next three years.

For those instances where earnings faltered, two involved the economy entering recessions (in the late 1980s cycle and late 1990s cycle), while one involved a nonrecessionary economic growth slowdown (in the mid-1980s). As we can see below, in many cases, the performance of the S&P 500 over that three-year period is nearly identical to earnings growth.

3 years following the first rate hike

	Change in fwd 12-month EPS	S&P 500 return
1983	18.3%	69.6%
1987	29.7%	27.8%
1994	51.4%	83.4%
1999	1.7%	-27.1%
2004	41.0%	40.7%
2015	40.2%	39.6%

Source: Bloomberg Finance L.P., as of February 18, 2022.

There are exceptions, each of which is related to an equity market bubble. Following the rate hike cycle of 1983 and 1984, the U.S. economy had slowed, and the Fed slashed rates by nearly 6% over the next two years. At the same time, even as earnings growth stalled, equity markets soared higher, culminating in the Black Monday market crash of 1987.[1]

The effects of the dot com bubble can be seen clearly in each of the rate hike cycles that started in the 1990s. Market returns outstripped even strong earnings growth in the mid-1990s as valuations soared, and the bubble popped in the early 2000s as returns lagged weak growth in earnings.

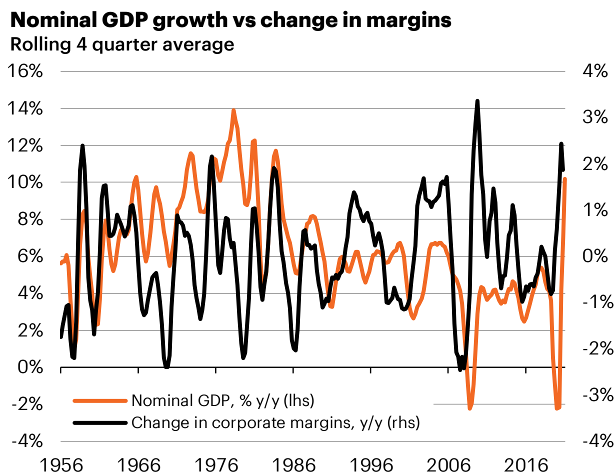
While a Fed hike cycle does not necessarily ring the death knell for earnings growth, it does raise the risk for a slowdown. After all, the purpose of rate hikes is to dampen inflation pressures by impacting aggregate demand via the cost of financing. By far the two most important (and related) questions for investors today are: How far will the Fed have to go in fighting inflation? And how resilient will the economy and earnings be in the face of higher rates?

It's the economy, stupid

As the market enters this precarious period, the backdrop for earnings has rarely been better. Earnings per share (EPS) for the S&P 500 in 2021 were 27% higher than in 2019, supported by robust nominal GDP growth and rising profit margins. These stellar fundamentals have provided space for valuations to contract even as markets continued to rise (until recently, at least). Earnings growth is now expected to moderate and settle in at a healthy 7% and 10% in 2022 and 2023, respectively.[1]

One of the crucial issues that has been top of mind for many investors is the stability of margins in the face of rising cost pressures. Inflation has forced companies to deal with sharply higher input and labor costs, calling into question how much more latitude companies will have to pass on higher costs to consumers. These are valid concerns and certainly paramount issues at the sector and company level, but aggregate corporate earnings are historically much more sensitive to revenues than costs. As the chart below shows, when nominal GDP growth (and by extension, revenue growth) is strong, margins tend to follow (and vice versa). This relationship holds true even during inflationary periods like the 1970s. In other words, corporate pricing power tends to increase in good economic times, allowing revenues to grow faster than costs.

Nominal GDP growth vs change in margins
Rolling 4 quarter average



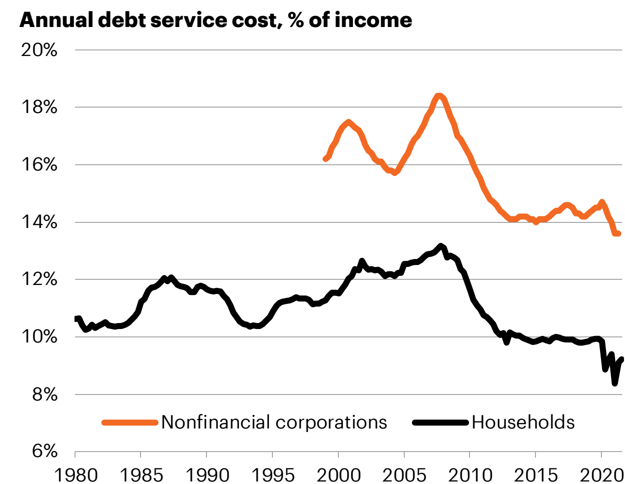
Source: U.S. BEA, as of December 31, 2021.

This leaves us with a rather simplistic setup: The fate of corporate earnings, and by extension the equity market, will come down to economic growth. The economy will need to deal with a hawkish Fed, at least for 2022 if not beyond that.

With inflation at levels this extreme, historical precedent suggests the risk of the Fed needing to tighten financial conditions more quickly than the economy can handle.

That said, it appears to us that the U.S. economy is better prepared to handle higher rates than it has been at many periods historically. Total consumer debt sits well below pre-GFC levels, and the amount households pay to service that debt is near an all-time low. While companies did take on additional debt throughout the recent contraction and recovery, many have taken advantage of historically low rates to lock in cheap long-term financing; the average maturity of investment-grade corporate bonds has risen from 9.6 years to 11.5 years since 2013.[2] Despite higher debt loads, corporations have also seen their debt servicing costs fall to multidecade lows thanks to rock-bottom rates. Additionally, both companies and households are sitting on record cash piles, a sign of healthy balance sheets.[3]

Annual debt service cost, % of income



Source: Bank for International Settlements, as of December 31, 2021.

