Equity market downturn

Unraveling the decline

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In the few months since March 16, when the Federal Reserve (Fed) finally started hiking policy rates in response to spectacularly high inflation, U.S. equities have tumbled. Since Fed liftoff, the S&P 500 has fallen 13%, bringing the total decline since the market's peak in early January to over 21%—almost erasing all last year's gains.

Such a negative immediate market response to Fed tightening is unusual. During the previous six Fed hiking cycles (dating back to the late 1980s)[1], the S&P 500 had, on average, delivered a 15.6% positive return during the initial 12 months after the first hike. For investors, the first step in deciding whether the most recent equity drawdown is complete is to unravel why the equity market response has been so much worse than previous Fed tightening cycles.

Equity markets 101

Equity market performance is largely driven by two key factors, valuations and earnings. Consider, in the first 12 months of the previous six hiking cycles:

Valuations have typically contracted. A rising interest rate environment is generally negative for equity valuations as investors need to discount future cash flows with higher yields.

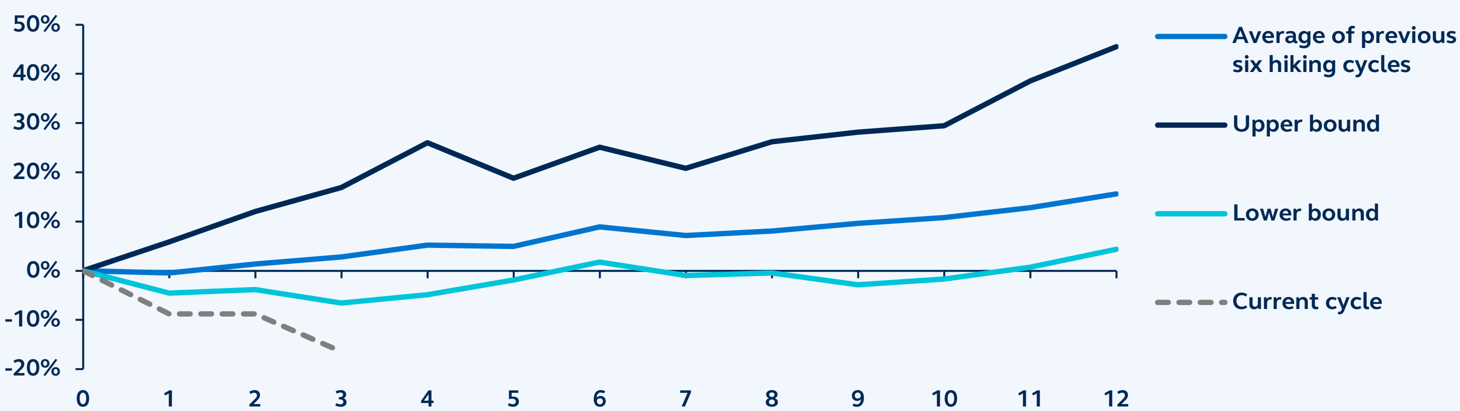
Earnings have typically risen. As the Fed often tightens monetary policy into a strengthening economy, earnings growth usually remains solid in the first 12 months after the hiking cycle starts, only slowing once higher rates have eventually fed through to the real economy.

On average, stronger earnings have more than offset the valuation contraction, driving a positive equity market performance. Indeed, breaking down the average S&P 500 price returns for the previous six hiking cycles reveals that earnings grew 22% on average, significantly outweighing the -4% loss stemming from valuation compression, resulting in a positive 15.6% return.

In the current cycle, valuation compression has been more significant than average, proving to be a powerful headwind to equities and, although not negative, earnings growth has been meaningfully weaker, providing insufficient support to equity markets.

S&P 500 performance over the previous six hiking cycles

Total return, 0 = month of rate action



Source: Bloomberg, Principal Global Investors. Data as of June 30, 2022.

Equity market downturn: Unraveling the decline

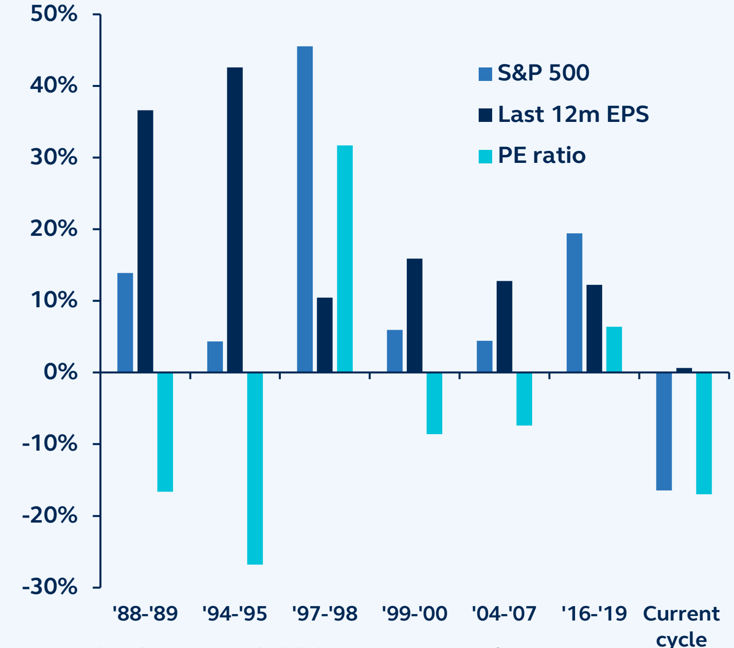
It's (sort of) different this time

Valuation compression

The key factor driving equities lower this year has been the hawkish Federal Reserve and the resulting steep rate expectations which, in turn, have significantly pressured valuations. In the space of three months, the S&P 500 P/E ratio has dropped from 22.8x in March to 19x today, a 17% valuation compression and a spectacular move even by historic comparisons.

