Global Matters Weekly

16 December 2024

Can US equity valuations be justified?

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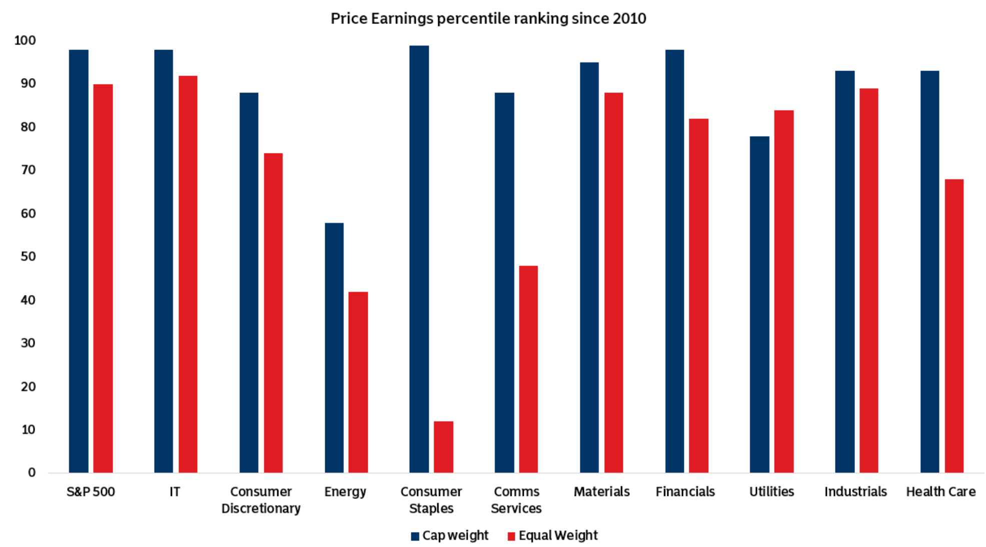
Chart of the Week



Sources: Bloomberg Finance L.P., Dececmber 2024.

What this chart shows

This chart shows a detailed view of US equity valuations, not only presenting the current market valuation as a percentile relative to the past 14 years but also breaking it down by sector. A closer look at the sectors reveals factors that make the broader index seem more expensive than it might otherwise appear. While elevated valuations of mega-cap stocks play a significant role, even an equal-weighted measure suggests that stocks remain high, trading at 19.1x earnings. These lofty multiples naturally generate headlines and raise concerns about long-term returns, but it's important to consider the underlying factors driving these elevated levels.

Why this is important

It is important to look past the headlines for greater granularity, especially over the basis of that valuation. In 2010, tech-related companies made up 18% of S&P 500 market cap; today it is circa 40%. Over this period, the fundamentals have improved as they have grown their revenues faster, with higher margins. Turning to S&P 500 companies in general, they have become less capital intensive, with both TECH+ and non-TECH+ companies becoming far more cash flow generative. Higher free cash flow companies generally return more to shareholders and should trade at higher P/E ratios. Using a combination of treasury yield and credit spreads suggest the current cost of capital is lower than the long-term average supporting a higher multiple.

Many investors assume that stock valuations, or equity risk premia, mean revert toward fair value, yet multiples generally only contract during recessions. The current consensus suggests above average earnings growth and accommodative monetary policy. Some caution is required at current euphoric sentiment/levels and clearly if monetary policy is less accommodative, due to inflationary surprises or fiscal sustainability concerns driving term premia higher and/or growth declines to promote recession risks, then multiples could contract sharply.

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