Get Back to Where You Once Belonged: How Long Until Prior Highs

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Jojo was a man who thought he was a loner But he knew it couldn't last...

The question of how long it will take to get back to prior highs always burns on investors' minds during a bear market. The following historical and future scenario analysis is presented in an attempt to answer this question.

Importantly, this is not an analysis to answer, "should I put new cash to work today?" The answer to that depends on where we are in the bear market (both tactically short-term and within the medium-term trends.) In the latter stages of a deep bear market, the answer to the question of new cash is usually "yes," given the potential for powerful returns looking out 2+ years, regardless of how long it takes to get back to prior highs.

Note: Our view is that this bear market can continue in the medium-term due to downward pressure on valuations and earnings (of course, with short-term rallies and sell-offs along the way.) With this view, we see opportunities for investors to add to select equities on weakness from these levels, given our long-term view. However, on the opposite side, we do not think investors should chase near-term relief rallies, given persisting headwinds.

The scenario analysis starts with a look at historical parallels from previous bear markets (2007-2013, 2000-2007, 1990-1991.) While each historical parallel has its own idiosyncratic factors that drove markets, it is still helpful to look at them in framing various outcomes.

There are a few conclusions to draw from the historical parallels:

- **Valuations going into a recessionary bear market matter: the higher the valuations are going into the start of the bear, the longer it takes for markets to break even.**
    - In the early 1990s recession, valuations were not stretched. They were at 16.5x going into the recession and quickly expanded to over 22x as the Fed continued to cut interest rates, allowing the market to rapidly recover to prior highs, despite earnings that took four years to recover to previous highs.
    - In the 2000s and post-global financial crisis (GFC) recovery, valuations were high going into the bear market and recession. The result was that earnings recovered long before markets did as valuations remained below prior peaks (the tables below show what the market price-to-earnings (PE) multiple was each year after the peak.)
- We cannot become too focused on valuations or earnings estimates coming out of bear markets. Instead, depending on the backdrop, one of these metrics will likely matter more than the other — will rapid economic recovery boost earnings, or will large monetary stimulus support boosted valuations?

It is this last point that makes forecasting the future return to new highs difficult. We do not know the growth or policy backdrop that will be vitally important for the future path of earnings and valuations.

The final portion of the piece will attempt to lay out our views on possible future scenarios assuming different growth and policy outcomes. The assumptions behind each will be outlined, along with a discussion of "reasonable" valuations.

Having an open mind is most important during times like this — looking for ways to be surprised to the upside and the downside instead of forcing the data to fit a pre-determined thesis or path.

