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Gauging risk-reward after the rally

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US stocks have surged on the heels of a softer-than-expected inflation reading and lopsided, bearish positioning. The S&P 500 now stands nearly 12% higher than its bear market low on 12 October. So, now what?

Stocks could certainly push higher in the near term as investors continue to dial back aggressive bearish positioning, but we think the risk-reward is not very compelling. Consider the following:

- The S&P 500 forward P/E is now 17.3x based on bottom-up consensus estimates. This is higher than the pre-pandemic average of 16.6x. It's possible valuations could expand a bit further, but upside of more than 5% (18x P/E) seems unlikely.
- An S&P 500 forward P/E of 18x is high by historical standards and the only times valuation moved higher on a sustainable basis were during the easy money eras of the dotcom bubble and the COVID-19 recovery.
- When valuations have been more than 18x, expected EPS growth is usually very rapid—averaging 14% over the next year. Growth of that magnitude seems highly unlikely over the next 12 months. Bottom-up consensus EPS growth expectations are currently 5%.
- Even 5% EPS growth seems optimistic. Tighter lending standards, likely further declines in the ISM Manufacturing index, and the Fed's expectation that the unemployment rate will rise suggest that EPS will fall next year. Our estimate calls for a 4% decline, which could be optimistic.
- While the softer inflation print may mean the Fed doesn't have to raise rates quite as much as anticipated, the central bank will very likely continue to raise interest rates further. Bear in mind that the Fed will want to see a string of positive inflation data to give it confidence that inflation is trending towards its target. Additional monetary tightening and the cumulative impact of this year's rate hikes suggest recession risks still remain elevated. In a full-blown recession scenario, stocks could fall 15–20%.

Our S&P 500 price targets for June and December 2023 remain 3,700 and 4,000, respectively.

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