

Earnings and Elections

Two key narratives I see for 2020



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KEY TAKEAWAYS

- While 2019's sharp expansion in stock valuations may seem problematic in the face of flat earnings growth, such occurrences are rather common around inflection points.
- The market had been counting on a better earnings picture in 2020; now that we're here, actual earnings had better come through.
- China's coronavirus outbreak raises some risk that the earnings rebound already priced into stock market valuations could get delayed.
- With increasing attention on the upcoming U.S. presidential election, we note that, historically, only a sweep seems to affect future returns in any meaningful way—and then just for the first two years of a president's term.

Now it's earnings' turn

The market's strong rally in 2019—driven by a 33% expansion in the price-earnings (P/E) multiple amid only 1% growth in earnings—has many bull-market skeptics moaning once again that the “everything bubble” is about to burst.

It's certainly true that the S&P 500® ended the year more dear than it began, and the index is indeed more expensive than it has been in some time. Reviewing data back to 1871, the S&P 500 index is now in the 88th percentile for valuation on a trailing P/E basis. Meanwhile, the Shiller CAPE ratio (cyclically adjusted P/E using 10-year average earnings) places the index in the nosebleed 95th percentile. Even using cash-yield valuation (dividends plus share buybacks), the stock market has moved to the expensive side of its historical average, rising from the 28th percentile a year ago to the 61st percentile more recently. And while that might be better than bonds, which have been trading at the 99th percentile, it's a far cry from a year ago, after stock valuations had been much improved by a sharp correction in the final quarter of 2018.

But what the bears fail to note is that 2019 was the flip side of the year prior: 2018 earnings soared 22% and the P/E ratio dropped 28%. This type of action often can happen at inflection points because the market is a discounting mechanism, meaning it looks ahead.

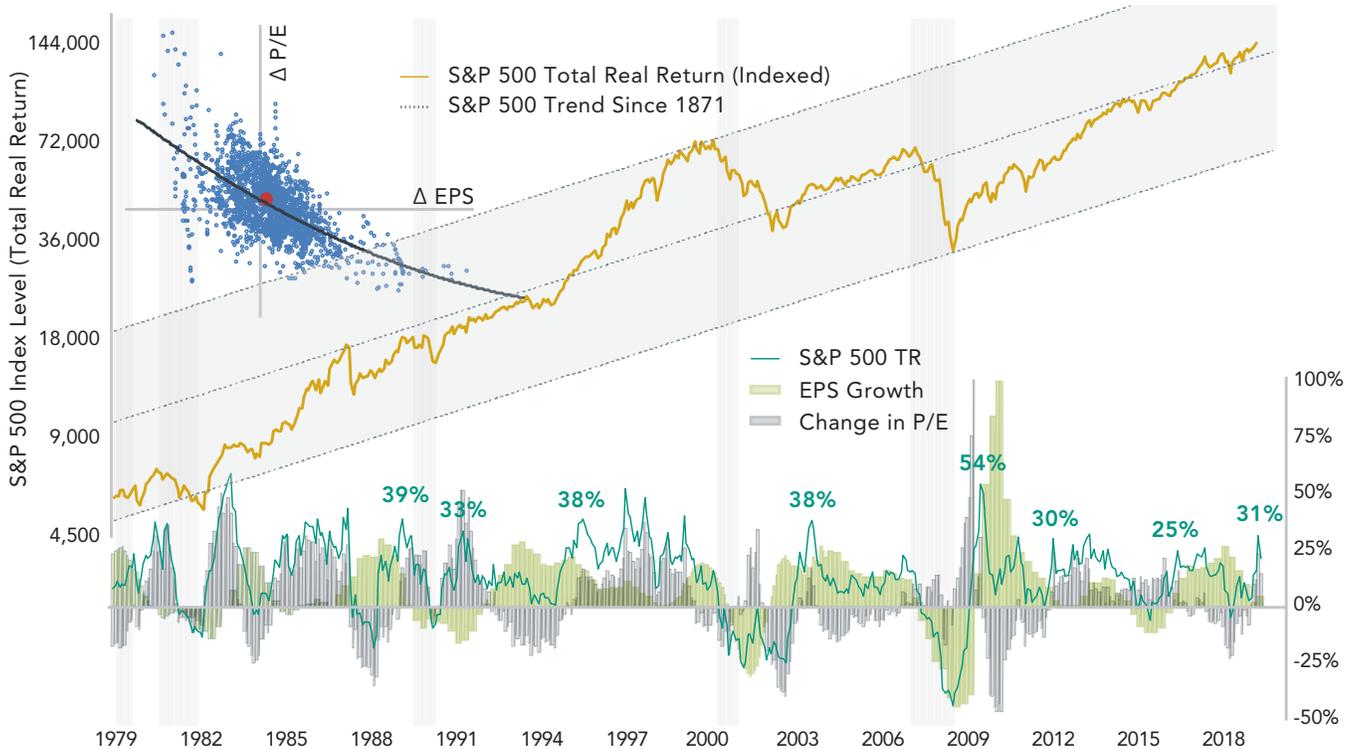
So in 2018, with a trade war looming and the market concluding that the big earnings gains induced by Trump’s tax cuts had been only temporary, the market failed to reward that year’s strong earnings growth with a higher valuation multiple. Instead, valuations fell from 19.7x expected earnings per share (EPS) in January 2018 to 13.7x by late December. The year 2019, on the other hand, experienced the opposite: The market was looking ahead to a better 2020 and pushed valuations upward ahead of time.

