Timmer: Investors should think twice before selling

The chances of an upside surprise may have increased.

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Key takeaways

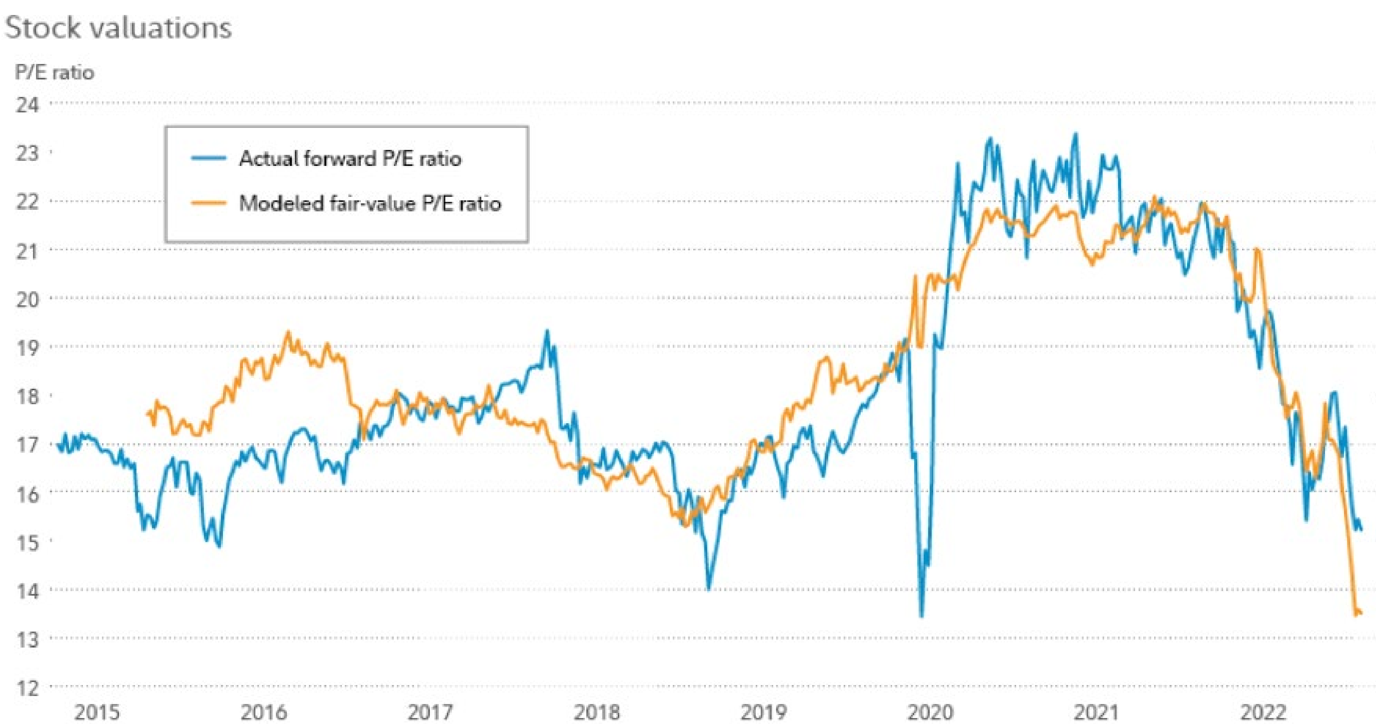
- After last week's inflation report, expectations shifted yet again for how high the Fed may go in this rate-hike cycle.
- Based on an estimated fair-value P/E ratio, the market could still have further to fall.
- However, considering that the Fed's projected path is already very restrictive, it seems less likely that we could see further hawkish pivots from here.
- Given how much the market has already fallen, stocks could potentially rise quickly if the Fed were to pivot to a less-hawkish stance.

The relentless bear market of 2022 continued last week for both stocks and bonds alike, with the S&P 500® reaching a new low for this cycle, and the yield on 10-year Treasurys crossing above 4% for the first time in more than a decade.