Historical Scenarios

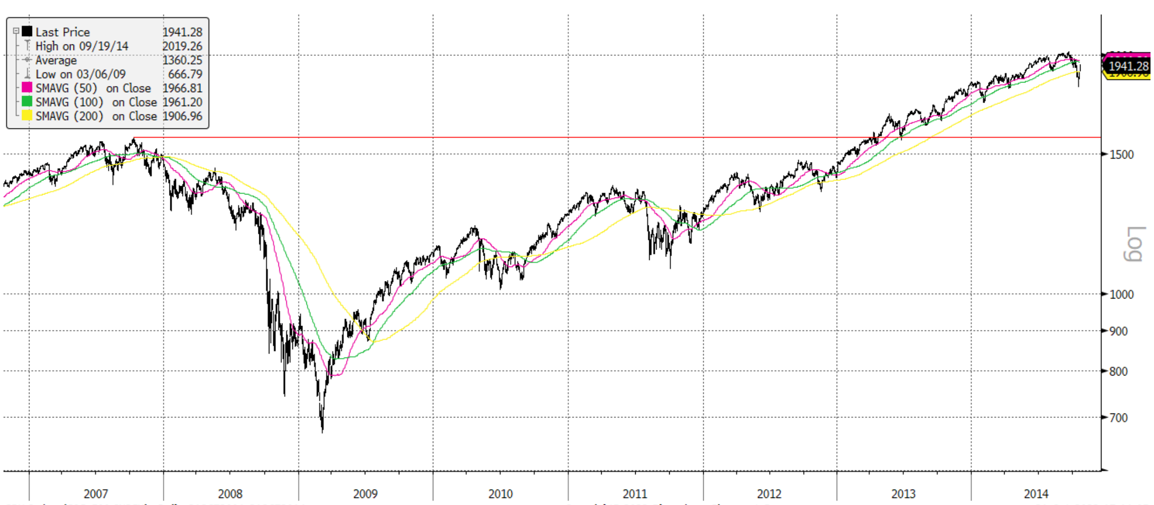
2007-2013 Period

- Coming out of the GFC lows, it took 6 years (from the 2007 high until 2013) for investors to regain their losses from the bear market (which was far more pronounced and protracted compared to what we have experienced today); it took 4 years (from 2009 to 2013) to make a new high off of the low.
- Interestingly, earnings shown as earnings per share (EPS) below, got back up to pre-GFC highs by 2011, but valuations at the 2007 peak were elevated, meaning it took an extra two years to climb back to prior highs.
    - **This is why valuation is not a great predictor of short-term returns, but is a great predictor of 3-5+ year returns.**

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
S&P 500 EPS	$74	$85	$80	$54	$58	$81	$93	$99	$106	$112
YoY		16%	-6%	-32%	6%	39%	15%	7%	8%	5%
PE @ 1,576 (2007 high)		18.5x	19.6x	29.0x	27.2x	19.6x	17.0x	15.9x	14.8x	

Source: Bloomberg

S&P 500 (2007-2014)



Source: Bloomberg

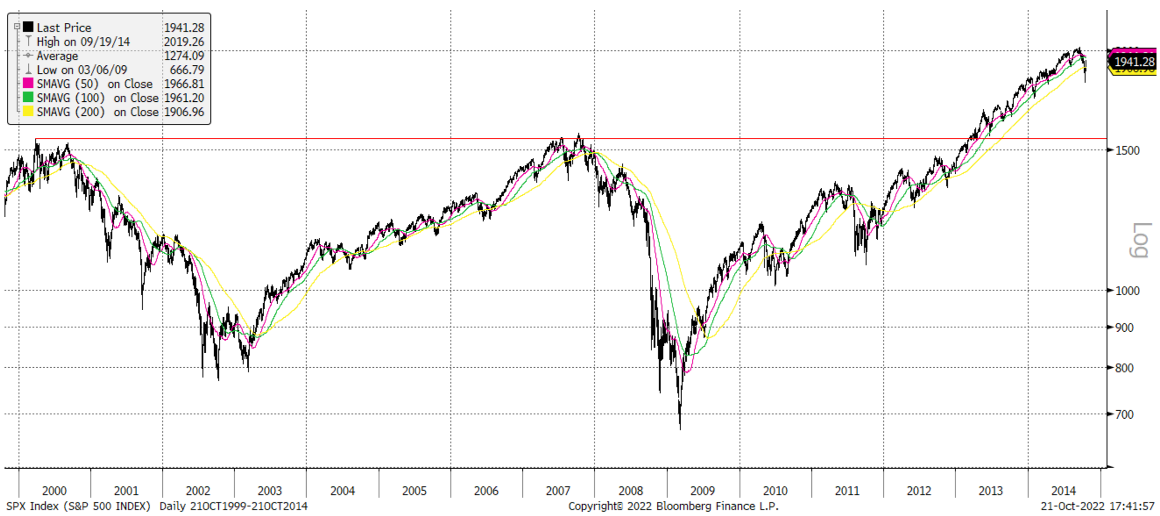
2000-2007 and 2007-2013 Periods

- The bursting of the tech bubble was far more detrimental to long-term returns for investors.
- It was a full 13 years before the S&P 500 sustainably made new highs (new highs were briefly made at the 2007 peak, right before the GFC bear market began and eventually undercut the 2002 lows.)
- Similar to the post-GFC period, coming out of the tech bubble, earnings returned to pre-recession highs by 2003, but it took another 4 years to reach new highs, only briefly, because valuations had been so elevated at the peak.

