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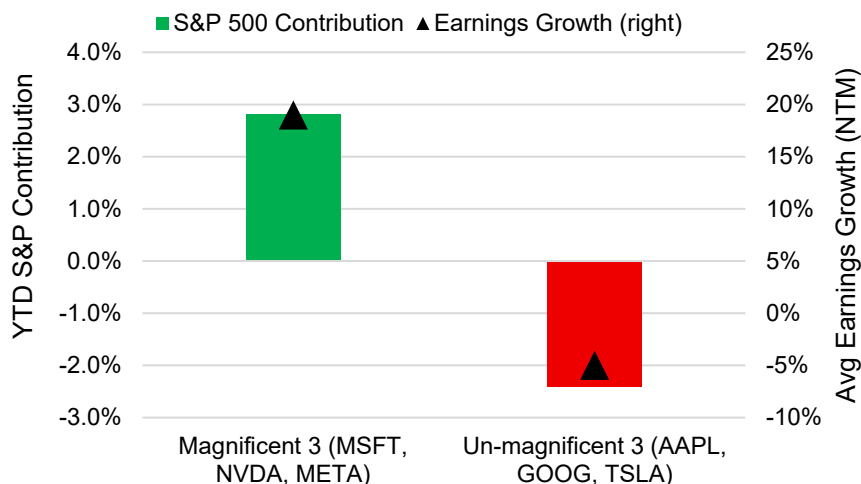
Craig Basinger

Valuations leave little room to stumble

Most would agree that this has been a rather unique year so far. The TSX is making new all-time highs at the same time both earnings and economic growth forecasts keep coming down. The TSX isn't just up, it is up nicely at almost 9% as we near the halfway point. It isn't abnormal for the top 10 contributors to make up over half the gains of this index that contains 223 companies, but the mix is odd with 5 gold companies, two financials, one consumer, one technology, and one energy.

The S&P is even more odd. Up only 4.2%, everyone knows how concentrated the index has become given the market caps of the Mag 7 which carry a 31% weight in the index. This isn't anything new, but the divergence sure is. Microsoft, Nvidia and Meta are the biggest three contributors to the S&P so far this year, adding +2.8%, while Apple, Tesla and Alphabet are the biggest detractors, subtracting -2.4%. Clearly we have a bifurcation of the Mag 7.

Bifurcation of Mag 7



Source: Bloomberg, Purpose Investments

There is a clear distinction between the Mag 7 winners and losers, its earnings growth. Led by Nvidia, the average earnings growth over the next 12 months is +19% for Nvidia, Microsoft & Meta, the positive index contributors. The average earnings growth for the laggard Apple, Tesla and Alphabet is -5%. High valuations are not necessarily a headwind for stock performance, unless those earnings start to wobble, then it is a big problem.

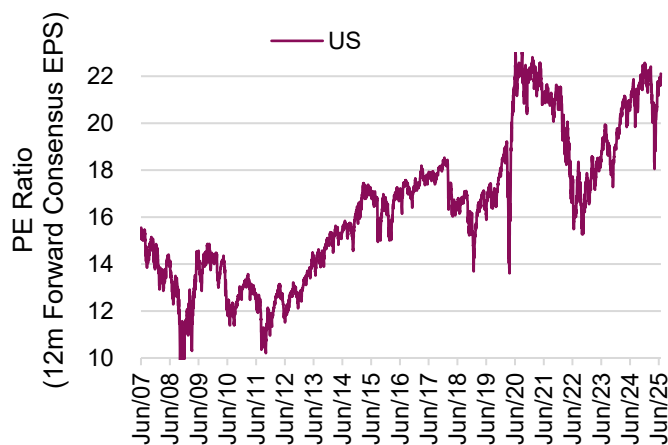
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Q2 earnings season is critical

In a few weeks, earnings season for the 2nd quarter will kick off. While every earnings season is important, this one may be more so. After the recent market rally and with indices making new highs, valuations are rather elevated. The S&P 500 has peaked out at around 22x a few times over the past five years. And while the TSX has seen valuations as high as 18x over the past decade, it certainly isn't cheap anymore.

The challenge is, valuations are elevated, at the same time earnings growth is slowing. We would be more comfortable with a 22x multiple for the S&P 500 if earnings were still growing at 12%. But at 7%, that is precarious. Same issue with Canada but to a lesser extent.