This new low was triggered by (what else?) inflation and the Fed. The Consumer Price Index report was a hot mess, again. While headline inflation seems to have peaked, it still came in higher than expected. Moreover, the core inflation rate reached a new high for this cycle, of 6.6% (core inflation excludes food and energy prices, which tend to be more volatile).

This stubbornness in core inflation caused expectations for the Fed to shift yet again. The Fed is now expected to raise the federal funds rate to about 4.9% by the end of this tightening cycle.

Interest rates have a direct impact on stock valuations, due to the basic logic of the discounted-cash-flow model of valuing stocks. In this model, a stock's value is essentially the sum of its future cash flows, with those cash flows converted to a "present value" by dividing them by the current interest rate. That's why every time we see an increase in the Fed's expected terminal rate, we also see a commensurate decline in stocks. Based on my own model for the fair-value price-earnings (P/E) ratio, using the 2-year nominal yield and 10-year real yield as inputs, the fair-value P/E ratio is now about 13.5 times expected earnings.



Past performance is no guarantee of future results. Forward P/E ratio is calculated using estimated earnings for the next 12 months. Modeled fair-value P/E ratio is calculated with a regression model using the 2-year nominal yield and 10-year real yield as independent variables. Source: Bloomberg, FMRCo.

That equates to a level of about 3,200 for the S&P (assuming earnings expectations hold up). This would imply another 9% of downside risk for the market.

Could we be nearing an upside surprise?

While the new fair-value P/E target of 13.5 is worrisome with its implications for the market, in my view it is too late to sell. That P/E model is a moving target. While so far this year we've only seen it move in one direction, it can move the other way too.

What could potentially cause such a move? A less-hawkish pivot from the Fed. Factoring in not only anticipated rate hikes but also the Fed's quantitative tightening (the opposite of quantitative easing, with the Fed shrinking its balance sheet), the central bank is now on an extremely restrictive path—in the same range as previous major tightening cycles such as 1989, 1999, and 2006.

In my view, this creates a more favorable risk-reward balance than at any time during this cycle. It's hard to imagine the Fed getting even more hawkish, but it's easy to imagine it pivoting by getting less hawkish. Such a pivot would produce lower nominal and real yields, which I believe would lift the fair-value P/E ratio.

This valuation math can be just as powerful on the way up as it has been on the way down. If real interest rates were to fall to their historical equilibrium levels, which would happen if the Fed pivots, the stock market could reprice itself very quickly to a higher P/E ratio (which would lift stock prices). I don't want to be short as we get closer to that possibility.

Lessons from turmoil in the UK

On another note, there may be lessons US investors can draw from how the market for gilts (UK sovereign debt) has unraveled. Yields on gilts shot up in recent weeks in reaction to a UK government plan to cut taxes and offer subsidies to offset rising energy bills (a plan that would add to the country's debt burden). While the Bank of England had planned to soon start shrinking its balance sheet by selling gilts, the sharp rise in yields on the bonds prompted it to delay this plan and instead start buying gilts, in order to provide emergency support to the market.

After years of intervention, central banks have become the dominant players in the world's bond markets. Inflation hasn't been a worry since before the Great Recession, which has meant that central banks could provide support anytime there was a market meltdown.

