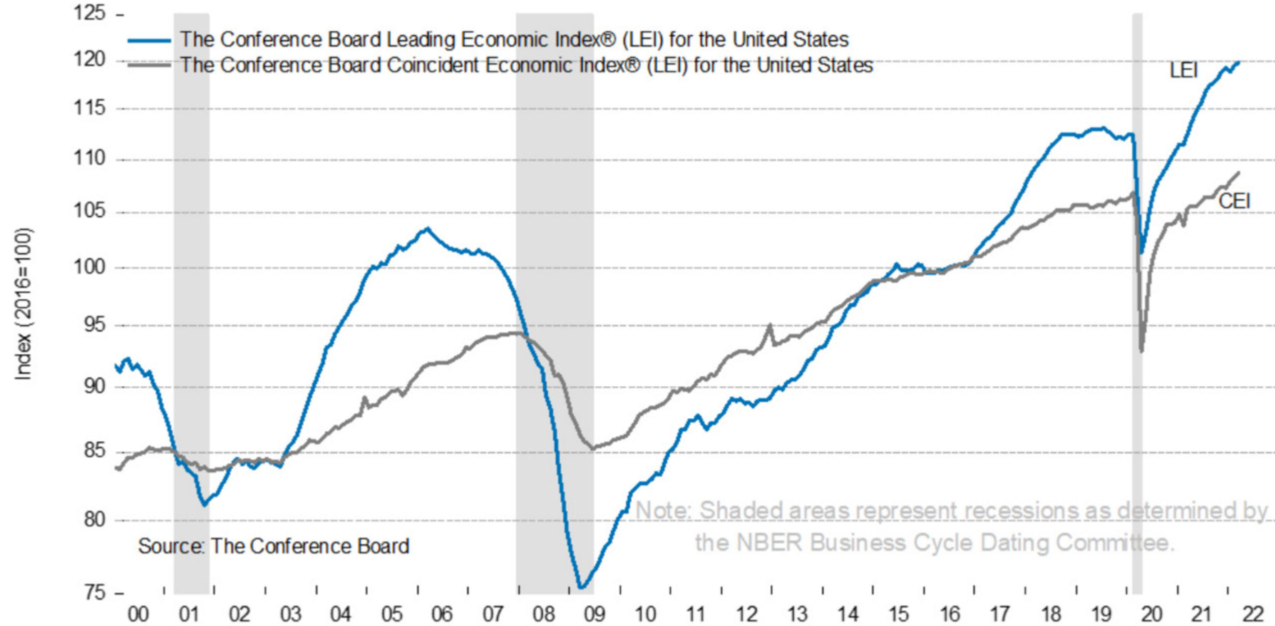
Week in Review

Friday, April 22nd, 2022

1. Latest Leading Indicators Continue to Support Growth in 2022

The Conference Board's Leading Economic Indicator Index (LEI), a broad gauge of the US economy, remained positive in March. The business organization's Index of Leading Indicators gained 0.3% to 119.8, after a 0.6% increase in February, which was in line with expectations. Over a six-month period dating back to September, the index has risen by 1.9%, which is in line with economic growth prior to the coronavirus pandemic.



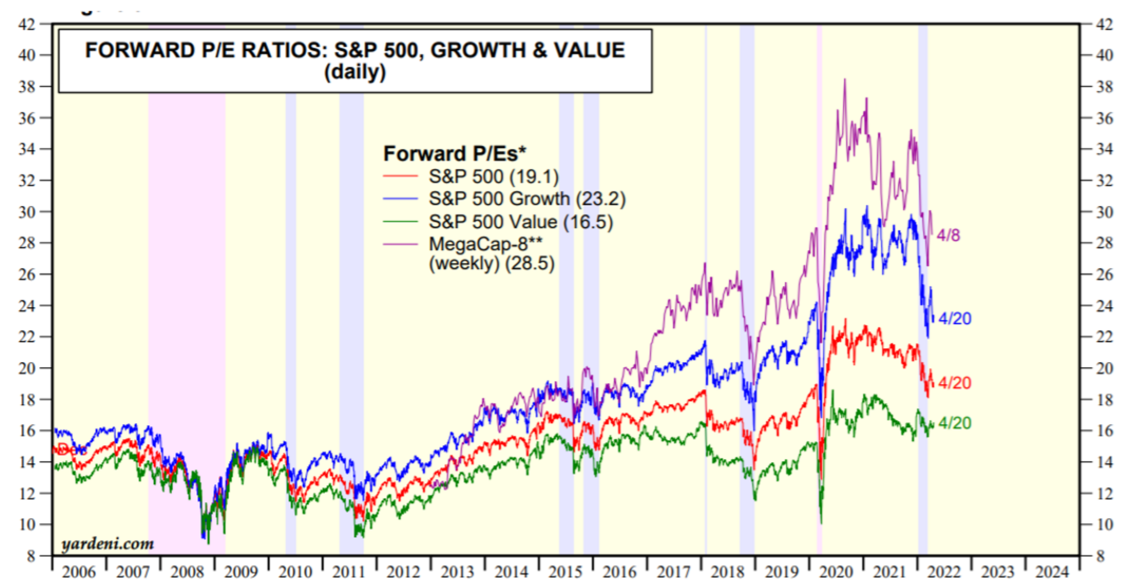
Source: The Conference Board

According to a Conference Board spokesman, the broad-based improvement signals economic growth is likely to continue through 2022 despite volatile stock prices and weakening business and consumer expectations. The Conference Board is projecting 3% US GDP growth in 2022, which is slower than the 5.6 percent pace of 2021, but still above the pre-Covid trend.

