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ON OUR MINDS

On Fundamentals and Valuations

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It doesn't require a very good memory to see that this year's stock market freefall has a familiar feel to it. For the second time in three years, stocks have followed a smashingly good year with a loud thud: In 2020, the onset of the Covid pandemic led to a 35% drop in just six weeks, while this year the military war in Ukraine and the Fed's economic war on inflation have led stocks down 18% through yesterday. In both cases, rich valuations and exogenous events punished prices more than changing fundamentals did.

Compared with 2020, this year's stock market decline has been much gentler; compared to the vicious 17-month 2008-09 bear market, this round has been both shorter and shallower. So why do we all feel so miserable?

I think there are two factors at play, and they both point to how investors can weather this particular storm. First, this year's market has been relentless and volatile. The S&P 500 has lost value in eight consecutive weeks, and in 15 of 20 weeks so far this year. Also, the market posted only seven trading days last year in which it moved more than 2% up or down on the day; it's done that 18 times already in 2022, including six times just this month.[1] Unlike the 2020 bear market, which was over almost as soon as it began, this downturn is testing the fortitude of all but the hardiest investors.

The second factor is the bond market, which has also been awful this year. In the 2008-09 and 2020 bear markets, bond prices rose when stocks fell, cushioning the blow to equity portfolios. This year, by contrast, bonds have tracked stocks all the way down: The Bloomberg Barclays U.S. Aggregate Bond index is down 10% this year, and it could have been a lot worse. Long-dated Treasury debt prices (as represented by the iShares 20+ Year Treasury ETF) are down 21% year-to-date. Ouch!

Perhaps the markets have felt more painful just because of our habit of using the arbitrary measure of a calendar year. The S&P 500 stock index peaked on the first trading day of 2022, meaning that the top-to-bottom price drop almost perfectly coincides with year-to-date performance data. An 14% drop after the market had already risen by, say, 10% in a given year means that the YTD number would only be down in the single digits; but that same 14% drop from January 2 through April 30 means double-digit YTD pain. It's the same loss of value, but the constantly quoted YTD numbers make it *feel* worse, don't they?

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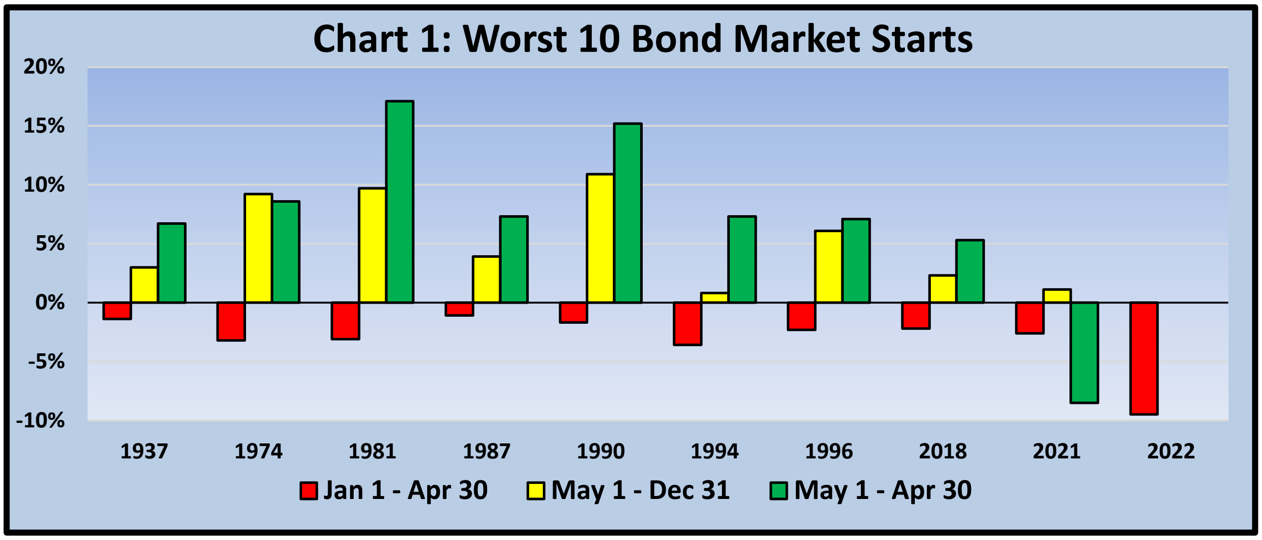
[1] *How long has this been going on?* Ace singer Paul Carrack asked of bassist Tex Comer's moonlighting with other bands; perhaps the better question for disconsolate investors feeling similarly betrayed by markets today would be the opposite: *How long can this keep going on?*