	1999	2000	2001	2002	2003	2004	2005	2006	2007
EPS	$50	$55	$42	$46	$54	$65	$74	$85	$80
YoY	15%	10%	-23%	8%	18%	20%	13%	16%	-6%
PE @ 2000 peak 1,552		28.2x	36.7x	33.9x	28.7x	23.8x	21.1x	18.2x	19.3x

Source: Bloomberg

S&P 500 2000-2014



Source: Bloomberg

1989-1991 Period

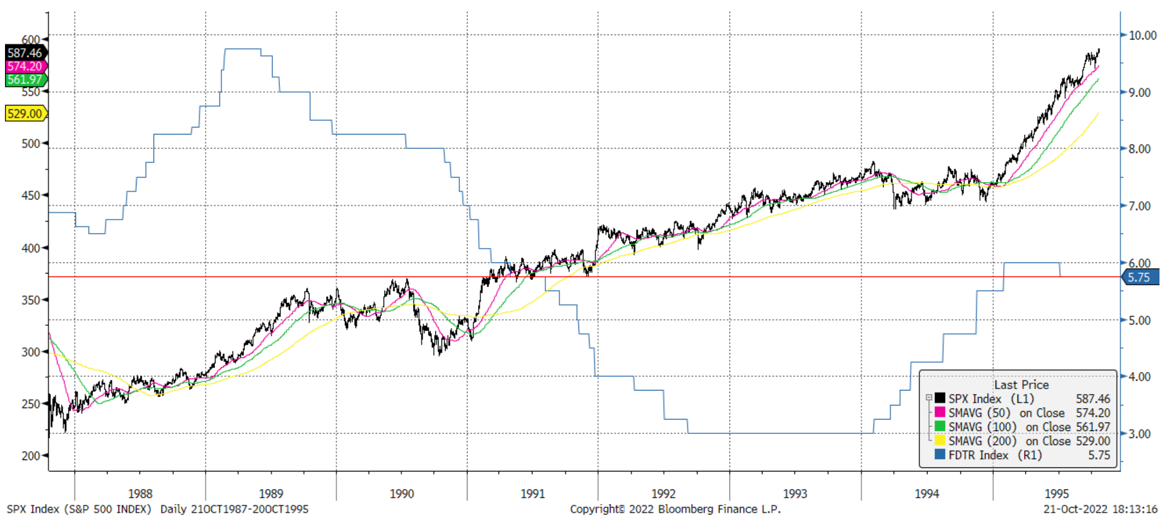
- The 1990-1991 recession following the Savings & Loan Crisis was mild in magnitude and time (8 months.)
- Markets experienced a short and shallow period of weakness as well, taking less than 1 year to experience a drawdown and a recovery to prior highs.
- Earnings did decline materially during the 1990 recession; however, this headwind was offset by rapid rate cuts from a high of nearly 10% in 1989 to a low of 3% in 1992, allowing multiples to expand.

- The 1994 rapid rate hiking cycle is also shown, where the market traded -11% in an initial reaction to the hikes and proceeded sideways through the remainder of the year.
    - This muted market reaction was made possible because as higher rates pressured valuations, earnings growth was incredibly powerful.
    - 1995 saw rate cuts, which allowed multiples to expand and added to significant equity returns driven by powerful EPS during the productivity, internet, and globalization boom of the 1990s.

	1989	1990	1991	1992	1993	1994	1995	1996	1997
EPS	$24	$22	$16	$18	$21	$30	$35	$39	$44
YoY	5%	-10%	-28%	14%	18%	42%	16%	13%	12%
PE @ 1990 peak 357		16.5x	22.8x						

Source: Bloomberg

S&P 500 1988-1995 (with Fed Funds rate)



Source: Bloomberg

Future Scenarios

- The following scenarios are presented with the logic of: ***What would earnings have to be in order to return to reach the prior high of 4,800 at a "reasonable" valuation?***
- Recall the lesson from the historical parallels mentioned earlier: valuations **going into a bear market matter. 2021's valuation was extraordinarily stretched at 24x**, creating a steeper uphill battle to claw back to prior highs and be at a reasonable valuation.
- What *should* the market multiple be? **We think 17-18x with a "neutral Fed."**
    - This depends on the liquidity backdrop: if COVID-era stimulus is recreated, then we think COVID-era bubble valuations can be achieved (meaning a return to 2021 highs sooner.)

