# Behind the Stock Market Pullback

## Valuations appear reasonable, but earnings and liquidity concerns have weighed on equities

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**KEY TAKEAWAYS**

- Stocks struggled in the first two months of 2016 and are below their 2015 peaks.
- Valuations are generally still supportive of the market, but earnings and liquidity conditions have been under increasing pressure.
- The earnings slowdown is spreading beyond just the energy sector, and tightening financial conditions have tempered equity returns.
- On a brighter note, with the Fed rate cycle now presumably on hold, the recent weakening of the U.S. dollar has eased financial conditions somewhat.

The stock market's recent poor performance has driven some indexes down near their 2015 lows. Through the third week of February, the S&P 500 was down 14% from its all-time highs last summer, and the small-cap Russell 2000 had declined more than 20%. The 10-year Treasury yield declined to 1.75%, and the fed funds futures curve had more or less "unpriced" many of the Fed rate hikes that were expected only a few weeks ago.

### Three pillars

A popular rule of thumb in the financial world is that a healthy stock market rests on three pillars: earnings growth, reasonable valuation, and a supportive liquidity environment. For the past several months, only one of these pillars (valuation) have been supportive. That may not be enough to keep the six-year U.S. bull market going, and it's one of the reasons why I believe that stocks have been in a stealth bear market since last summer. Here's a closer look at the health of the three pillars:

#### 1. Valuations: still reasonable

In my opinion, the market is fairly valued. The 12-month forward price-to-earnings (P/E) ratio for the S&P 500 is 15.4,[1] which is in the middle of its historical range and appropriate for where interest rates and earnings are currently. Valuation multiples typically expand during cyclical bull markets, and especially in secular bull markets. Nevertheless, the market is also reasonably valued based on the "Rule of 20," which states that the P/E should be equal to or lower than 20, minus the inflation rate. So with the current inflation rate at 0.73% and the market's P/E at 15, valuation is definitely not a concern. But the market does have a problem with the other two pillars: earnings growth and the liquidity environment.

#### 2. Earnings: expectations falling

Until recently, the slowdown in earnings growth for the S&P 500 was almost entirely due to the struggles of the energy sector. The growth in the U.S. shale industry created a boom in capital spending, much of which was financed through the high-yield corporate bond market and bank credit. When oil was upwards of $100 per barrel, these companies were making plenty of money, considering that the marginal cost per barrel is around $50. That added lots of earnings momentum to the market.

1 Source: FactSet, as of Feb. 19, 2016.

But then oil prices dropped 75% (from $107 to $26). Predictably, this took a big bite out of energy sector earnings, which in turn affected the market's overall earnings growth. As a result, with most S&P 500 companies now reporting earnings to date for Q4, earnings for 2015 are on track to be slightly negative for the first time since the financial crisis. In contrast, at the beginning of 2015, earnings growth was expected to be 6.4% for the year. But, as I said, the problems were mostly contained within the energy sector.

If energy is excluded, earnings estimates for 2015 move from slightly negative to an increase of almost 5%, although that projection was 9.7% at the beginning of the year. Still, 5% growth is consistent with recent years (2013 and 2014 both produced 5% growth), and estimates have a tendency to start high and end at a more moderate pace.

But now something else is happening. The loss in earnings momentum has spread to the rest of the market. What started out as purely an oil story seems to have morphed into something bigger. Ex-energy, the consensus earnings estimates for the first and second quarters of 2016 have fallen quite a bit in recent weeks. For example, a month ago the growth estimate for Q1 was +2.5% (year-over-year). Last week it had dropped to –3.0%. Likewise, a month ago the growth estimate for Q2 was +5.0%. Now it's +1.5%. These are big moves in a short amount of time. The table on page 3 illustrates the loss in earnings momentum.