If we take 2018 and 2019 together, then, what do we get? Well, we get earnings growth of around 23%, dividends of 4% (over the two years), and an S&P 500 total return of 27%. Nothing terribly problematic *there!*

Historically, stocks have tended to alternate periods of P/E multiple expansion with periods of earnings growth—and rarely the twain shall meet. In Exhibit 1, below, the inset scatterplot portrays this inverse correlation and also shows that, as of 2019, the yin-yang of earnings and valuation (red dot) was right at the trend line. Again, nothing to see here; nothing, that is, so long as the expected recovery in earnings growth indeed materializes. With valuations as they are, if the earnings growth recovery doesn’t turn up, the stock market risks finding itself out over its skis.

EXHIBIT 1: Expensive, yes; but are stock-market valuations too far out of line? I don’t think so.

Various Measures of Stock Market Valuation and Earnings (Estimated and Actual) Over Time



EPS: Earnings per share. P/E: Price-earnings ratio. The symbol “Δ” denotes change in a variable (e.g., EPS or P/E ratio). Gray-shaded bars indicate bear markets. Source: Haver Analytics, FactSet, Robert Shiller, Fidelity Investments; monthly data through December 2019. Past performance is no guarantee of future results.

\$186

2020 Earnings Estimate
12 months ago

\$175

2020 Earnings Estimate
Most Recent