However, downside risks to the growth outlook remain, associated with intensification of supply chain disruptions and inflation that is linked to lingering pandemic shutdowns and the war, as well as with tightening monetary policy and persistent labor shortages.

2. Valuation Multiples Under Pressure as Rates Increase

Economic data and the start of earnings season supports the current projection for corporate earnings at the aggregate level for 2022. Consensus estimates have risen since the beginning of the year and currently stand at around 230 to 235. As earnings have grown and the market indices have pulled back, price to earnings ratios (P/E) have also pulled back.

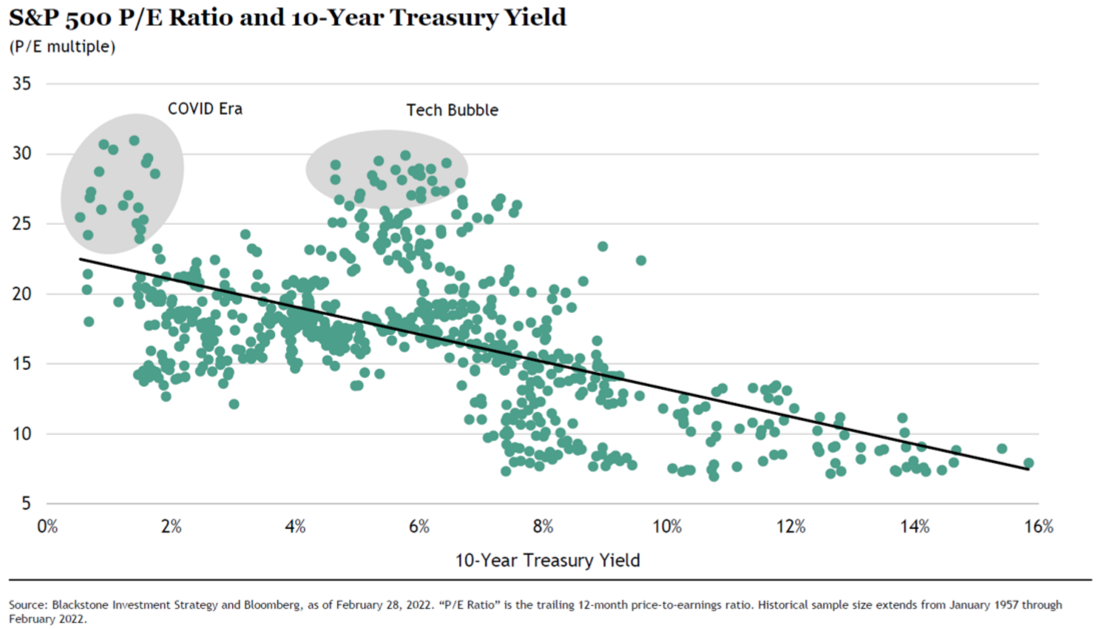


Source: Yardeni Research

The P/E ratio for 2022 for the S&P 500 is approximately 19.0. The P/E ratio is above the 5-year average of 18.6 and above the 10-year average of 16.8. Growth stocks have seen a larger pull back than value stocks, although a large part of the differentiation has to do with the greater weighting within the value cohort of energy, commodity and utility stocks, which have performed well on a year-to-date basis on the spike in energy prices and concerns about slowing growth.

One component determining the level of P/E is growth. The pace of growth is projected to slow throughout 2022 versus 2021 and slow further in 2023. However, from a historical perspective, growth is still expected to be above the 10-year average, supporting a P/E premium.

Another factor changing the landscape for market multiples, though, is rising interest rates. As interest rates rise, there is a correlation towards lower P/E multiples. This factor likely accounts for the heightened volatility in markets as the Federal Reserve is expected to be more hawkish in terms of policy to fight inflation.



Source: Blackstone

Currently, the P/E multiple for 2022 is slightly below the trend line based on a multiple of 19X and the current 10-year Treasury yield of 2.9%. Looking at the historical data, there is a risk of further compression of the P/E multiple from higher interest rates, but the risk looks moderate below a 10-year Treasury level of 6%. That being said, there is an increasing belief that the Federal Reserve will be relentless in fighting inflation, impacting both growth and pushing up Treasury yields, which suggests that ongoing risks prevail to financial valuation metrics.

While slowing growth and higher interest rates have weighed on the market and upon the highest multiple stocks, the market P/E, while elevated, does not appear to be consistent with periods of speculation. Investors should not expect multiple expansion to drive valuations going forward. Focus on companies able to deliver strong, consistent earnings growth over a multi-year basis and trading at reasonable P/E levels will be key to driving returns in a structurally higher rate environment.

Thinking Ahead

Economic data and corporate earnings reports suggest that the US economy remains on track for growth in 2022. The market has remained volatile as it digests the landscape for higher interest rates. Higher rates are having an impact in the near term on valuations, slowing economic growth and compressing multiples. Investments that can offset valuation compression through consistent and growing earnings should be relatively attractive. Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.