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WEALTH PARTNERS

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MARKET PERSPECTIVE

Earnings Growth Needed from Here

By James M. Walden, CFA

After slowing in previous quarters, U.S. economic growth reaccelerated in the second quarter—a welcome development, to be sure. That, combined with continued progress taming inflation and hype around artificial intelligence, has contributed to strong gains in the S&P 500 in the year so far.

But after the market's rally, stocks are no bargain. The exhibit below shows how cheap or expensive the S&P 500, as measured by its price-to-earnings (P/E) ratio. Virtually all the market's gain has come from P/E expansion and none from earnings growth. As a result, the market is approaching "expensive" levels seen only during two periods in the previous 25 years: the dot-com bubble and the period immediately after the strong V-shaped rally post-Covid (and right before last year's 25% decline).

DASHBOARD

- Business Cycle
- Valuation
- Trend

S&P 500 Index: Forward P/E ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	19.57x	16.78x	0.84
CAPE	Shiller's P/E	31.69x	27.79x	0.62
Div. Yield	Dividend yield	1.55%	1.98%	1.26
P/B	Price to book	3.94x	3.10x	1.04
P/CF	Price to cash flow	14.94x	11.25x	1.68
EY Spread	EY minus Baa yield	-0.65%	0.32%	0.51

Source: FactSet, Federal Reserve Board, Refinitiv Datastream, Robert Shiller, Standard & Poor's, ThomsonReuters, J.P. Morgan Asset Management, Clayton Wealth Partners.

Valuation is a condition, not a catalyst. Stocks can stay expensive for a long time. But for healthy valuation relief, let alone sustainable market gains from here, increases in corporate earnings need to start doing more of the heavy lifting.

That's certainly possible. Changes in P/Es typically precede any changes in earnings. But meaningful gains in earnings typically coincide with ongoing growth in a healthy economy. We're open to the possibility of a "soft landing" from here, but several gauges that we monitor that have pointed to recession in the past continue to broadly flash warning signs. Indeed, it would need to be that "this time is different."

Bullish

- The Fed is making progress toward reducing inflation
- Significant pent-up consumer demand
- The services sector of the U.S. has remained strong
- The most attractive yields for fixed income and cash in years
- Consumer and corporate balance generally remain healthy

Bearish

- Global inflation remains too high
- Global central banks tightening
- Slowing global economic growth with recession pressures mounting
- Deterioration in leading indicators of unemployment, such as a lower number of job openings and increasing layoffs and initial jobless claims
- Delinquency rates on consumer loans are rising
- Russia-Ukraine war and other geopolitical concerns
- China's post-Covid economic rebound has lost momentum, with deflation fears growing
- Federal debt and deficits have ballooned

JAMES WALDEN, CFA
Partner and Chief Investment Officer

As Partner and 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 and 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.

CLAYTON WEALTH PARTNERS

716 S. Kansas Ave.
Topeka, KS 66603

832 Pennsylvania St., Suite 1005
Lawrence, KS 66044

785-232-3266 | claytonwealthpartners.com