\$160

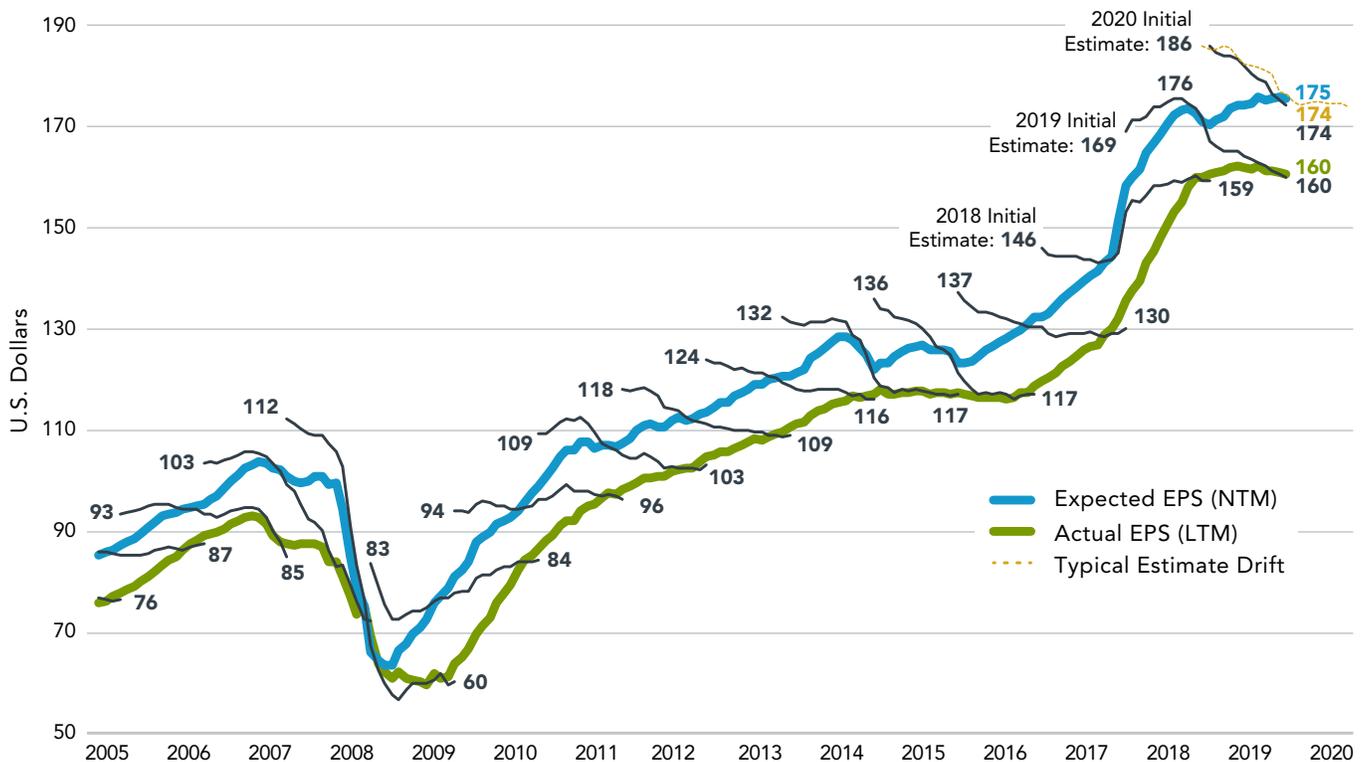
2019 Actual Earnings
Upcoming

Fortunately, earnings growth may indeed be close to a bottom (thus potentially preparing for a rebound) following the slowdown of 2019 (Exhibit 2). FactSet’s most recent S&P 500 earnings estimate for 2020 stands at \$175. As often happens, the earnings estimate started out way too high 12 months prior, at \$186. Over the past year or so, the estimate descended right in line with the typical downward drift drawn by the passage of time to connect actual earnings reports. Based on that historical drift, the most recent estimate has another dollar or so to drop, to around \$174, by my calculation.

With 2019 actual earnings likely ending somewhere near \$160 per share and what I perceive as an imminent earnings bottom, EPS growth mathematically should rebound to around 8% in 2020. If we achieve that 8% EPS growth, then even if we see some compression of the valuation multiple, I’d think the stock market would be well able to post a mid-single-digit return for 2020. After the S&P 500’s 32% run-up in 2019, I’d take that as a win.

EXHIBIT 2: “Everything is going according to plan.”

S&P 500 Index Earnings over Time (Estimated and Actual) and Estimate Drift by Year



NTM: Next 12 months. LTM: Last 12 months. Source: FactSet, Refinitiv DataStream, Fidelity Investments; monthly data through December 2019.