This same calendar quirk makes for some interesting historical comparisons, too. Charts 1 and 2 compare the ten worst four-month starts to a calendar year since 1926, with the January-to-April total return shown in red. It's bad enough that 2022 represents the stock market's third-worst initial trimester in nearly a century – but the bond market's performance this year is far and away its worst start over that same period.

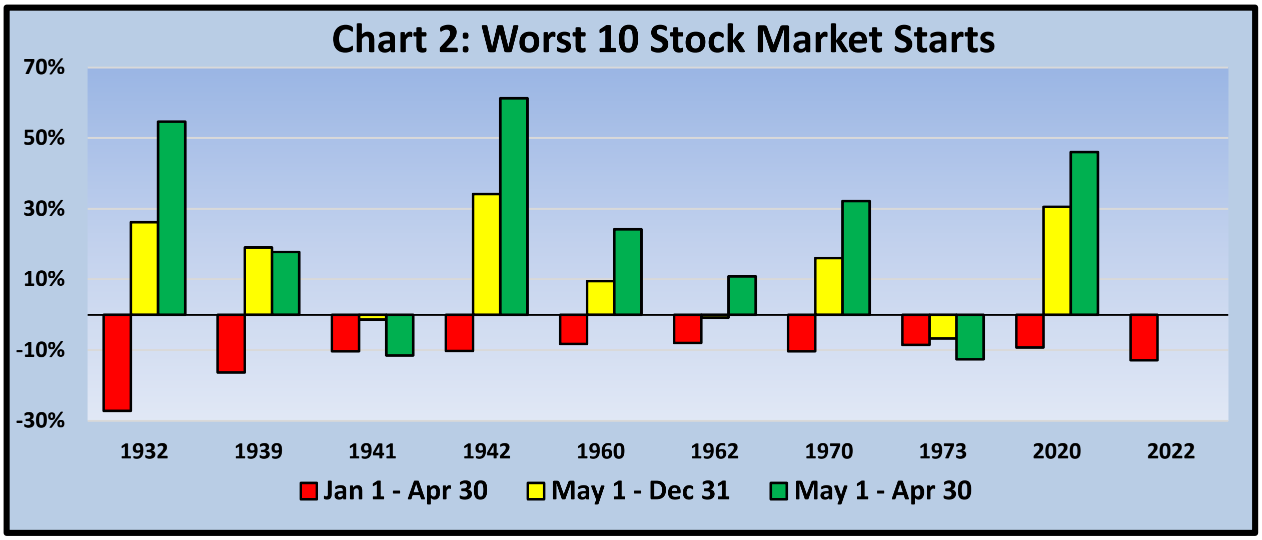


Sources: Morningstar, BlackRock

In short, we've been treated this year to historically bad stock markets and historically bad bond markets at the same time – small wonder many investors are feeling betrayed by their portfolios. Yet there are important reasons for optimism in Charts 1 and 2. Looking first at the bond market (here measured as the Bloomberg Barclays U.S. Aggregate index and its forebears), the yellow columns indicate that the bond market went on to post positive returns in the remaining eight months of every one of the ten calendar years shown on the chart. The bond market tends to right itself quickly, fulfilling its function as stabilizing ballast for investor portfolios. The stabilizing influence extended well into the following calendar year, too, as the green columns indicate: After nine of the ten "worst-ever starts," the bond market posted gains over the ensuing 12 months. The one exception was 2021, for which the one-year-following record includes this year's horrendous start.

