The Bright Report

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Inflation or Consolidation?

by Mark LaGrone, CFA *Director of Investments*

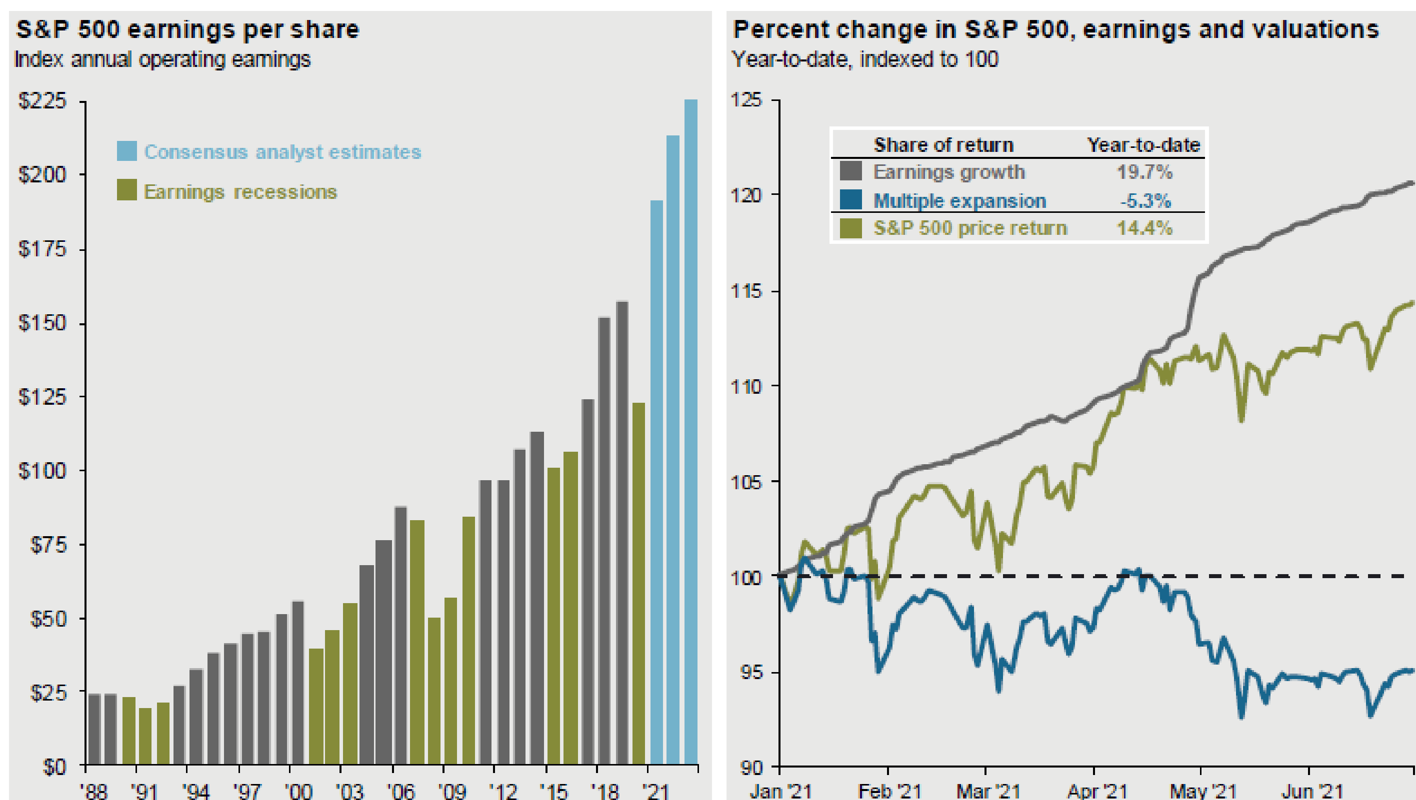
The second quarter of 2021 witnessed continued advances across stocks and commodities as investors weighed strong prospects for economic growth against concerns around inflation, the labor market, supply chains, and the Delta variant of COVID-19. With the Consumer Price Index (CPI) surging in May at the fastest rate since 2008, the thesis that the current levels of inflation are transitory is being stress-tested. To see a sustained increase in inflation, we would need to see wage pressure rising as well. While there are currently pockets of heat in the labor market as employers compete with augmented unemployment benefits at the low end of the pay spectrum, it is important to keep in mind that a post-pandemic equilibrium is still a ways away. We expect that expanded unemployment benefits will continue to distort labor-market conditions over the course of the summer.

The inflationary bursts in the U.S. and elsewhere prompted the Federal Reserve in mid-June to indicate that it may begin increasing rates and taper its bond-buying program earlier than expected. Despite an initial spike in rates following this news, we have since seen sustained downward pressure, with the 10-year treasury falling below 1.25% on July 8. This is a marked decrease from the 2021 high of 1.77% observed on March 30. This downward pressure on rates bodes well for concerns that inflation is getting out of control, although it may also reflect increased pessimism in the economic recovery. While we are encouraged by the stability in which the markets received the Federal Reserve's message, we will be watching closely for the market's reaction when the Federal Reserve begins to tighten the monetary supply in 2022 or 2023 as such actions have historically created significant market volatility.

As of the end of the second quarter, we have seen year-to-date earnings growth in the S&P 500 of 19.7% and compression in the Price-to-Earnings (P/E) multiple of 5.3%, leading to a price return of 14.4% for that index. The 12 month forward-looking P/E multiple of the S&P 500 remained elevated at 21.53x at the end of the quarter versus a 25 year average of 16.71x. Although this represents an expensive market by historical standards, as long as earnings growth continues to outpace price returns for equities, we should continue to see multiples revert toward historical norms. It is also worth noting that the Earnings Yield (EY) of the S&P 500, which represents the earnings per share divided by the price of the index, is elevated relative to fixed income from a historical standpoint. One metric we monitor is the EY spread to BAA-rated corporate bonds. The higher this spread, the greater compensation an investor receives relative to owning a bond with a credit profile similar to the S&P 500 as a whole. At the end of the quarter, this EY spread was 1.28% versus a 25 year average of 0.09%. In the current low rate environment, the attractive earnings of the S&P 500 relative to fixed income remain compelling for investors and can provide justification for a P/E multiple above historical levels.

All of these things lead us to believe that the second half of the year may see a choppy market as earnings growth peaks with inflation pressures amid the economic transition to an expansion "jog" from a recovery "sprint." We expect this to allow multiples to continue to ease as earnings catch up to prices. While this may mean lower price returns relative to what we have seen over the last year, it should create a stronger foundation for continued growth in equity prices for the years to come.

Corporate Profits and Sources of Total Return



The graph above and to the left shows historical earnings for the S&P 500 in green and grey, with green bars representing earnings recessions. The graph above and to the right breaks down the price return for the S&P 500 into the amount of return that can be attributed to earnings growth of constituent companies in the index and the amount that can be attributed to the expansion (or contraction) of the Price-to-Earnings multiple.

Source: J.P. Morgan Asset Management Guide to the Markets, U.S. 3Q 2021

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