With the “base effect” of a low starting multiple likely to dissipate as 2020 progresses, the year-over-year P/E growth rate should fall back to earth, in my opinion, even if the multiple itself doesn’t change much. But while earnings estimates *usually* drift down over the course of a year, they can also reverse as a cycle turns. While such a turn is not my base case, a drop in the U.S. dollar—which I think possible as long as the Federal Reserve keeps adding excess reserves to the banking system—could stir things up. A dollar decline could boost corporate revenues down the road (with a lag of perhaps several quarters), which likely would find their way into higher earnings.

Thus, I think earnings and the dollar are likely to be key drivers in 2020. *Cui bono?* With a gain in the former and a decline in the latter, I think chances are that 2020 could generate excess returns for non-U.S. equities—in particular, emerging-market equities—much like what happened in 2017, although probably on a smaller scale given China’s more modest stimulus this time around.

So that’s the “bullish” argument: decent earnings perhaps combined with some multiple-contraction producing an average year. What could derail this scenario? Lofty valuations don’t tend to revert to the mean all by themselves; they need some downward catalyst. Could geopolitics provide the impetus? Higher interest rates? China’s new coronavirus? The November elections?

The dangerous coronavirus now flaring up in China is one of those impossible-to-anticipate “left tail” events, and it’s unknowable in real time what impact, if any, the virus may have on global growth and, therefore, on corporate earnings. Natural disasters—including viral outbreaks—historically have tended to have only a temporary effect on economic activity. For example, previous coronavirus-type outbreaks such as SARS (severe acute respiratory syndrome) in 2002 and MERS (Middle East respiratory syndrome) in 2012 may have interrupted prevailing trends, but they didn’t change them. Similarly, the 2019 coronavirus may simply delay the earnings recovery already underway.

Nevertheless, with the stock market priced for a global rebound, even a delay of just one or two quarters could cause a P/E multiple-compression of several points. In the absence of positive earnings growth, that alone could knock 5% to 10% off the S&P 500.

What about the U.S. Federal Reserve? After three cuts last year, I think the Fed’s made it clear that it’s out of the picture unless either the economy weakens significantly (rate cuts!) or inflation makes a sustained comeback (rate hikes!). I don’t find either scenario likely in the near term, and thus I suspect the Fed will indeed keep to the sidelines this year. Indeed, this is more or less what the Fed announced at its most recent FOMC meeting. But with the yield curve flattening once again in the wake of the coronavirus, I suspect that the Fed is on the lookout for signs of deteriorating fundamentals.

Fearing the 2020 election? I wouldn’t.

That leaves the upcoming U.S. presidential election. Some investors hew to the “presidential election cycle theory,” developed in 1968 by market historian Yale Hirsch. He described a general pattern wherein the first two years of a presidential term tended to coincide with below-average returns, whereas the last two years observed above-average returns.

The reasoning behind the theory is that, presumably, a president’s new agenda can take a couple of years to work its way through the economy—and might even produce some financial indigestion if said agenda is not found “market friendly.” But during an administration’s latter half, the thinking goes, the party in power usually is focused more on retaining the presidency, and a re-election bid might include fiscal stimulus. (Prior to 1951, the year the Fed reclaimed its independence from the Treasury, even monetary stimulus might have been part of a presidential re-election campaign.) Such stimulus can goose the economy and, in turn, create a rally that clinches the incumbent party’s re-election—or at least that’s the goal. The market’s lackluster 2018 followed by strong performance in 2019 certainly fits the pattern, and the bulls are hoping for more of the same in 2020.

