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Market Commentary

Weekly perspective on current market sentiment January 25, 2023

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Last week's S&P 500 Index: -0.7%

A look at valuations in the current environment

Key takeaways

- Valuation contraction was the main reason stocks posted negative returns last year.
- Given our call for a moderate recession, valuations of the more high-quality defensive sectors of the market are likely to hold up better than the more cyclical economically dependent sectors.

We talk a lot about macroeconomic influences in this weekly piece. After all, the economy is what allows companies to sell goods and services and, when all is said and done, produce earnings (or losses). In addition to the overall strength or weakness of the economy, pieces of the puzzle like input costs (margin effect) and the price of credit play a big role in how companies manage through the operating environment that ebbs and flows throughout any cycle.

One thing we have not spent much time on lately is valuations. Valuations have been coming down as measured by the price-to-earnings (P/E) ratio on the S&P 500 (SPX) and to varying degrees for each of the 11 equity sectors. We know that higher interest rates have created headwinds for the economy, as the Federal Reserve (Fed) desires, as well as P/E ratios for stocks. Note that there is typically a rather strong inverse relationship between inflation and interest rates and P/Es.

Think about that for a minute. When inflation and interest rates are high, and especially when the Fed is in the process of making credit more expensive in an effort to reduce demand, the result is likely to be lower valuations, as future earnings and dividend streams from equities suddenly look less attractive when rising interest rates make fixed income comparatively more attractive. And later, as the economy slows or falls into recession, then earnings decline. Only after the economy and earnings look set to recover do investors typically find stocks' low valuations to be attractively priced."

Valuation contraction was the main reason stocks posted negative returns last year. Many investors might be surprised that the analyst consensus expectation for S&P 500 Index earnings per share in 2022 is $221. If the consensus is correct, that would be an all-time record high. Yet, the index tumbled more than 19%, excluding dividends, in 2022. Investors were looking ahead and anticipating an economic and earnings slowdown or recession as a result of higher interest rates.

When P/E valuations contract in a higher-interest-rate/inflationary/slowing-growth environment, it is typically sectors that are very sensitive to the level of economic activity such as Financials, Industrials, and Materials that see the largest downside valuation adjustments. High-growth sectors such as Technology and Consumer Discretionary also saw valuations fall as interest rates rose. It is typically more defensive sectors like Health Care and Consumer Staples where valuations tend to hold their levels better on a relative basis as consumers use the goods and services these segments produce whether the economy is good or bad.

Given our call for a moderate recession, we believe valuations of the more high-quality defensive sectors of the market are likely to hold up better than the more cyclical economically dependent sectors.

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