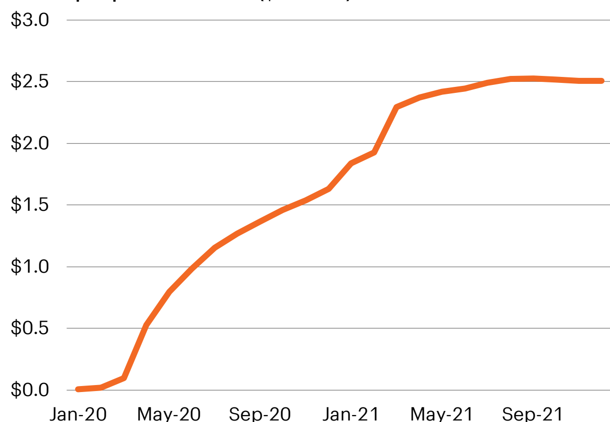
One sector of the economy to watch will be the housing market. While only comprising around 4% of total GDP, rising home prices have added $6 trillion to total household wealth since the start of the pandemic, an increase equal to that of the previous 13 years.[3] Mortgage rates, which have already risen by more than 100 bps over the past 6 months, could continue to put pressure on home affordability.[1] Should demand wane and home prices moderate, it could impact homeowners' willingness to spend in other arenas. That said, the supply of homes remains historically constrained, and the secular drivers of housing demand remain quite powerful.

[2] ICE BofAML Corporate Bond Index, as of February 18, 2022.

[3] U.S. Federal Reserve, as of December 31, 2021.

At the end of the day, the durability of growth and earnings will come down to spending by consumers and businesses. Consumers have amassed nearly $2.5 trillion in excess savings since the start of the pandemic.[4] Financial gains have been felt across the income spectrum; while upper-income households reaped the benefits of higher asset prices, lower-income households benefitted from COVID-era fiscal policy. Additionally, the largest wage gains continue to be centered in lower-wage and hourly-paid jobs. These are important points given that lower-wage consumers are more likely to spend a marginal dollar of income. Of course, the top economic risk continues to center around inflation-driven erosion of purchasing power, especially at the lower income strata. At 70% of GDP, the willingness of consumers to draw down and spend this excess savings will be the largest factor in determining economic growth over the next two years.

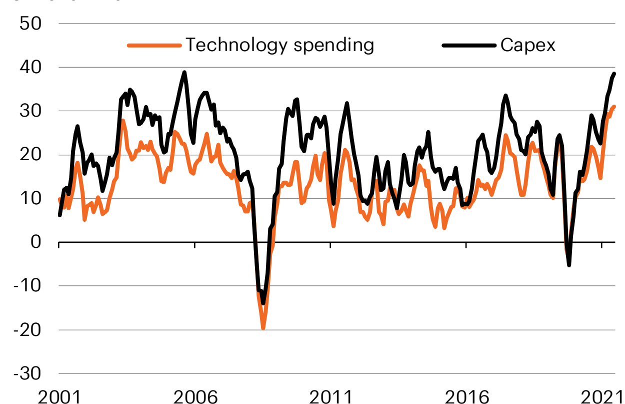
Excess personal savings
Versus pre-pandemic trend ($ trillions)



Source: U.S. BEA, as of December 31, 2021.

While the consumer was the primary driver of mediocre GDP growth over the past decade, business spending underwent a period of malaise. The recovery from the COVID recession has been quite different. Expenditures on equipment and intellectual property products quickly rebounded and eclipsed pre-recession levels. Surveys, such as the Empire State Manufacturing Survey, show company intentions for capital expenditures and technology spending surging. Of course, companies' willingness to invest will be predicated largely on their confidence that the economic cycle will be durable and future demand will be strong.

Business spending intentions
3-month m.a.



Source: Empire Manufacturing Survey, NY Fed, as of February 15, 2022.

Our base case is that as the impact of COVID on the economy continues to wane, consumers will feel more confident to draw down on a portion of their excess savings. We believe the prospect of durable demand will continue to give companies the confidence to invest, a trend that is sorely needed given the inability of the supply side to adequately service demand at the current moment. If this is the case, current S&P 500 EPS growth estimates of 7% and 10% in 2022 and 2023 will likely prove too low.[1]

However, investors should recognize that the distribution of potential outcomes in the next two years is extremely wide. Inflation is the most important factor, as it will dictate both the magnitude of the policy response required as well as the consumer outlook. We believe the following will be the key tenets for investors over the next year.

1. **Malleability is key.** Given the wide distribution of potential outcomes, investors will need to be tactical this year and willing and able to react to incoming data around the economy and earnings. Fundamentals are back in the driver's seat.
2. **Inflation calls for a new approach.** Surging inflation limits the Fed's ability to be flexible. After the Q4 2018 growth scare that sent stocks plunging and credit spreads wider, the Fed relented and cut rates three times in 2019, boosting equities in the process. With inflation well above target, the Fed will have less ability to reverse course unless the economic outlook seriously deteriorates. Inflation changes the nature of the "Fed put," setting the strike price lower. As policy becomes less flexible, investors will have to be more so.

[4] U.S. BEA, as of December 31, 2021.

3. **Dispersion will be prominent.** Higher inflation drives a wedge between company fundamentals, creating winners and losers across value chains. We expect discrepancies between results for suppliers and buyers to be elevated across industries, calling for an active approach.

We will continue to explore these topics in greater detail alongside our colleagues at Chiron Investment Management in the coming months. Our core view remains that markets are mired in the later stages of a mini-cycle within a larger economic cycle, a unique backdrop that presents both opportunities and potential pitfalls for investors.

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