Stocks Could Rise Even If Earnings Fall

History suggests the market may already have priced in weakening fundamentals—especially in financials.

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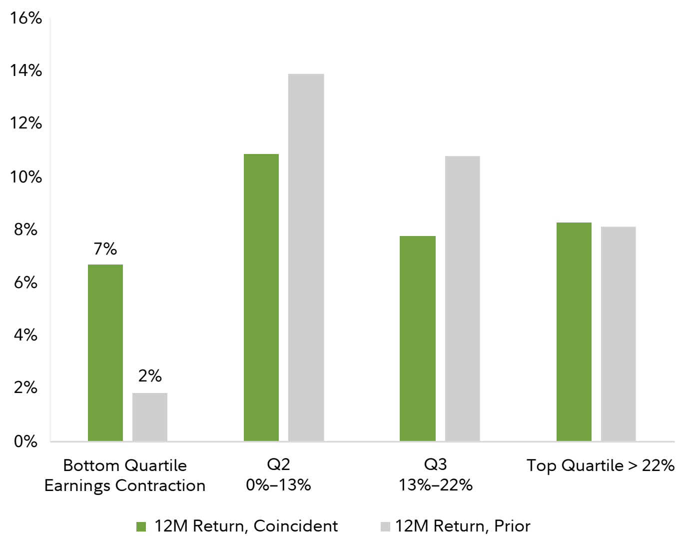
I approach my research by looking at market data through a historian's lens. I believe historical patterns, when considered in the appropriate context, can help investors build conviction about future trends. This month, I'm focusing on what a weak earnings outlook may mean for stocks and the implications of low valuations in the financials sector.

Stocks may rise even if earnings contract

Leading indicators, including consumer confidence and global manufacturing orders, suggest earnings are likely to fall over the next year. It may seem logical to assume a contraction in earnings will cause a broad stock market decline—but that hasn't usually been the case. I reviewed the S&P 500's performance since 1963 during 12-month periods in which earnings fell. The index rose in almost two-thirds of these periods, for an average gain of 7% (Exhibit 1, page 2.) One possible explanation: Earnings weakness may have been priced into the market at the start of these periods. This theory is supported by the market's meager 2% average return in the 12 months just prior to the periods with earnings declines. Moreover, I found that the worse the market performed before an earnings decline, the more likely it would advance while earnings fell. In fact, during 12-month earnings contractions, the S&P 500 had 80% odds of an advance and a 16% average gain if it had posted a double-digit loss over the previous year, as it has over the past 12 months.

EXHIBIT 1: The market has tended to advance while earnings contract.

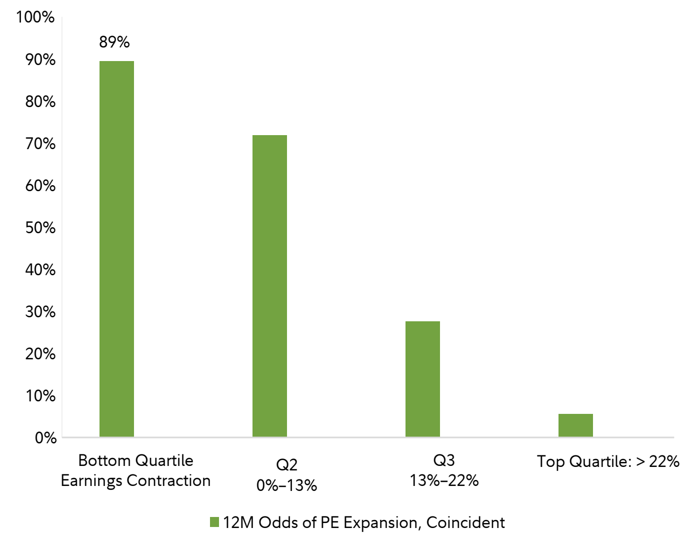
NTM S&P 500 Performance in Quartiles of Future Earnings per Share Growth, 1963–Present



Past performance is no guarantee of future results. NTM: Next twelve months. Analysis based on the S&P 500. Sources: Haver Analytics, Fidelity Investments, as of 9/30/22.

EXHIBIT 2: Valuations have tended to rise as earnings contract.

Historical S&P 500 Odds of Price-to-Earnings Expansion in Quartiles of Future Earnings per Share Growth, 1963–Present



Past performance is no guarantee of future results. PE: Price to earnings. Analysis based on the S&P 500. Sources: Haver Analytics, Fidelity Investments, as of 9/30/22.

