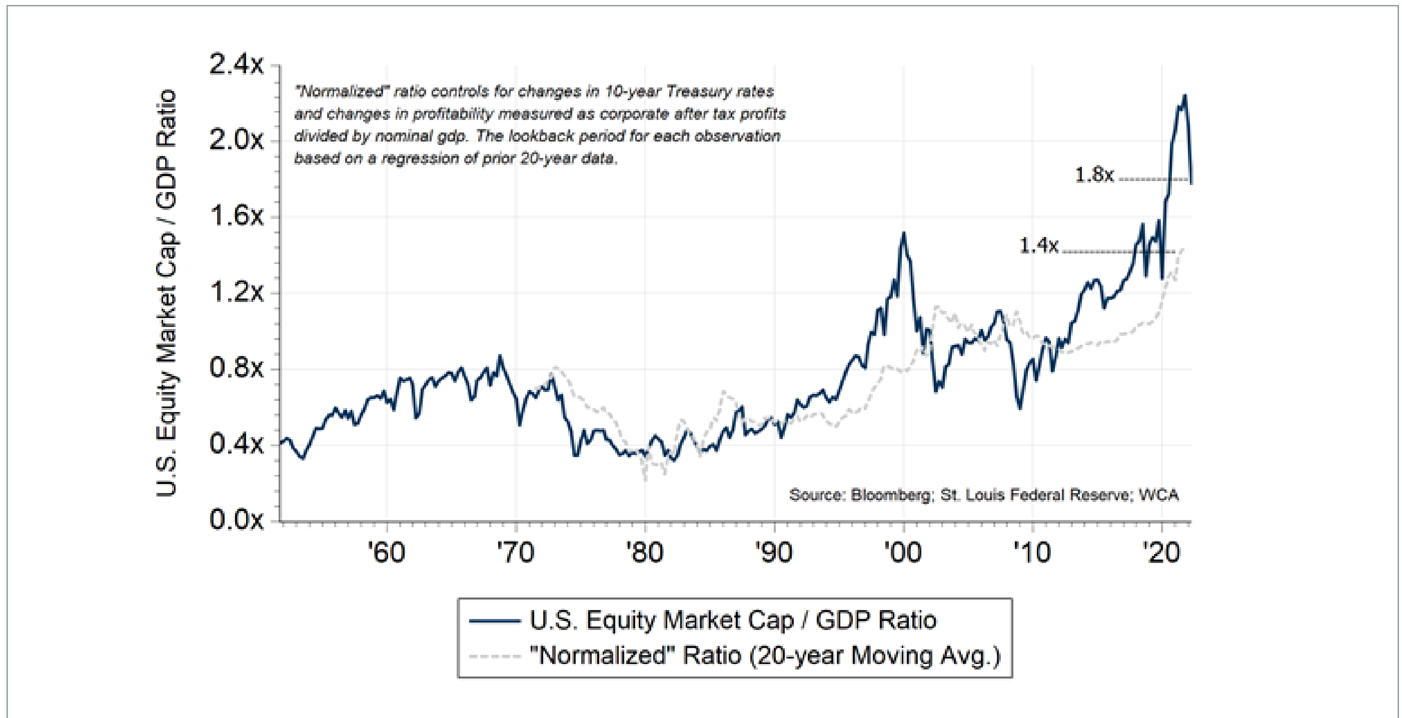
MARKET COMMENTARY

DOWN TO EARTH?

On the surface, valuations appear to be coming back down to earth. The Standard & Poor's 500 stock index has declined to nearly 4,000 from almost 4,800 in January. Back at the January peak, forecast year-ahead earnings for the index stood at $223, and now those forecasts are at $237. Today's price-earnings ratio is 17x compared with 21x in January and in line with the 10-year average. So, stocks are moving down despite rising profit forecasts, resulting in better value.