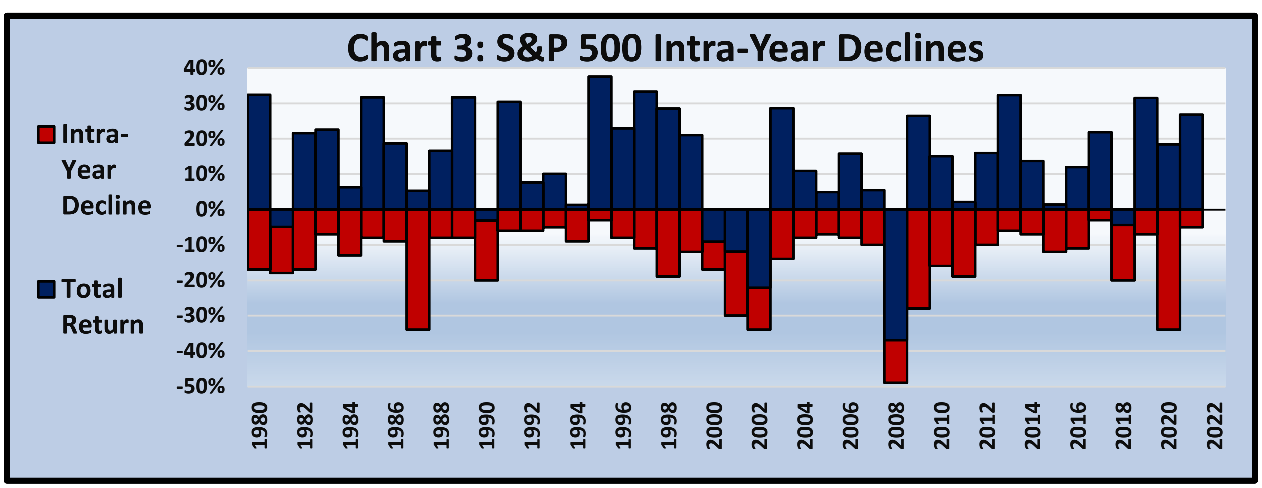
The implication of Chart 1 is that bonds rarely punish investors for very long. To be sure, bond investors still do have reasons to fear further pain: Most notably, inflation is still uncomfortably high and the Fed is still promising *another* 200 basis points of rate hikes this year. Yet markets are anticipatory by nature, and there are two foreseeable outcomes that could be bullish for the bond markets: First, if the Fed is too aggressive and the economy slides into recession, it's reasonable to expect long-term interest rates to fall and bond prices to rise; second, if the Fed is successful in taming inflation, the central bank may curtail its rate cycle early. Either outcome – recession or soft landing – could be good for bond investors, especially since they are now starting from lower prices after the worst first trimester in the past 96 years. We may not yet have hit bottom in the bond markets, but the evidence suggests that we are close.

Switching to the stock market, the red columns in Chart 2 appear to tell a similar story: Here, too, the 2022 return ranks among the worst ever, trailing only the Great Depression years of 1932 and 1939. Stocks are more volatile than bonds, so it's not surprising that they didn't bounce back as quickly as bonds did; only in six of the nine prior periods did stocks post positive returns through the balance of the calendar year. Indeed, there were two instances in which stock returns were negative over the full twelve months after posting their initial four-month drops.



