The 2020 Valuation Debate

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Key Takeaways

- Given current conditions, the current 21.5x multiple does not necessarily mean the market is too expensive.
- Low interest rates are the primary catalyst behind the market's upward climb.
- The technology sector has played a critical supporting role in fueling market multiples.

While the focus has been on the presidential debate season, there's another fierce debate raging on—is the market too expensive? For the past 25 years, the S&P 500 has traded at an average of 16.5x its forward earnings. Today, the market is trading at a seemingly rich 21.5x! Valuations rebounded to new heights after dipping during the middle of the COVID economic shutdown, even as earnings struggle to fully recover. Here's why the P/E ratio doesn't have to contract.

Low Rates for Foreseeable Future

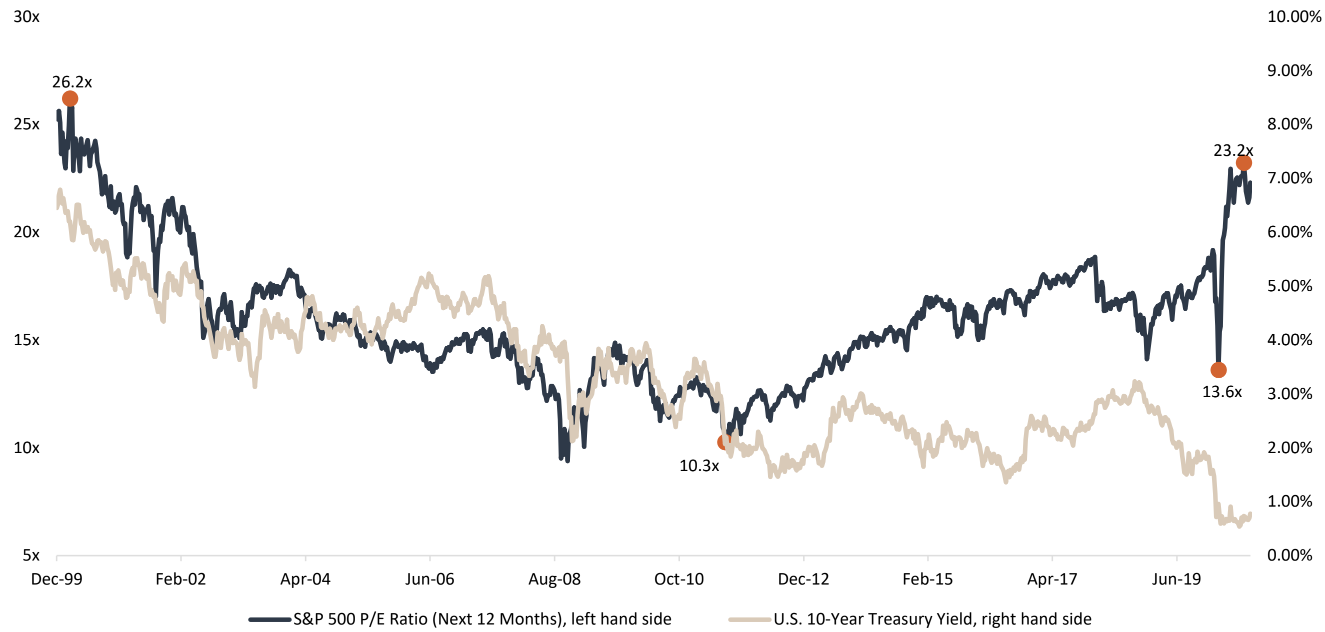
For nearly 40 years, we have witnessed a secular decline in interest rates. The pandemic turbocharged this trend, driving the 10-year Treasury rate below 1% for the first time. The decline in rates has been a huge tailwind for the stock market, and the forces helping to push them downward - demographics, globalization and a technology boom - still appear to be in place. What remains unknown is the impact the move towards populism and increasing trade barriers may have on globalization. Even with the friction between the U.S. and China, and the disruption of global supply chains, inflation continues to be of little concern. Interest rates cratered during the market volatility in February and March. Since the Fed has re-engaged quantitative easing, lowered short-term rates back to zero, and introduced various lending programs, the 10-year Treasury rate has hovered between 0.50% and 0.90%. Lower rates have driven up stock market valuations through two key mechanisms:

- **Lower Discount Rate.** The stock market or any security equals the sum of its future cash flows discounted back to the present. Underlying interest rates play an important part in that equation as they are used to calculate the discount rate. All else equal, a lower risk-free rate increases the value of a security. A lower risk-free rate drops the discount rate that applies to future cash flows, increasing the value of a security and raising the P/E.

- **Portfolio Rebalancing Effect.** Investment professionals who face the constant choice of allocating assets are more inclined to switch from fixed income and cash investments to stocks to meet their return targets.

In light of the Fed's policy, investors have adjusted their views about the future path of rates, and correspondingly, the market multiple has climbed to 21.5x.