The Federal Reserve has only recently recognized the full extent of its previous erroneous read of the inflation situation and has now committed to bring down inflation through aggressive tightening, seemingly irrespective of how the U.S. economy responds.[2] With the Fed playing a risky game of catch-up, the current trajectory for policy rates (implied by futures) is significantly steeper than the average hiking path in the previous six cycles. To put into context, by the end of July 2022, in the space of just four months, the Fed's tightening will likely have matched the Fed's entire three-year hiking cycle of 2015–2018 .

12-month change from first rate hike
Previous six and current Fed hike cycles



Source: Bloomberg, Principal Global Investors. Data as of June 30, 2022.

In the current cycle, the market is anticipating Fed rate hikes to be front-loaded (larger increases at the start of the cycle), with policy rates ultimately rising 330 bps in the first year following liftoff.

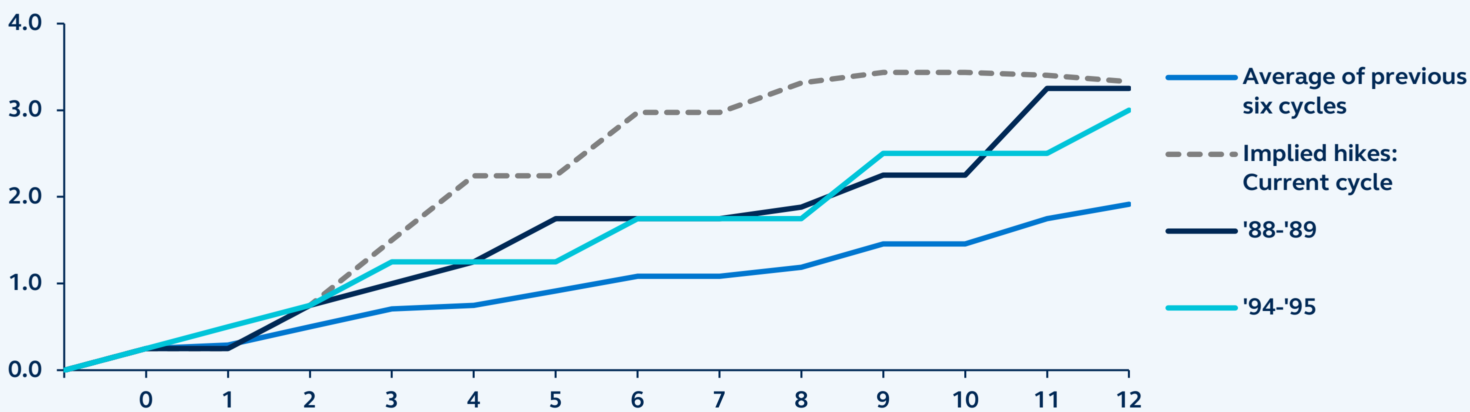
The closest resemblances to this anticipated path are the hiking cycles in 1988–1989 and 1994–1995.

1. In 1988–1989, although the Fed also raised policy rates by 300 bps in the first 12 months, the tightening was more back-loaded—gradual at the start, before accelerating towards the end of the first year. Valuations in the 12 months after liftoff contracted 17%—the same amount as has already been recorded in the current cycle.

2. In 1994–1995, the Fed started tightening at a similarly rapid pace as today, but it ultimately "only" raised policy rates by 275 bps. Valuations compressed 27% in the first 12 months after liftoff.

[2]Read more about the Fed's inflation misread in our April 29 edition of Quick Takes on Capital Markets.

Federal Reserve rate hike movement over the previous six hiking cycles
Total return, 0 = month of rate action



Source: Bloomberg, Principal Global Investors. Data as of July 13, 2022.

Earnings growth

Whereas valuation compression weighing on equity returns was sizeable in the 1988–1989 and 1994–1995 cycles, earnings growth was more significant, ultimately carrying equity returns into positive territory. In contrast, earnings growth in the current cycle has been considerably more muted, failing to offset the drop in valuations and resulting in the very poor performance of U.S. equities.