Sources: Morningstar, BlackRock

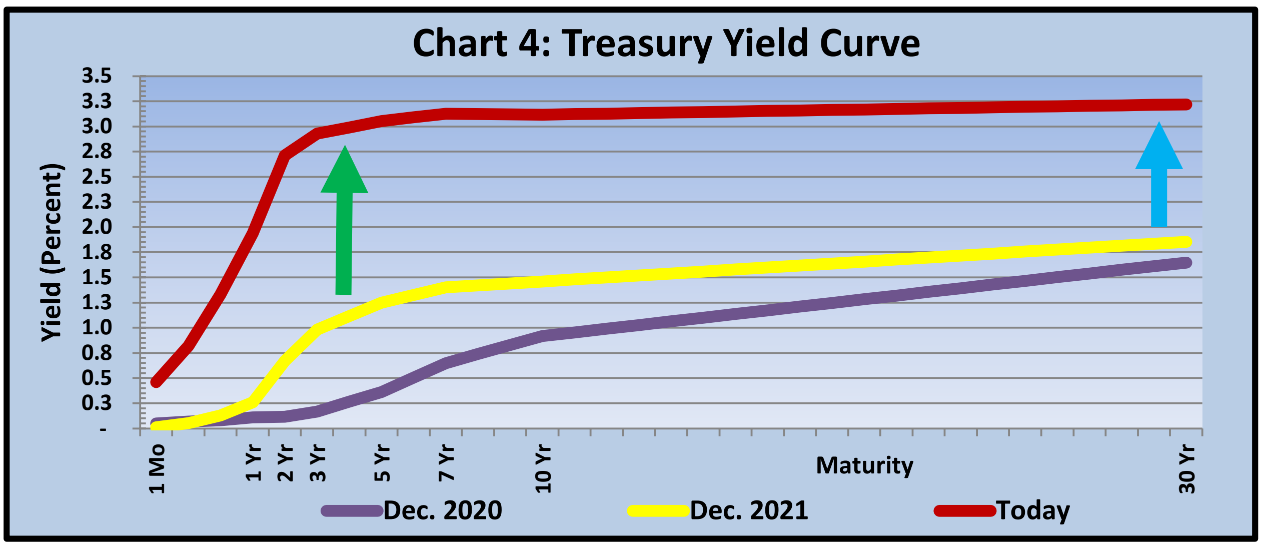
Stocks go through periods of falling prices frequently, and even the deeper 10% corrections come with surprising regularity. The red columns in Chart 3 show the largest intra-year decline for the S&P 500 in each year since 1980, while the blue bars show the calendar year's ultimate total return. In 21 of the past 42 years, the S&P 500 had declined by at least 10% at some point during the calendar year – on average, in half of all years. Yet the blue lines show that the market posted a positive return in all but 7 of those years. Stocks experience 10%-plus corrections every 18 months or so, including six in the past ten years (some of which span multiple calendar years, of course). In this respect, the stock market's behavior this year has been quite ordinary.



Source: BNY Investment Management

All in all, history suggests that patient investors will be rewarded for their fortitude; markets will eventually recover. The challenge now is to assess when and how that will happen. A good first step is to distinguish between two factors in the markets' performance year-to-date: valuation and fundamentals. For both stocks and bonds, it appears that changes in valuation account for nearly all of the markets' weakness, which means that investors haven't (yet) changed their assumptions about the economy's fundamental outlook.

In the bond market, interest rates and credit spreads provide useful insights into investor attitudes about valuation and fundamentals, respectively. Interest rates have risen sharply across the entire maturity spectrum this year, as shown in Chart 4 for the Treasury market. At the long end of the yield curve (blue arrow), 30-year maturities now (in red) yield about 120 basis points more than they did just five months ago (in yellow); in the intermediate middle of the curve (green arrow), yields on 3-year maturities have jumped almost 200 basis points this year. Because the duration[2] of a long-term bond is so much greater than that of a shorter instrument, long-term Treasury bonds have fared far worse this year than short-term Treasury notes. Valuation – i.e., the change in interest rates – accounts for essentially all of the price erosion in Treasury debt this year.

