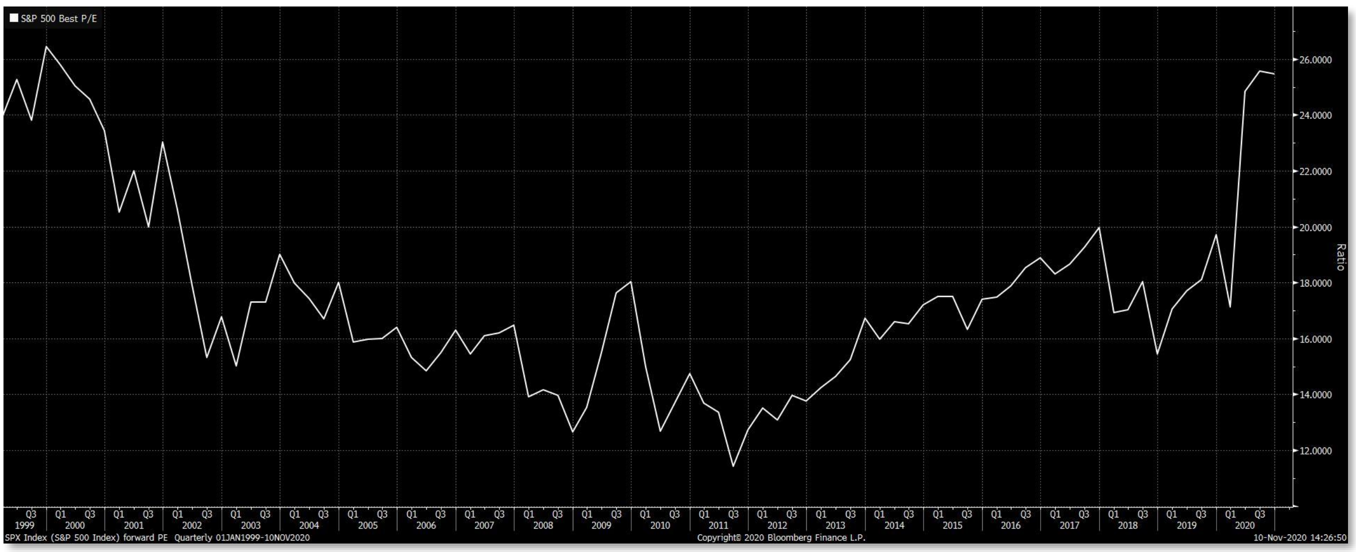
Are Stocks Expensive, Fair, or Cheap?
It Depends on Earnings Growth

As the U.S. stock market once again approaches record highs, many have suggested that it has entered overvalued territory. Indeed, in terms of a widely cited measure of equity valuation, the forward price-to-earnings multiple (current price divided by the next-twelve-months consensus EPS estimate), U.S. equity markets are currently at a level not seen since the year 2000 during the dot-com era. There are, however, reasons to believe that valuations are currently reasonable and maybe even attractively priced. In order for this assertion to hold, earnings must be able to grow into this valuation.

THE U.S. STOCK MARKET'S 'RICH' VALUATION

One need not look far to find a case that the valuation level of the S&P 500 Index has entered nose-bleed territory. As mentioned above, the forward earnings multiple for the S&P 500 Index (as well as other U.S. equity market indices) has recently approached all-time highs. The following graph illustrates this point.



Source: Bloomberg

Investors are now paying 50% more for next year's estimated earnings than the average over the last ten years. However, assuming that stocks are overpriced simply because current levels are elevated relative to historic averages without considering context may be a flawed conclusion. If one defines 'overvalued' as a state in which the market's current price level is above that which is justified by its earnings outlook then one might conclude the market is more reasonably priced.