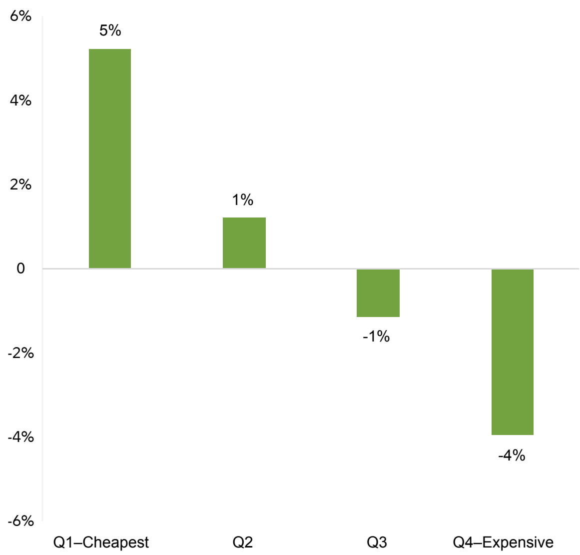
Investors also might think valuations look high, considering the potential earnings decline on the horizon. But the S&P 500's price-to-earnings ratio is in line with historical averages for the beginning of 12-month periods with falling earnings: 15 times estimated forward earnings and 20 times earnings for the previous 12 months. Also, investors should be careful not to assume falling profits mean falling valuations, because that combination has been rare historically. When earnings have contracted in the past, valuations have increased nearly 90% of the time. (Exhibit 2)

Cheap valuations make financials appealing

Financial stocks continue to be historically cheap. The sector's relative price-to-earnings and relative price-to-book ratios are in the bottom decile of their historical range, making the sector considerably cheaper than it was even during the financial crisis of 2007–2009. Low valuations have been a great driver for financials in the past: The sector has outperformed the market by an average of 5% during 12-month periods after its relative forward PE ratio hit the bottom quartile of its historical range (Exhibit 3, page 3).

EXHIBIT 3: Financials have outperformed after low valuations.

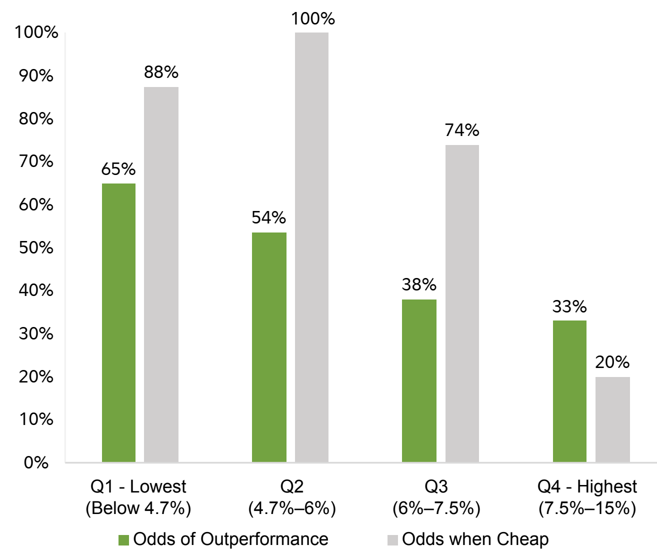
Average Next-Twelve-Month Relative Performance in Quartiles of Relatively Forward Price-to-Earnings, 1963–Present



Past performance is no guarantee of future results. Analysis based on the S&P 500. Sources: Haver Analytics, Fidelity Investments, as of 9/30/22.

EXHIBIT 4: With financials, cheapness matters when entering recession.

Historical Odds of NTM Outperformance When Financials Stocks Are Priced in Their Bottom-Quartile Valuation Range, Segmented by Unemployment Rate, 1962–Present



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Recession? Financials may still fare well

Investors continue to worry about a potential recession, including the effects it might have on the financials sector. Historically, financials' performance entering recession has depended greatly on sector valuations and the recession's severity. I reviewed 12-month periods when unemployment rose since 1962 and segmented them by the unemployment rate. Overall, financials were more likely to outperform in periods in which unemployment didn't rise as high—no surprise there.

But valuation mattered a lot. When financials were in the bottom quartile of their relative valuation range, as they are now, the sector had high odds of outperforming the broad market, provided unemployment didn't surpass 7.5%—about double the current unemployment rate (Exhibit 4). Based on this analysis and other research, I have a positive outlook for stocks in the coming year, and I continue to believe the financials sector may offer opportunities for investors.

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Denise Chisholm is a market strategist in the Quantitative Research and Investments (QRI) division at Fidelity Investments. In this role, she is focused on historical analysis, its application in diversified portfolio strategies, and ways to combine investment building blocks, such as factors, sectors, and themes. In addition to her research responsibilities, Ms. Chisholm is a popular contributor at various Fidelity client forums, is a LinkedIn 2020 Top Voice, and frequently appears in the media.

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Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.

Index definitions

The S&P 500® Index is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of Standard & Poor's Financial Services LLC. Sectors and industries are defined by the Global Industry Classification Standard (GICS).

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