Valuation Here & There

See the collection of the individual charts linked below.

(1) The ideal mix of inflation, interest rates, and growth might be 2-2-2. (2) Low growth is good growth the longer it lasts. (3) Why are analysts’ long-term earnings growth expectations so high? (4) Blame Consumer Discretionary, not Tech this time. (5) PEG ratios aren’t extreme. (6) Heads or tails? High P/Es win either way? (7) Stay Home investment strategy is still winning and driving up US P/Es relative to the rest of the world. (8) Five MSCI sectors have higher P/Es in US than abroad. Tech is not one of them!

Valuation I: The Growth Question. The US economy is rolling triple deuces. Real GDP continues to grow around 2% on a y/y basis. Inflation is around 2%, and the 10-year US Treasury bond yield is also around 2%. This seems to be a very lucky combination for the US stock market.

In yesterday’s Morning Briefing, Joe and I wrote: “Should investors be willing to pay high P/Es when inflation and interest rates are low, but growth is weak? That doesn’t seem like a good deal. Then again, the combination of low inflation and interest rates with slow growth may result in a longer-than-usual economic expansion. The current one became the longest one on record just this month. If it keeps going, even at a slow pace, maybe it makes sense to pay relatively high P/Es.”

We concluded that the current mix of inflation and interest rates and economic growth merits relatively high, above-average valuations, especially for stocks of companies that can generate consistently above-average earnings growth.

Today, let’s have a closer look at analysts’ consensus expectations for long-term earnings growth (LTEG) before turning to a comparison of valuation multiples in the US versus overseas. We track LTEG for the S&P 500 and its sectors on a weekly basis. While the headline news clearly suggests that powerful secular forces are weighing on global economic growth, they don’t seem to be weighing on LTEG. Consider the following:

(1) LTEG is remarkably high. Perhaps industry analysts haven’t received the global-growth-slowdown memo yet. I/B/E/S calculates LTEG as the consensus median five-year expected earnings growth rate. For the S&P 500, it was 14.4% during the 7/11 week (Fig. 1). The weekly data start during January 2006. Monthly data are available from 1985. The latest weekly reading is down from a recent peak of 17.5% during the 10/18/18 week. The latest weekly reading and the latest cyclical peak aren’t that much lower than the record high of 18.7% during August 2000, when the Tech bubble was about to burst.

The latest weekly LTEG, at 14.4%, is well above the latest readings for both STEG (i.e., consensus expected short-term earnings growth), at 7.9%, and STRG (i.e., consensus expected short-term revenues growth), at 5.3% (Fig. 2).

(2) Don’t blame Tech this time. During the bull market of the 1990s, Tech led the dramatic ascent in
LTEG to its record high (Fig. 3). The S&P 500 LTEG rose from 11.5% at the start of 1995 to peak at 18.7% in August 2000. Over that same period, the Tech sector’s LTEG soared from 15.7% to peak at 28.7% during October 2000. Interestingly, Tech’s LTEG always exceeded the S&P 500’s LTEG until February of last year. The former has continued to be slightly below the latter since then. During the 7/11 week, Tech’s LTEG, STEG, and STRG were 13.6%, 7.0%, and 4.4%, respectively (Fig. 4).

(3) Blame Amazon. This time, the outlier is the Consumer Discretionary sector, led by the Internet & Direct Marketing Retail industry, which includes Amazon. Here is the performance derby for the S&P 500 LTEGs as of the 7/11 week: Consumer Discretionary (38.3%), Energy (15.2), Communication Services (13.9), Materials (12.1), Financials (11.7), Industrials (10.0), Health Care (9.8), Consumer Staples (5.7), and Utilities (5.0) (Fig. 5).

The Internet & Direct Marketing Retail industry (Amazon, Booking Holdings, eBay, and Expedia) had LTEG, STEG, and STRG rates of 83.0%, 28.0%, and 16.4%, respectively, during the 7/11 week (Fig. 6).

(4) PEGs are relatively cheap if LTEGs are relatively accurate. The S&P 500 forward P/E divided by LTEG (a.k.a. the “PEG ratio”) was 1.19 during the 7/11 week (Fig. 7). That’s relatively low. During the current bull market, PEG peaked at a record 1.68 during the 1/28/16 week. It was still high at 1.44 during the 12/14/17 week.

Here is the performance derby for the S&P 500 sectors’ PEGs as of the 7/11 week: Utilities (3.8), Consumer Staples (3.4), Health Care (1.6), Industrials (1.5), Information Technology (1.4), Materials (1.4), Communication Services (1.3), Energy (1.0), Financials (1.0), and Consumer Discretionary (0.6) (Fig. 8). Utilities and Consumer Staples stand out as particularly expensive on a PEG basis.

