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Market Ethos

The latest market insights from Richardson Wealth

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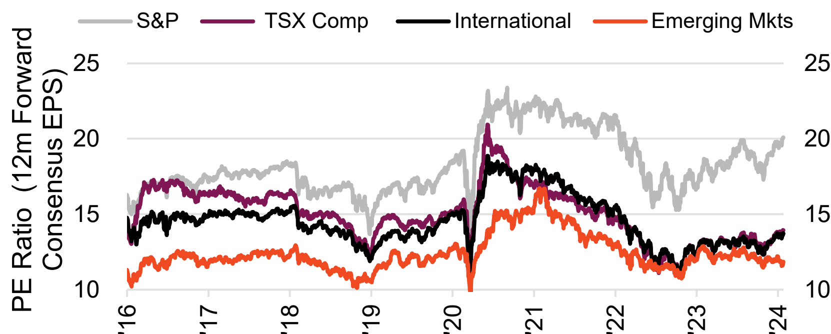
RICHARDSON Wealth

Evaluating valuations

One could certainly question the importance of valuations in this market. If you were bold enough to buy Nvidia a year ago, ignoring the 60x price-to-earnings (forward earnings), you made money. And look at Microsoft, which sits at 33x and continues to go up even though its forecast earnings growth is only about 15%. Or which pharmaceutical company would you like to own, the one trading at 50x earnings or 12x? Surprisingly, the right answer was the 50x Lily and not the 12x Pfizer. Sure, solving for a pandemic is nice, but solving for fat is much more lucrative.

For the S&P 500, the quartile of companies that were trading with the lowest valuation at the start of 2023 enjoyed an average return of 8.9%. Not bad. But the companies with the highest valuations returned 17.7%. It's not just within U.S. equities that it may appear valuation doesn't matter. Emerging markets have been trading at very low valuations for years and have consistently lagged developed markets. Based on the Bloomberg Developed (DM) and Emerging (EM) markets indices, the spread is wide at about 18x vs 12x. Also of interest is that EM earnings are expected to grow at 28% compared to 18% in DM over the next couple of years. Or the TSX at 14x compared to 20x for the S&P, a long-standing valuation spread, yet the more expensive S&P keeps winning.



Source: Bloomberg, Purpose Investments

Now, comparing one market's valuations to another is like comparing apples and oranges. The composition of the market and different sector weights can often explain much divergence in valuations. For instance, the S&P currently has a 30% weight in technology, often a higher multiple sector. That compares to under 10% for the TSX. The S&P has more consumer staples, more health care, less energy, and less financials compared to the TSX. Staples and health typically carry higher valuations than the more cyclical energy and financials.