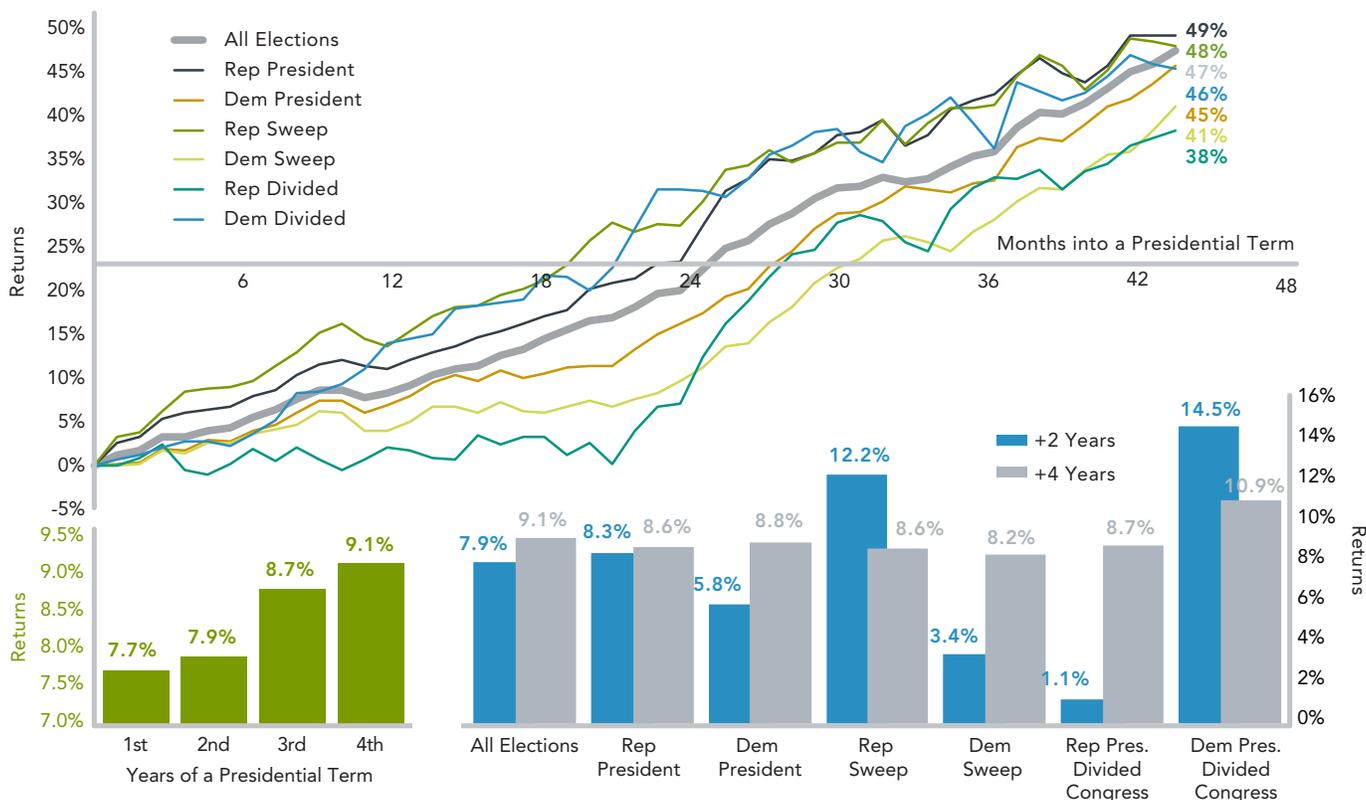
Can we test the power of this presidential election cycle theory? Well, as it turns out, I have for many years studied the elections and their potential (and practical) effects on the stock market, crunching data back to the 1850s. I recently updated my analysis, extending its history to the first presidential election under the U.S. Constitution, dating all the way back to 1789. (Yes, we have stock market data back that far, though one must splice together a few somewhat disparate series.)

The lower left panel of Exhibit 3, below, displays the annualized market return for each incremental one- to four-year post-election period. The lower right shows annualized forward returns based on various election outcomes, measured from the close of the October preceding the election to two and four years later.

I included the shorter segment because two years brings us to the mid-term elections, which can change the power dynamic in Washington and, in turn, affect market momentum. I sliced and diced the data several ways, showing the stock market outcome for all presidential elections (58 occurrences), a win by a Republican (24) versus a Democrat (24), a “sweep”—where one party controls not only the presidency but both chambers of Congress—by Republicans (16) and by Democrats (19), and various forms of “gridlock,” with one party in the White House and the other in charge of the Senate, the House, or both. Note that since the party system was not in every instance “Republican versus Democrat,” the numbers don’t add up to the total number of elections since 1789.