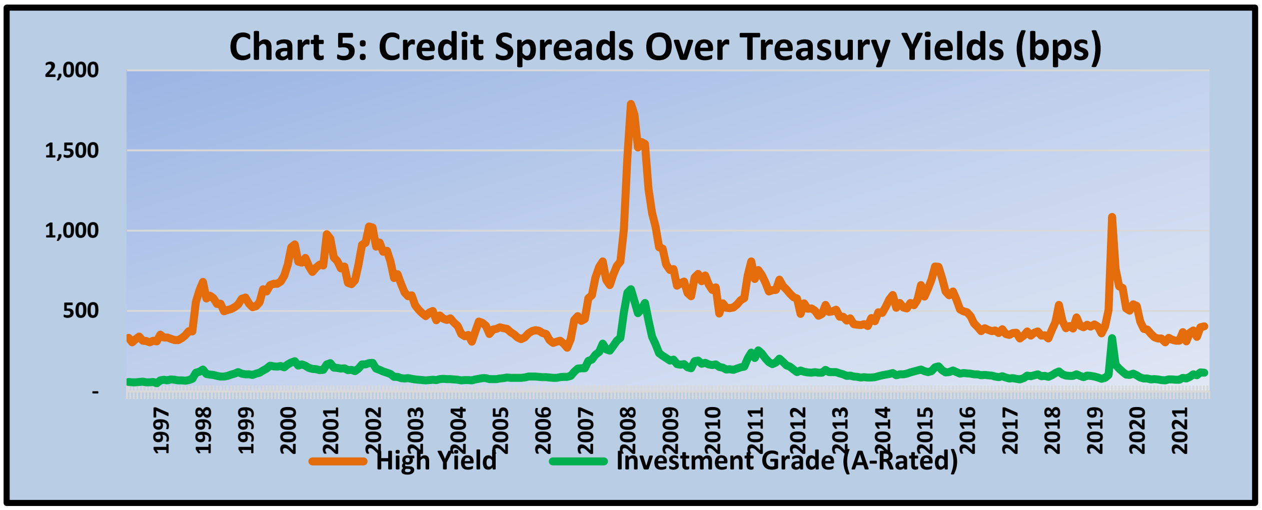


Source: FactSet

In contrast, fundamentals – the assessment of changes in the ability of bond issuers to service their debt – haven't affected bond prices much. The best measure of investor attitudes toward credit quality is the extra coupon yield that an investor will require to hold a riskier corporate bond than a safe Treasury bond; through last week, changes in these credit spreads had been quite small this year, as shown in Chart 5. The implication is that investors haven't been worried about whether recession is on the way.

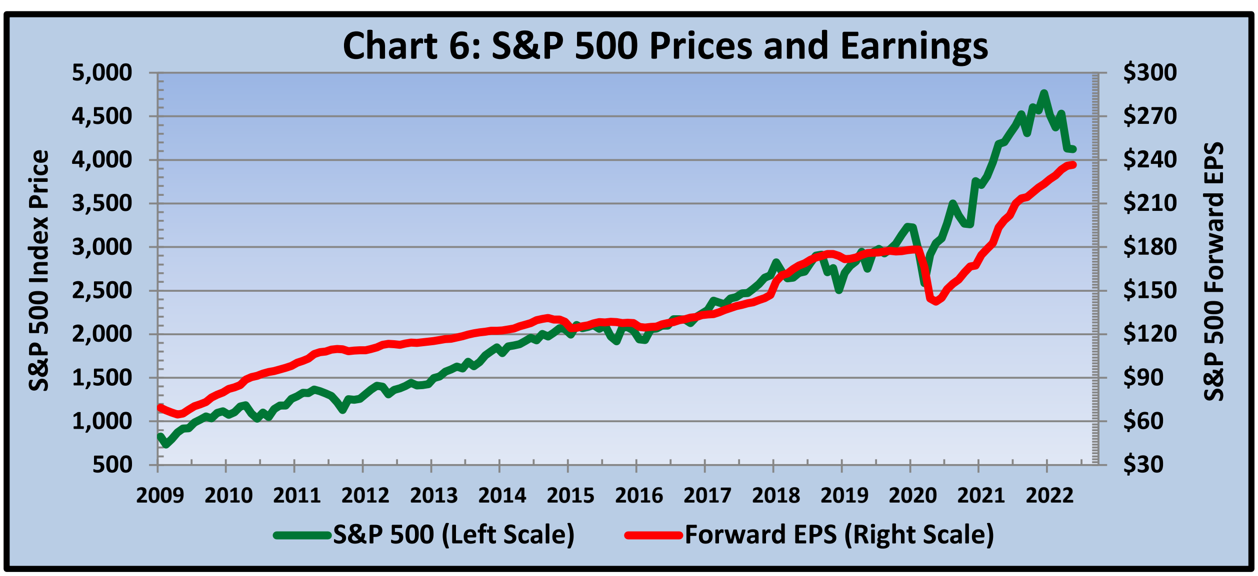
[2] Essentially, duration represents the weighted average time over which a security returns cash to the investor. Securities with longer durations – long-term bonds, low-dividend or high-growth stocks, for example – tend to react more violently to changes in interest rates, because the present value of future cash flows changes by larger amounts the further into the future those cash flows occur.