Chart A | THE U.S. MARKET CAP TO GDP RATIO



VALUATION RISK

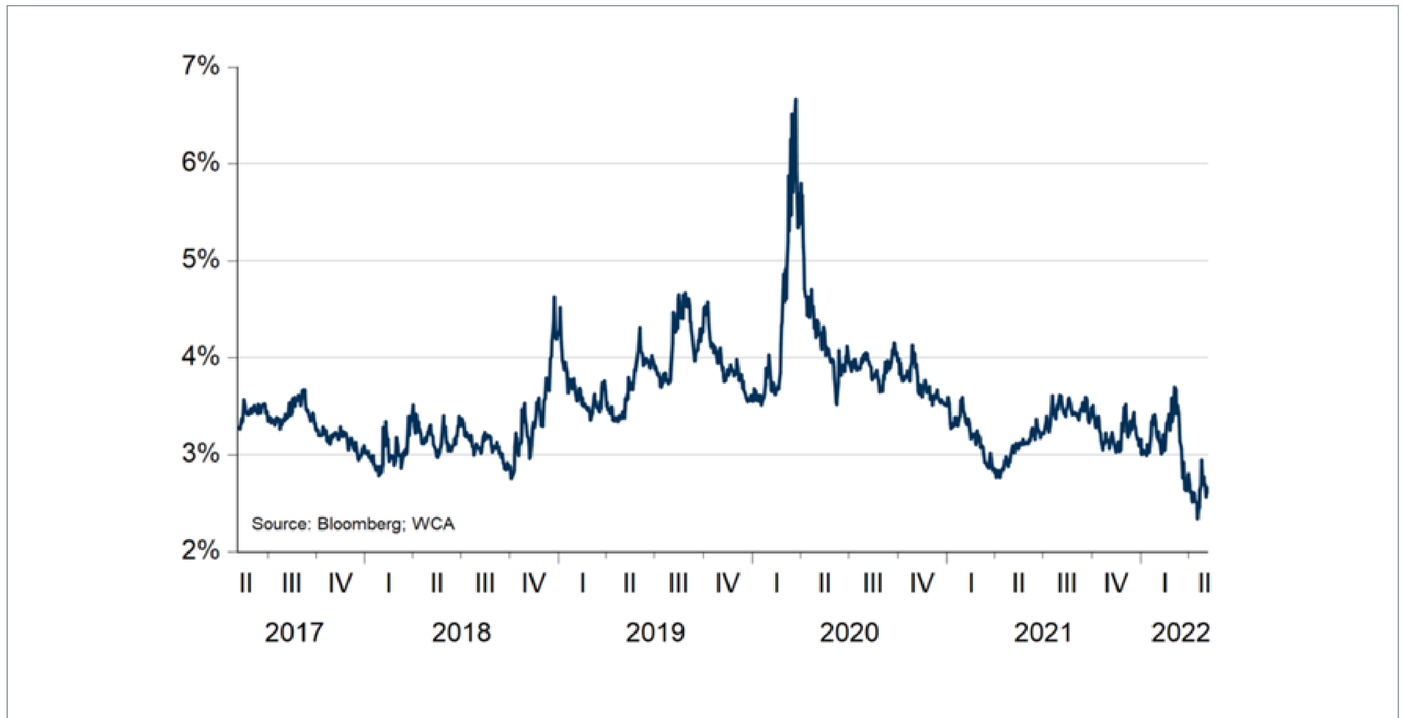
The Federal Reserve (Fed), in its recent "Financial Stability Report," expressed concern over asset values. According to the report, asset values appeared "elevated." Moreover, the Fed sees valuations as "high relative to economic fundamentals or historical norms." The report went on to show that stocks appeared expensive relative to earnings and real estate was attractive compared to rents. We agree with this assessment but point out that some adjustments are needed to make comparisons with history more meaningful.

BIG PICTURE

For U.S. stocks, we often compare the total value of domestic corporate equity to the economy's size. Chart A above shows this relationship since 1950. Immediately, we see that, at 1.8x gross domestic product (GDP), stocks are not cheap. Yet, we must consider two critical factors: interest rates are still low, and profitability is high compared to the past.

The grey line in the graph "normalizes" the effect of low rates and profitability by examining the relationship between stock multiples, interest rates, and profitability over 20-year rolling periods. Even adjusting for these factors, today's 1.8x multiple appears stretched compared to our "normalized" 1.4x multiple. So, even controlling for these two factors, we still end up with a market that seems expensive.

Chart B | EQUITY RISK PREMIUM



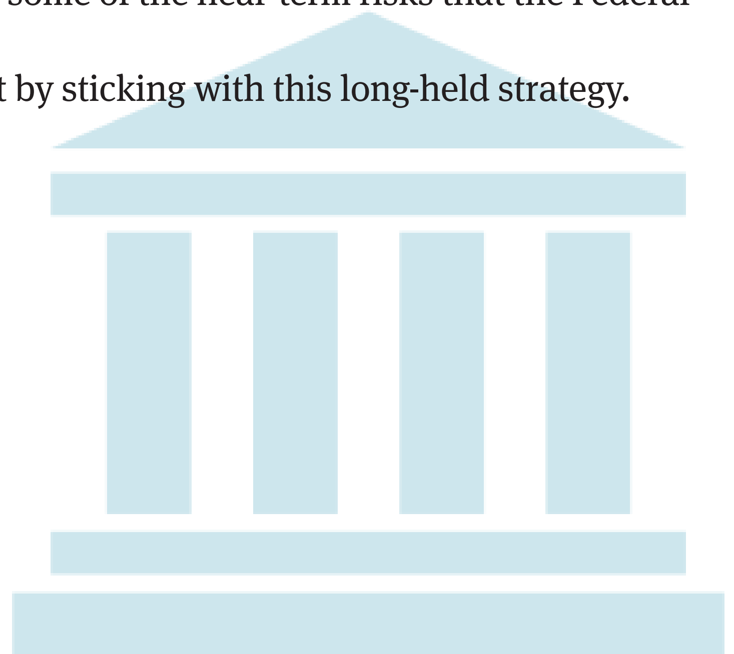
THE CRUX OF THE MATTER

Concern over falling profits due to the war in Ukraine or inflation is not the cause of the 800-point decline in the S&P 500 from the January peak. Instead, a combination of rising interest rates and an increase in risk aversion is the crux of the matter. When Treasury rates rise, the bond market offers a more attractive alternative to stocks, all else being equal. Since the start of the year, the 10-year U.S. Treasury yield has jumped to near 3% from 1.75%. Naturally, stock investors are taking a second look at bonds, and the present value of future stock earnings is lower.

Rising inflation and war in Ukraine also contribute to more caution among stock investors. After throwing caution to the wind the past couple of years, excess enthusiasm is cooling. A measure of the "equity risk premium" — the extra compensation that investors require for holding stocks relative to Treasury bonds — is still low. We calculate this by subtracting the 10-year Treasury yield from the forward S&P 500 earnings yield (Chart B, above). As you can see, there has been a slight uptick in the equity risk premium, but it remains low compared to the past.

CONCLUSION

We agree with the Federal Reserve's assessment that valuations for stocks and other assets appear rich. Moreover, these elevated valuations pose additional economic risks, especially as policy supports are wound down. The Fed's task of engineering a "soft landing" is complicated by high inflation. Consequently, we believe it is essential to maintain a focus on owning highly flexible, durable, and predictable businesses at reasonable valuations. We hope to address some of the near-term risks that the Federal Reserve's recent risk assessment points out by sticking with this long-held strategy.



WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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