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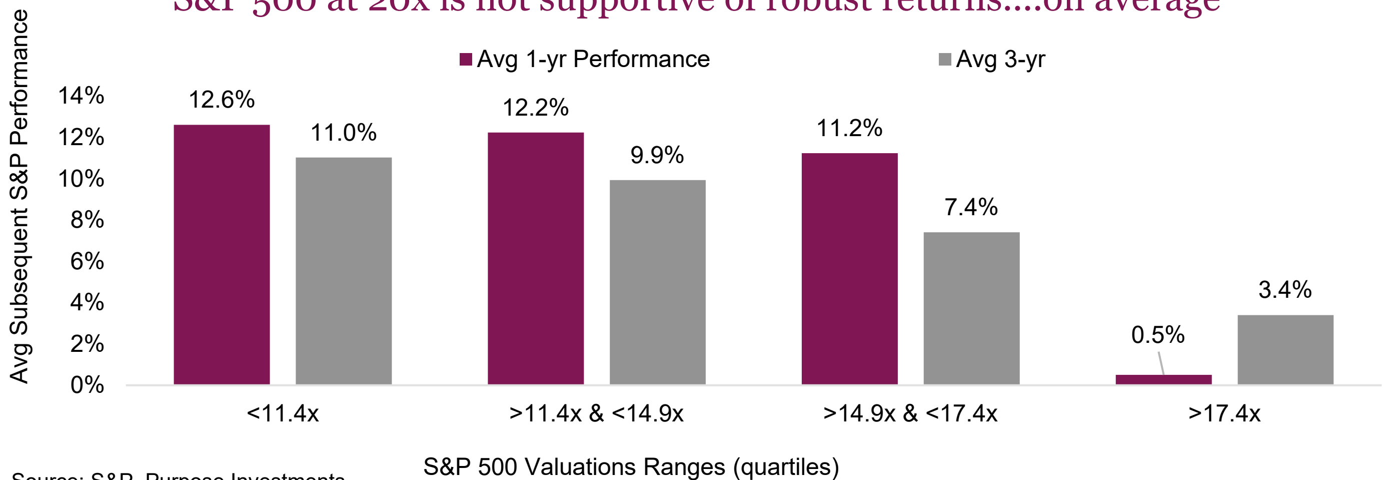
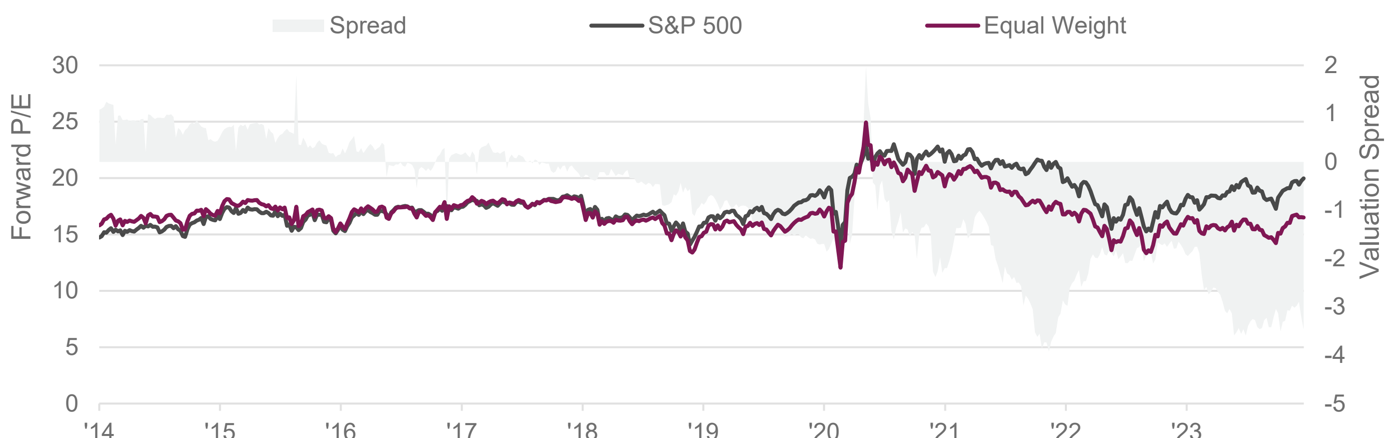
Yet valuations do matter. The chart below uses S&P 500 data back to 1950 and calculates the average performance for the S&P 500 based on starting point valuations. It is clear that higher valuations equate to lower returns going forward, on average. And that is the crux: averages can hide a lot of data. Sure, the average return from a starting point in the most expensive quartile bucket is close to zero, yet the one-year return ranges from +39% to -38%. That is pretty wide. The 3-year return ranges from -17% to +18%. So, even though valuations are high, anything can happen.

Worth noting, the range of performance outcomes when the starting point is cheap (less than 11.4x), are compelling. The 3-year annualized worse case was flat, and the best case was +26%. Today, though, we are not in the bargain basement; we are in the valuation luxury penthouse.



Source: S&P, Purpose Investments

Pushing the S&P 500 up to the penthouse of valuations is the Magnificent 7 (or Enormous 8), or whichever funny label you prefer for the megacaps sitting atop the index. The concentration in the S&P 500 is at or near historically high levels, which is also pushing the valuation to the upper levels. To give an idea, the chart below shows the relative valuations of the S&P 500 (traditional market capitalization-weighted version) and the Equal Weight S&P 500 index. It is those megacaps making the S&P 500 expensive; the broader market is not nearly as elevated.



Source: Bloomberg, Purpose Investments

Final thoughts

The Enormous 8 could very easily become more enormous in 2024, which would once again drive the most expensive part of the market higher. The average PE across the Enormous 8 is currently 36x forward earnings, but as we learned in 2023, a high starting valuation doesn't guarantee anything as, in the short term, anything is possible. However, given concentration and given valuations, the odds are likely tilted in the other direction. Don't lose sight of valuations; in the long run, they are one of the best indicators of performance and can offer a margin of safety.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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