(5) Bottom line. Surely, investors aren’t buying what the analysts are selling about the heady outlook for LTEG. Then again, while everyone is aware of the secular-slowdown story for the global economy, some investors may be purchasing stocks that they believe will outperform the more realistic, weaker top-down (headline) outlook. If so, then they are likely to buy the bottom-up optimism of industry analysts for the stocks that they are buying. In other words, they are willing to pay a relatively high valuation multiple for their favorite companies that are expected to grow their earnings faster than other companies. Collectively, this all may add up to lots of companies’ stocks selling at valuation multiples not justified by the companies’ actual long-term earnings growth.

Investors who don’t buy analysts’ LTEG mostly believe that subpar economic growth is here to stay. That’s not great for actual long-term earnings growth. But it might still justify relative high P/Es, as we wrote yesterday: “Then again, the combination of low inflation and interest rates with slow growth may result in a longer-than-usual economic expansion. The current one became the longest one on record just this month. If it keeps going, even at a slow pace, maybe it makes sense to pay relatively high P/Es.”

Valuation II: A World of Cheap For a Reason. LTEG, STEG, and STRG outlooks for the All Country World ex-US MSCI were more subdued during the 7/11 week—at 9.6%, 7.5%, and 4.2%, respectively—than the comparable figures for the S&P 500 were (Fig. 9). That helps to explain why the forward P/E of this composite of overseas stocks was relatively cheap, at 13.2 during the 7/11 week (Fig. 10). Here is the performance derby of the forward P/Es of the major MSCI composites during the 7/11 week: US (17.4), EMU (13.3), Japan (12.8), UK (12.4), and Emerging Markets (12.0) (Fig. 11).

Stocks in the rest of the world are cheap compared to those in the US. However, keep in mind that this has been so most of the time since the start of the current bull market. As we’ve often observed, our
Stay Home investment strategy has outperformed the Go Global alternative since the start of the current bull market (Fig. 12). Here is the performance derby, showing the percent gains in the major stock market MSCIIs since 3/9/09 in US dollars: US (340%), Emerging Markets (118), Japan (99), EMU (97), and UK (88) (Fig. 13 and Fig. 14).

The US economy has weathered the Great Financial Crisis better than have the other major economies. The US economy and stock market are also more diversified than elsewhere. The US economy is less dependent on exports than are other countries. The US capital market is the biggest in the world and provides ample financing of economic activity through the banking system as well as through lots of other financial intermediaries. The US has the largest private equity market in the world. In the US, distressed asset funds continue to attract lots of money and collectively act as a very good shock absorber in the credit markets.

**Valuation III: Global Sectors Rankings.** I asked Joe to compare the forward P/Es of the 10 sectors of the major MSCI stock market composites around the world (Fig. 15). Here are a couple of his key findings:

1. The forward P/Es of the US MSCI exceed those of all the other major markets for Consumer Discretionary, Energy, Financials, Materials, and Utilities sectors.
2. Here is how the other US sectors currently rank around the world: Consumer Staples (fourth place), Industrials (second), Information Technology (second), and Communication Services (second).

**CALENDARS**

**US. Tues:** Existing Home Sales 5.34mu, FHFA House Price Index 0.3%, Richmond Fed Manufacturing Index 5. **Wed:** M-PMI & NM-PMI Flash Estimates 51.0/51.8, New Home Sales 658k, MBA Mortgage Applications, DOE Crude Oil Inventories. (DailyFX estimates)

**Global. Tues:** Eurozone Consumer Confidence -7.2, Japan Machine Tool Orders. **Wed:** Eurozone, Germany, and France C-PMI Flash Estimates 52.1/52.3/52.5, Eurozone, Germany, and France M-PMI Flash Estimates 47.6/45.2/51.6, Eurozone, Germany, and France NM-PMI Flash Estimates 53.3/55.2/52.8, Japan M-PMI Flash Estimates.(DailyFX estimates)

**STRATEGY INDICATORS**

S&P 500/400/600 Forward Earnings (link): Forward earnings mostly fell last week for the S&P indexes, but remain in the uptrends that began during March. LargeCap's has risen during 19 of the past 23 weeks; MidCap's 14 of the past 19 weeks; and SmallCap's 11 of the past 17 weeks. LargeCap's rose back up to a record high last week, while MidCap's and SmallCap's are 0.7% and 5.7% below their mid-October highs. At their bottoms, LargeCap's forward EPS had been the most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged down to a 31-month low of 3.6% y/y from 3.7%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change slipped to a 34-month low of 2.9% from 3.3%, which compares to 24.1% in mid-September (the highest since April 2011). SmallCap's -2.4% y/y is the lowest since January 2010. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019,
and 2020: LargeCap (22.7%, 2.3%, 11.5%), MidCap (22.7, 0.4, 14.2), and SmallCap (22.4, 1.2, 19.2).