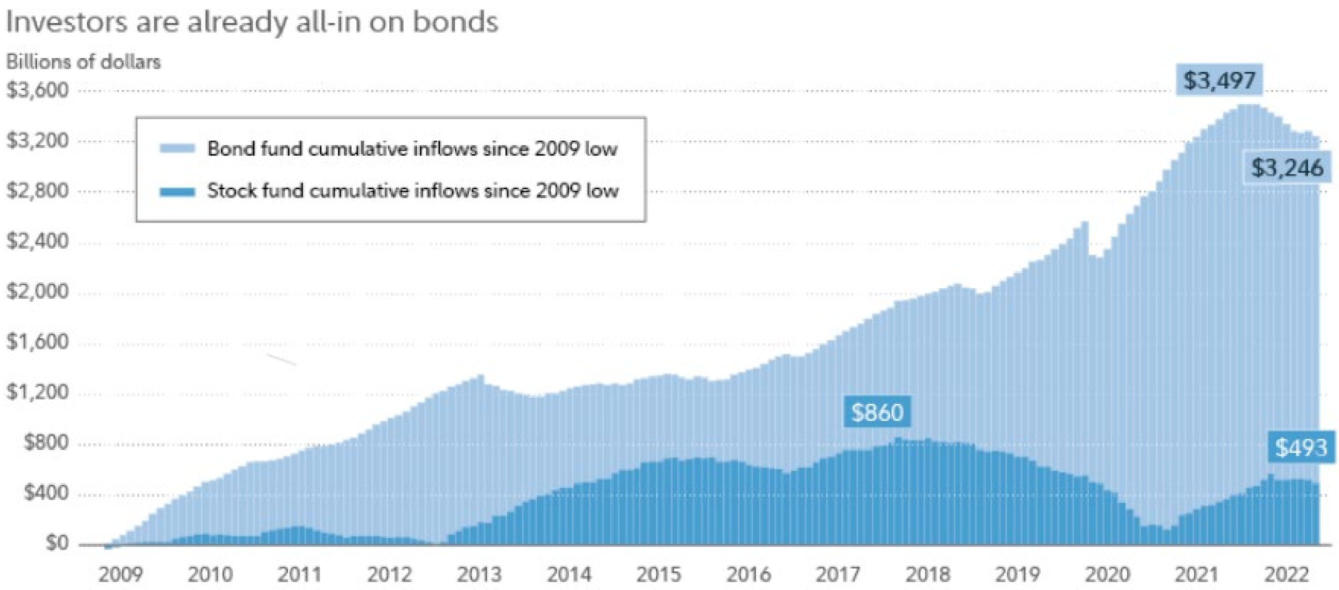
But now inflation is back, and this is forcing those central banks to walk away from sovereign debt markets that are now highly dependent on their support. This is creating all kinds of plumbing and liquidity issues, as we are seeing unfold in real time in the UK and elsewhere.

Which raises the question: Can central banks really disengage cold turkey from the markets after creating these dependencies in the first place? They checked in, but can they ever check out? I don't think it's possible, which means that—like it or not—the Fed and other central banks may remain permanent features of the markets.

The basic reality is that the developed world has too much debt, and therefore can't afford high interest rates. With population growth slowing everywhere, future economic growth may not be strong enough to grow our way out of debt.

We only have to look at Japan to see how the developed world's biggest debtor—with a debt-to-GDP ratio of more than 200%—has dealt with this problem (and the price it has had to pay for it through currency devaluation). The Bank of Japan owns half of the government debt stock, and in the process has tamed the market for Japanese government bonds. The annualized volatility of long-term Japanese government bonds is a mere 3%, compared with 13% for long-term Treasurys. I imagine the Bank of England may be looking with envy at the Bank of Japan. Perhaps the Fed will too if yields keep climbing.

The problem for the US bond market is that there are no buyers left. Investors already bought $3.5 trillion in bonds from 2009 through 2021. They are already in. And central banks worldwide have now turned to sellers. That leaves only the Fed as the Treasury market's buyer of last resort.



Stock fund inflows represent cumulative flows into equity mutual funds and exchange-traded funds (ETFs) as reported by the Investment Company Institute (ICI). Bond fund inflows represent cumulative flows into bond mutual funds and ETFs as reported by the ICI. Source: FMRCo, ICI, Bloomberg, Haver Analytics.

We may have had to say goodbye to Fed support in the stock market this year, but sooner or later we may be saying hello to a new kind of Fed support, this time for the bond market.

And if that acts to keep rates lower than they otherwise would be, it could additionally end up providing support for stock valuations.