A Tale of Two Markets

Last year was a terrific year to be a high-risk, growth-oriented investor. While more conservative investments that rely on interest rates continued to struggle, riskier assets such as stocks, commodities, and real estate rewarded investors extremely well. A closer look shows a tale of two markets, with a steady upward trajectory in the first eight months of the year followed by a volatile and mostly flat performance after Labor Day. Two of the major news items in the last four months of 2021 were US corporate profits setting a record (as measured by profits as a % of the entire economy), and inflation data coming in higher than expected. This provides us with a wonderful case study to discuss where stock market returns come from.

A quick refresher: at the most basic level stock prices & returns are based on a combination of three things:

1) A company's profits (earnings)
2) The expected growth of future profits (earnings growth)
3) The amount an investor will pay per $1 of current or future earnings (valuation)

We have previously written about the impact that interest rates have on valuations: as interest rates rise and investors can earn more yield on risk-free assets, they will demand higher returns on riskier assets, meaning they are willing to pay less per $ of current or future earnings. The first eight months of 2021 saw record current earnings, strong projections for earnings growth, and little change in interest rate expectations. This resulted in factors one & two driving stock prices upwards, with factor three staying mostly neutral.

However, the roadmap changed in September when the US began reporting higher than expected inflation numbers. While current earnings continued to break records, the expectations of future earnings growth suddenly became murkier since not every company can raise prices enough to offset higher costs, or at least not immediately. Furthermore, the primary tool the Federal Reserve uses to fight inflation is to raise interest rates. Therefore, higher inflation expectations mean higher interest rate expectations, which as we know means investors will pay less per $1 of earnings, forcing stock prices down.

The net result is that the three driving forces of stock returns ended up working against each other, with strong current earnings competing against decreasing valuations and uncertain earnings growth. In this light the results of the last four months make sense - a volatile but mostly flat market.

Getting a bit more granular, within the stock market we categorize "Growth Stocks" (value comes not from current earnings but expected future earnings growth) vs. "Value Stocks" (value comes primarily from current earnings). Higher inflation means that a dollar one earns in the future is worth less than a dollar one earns today. The result is that in addition to adding uncertainty about future earnings growth, higher inflation also directly decreases the present value of expected future earnings. This tends to hurt growth stocks (whose valuations are primarily based on those future expected earnings) much more than value stocks (whose valuations are primarily based on current earnings). This would be a major reversal from the strong outperformance we have seen from growth companies over the last few years.

In summary, it's no surprise that interest rates are expected to go up, which will create a headwind for stocks as valuations are likely to work against earnings & earnings growth. The speed and the magnitude of the headwinds are unknown, which is why every new piece of inflation data and every word coming from the Fed has such an immediate impact on the market. If high inflation hurts expected earnings growth and simultaneously leads to interest rates rising faster than expected, then there is the possibility of a market correction. However, if inflation fades as supply chains get fixed, then continued earnings strength may reignite stocks upward trajectory. As we regularly tell clients, it is extremely difficult (and risky) to position a portfolio based on correctly guessing these short-term events. Importantly though, understanding these three sources of stock prices/returns does allow us to make macro-level projections for the long-term, which play a critical role in our asset allocation and construction of client portfolios.

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