A GAME CHANGER: THE COVID-19 VACCINE

On Monday, Nov. 9th, Pfizer ("PFE") announced preliminary results for a Covid-19 vaccine that substantially exceeded medical experts' expectations. The vaccine has an efficacy level of 95%, which is similar to results for the vaccine Moderna ("MRNA") has developed. The implications of these vaccines are significant for several reasons:

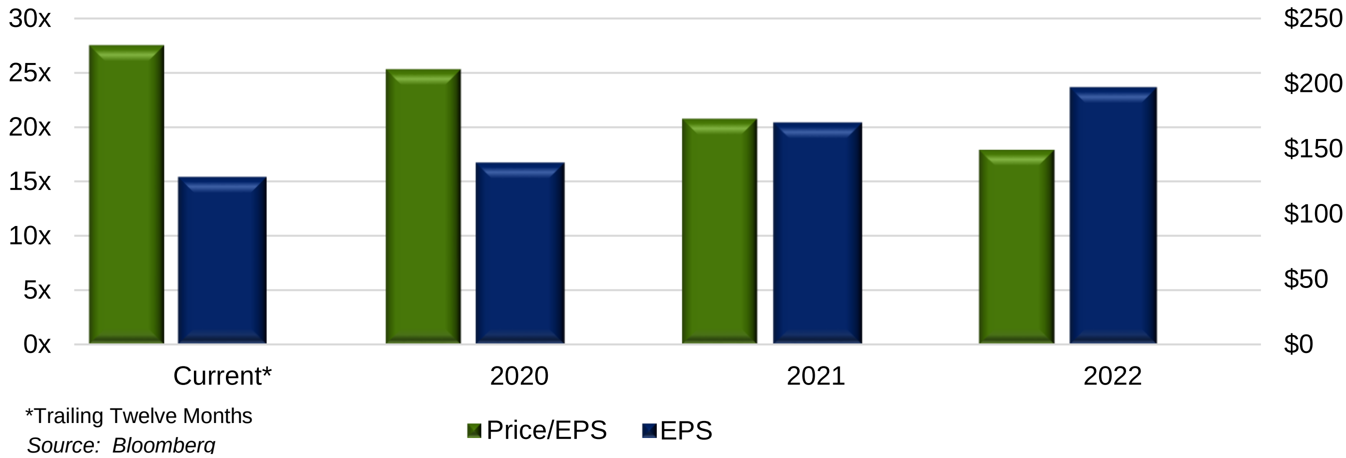
1. The data appears robust. Rather than evaluate efficacy sooner, PFE waited for more data, which gives greater credibility to the results. MRNA's results lend further credibility.
2. The 95% efficacy level is substantially higher than most experts had anticipated.
3. The PFE and MRNA vaccines use a new messenger RNA approach to use the human body as a vaccine factory of sorts. Other trials have taken a similar approach so they may report similar results.
4. Absent reports of debilitating side effects when safety data becomes available (likely before the close of November), swift emergency use authorization is likely considering the FDA's bar for efficacy is just 50%.

There are of course limits as to how quickly and effectively these vaccines can help contain the spread of Covid-19. We do not know how successful the vaccines will be at inhibiting transmission, protecting the most vulnerable, or how long protection lasts. However, immune responses that protect so many vaccine trial subjects are likely to perform well in other areas. The bigger area of concern will be availability. Again though, the use of the mRNA approach by other companies provides reason to believe other effective vaccines may be around the corner.

GROWING INTO A 'RICH' VALUATION

As mentioned earlier, the forward multiple for the S&P 500 Index stands at the highest level since the year 2000 – when speculative excesses pushed valuations well beyond what could be justified by future earnings. A two-year bear market characterized by large negative returns of previous market leaders followed as a result. Of course, valuations can be (and remain) elevated if earnings growth can justify said valuation levels. To begin making this determination, one must assess valuation levels against consensus EPS estimates for the S&P 500. The graph below compares these figures for the trailing-twelve-month, 2020, 2021, and 2022 periods.