EXHIBIT 3: Would one be wise to wager on the presidential election cycle?

Stock Market Results for Various Periods Following U.S. Presidential Elections



Source: Fidelity Investments; monthly data since 1789 (a mix of S&P 500, Dow Jones Industrial Average, and Cowles Commission indexes). Past performance is no guarantee of future results. Indexes are unmanaged. It is not possible to invest directly in an index.

What's interesting to me is that whatever differences in performance arose during a presidency's first two years (and there are many), those differences all but disappeared by the end of the full four-year term. For instance, the market did better in the first two years following a win for Republicans (+8.3%, annualized) than it did for Democrats (+5.8%), but over a full term the difference shrinks to relative insignificance: +8.6% and +8.8%, respectively. The contrast is even greater following a sweep: A Republican sweep saw a two-year forward return of +12.2% (annualized), whereas its Democratic complement averaged a mere +3.4%. But again, after four years the gap was much smaller: +8.6% versus +8.2%, respectively.

We also see a difference between gridlock scenarios. A Republican president ex a majority in the House or Senate presided over a forward return of only +1.1%, on average, whereas a Democratic president facing opposition in Congress enjoyed an average forward return of +14.5%. Here again, over the four-year term the difference narrows significantly, to +8.7% versus +10.9%, respectively, for these scenarios.

Much of the difference likely is attributable to small sample sizes. For example, my analysis captures only six instances of a Democrat winning the White House without also taking party control of both houses of Congress; this includes the second term for both Presidents Obama (beginning in 2012) and Clinton (1996). Each coincided with strong market performance, with stocks returning +22% and +27%, respectively.

Only nine gridlock cycles appear on the Republican side, including the first term of George W. Bush (2000), who took office just after the dot-com peak and thus presided over a two-year annualized return of -25%. Ronald Reagan's first term (1980) included a two-year annualized return of -2%, as the double-dip recession of the early '80s was still searching for a bottom. In contrast, Reagan's re-election in 1984 preceded a +26% annualized result over the subsequent two years.

Exhibit 4, on the next page, illustrates the array of two- and four-year outcomes, charting the distribution of annualized returns over each term's first two years (left) and the full four years (right). The outcome distribution over the first two years is less normal than it is over four years, with more differences between the Republicans (blue) and Democrats (yellow).

