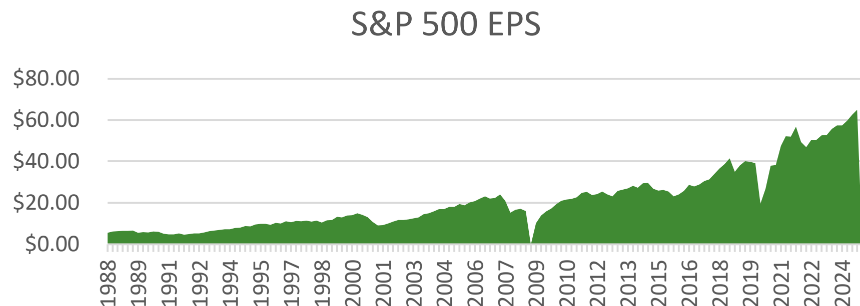
Fundamentals

Long-term investors, including ourselves, often talk about focusing on "Fundamentals", meaning data that measure a company's actual financial performance & outlook. These metrics are more closely aligned with what the companies themselves are focused on, such as sales, profit margins, growth rates, debt ratios, etc. The theory is that in the short-term, markets are inefficient and are heavily influenced by popular sentiment, liquidity & trading patterns, and shifting valuations. Longer-term, however, markets *are* more efficient and companies underlying fundamentals will eventually drive their stock prices. Since the primary purpose of investing in a company is to eventually share in that company's profits, the most fundamental financial metrics are those measuring current & historical earnings, earnings growth rates, and future earnings expectations.

We have written extensively on stock market valuations in recent years due to the extraordinary impact that changing valuations have had on stock market returns. Just as rising valuations were largely responsible for the strong market performance prior to last year, the current market downturn is largely the result of those valuations coming down to more normal levels. This implies that the recent downturn is *not* being driven by earnings, which we believe is true. With that said, let's take a closer look at earnings and what they are telling us about current financial markets. The following chart shows the actual earnings (per share) of companies in the S&P 500 over the last 35 years.

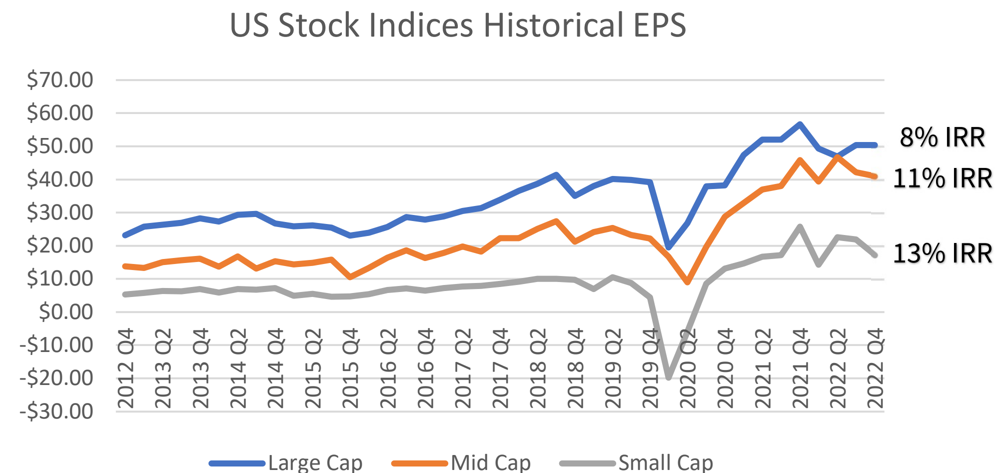


Source: S&P Global

As the chart shows, corporate earnings tend to grow steadily over time, with periodic V-shaped drops. The most prominent visible dips correspond to actual market downturns following 09/11, the 2008 Financial Crisis, & the 2020 Covid Pandemic. Despite the severity of the current market downturn, there is no corresponding drop in corporate earnings.

While this is unique in recent history, it also makes sense. Mathematically, market downturns must be connected to either lower earnings or lower valuations (or both). The three previous downturns involved major catastrophes that hurt the entire global economy and are all examples of earnings-driven downturns. In contrast, the current market is not being driven by a global catastrophe, but rather by higher interest rates and is an example of a valuation-driven downturn.

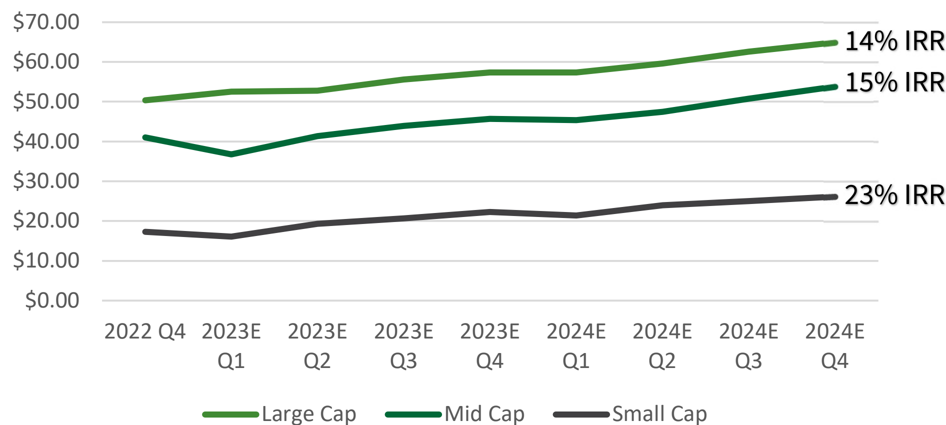
The story is similar outside of just the S&P 500. The following chart shows the earnings (per share) of all three market capitalizations of US stocks, along with the average growth of those earnings over the last ten years.



Source: S&P Global

While there is some flattening at the very end, there is a noticeable absence of a serious earnings drop in any of the three categories of US stocks. This would suggest that the recent downturn has been driven primarily by lower valuations, not lower earnings.

Looking ahead, earnings metrics are as much about future expectations as they are about past results. The following chart shows the earnings (per share) expectations for the same three categories of US stocks through 2024, as reported by the companies themselves. The annual growth rate of those expected earnings is also shown.



Source: S&P Global

Once again, the data paint a rosy picture. Not only has there been no significant drop in corporate earnings since the down market began, but future earnings are expected to grow at an even faster pace than they have over the past decade.

So what is missing from this picture, and why is there so much talk of a looming recession? First and foremost we need to recognize that we measure economic data differently from the way we typically measure stock market data. Most economic data such as GDP Growth is measured in “real” terms, meaning it is being adjusted for inflation. However, this is not typically true for stock market data where we measure returns, as well as fundamentals like earnings, in “nominal” terms (not adjusting for inflation). If the economy grows by 2% but inflation is 4%, that would be considered a “real” growth rate of -2%, a shrinking economy, and eventually a recession. In this scenario though, “nominal’ earnings may still be positive, despite a “real” recession. That is a very distinct possibility right now.

Secondarily, the current speed of interest rate hikes and tightening monetary policy is unprecedented, creating new risks that are difficult for investors or companies to quantify or predict. The recent failures of some regional banks serve as a stark reminder of this, and only time will reveal the full ripple effects of the Fed’s actions. At the moment, however, the corporate earnings picture is positive despite the market turmoil of the last 18 months.