PRICE/EPS vs. EPS



*Trailing Twelve Months
Source: Bloomberg

As the graph above illustrates, the market currently trades at roughly 25x consensus 2020 earnings. This is an elevated level. By comparison, the historic average for this multiple typically falls between 15x and 18x depending on length of the historic period. However, EPS is expected to increase from $127.96 over the last twelve months to $196.69 in 2022, which implies that investors are currently paying roughly 18x 2022 EPS. Investors have been willing to pay such steep prices primarily for two reasons:

1. Interest rates are at historic lows. All other thing equal, investors are typically willing to pay more for stocks when rates are lower than when they are higher.

2. Analyst consensus estimates imply the steep drop in S&P 500 EPS is expected to be followed by a robust earnings recovery in the second half of 2021 and into 2022.

THE CASE FOR OPTIMISM

While extraordinarily low interest rates will likely keep a cap on market multiples, they may remain at elevated levels over several more years. The prospect of an effective vaccine implies that the second half of 2021 can potentially be a post-Covid economy. If true, EPS estimates should come up over the next few weeks and actual earnings may exceed those estimates over the next few years. This does not seem like a stretch. Even before news of the vaccine broke, the earnings environment for U.S. companies had been improving for both large and small cap companies.

The following graphs illustrate this point by graphing the ratio of boosted estimates to lowered ones. This ratio stands at 2.3x for the Russell 1000 Index and 2.0x for the Russell 2000 Index.

Chart 1 - A new high for earnings revision ratio in Small...

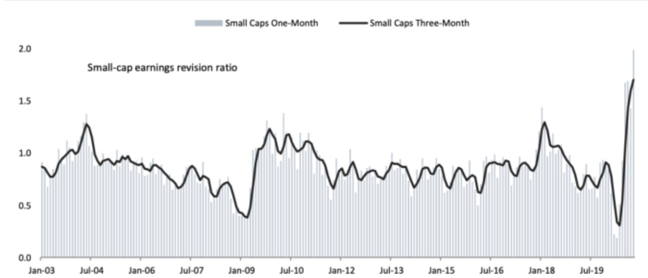


Chart 2 - ...And in Large caps

Source: Steven DeSanctis, Jefferies

Even as S&P 500 companies beat 3Q 2020 expectations handily, consensus 2021 EPS forecasts have increased by only 1% since the end of September. This reluctance to upgrade 2021 EPS estimates is likely (at least partly) because analyst numbers already reflect a growth rebound in the second half of the year. If the earnings recovery continues to surprise to the upside, analysts will likely increase their estimates. The following are further reasons U.S. company earnings may be poised for a robust rebound:

1. The U.S. may soon have a split government. A Democratic White House coupled with a Republican-controlled Senate may prove accommodative to EPS growth. In such an environment companies could continue to benefit from President Trump's pro-growth policies (e.g., corporate tax cuts) and a more stable environment for investment (i.e., reduced trade tension/volatility).
2. Unlike the last two cycles, there is nothing 'broken' in the economy that needs to heal – no excessive investment to be unwound, no obvious financial bubble and, no excess activity in any one sector.
3. Household balance sheets have not been decimated like they were following the 2008 global financial crisis. Instead, reduced spending, fiscal stimulus, rising home values, and a resilient stock market have helped raise household net wealth past its pre-Covid peak.
4. The demographic composition in the U.S. is much more supportive of growth than during the last recovery when the Baby Boomers were aging out of the workforce and the larger Millennial generation was just entering college. Now, Millennials are entering their prime home-buying years and will be entering their peak-earning period.
5. There is considerable pent up demand for durable goods as well as services like leisure and hospitality. Household savings have grown by over $1 trillion and these savings can provide fuel for a post-Covid economy as people begin to feel comfortable spending on big-ticket items and traveling again.

Of course, Covid-19 is far from contained and daily reported cases continue to climb to new highs as we begin winter. Even if the U.S. economy can begin to move past Covid-19 in 2021 and these assumptions come to fruition, U.S. equity markets may still prove to be overvalued. As we stated up front, whether you consider stocks to be expensive, fair or cheap depends on earnings growth. At this time Gyroscope remains optimistic that valuations are beginning to look a lot more reasonable.