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3 February, 2021

Here is why talk of stretched equity valuations is questionable

♦ The equity risk premium of the S&P 500 remains higher than its historic mean, suggesting room for more gains.

♦ The current earnings yield of the S&P 500 at 3.27% is 215 basis points higher than the 10-year US Treasury yield and 0.5 of a standard deviation higher than the 30-year average of 98 basis points.

♦ With about half of the S&P 500 companies having reported earnings, the average 2020 profit fell 1%, much less than the 8.8% drop forecasted by the consensus of analysts.

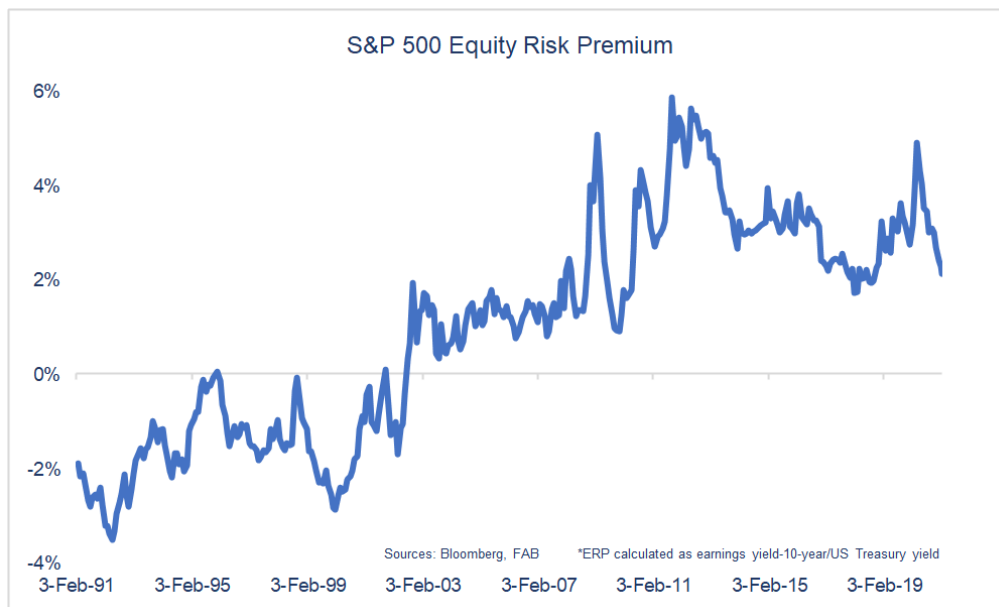
♦ So far, 80% of the companies beat analyst expectations, higher than the long-term average of 63%.

♦ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight alternatives.

As the S&P 500 makes its way back to record highs the media chorus has again started to chant calls of overvalued stocks. To justify it, many commentators have used the forward price-to-earnings ratio, currently at 22.7 times, higher than the 20-year average of 16.7 times.

The trouble with using that metric is that it changes depending on what analysts expect will be the future earnings of the companies in the index. And the numbers coming through in the earnings season are saying that analysts were too bearish.

If they really were, they have to start revising those forecasts higher and with that, the forward P/E ratio could move further toward its five-year average of 19 times without stock prices falling.



In fact, that is already happening. Since 1 January, the year-ahead consensus forecast for average earnings of the S&P 500 has increased 3.6% to US\$169.19 per share from US\$163.39 per share. That shift could accelerate after the earnings season finishes.

With about half of the companies in the S&P 500 having reported earnings, 80% beat estimates, much more than the 63% long-term average beat for full-year reports, according to Bloomberg. So far, the 1% average profit drop has also been a lot smaller than the 8.8% fall expected.

The better-than-expected results are coming despite a recent slowdown in the US economy after a new wave of SARS Cov2 cases closed many states. This, suggests that if the US economy recovers as well as economists expect, the earnings growth could be even stronger. In other words, saying stocks are expensive based on forward price-to-earnings could soon be a moot point.

The S&P 500 equity risk premium is still higher than its historic mean and its lows

Another way of looking at stock market value, however, suggests there is room for more gains. The earnings yield of the S&P 500 remains at 3.27%, about 215 basis points higher than the 10-year US Treasury yield of 1.12%. This is much higher than the 30-year average equity risk premium of 98 basis points. That same measure has even been negative during particularly heady equity markets, such as the dot-com era.

In a time when negative-yielding debt continues to grow across the world, such a high return is too attractive to pass. Hence, investors are likely to continue to favour equities over government bonds, in the same way as the FAB Asset Allocation Committee does now. At these rates, equities still offer a decent relative return.

Investment Strategy Update

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