- But if very aggressive stimulus is not provided to markets (possibly because inflation remains above the Fed's 2% target, or the fear of very high inflation returning persists), then a return to those elevated valuations is simply not realistic.
- We assume that 17-18x is a reasonable valuation for the market with Fed policy that is closer to neutral (not like today's restrictive policy, which demands lower valuations.)
  - This level is slightly above the average of 16.5x in order to account for the higher weighting to high margin, high return on invested capital (ROIC) tech/growth names, compared to the greater capital intensity of prior market periods.
- Also, remember that valuations can become very elevated in periods of very deep earnings corrections; typically, these elevated valuations are not sustained, meaning as earnings recover, they "grow into" the trough valuations.

- Again, these scenarios are NOT promises or predictions. A lot can and will change in the coming years; these are just four of a myriad of potential outcomes. So we must be open to being surprised:
  - **Things that would surprise us to the upside:** much more resilient earnings growth, a productivity boom, powerful recovery in the weakest economies such as China, inflation fading away on its own and allowing the Fed to become more supportive of markets/multiples, and more.
  - **Things that would surprise us to the downside:** a deeper earnings recession, a liquidity crisis that causes a larger debt restructuring, inflation being more persistent and causing the Fed to stay restrictive for longer, unsupportive policies for earnings, and more.

Scenario 1: Mild Recession, with strong recovery

- Assumptions:
  - -10% EPS in 2023, assuming a mild recession
  - +20% EPS in 2024, assuming a very strong rebound
  - +8% in 2025 gets you to ~18x earnings, which is possible with a neutral Fed
- Note: in this scenario, the market would likely trade lower than today's levels before recovering

Scenario 1: Mild Recession, with strong recovery

	2019	2020	2021	2022	*2023E*	*2024E*	*2025E*	*2026E*
EPS	$156	$138	$199	$226	*$203*	*$244*	*$264*	*$285*
YoY	3%	-11%	44%	14%	*-10%*	*20%*	*8%*	*8%*
PE @ 4,800			24.1x	21.2x	23.6x	19.7x	18.2x	16.9x

Source: Bloomberg, NewEdge Estimates

Scenario 2: No earnings recession, just flat, mild growth after

- Assumptions:
    - Flat EPS in 2023, assuming a mild recession
    - +8% in 2024, much less of a recovery given the lack of very easy comparisons/pent-up demand/coiled spring
    - +7% in 2025 gets you to ~18x earnings, which with a neutral Fed, is possible

Scenario 2: No earnings recession, mild growth

	2019	2020	2021	2022	*2023E*	*2024E*	*2025E*	*2026E*
EPS	$156	$138	$199	$226	*$226*	*$244*	*$261*	*$274*
YoY	3%	-11%	44%	14%	*0%*	*8%*	*7%*	*5%*
PE @ 4,800			24.1x	21.2x	21.2x	19.7x	18.4x	17.5x

Source: Bloomberg, NewEdge Estimates

Scenario 3: Current consensus growth for 2023, slower growth after

- Assumptions:
    - +8% EPS in 2023, assuming current consensus growth
    - +5% in out years, assuming no pent-up demand/coiled spring on earnings
- Note: in this scenario the market likely stages a sharp rebound before getting challenged by a valuation ceiling. Still, there could be potential for the market to trade a high “crisis averted” relief multiple (this also depends on the Fed’s policy stance)

Scenario 3: Growth in 2023, slowing in out years

	2019	2020	2021	2022	*2023E*	*2024E*	*2025E*	*2026E*
EPS	$156	$138	$199	$226	*$244*	*$256*	*$269*	*$283*
YoY	3%	-11%	44%	14%	*8%*	*5%*	*5%*	*5%*
PE @ 4,800			24.1x	21.2x	19.7x	18.7x	17.8x	17.0x

Source: Bloomberg, NewEdge Estimates

Scenario 4: Deeper earnings recession

- Assumptions:
    - -20% EPS in 2023, assuming current consensus growth
    - +30% EPS in 2024, assuming a powerful recovery
- Note: in this scenario, the market would likely trade far lower from today’s levels before recovering

Scenario 4: Deeper Recession in 2023, rebound in out years

	2019	2020	2021	2022	*2023E*	*2024E*	*2025E*	*2026E*
EPS	$156	$138	$199	$226	*$181*	*$235*	*$259*	*$272*
YoY	3%	-11%	44%	14%	*-20%*	*30%*	*10%*	*5%*
PE @ 4,800			24.1x	21.2x	26.5x	20.4x	18.6x	17.7x

Source: Bloomberg, NewEdge Estimates

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