Having said this, consensus estimates can fall, but they can also rise. These are just snapshots of what Wall Street thinks Corporate America will earn. Also, at this point, the consensus still calls for +3.7% earnings growth in 2016, and +6.2% ex-energy. So, we're not looking at contracting year-over-year earnings estimates, which would normally be associated with bear markets. But there has clearly been a loss in momentum, which is one of the reasons the markets have been struggling lately.

### 3. Liquidity: global tightening

The third pillar is liquidity, meaning financial conditions in general (e.g., the level of interest rates, Fed policy, inflation, the strength of the U.S. dollar, the availability and cost of credit, etc.). From 2009 until 2015, the liquidity environment was extremely supportive for stocks. A number of central banks around the world had a zero-interest-rate policy (ZIRP), quantitative easing (QE) was the order of the day, credit spreads were narrow, and the dollar was declining. But that changed in 2015 when the Fed started tightening, first indirectly, and then formally lifting rates in December. With the rest of the world still in an easing mode, the dollar shot up and compounded the tightening of financial conditions.

But that's only part of the story. Across the globe, China's central bank is trying to orchestrate an orderly decline of its currency, the yuan. As I pointed out in last month's commentary ("Looking for Signs of a Turnaround" Jan. 2016), the yuan is loosely pegged to the dollar, and as the dollar has strengthened in recent years, so has the yuan. But with the Chinese economy slowing, capital is leaving and creating downward pressure on the yuan.

The People's Bank of China (PBoC) has been trying to manage this slide, but it comes at a cost. Every time it tries to stem the decline, it has to draw on its valuable currency reserves. The numbers just released show another $99 billion drawdown in January. In fact, global FX reserves are down a whopping $1 trillion from their peak. That too is a form of tightening, and it puts pressure on the markets.

**What's next?**

In terms of the three pillars, we are one for three right now. This is why the market is struggling. Contrary to popular belief, it is not just because oil prices are falling. At this point, with the loss of earnings momentum spreading beyond energy, I see falling oil prices as more of a symptom than a cause. Don't mistake correlation for causation.

So what should investors do? Long-term investors should do what they should always do: Have a plan and stick with it. If that plan is to dollar cost average into a 401(k) every month, then keep doing it.

Eventually the liquidity environment will ease up, either because the Fed has to abandon its tightening bias or because China has gotten the yuan down to what it considers fair value. In that sense, it's promising that the dollar has weakened a bit in recent days, and with it, financial conditions have become more supportive of stocks.

**Exhibit 1** Year-over-year earnings growth projections (by quarter) have turned increasingly negative.

QUARTERLY EARNINGS ESTIMATE PROGRESSION (YEAR-OVER-YEAR GROWTH)