In the past few days, however, credit spreads have widened further, following reports from major retailers of overstaffing and consumers shifting their spending toward lower-priced items. This appears to be the first evidence that the bond market is beginning to be concerned about fundamentals, not just valuation. Similarly, the Treasury bond rally yesterday, in the face of a stock market retreat, suggests a shift in focus from interest rates and inflation to economic slowdown or recession.



Source: Bank of America, St. Louis Fed

The stock market is showing similar behavior. Chart 6 disaggregates the market's behavior into valuation and fundamentals. In this chart, the S&P 500 price per share is shown in green, and the earnings per share in red. Where the two lines cross, the market is priced at exactly 16 times expected year-ahead earnings, approximately its average valuation over the entire 96-year history of the index. When the green line is higher than the red line, stocks are trading more expensively than their historical average, and when the green line is below the red line, stocks are cheaper.



Source: FactSet

Since the bottom of the pandemic-induced bear market in March 2020, stock prices have run ahead of earnings growth, as investors anticipated earnings growth related to emergence from lockdown conditions. When the Fed cut overnight rates to zero, the rush into risk assets (i.e., stocks) gathered momentum that carried through to year-end 2021. The yawning gap between prices and earnings in 2021 was a clear indication that valuations were becoming too rich. The sharp correction this year has brought the market's P/E ratio down to about 17 times forward earnings, well within one standard deviation of the historical average. The market's valuation froth has dissipated, leaving stocks priced fairly in comparison to historical norms.

While the valuation of the market has come under pressure, the stock market's view of the economy hasn't changed meaningfully. The red earnings line shows no signs of weakness, suggesting that investors have not wavered in their fundamental expectation of continued earnings growth over the next year. This year's double-digit negative returns have so far been all about valuation – i.e., interest rates – and not at all about fundamentals. As with the bond market, yesterday's retail-driven bloodbath was perhaps the first significant indication that equity investors are becoming worried about fundamentals, too.

Where do we go from here? With valuations now in line with higher observed and expected interest rates, it's reasonable to conclude that the losses of the first four months of the year are nearing an end. That conclusion depends, however, on the premise that earnings growth and credit quality continue to track along prior expectations. Conversely, if the economy falters – if consumers resist paying higher prices while companies up and down distribution chains suffer from compressed profit margins, or if higher mortgage rates crush the housing market – then it's just as reasonable to conclude that a fresh round of stock market losses will ensue, this time driven by fundamentals rather than valuation. That's why investors are praying that the Fed can steer the economy toward a soft landing rather than toward a recession.

We can't know in advance whether a soft landing is coming, and we can't be sure that further interest rate hikes won't trigger further changes to the market environment. We are building client portfolios against a base case of higher interest rates, higher inflation, and slower (but positive) economic growth; but we also build in plenty of awareness that this outcome may not come to pass, and so we also include securities that will behave more favorably if we're wrong in our economic assessment. Resiliency, along with patience and fortitude, are the most valued attributes we seek today.