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Investment Institute

Market Commentary

Weekly perspective on current market sentiment **July 12, 2023**

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Last week's S&P 500 Index: -1.2%

Stocks up on price/earnings expansion

Key takeaways

- One of the most consistently observable trends is the movement of the S&P 500 Index price/earnings multiple at given points in the cycle.
- The stock advance this year has been based on an expansion of the P/E ratio. Investors are discounting the effects of higher-for-longer rates on the economy and earnings.

When you look at the price action of an index like the S&P 500 Index (SPX) over the course of economic cycles, there are a number of observations that one can make over and over. Granted, all economic and market cycles are not alike, but as we like to say in the strategy world, they quite frequently "rhyme." One of the most consistently observable trends is the movement of the SPX price/earnings (P/E) multiple — what investors are willing to pay for a dollar of earnings — at given points in the cycle.

While it is tough to call this particular cycle typical, we believe there are factors that need to be taken into account that are similar to past periods. Inflation and Federal Reserve (Fed) policy are usually the keystones that drive the ebb-and-flow of the economic cycle. In this COVID-influenced cycle, massive amounts of stimulus were injected into the domestic economy in an attempt to prevent a severe, prolonged recession (or something even worse) from happening. This immense stimulus drove demand for goods that overwhelmed global supply chains while services-oriented businesses like restaurants and cruise ships were all but shut down and consumers were trapped at home most of the time. As a result, and in-line with basic economic theory, when demand far outstrips supply, prices tend to rise. And that is indeed what happened. Now, the Fed is trying to slow demand to lower inflation by raising the cost of borrowing and spending and reducing money-supply growth.

From a P/E ratio perspective and using our $205 earnings estimate for the SPX this year and $220 estimate for 2024, the SPX is trading at 21.5x this year's earnings and 20x next year's at the time of this writing. These valuation ratios are both well above the long-term averages. We have a hard time justifying current valuations. Recall that P/Es and interest rates are normally negatively correlated. In other words, when interest rates and inflation are higher, P/Es generally tend to be lower as the market expects the Fed to raise interest rates in an effort to slow the economy and inflation. A slower economy leads to slower earnings growth or an outright contraction in earnings. We expect equities to have trouble moving higher when earnings are not growing or contracting. That has not been the case since the October 2022 SPX low.

We believe the Fed is not finished hiking interest rates in this cycle. We also believe that earnings estimates, particularly for next year, are too high. We look for the economy to slow and slip into recession and for the SPX to post lower earnings this year compared to 2022.

The stock advance this year has been based on an expansion (increase) of the P/E ratio. We believe investors have decided, so far, that they are willing to pay more for lower earnings this year and are discounting the effects of higher-for-longer rates on earnings. We think that is a mistake. We believe a potential buying opportunity will come, but now is not the time.

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Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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