Market Multiple & Rates

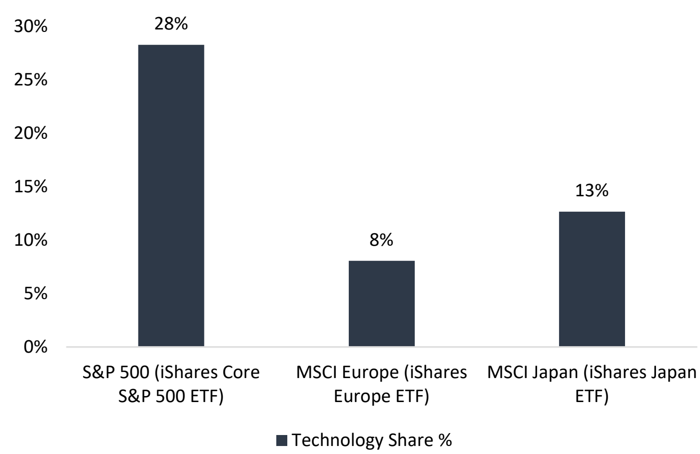


Source: FactSet

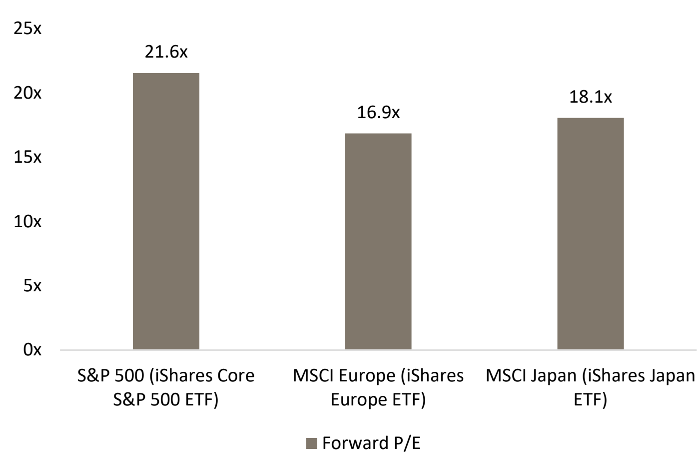
The Power of Tech

However, low rates on their own are not enough to drive valuations to their current levels. The U.S. is far from alone in living in a world of low rates. The European Central Bank and Bank of Japan have both experimented with negative interest rates and expanded their balance sheets. Today, the 10-year German bund yields -0.54% while the 10-year Japanese government bond yield sits at 0.03%. And yet the U.S. trades at a higher forward P/E than Europe or Japan. Investors are willing to pay steeper multiples for companies or markets growing at higher rates. The dynamism of the technology sector has propelled U.S. stock markets for the past decade. Below are the respective technology sector weights as percentages of the total market and the valuation multiples for the U.S., Europe, and Japan. Low rates alongside the potential for future growth provide the recipe for higher multiples.

Technology Share %



Forward P/E Ratio



Source: iShares Website, Factset

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Comparisons to The Tech Bubble

A sect of the finance community strongly believes in mean reversion. This theory asserts that over time, market variables such as profit margins, interest rates and P/E ratios should revert to their long-term averages. Markets are notorious for over and undershooting their fair value, driven by episodes of optimism and pessimism. Believers in the theory point to the technology bubble as the playbook for the current uptick in valuations. The stock market's valuation skyrocketed in the late 1990s on the back of enthusiasm for new age internet and telecom stocks. Investors bought into the growth hype of exciting internet companies. They were willing to pay through the roof based on little more than a concept and a company with dotcom in the name. The S&P 500's forward P/E ratio peaked at approximately 26x before crashing as the era's darlings failed to deliver on their growth expectations.

Current valuation bears point to the rise in the P/E multiple approaching 1999/2000 levels and the lack of absolute economic growth backing up the markets. The economy is still dealing with the aftershocks of the COVID recession, uncertainty about a second wave, and certain sectors of the economy that may be permanently damaged. In their minds, the fundamentals simply don't justify current equity prices, and the P/E multiple should fall back to its longer-term average.

In contrast, we believe the dynamics today are different than the conditions in 1999/2000. During the tech bubble, unachievable implied growth rates and companies with questionable business models drove valuations. This time, lower interest rates are fueling the current market P/E ratio.

Our Take

In a world devoid of inflationary pressures and a Fed willing to provide accommodative monetary policy, conditions are set for rates to remain low. Add on supportive fiscal policy, and the stock market multiple can stay at its current level. A change in the growth and/or inflation environment towards either an unexpected surge in consumer prices or a deflationary shock would push the P/E downward. While we remain attuned to these outcomes, the current 21.5x multiple does not necessarily mean the market is too expensive.

For additional market insights, please contact a Cerity Partners advisor or visit the thought leadership section of ceritypartners.com.

Tom is a Partner in the New York office and has more than five years of experience in various investment management roles. He is a member of the Investment Committee, Investment Manager Selection Sub-Committee, the Compliance Sub-Committee and the Performance Monitoring Sub-Committee.

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