CLAYTON
WEALTH PARTNERS

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MARKET PERSPECTIVE

Yearning for Earnings

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The current price of any individual stock or broad equity index can be deconstructed into two variables: (1) its earnings per share, and (2) the price the market is willing to pay for each $1 of earnings per share. (This variable is known as its price-to-earnings, or P/E, ratio.)

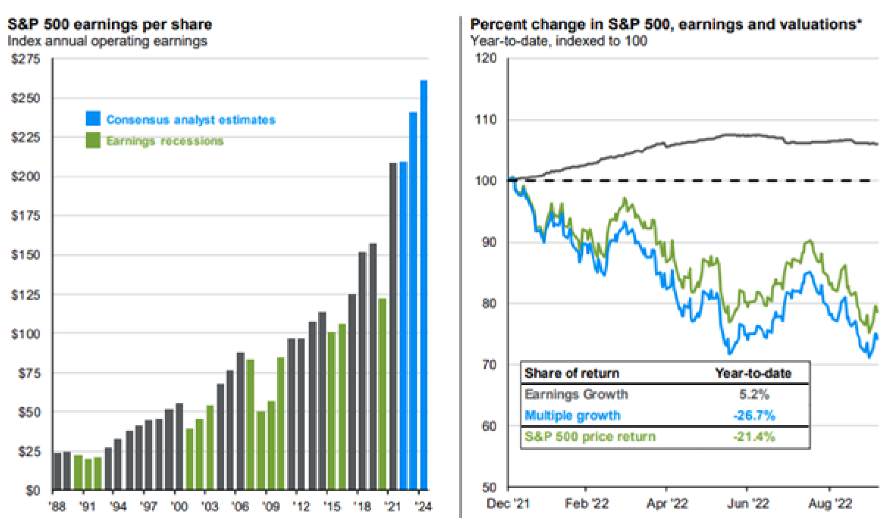
This can be written as a simple algebra equation:

Current market price per share = (Earnings per share) x (P/E ratio)

It follows, then, that any change in a stock's price per share is a function of changes in its earnings per share, P/E ratio, or both.

Let's see this logic applied to the S&P 500's current bear market.

EXHIBIT: CORPORATE PROFITS AND SOURCES OF TOTAL RETURN



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management, Clayton Wealth Partners.

Historical EPS levels are based on annual operating earnings per share. Earnings estimates are based on estimates from Standard & Poor's and FactSet Market Aggregates. *Earnings and multiple growth are both year-to-date percent changes of next 12-month estimates. Past performance is not indicative of future returns. Data are as of October 6, 2022.

DASHBOARD

- Business Cycle
- Trend
- Valuation

Through September 30, the S&P 500's price was down 21.4% year-to-date. As shown in the inset table of the exhibit on the previous page, more than *all* the S&P's decline came from a 26.7% decline in its P/E ratio. So far, estimated growth in earnings of 5.2% has helped offset that P/E reduction.

To a large extent, the decline in the P/E ratio is from the immediate impact of higher inflation and related higher interest rates. More money being consumed by inflation and increased interest expense means that less money is available for investment, all else equal. And since the value of an investment is the sum of the present value of all its future cash flows, higher interest rates mean those future cash flows are worth even less today.

Higher interest rates can affect corporate profits, too, but often with a lag. Companies can sometimes pass along higher costs to consumers. But at some point, higher costs impact consumer demand and, ultimately, earnings.

All eyes will be on third-quarter earnings results, which companies are poised to begin reporting en masse. Wall Street analysts have already lowered their expectations for third-quarter earnings growth. But they still expect growth in the third quarter and for all of 2022 and beyond. (See the panel on the left in the exhibit.)

If we slip into recession, earnings could fall, turning that variable of our algebra equation into a headwind and providing another leg down in the current bear market. In this environment, we think it's prudent to remain cautious.

Bullish

- Significant pent-up consumer demand
- Strong jobs environment
- Relatively healthy consumer finances
- Reasonable equity valuations

Bearish

- Slowing global economic growth
- High global inflation
- Tightening by the Fed and other global central banks
- Russia-Ukraine war and other geopolitical concerns
- Equities in a downtrend

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As Partner & Chief Investment Officer, James Walden strives to maximize our clients' long-term, risk-adjusted portfolio returns. This includes determining strategic and tactical asset allocations, as well as specific investment analysis and prudent rebalancing. Jim is also a partner & management team member. His expertise includes advanced investment research and valuation, and he is passionate about his role in helping clients reach and exceed their financial goals.

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