**S&P 500/400/600 Valuation** ([link](#)): Valuations moved lower last week for the three S&P market-cap indexes. LargeCap’s forward P/E lost 0.2 point w/w to 16.9 from a 16-month high of 17.1. That’s compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E edged down 0.1 point to 15.7 from 15.8. That’s down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E dropped 0.2 point to 16.2. That’s still well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed. SmallCap’s P/E was below LargeCap’s P/E for a ninth straight week, after being below for much of December for the first time since 2003.

**S&P 500 Sectors Quarterly Earnings Outlook** ([link](#)): With the Q2 earnings season kicking into high gear, the earnings hook is appearing again. Last week saw the S&P 500’s blended Q2-2019 EPS forecast rise 17 cents w/w to $40.37. That represents an earnings decline of 1.5% y/y, but should continue to improve as more companies report in the coming weeks to our forecast of $41.00 and flat earnings y/y. On a pro forma basis, the blended Q2 earnings growth rate is 1.0% y/y, which would be the 12th straight y/y rise and compares to 1.6% in Q1, 18.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Six of the 11 sectors are expected to record positive y/y earnings growth in Q2-2019, versus five a week earlier, with only one rising at a double-digit percentage rate. That compares to six positive during Q1, when one also rose at a double-digit percentage rate. Five sectors are expected beat the S&P 500’s Q2 growth rate, the same as during Q1. Communication Services, Financials, and Utilities are the only sectors currently posting better growth on a q/q basis during Q2. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (16.4% in Q2-2019 versus -9.9% in Q1-2019), Financials (8.9, 8.0), Health Care (4.2, 10.3), Real Estate (1.5, 6.2), Utilities (0.9, -0.5), Industrials (0.2, 6.9), Consumer Discretionary (-0.2, 8.1), Consumer Staples (-0.2, 1.0), Information Technology (-5.8, -1.1), Energy (-10.2, -26.1), and Materials (-32.7, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to be up 1.6% y/y in Q2, down from 3.0% in Q1 and well below the 14.2% y/y gain in Q4. Q2’s forecasted gain would mark the lowest ex-Energy growth rate since Q2-2016. Looking ahead to the future, analysts as usual are trimming their forecasts for the next quarter. The S&P 500’s Q3-2019 EPS forecast dropped 14 cents w/w to $42.57. The consensus’ $42.57 estimate is down 1.0% in the three weeks since the start of the quarter, and now represents an earnings decline of 0.2% y/y. On a pro forma basis, the consensus Q3 estimate represents an earnings decline of 0.1% y/y, compared to a gain of 0.3% a week earlier and 0.8% at the end of Q2.

**S&P 500 Q2 Earnings Season Monitor** ([link](#)): With the Q2 earnings season 16% complete, the early indications compared to the same point during Q1 show that a sharply higher percentage of companies is reporting positive revenue surprises and y/y earnings growth is higher. The rest of the surprise and growth metrics are about the same as Q1, but these figures will continue to change as more Q2-2019 results are reported in the coming weeks. Of the 81 S&P 500 companies that have reported through midday Monday, 78% exceeded industry analysts’ earnings estimates. Collectively, these reporters have averaged a y/y earnings gain of 6.8%, and exceeded forecasts by an average of 5.6%. On the revenue side, 64% of companies beat their Q2 sales estimates so far, with results coming in 0.9% above forecast and 2.8% higher than a year earlier. Q2 earnings growth results are positive y/y for 69% of companies, versus a higher 71% at the same point in Q1, and Q2 revenues have risen y/y for 69% versus 71% during Q1. Looking at earnings during the same point in the Q1-2018 reporting period, a
slightly higher percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a slightly higher 5.8%, and earnings were up a lower 5.0% y/y. With respect to revenues at this point in the Q1 season, a sharply lower 52% had exceeded revenue forecasts by a slightly lower 0.7%, but sales rose a higher 4.0% y/y. Compared to 2018’s stellar results, these early readings for Q2 indicate a continuation of a marked slowdown in revenue and earnings growth and a slight deterioration in profit margins. But that should come as no surprise to investors. Q1-2019 had marked the 11th straight quarter of positive y/y earnings growth and the 12th of positive revenue growth. However, earnings growth trailed revenue growth during Q1-2019 for the first time since Q2-2016. That has happened just five times in the 42 quarters since the bull market started in Q1-2009; quite possibly, Q2-2019 will make the sixth.