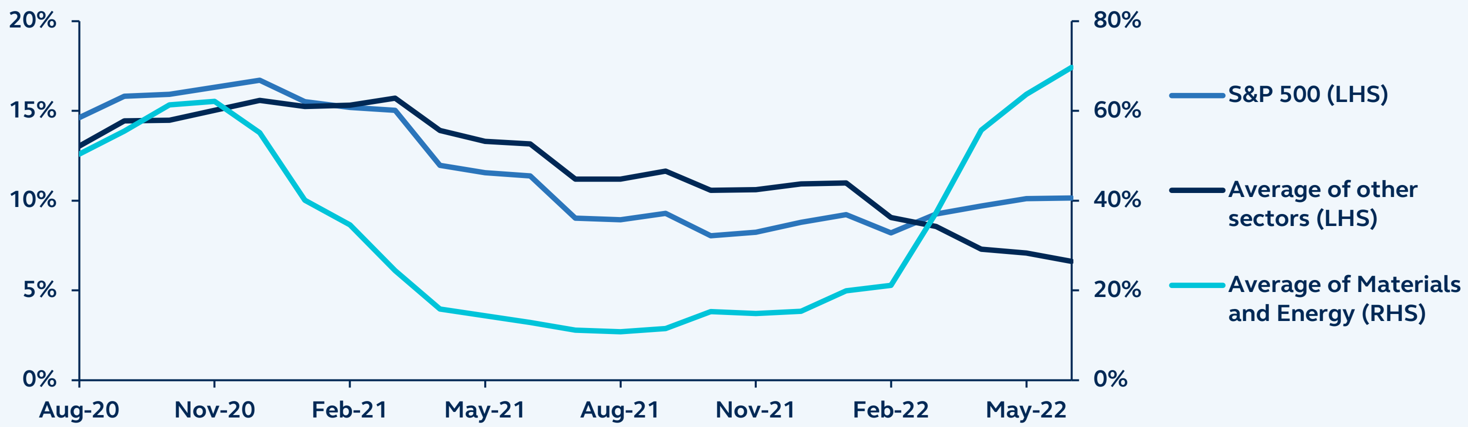
While earnings strength in a Fed hiking cycle may seem counter-intuitive, the current tightening cycle is the unusual one. The Fed has typically responded to higher inflation pressures as they emerge and, usually, inflation pressures have been driven by an over-heating economy. In those situations, earnings would have been strong as the Fed embarked on pulling back monetary accommodation. By contrast, in this cycle, the Fed waited until inflation had become entrenched and sticky before they responded, by which time price pressures were already starting to constrain household budgets, wage growth began pressuring corporate margins, and the economic slowdown had already kicked off.

The Fed's delayed tightening response this year has meant that not only have market rate expectations soared, crushing equity valuations, but earnings growth was already slowing and therefore has been too soft to support equities higher.

From here, although U.S. valuations have contracted significantly, given stubbornly high inflation and Fed commentary emphasizing that price stability is their priority, valuations could still fall slightly further. Certainly, on a historical basis, as U.S. equities have still been cheaper around 80% of the time, there is little pressure for multiple expansion.

Yet, with the bulk of valuation compression likely now behind markets, whether they can bounce back or drop further will largely depend on if earnings momentum can recover and deliver strong growth. Early indications are not encouraging.

2022 expected earnings growth
August 2020–present



Source: Bloomberg, Principal Global Investors. Data as of June 30, 2022.

Earnings watch—a bear is still lurking

At an aggregate level, while expected 2022 earnings growth has declined since early 2021, more recently, it has stabilized at around 10%. If this stabilization can be sustained in coming months, earnings growth could prove solid this year, and offer a decent buffer to additional U.S. equity weakness, despite ongoing valuation headwinds.

A look under the earnings hood, however, reveals some worrisome signs. While overall earnings growth has been stable, it's been carried by the strength in deep cyclical sectors. Roaring commodities prices, for example, have sent energy and materials sectors earnings growth to the sky. On the other hand, many of the other S&P 500 sectors' earnings are already moving in a downward trend, driven by margin concerns as inflation pressures mount and consumers pull back. If this negative momentum is maintained, and despite cyclicals best efforts, it risks bringing down the overall earnings outlook and dealing a significant blow to the equity market outlook.

Navigating in unchartered waters

Investors widely use historic trends and relationships to light the path ahead for markets. However, this recency bias may have already cost investors painfully. Analysis shows that the Fed is hiking at a more aggressive pace and into an already slowing economic environment—this time is (a bit) different.

The path forward will be largely earnings-led. Technical factors, such as investor sentiment, flows and cash allocations, as well as news of the much-awaited U.S. inflation peak, may set the stage for a short-term market rally. But until the effect of slowing, and even contracting, economic growth on earnings has been fully felt, and valuations fully capture the negative fundamental outlook, equity market headwinds will persist.

[1] *Hiking cycle in this paper is defined as period from the first hike to the month before the next cut. Before 1988, except for two episodes, hiking cycles tend to be short lived and difficult to use as reference. So, the analytical period in this paper is from 1988 to 2022. The six hiking cycles are Mar-'88 to May-'89, Feb-'94 to Jun-'95, Mar-'97 to Aug-'98, Jun-'99 to Dec-'00, Jun-'04 to Aug-'07 and Dec-'16 to Jun-'19. The last one technically started from Dec-'15, but Fed paused over a year before resuming consecutive hikes, so Dec-'16 was a more proper starting point for this analysis.*

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results.

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