CLAYTON WEALTH PARTNERS

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MARKET PERSPECTIVE

A Recession Doesn't Appear to Be Priced in … Yet

By James M. Walden, CFA

The S&P 500 fell 25% from its January 2022 high to its October 2022 low. With such a meaningful decline in the S&P 500, one might easily assume that high inflation and rising interest rates caused corporate profits to plummet.

Not so.

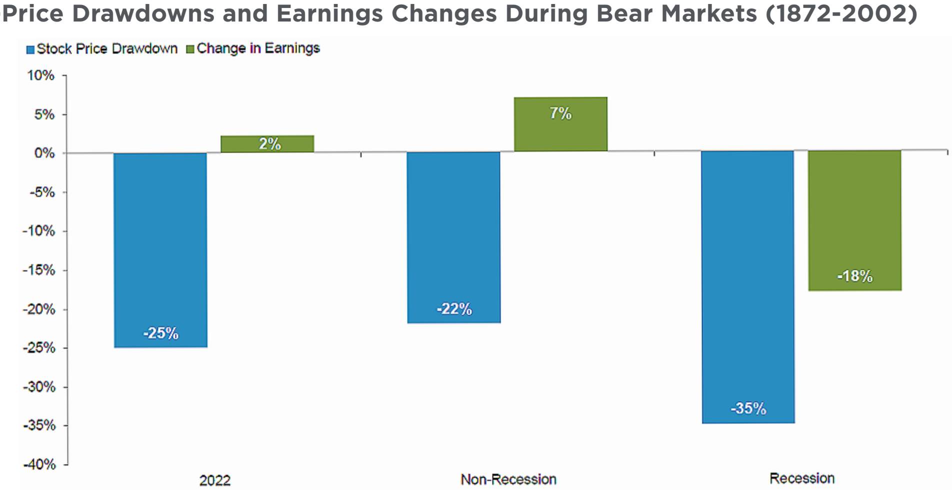
Corporate earnings were resilient in 2022, and Wall Street analysts still forecast slight earnings growth for 2023. The impact of 2022's high inflation and interest rates was on how much investors *were willing to pay for those earnings*. (This variable is often known as the market's price-to-earnings, or P/E, ratio.)

DASHBOARD

- Business Cycle
- Valuation
- Trend

What we've experienced so far resembles past bear markets that have occurred without a recession. The exhibit below shows that, historically, bear markets that do not coincide with recessions are relatively shallow because earnings growth remains positive.

Exhibit: Stock-Price Drawdowns and Earnings Changes During Bear Markets (1872-2002)



Price changes include intraday trading for the S&P 500 index. 2022 change in earnings is the consensus forecast for 2023.

Source: National Bureau of Economic Research, FactSet, Bloomberg Finance, Haver Analytics, Fidelity Investments, Clayton Wealth Partners, as of 12/31/22.

It follows that we may have already seen the S&P 500 low for this cycle—if we don't enter a recession.

If we do slip into a recession, it's likely to coincide with a drop in earnings, becoming the other shoe to drop in this bear market.

Which begs the question: Are we headed for a recession? Evidence is mounting that we will likely enter a recession sometime this year. We have an inverted yield curve, Fed tightening, and elevated inflation, all of which have typically preceded previous recessions.

For now, we remain cautious.

Bullish

- Significant pent-up consumer demand
- Strong jobs environment
- Relatively healthy consumer finances
- Reasonable equity valuations
- The most attractive yields for fixed income in years
- The Fed's progress in reducing inflation
- China's easing of Covid restrictions, which could provide lift

Bearish

- Slowing global economic growth with recession pressures mounting
- 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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