S&P 500 PE ratio has topped out a few times around 22x



Source: Bloomberg, Purpose Investments

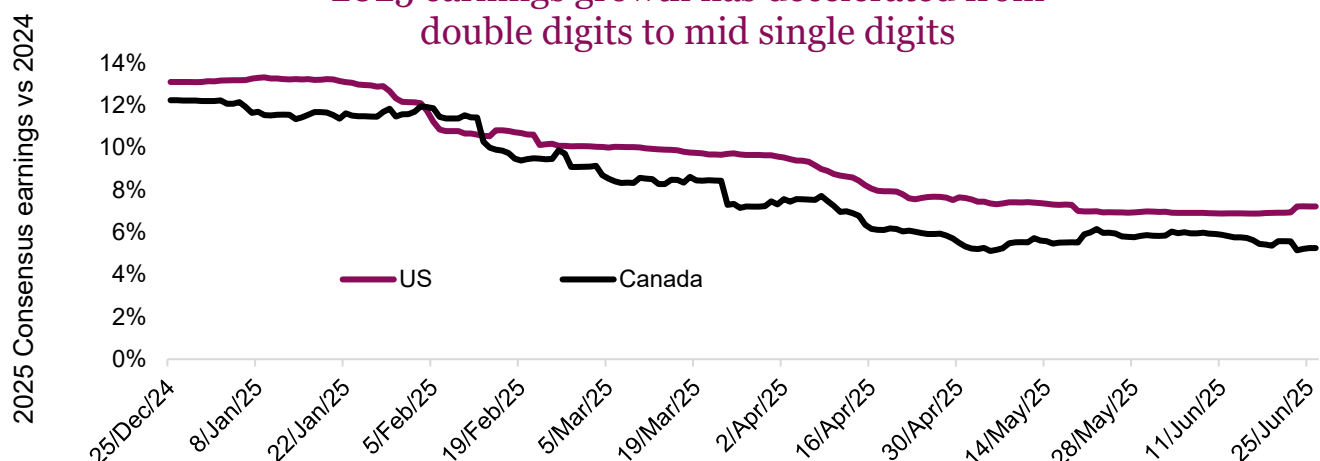
TSX is cheaper but it too is now elevated vs historic



Source: Bloomberg, Purpose Investments

There are some optimistic factors though. The bar may be set reasonably low for Q2 earnings after all these negative revisions. There are some signs the revisions have slowed or even turned a bit positive in the past couple weeks. The U.S. dollar is also lower, that is generally positive for U.S. S&P 500 earnings given the decent percentage of sales/operations overseas.

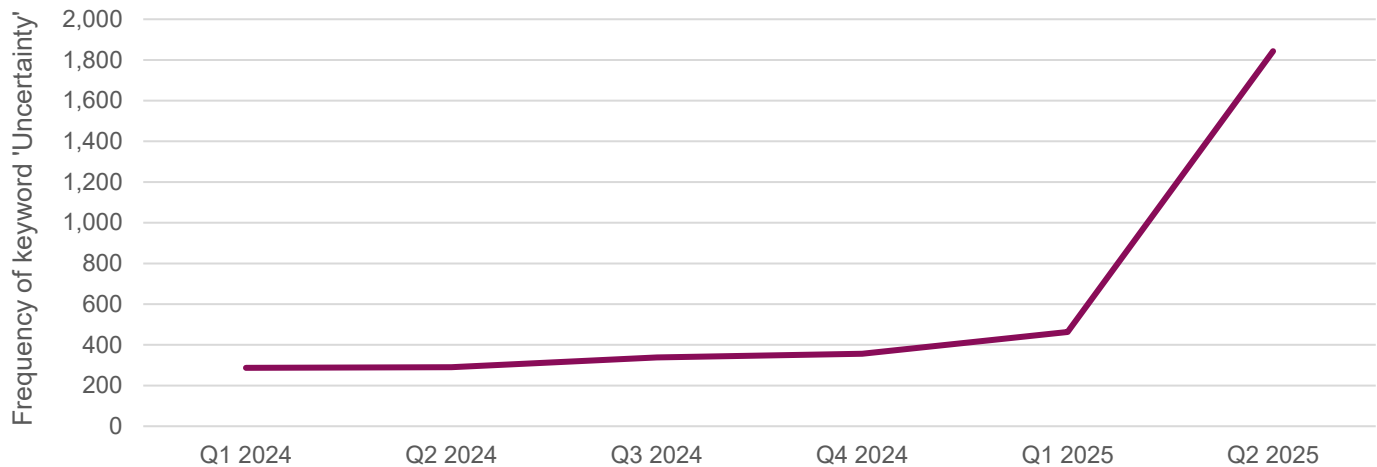
2025 earnings growth has decelerated from double digits to mid single digits



Source: Bloomberg, Purpose Investments

The headwind is well known, that is Mr. Uncertainty. The extended period with uncertainty around tariffs has certainly reduced the confidence of company leaders in the outlook. During Q1 earnings season, the trend was for companies to pull guidance as they just don't know what will happen. Still without clarity, will we see more companies pull guidance or are they going to start reducing guidance? That is likely a more important factor in this coming earnings season compared to how many companies exceed estimates.

Trend of keyword 'Uncertainty' in S&P 500 earnings calls



Source: Bloomberg, Purpose Investments

The valuations or market multiple is certainly elevated, but it is influenced by many other factors than just earnings growth. Bond yields have come down over the past few weeks, that has helped the multiple expand. Investor sentiment has improved from overly bearish to more of a neutral mood. The geopolitical headlines certainly impact the multiple, and most of this news flow has been market friendly of late.

The challenge is these positive levers have already been pulled. To help this market keep going we would likely need to see a re-acceleration of earnings growth to maintain or improve the current multiple. That may be a big ask.

Final Thoughts

Will the months of uncertainty which is starting to show up in some pockets of economic data also show up in earnings this season? Maybe, but the stock moving factor will likely be the tone and guidance from company leadership. And given valuations are already at the upper echelon, stumbles may prove painful.

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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