| | S&P 500 | | | | | | | S&P 500 excluding energy | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q1 2015 | Q2 2015 | Q3 2015 | Q4 2015 | Q1 2016 | Q2 2016 | | Q1 2015 | Q2 2015 | Q3 2015 | Q4 2015 | Q1 2016 | Q2 2016 |
| 1/2/2015 | 3.4% | 3.2% | 5.6% | | | | 1/2/2015 | 8.0% | 7.4% | 9.2% | | | |
| 1/16/2015 | 1.4% | 1.4% | 4.1% | | | | 1/16/2015 | 7.3% | 6.9% | 8.9% | | | |
| 1/30/2015 | –2.1% | –1.1% | 1.9% | | | | 1/30/2015 | 4.8% | 5.5% | 7.8% | | | |
| 2/13/2015 | –4.2% | –2.6% | 0.8% | | | | 2/13/2015 | 3.3% | 4.6% | 7.3% | | | |
| 2/27/2015 | –4.9% | –3.2% | 0.2% | | | | 2/27/2015 | 2.7% | 4.2% | 6.9% | | | |
| 3/13/2015 | –5.3% | –3.5% | –0.1% | | | | 3/13/2015 | 2.4% | 4.0% | 6.8% | | | |
| 3/27/2015 | –5.6% | –4.0% | –0.8% | 5.6% | | | 3/27/2015 | 2.0% | 3.5% | 6.2% | 9.6% | | |
| 4/10/2015 | –5.6% | –4.3% | –0.8% | 5.5% | | | 4/10/2015 | 2.1% | 3.4% | 6.3% | 9.5% | | |
| 4/24/2015 | | –5.4% | –2.1% | 4.6% | | | 4/24/2015 | | 2.4% | 5.0% | 8.7% | | |
| 5/8/2015 | | –6.1% | –2.5% | 4.1% | | | 5/8/2015 | | 1.4% | 4.4% | 8.1% | | |
| 5/22/2015 | | –6.4% | –2.6% | 3.9% | | | 5/22/2015 | | 1.0% | 4.3% | 8.0% | | |
| 6/5/2015 | | –6.3% | –2.1% | 4.0% | 7.9% | | 6/5/2015 | | 0.9% | 4.7% | 8.0% | 7.8% | |
| 6/19/2015 | | –6.6% | –2.4% | 3.7% | 7.8% | | 6/19/2015 | | 0.6% | 4.4% | 7.8% | 7.7% | |
| 7/3/2015 | | –6.5% | –2.8% | 3.4% | 7.6% | | 7/3/2015 | | 0.6% | 4.0% | 7.5% | 7.6% | |
| 7/17/2015 | | –5.3% | –3.0% | 3.2% | 7.5% | | 7/17/2015 | | | 3.6% | 7.3% | 7.6% | |
| 7/31/2015 | | | –6.0% | 1.1% | 5.5% | | 7/31/2015 | | | 0.5% | 5.2% | 5.7% | |
| 8/14/2015 | | | –6.5% | 0.6% | 5.4% | | 8/14/2015 | | | 0.1% | 5.1% | 6.0% | |
| 8/28/2015 | | | –6.0% | 0.9% | 5.9% | | 8/28/2015 | | | 0.7% | 5.6% | 6.7% | |
| 9/11/2015 | | | –6.2% | –0.8% | 4.9% | 7.6% | 9/11/2015 | | | 0.8% | 4.4% | 6.2% | 7.9% |
| 9/25/2015 | | | –6.6% | –1.2% | 4.6% | 7.3% | 9/25/2015 | | | 0.5% | 4.1% | 6.0% | 7.8% |
| 10/9/2015 | | | –7.2% | –2.0% | 3.8% | 6.4% | 10/9/2015 | | | –0.3% | 3.5% | 5.5% | 7.1% |
| 10/23/2015 | | | | –3.6% | 2.7% | 5.9% | 10/23/2015 | | | | 1.8% | 4.5% | 6.7% |
| 11/6/2015 | | | | –4.6% | 1.9% | 5.1% | 11/6/2015 | | | | 0.8% | 3.8% | 6.0% |
| 11/20/2015 | | | | –5.3% | 1.7% | 4.9% | 11/20/2015 | | | | 0.0% | 3.5% | 5.7% |
| 12/4/2015 | | | | –5.6% | 1.6% | 4.7% | 12/4/2015 | | | | –0.3% | 3.5% | 5.6% |
| 12/18/2015 | | | | –6.1% | 0.9% | 4.4% | 12/18/2015 | | | | –0.6% | 3.2% | 5.5% |
| 1/1/2016 | | | | –6.7% | –0.1% | 3.7% | 1/1/2016 | | | | –1.2% | 2.5% | 5.0% |
| 1/15/2016 | | | | –7.0% | –1.0% | 3.1% | 1/15/2016 | | | | –1.3% | 2.1% | 4.9% |
| 1/29/2016 | | | | | –4.5% | 0.3% | 1/29/2016 | | | | | –0.9% | 2.8% |
| 2/12/2016 | | | | | –7.0% | –1.4% | 2/12/2016 | | | | | –2.7% | 1.6% |
| 2/19/2016 | | | | | –7.4% | –1.7% | 2/19/2016 | | | | | –3.0% | 1.5% |

*Source: Bloomberg Finance L.P., as of Feb. 19, 2015.*

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