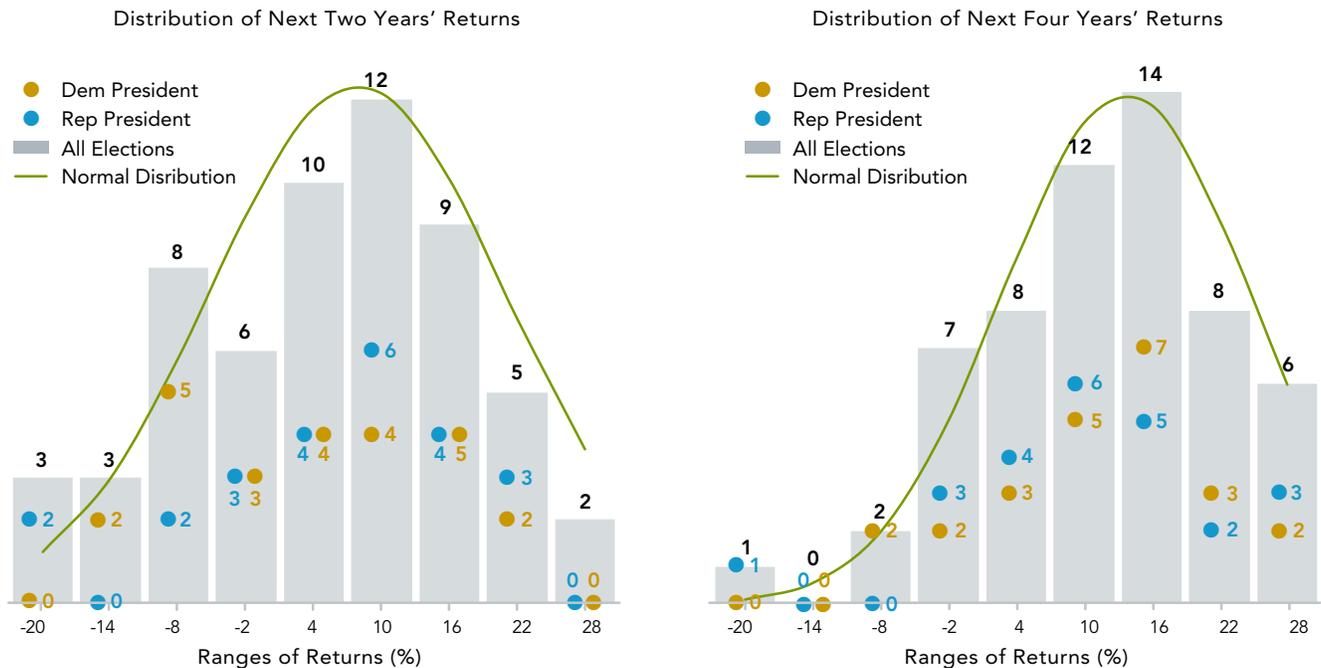
Midterm elections likely play a role in the contrast between the two- and four-year results. The political pendulum is always swinging—sometimes quickly, sometimes slowly. Some midterm elections reinforce a president's mandate, others cancel it out, "correcting" whatever market momentum (positive or negative) was underway during an administration's first two years.

But it also could just be that with enough of a wait, long-term fundamentals—earnings, interest rates, labor growth and productivity, and the mean-reverting nature of an independent monetary policy—retake control as the drivers of longer-term results. And I think, ultimately, that's what is going on here: The economy, and therefore the market, simply generates greater force and momentum than whichever way the political winds of Washington happen to be blowing. Moreover, midterm elections historically have tended to equalize any lopsided results scored over a term's first two years.

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EXHIBIT 4: Does one party trump the other in terms of returns?

Comparison of Two- and Four-Year Post-Election Annualized Return Distributions



Normal distribution: A bell-shaped density curve symmetric around its mean (average); central observations occur more frequently than those closer to the tails. Standard deviation: A measure of the spread (dispersion) of the distribution. Each distribution has its own maximum, minimum, and mean value. The return distributions above are displayed in increments of one-quarter standard deviation. Source: Fidelity Investments; monthly data since 1789 (a mix of S&P 500, Dow Jones Industrial Average, and Cowles Commission indexes). Past performance is no guarantee of future results. Indexes are unmanaged. It is not possible to invest directly in an index.

Let this serve as a reminder: While drama over which party is “good” or “bad” for the stock market makes for compelling political theatre, long-term fundamentals are still what matter in the end. Political initiatives relating to taxes and spending can certainly impact markets, but so can demographic trends and effective monetary policy.

The upcoming U.S. presidential election is, of course, vitally important, taking place not only at a time when the country is more divided than ever but also as

the aging demographic wave demands increasing emphasis on fiscal policy, with ever-rising debt levels and “permanently low” interest rates counting among potential outcomes. Nevertheless, my personal sense is that the 2020 election is likely to have less of a market impact than some people fear. Beyond any single election or any one party—at least in my experience—in the long run it’s the long wave that drives the markets.



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Cowles Commission Common-Stock Index, published by Cowles Commission for Research in Economics, includes data available for industrial, public utility, and railroad common stocks traded on the New York Stock Exchange, 1871–1937. Cowles Commission Composite Monthly Common Stock Price Index is now the S&P 500.

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