Yardeni Research

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Morning Briefing

Valuation In A Resilient Economy

Check out the accompanying chart collection.

Executive Summary: Goldman Sachs' bold projection that the next 10 years may be a "lost decade" for stocks, with mere 3% annual returns, is unlikely in the extreme, says Dr Ed. It seems to rest on the assumption that valuations in the future will be lower than today's. Even without expanding valuation multiples, earnings growth would likely boost the S&P 500 price index at a pace that's at least twice Goldman's projection, and returns would be more like 11% a year including reinvested dividends. Furthermore, in our Roaring 2020s economic scenario, earnings growth and valuation—and the index's appreciation potential—would be even greater than that, driven by a technology-led productivity boom. ... Also: Dr Ed reviews "Monsters (+ + +).

YRI Weekly Webcast. Join our live webcast with Q&A on Mondays at 11 a.m., EST, with Ed and Eric. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Strategy: Evaluation of Goldman's Valuation Model. We admire the economists and strategists at Goldman Sachs. They often agree with us, though we often scoop them. However, we don't agree with their recent depressing long-term prediction for the S&P 500 returns over the next 10 years. We explained why in our Tuesday, October 22 *QuickTakes* titled "Lost Decade Ahead For Stocks With Only 3% Annual Returns?"

We did receive a few questions from our readers on the issue of valuation raised by Goldman's analysts. According to the October 25 *Briefings from Goldman Sachs* (which is *publicly available*): "The most important variable in this forecast is starting valuation. 'In theory, a high starting price, all else equal, implies a lower forward return,' writes David Kostin, chief US equity strategist at Goldman Sachs Research."

That suggests that starting valuations now are high relative to what they'll be in the future—so it seems to assume that they'll be lower 10 years from now. However, that's clearly a "known unknown": We know that 10 years from now, valuations will be higher, the same, or lower than now; but we don't know which.

Granted that current valuation multiples are stretched by historical standards; but 10 years into the future, they might still be as high as they are now even with drops along the way. If so, then over the next 10 years the S&P 500 price index would rise along with its earnings—at a pace that should be at least twice as fast as Goldman's 3% annual projection and closer to 11% including reinvested dividends. In our Roaring 2020s (and maybe Roaring 2030s), valuations might be higher than they are today.

Goldman acknowledges that the S&P 500's annualized nominal total return over the past decade was 13%, a bit higher than the 11% long-term average. Our numbers agree with theirs (*Fig. 1*). We also note that the longer-term average gain of the S&P 500 stock price index (excluding dividends) has been around 6% per year. That has been the same as the longer-run average of the annual growth rate of S&P 500 reported earnings per share (*Fig. 2*). There's no reason to expect earnings to grow less than 6% per year on average over the next 10 years. In our Roaring 2020s (and maybe Roaring 2030s), they might grow at a faster pace.

If the valuation multiple were to be halved over the next 10 years, then the S&P 500 stock price index indeed might rise by only 3% per year. But that still leaves an extra 4% annualized return given that the difference between the total return of the S&P 500 index and the return on just the index itself has been roughly 4% per year on average over the longer run. That differential represents the powerful effect on the S&P 500's total return of compounding dividends (*Fig. 3*).

Goldman's concern about the potential downside of the stock's market's valuation multiple over the next 10 years is heightened by the market's concentration. According to the *Briefings* cited above: "At present, the 10 largest stocks in the S&P 500 account for more than a third of the total market cap. The current level of market concentration—at a multi-decade high—represents another drag on our analysts' forecast. Without this variable, the baseline return forecast would be roughly 4 percentage points higher (7% rather than 3%) and the range would be 3% to 11% rather than -1% to 7%."

Let's further critique Goldman's analysis by focusing on its valuation assumption and its issue with concentration:

(1) *Valuation and returning to the mean*. One of the most popular and simple models of valuation is reversion to the mean. The four-quarter trailing P/E of the S&P 500 has averaged 19.6 since the start of 1964. It was well above that during Q2-2024, at 26.8 (*Fig.*

4). The trailing P/E, using either reported or operating earnings, tends to exceed the forward operating P/E of the S&P 500 (*Fig. 5*).

The S&P 500 forward P/E averaged 15.7 since the start of 1985 and was 21.8 during the October 25 week (*Fig. 6*).

The reversion-to-the-mean model confirms that P/E valuations are stretched. They aren't as high as they were during the tech bubble in 1999 and 2000, but they are getting close. The forward P/E hit a high of 25.0 during the April 13, 1999 week. If the current P/E revisits that level, such a meltup could set the stage for a meltdown, as occurred during the tech wreck of the early 2000s.

If so, that scenario would more likely play out over the next couple of years than over the next 10 years, when valuations might be as high or higher than they are today. The stock market certainly recovered from the tech wreck of the early 2000s and the valuation multiple today is fast approaching the one back then!

To be fair to Goldman, a lost decade for stocks isn't unheard of: The S&P 500 was basically flat 10 years after it peaked at a record high during April 2000. However, that's largely attributable to the Great Financial Crisis. By April 2013, it was back at a new high and nearly quadrupled since then. Over that so-called lost decade from Q2-2000 through Q2-2010, S&P 500 dividends rose 41%.

(2) *Valuation and interest rates.* Valuation is certainly influenced by both interest rates and inflation rates (*Fig. 7* and *Fig. 8*). However, the Fed's Stock Valuation Model (as Dr Ed dubbed it in 1996), showed that the correlation between the 10-year Treasury bond yield and the S&P 500's forward earnings yield (i.e., the reciprocal of the forward P/E) was much higher from 1985 through 1999 than it has been since then (*Fig. 9*).

In any event, interest rates and inflation rates are hard enough to forecast on a short-term basis let alone over the next 10 years. Furthermore, despite the ups and downs of both over the past several decades, the S&P 500 stock price index has reliably delivered annual gains averaging between 5.0% and 6.0%, and dividends have been trending higher.

(3) *Valuation and the Misery Index.* We recently observed that the S&P 500 forward P/E has been inversely correlated with the Misery Index since 1985 (*Fig. 10*). Again, forecasting the Misery Index, which is the sum of the unemployment rate and the inflation rate, over the next 10 years is an undertaking accepted only by the Congressional Budget Office (CBO) to

project the outlook for the federal deficit over that period. The CBO adjusts its forecasts on an annual basis and isn't held accountable for being regularly wrong.

(4) *Concentration.* Goldman's concern about the market's lofty valuation is heightened by the concentration of the stock market. The Magnificent-7 stocks currently account for the following shares of the S&P 500: 29% of the market capitalization, 21% of forward earnings, and 11% of forward revenues (*Fig. 11*). Collectively, the group has a forward P/E of 29.0 (*Fig. 12*). The S&P 500 forward earnings with and without these seven companies is 21.9 and 19.6.

Here is how we addressed the market concentration issue in Tuesday's *QuickTakes*: "One of the biggest 'worries' in Goldman's analysis is that the stock market is highly concentrated. But while the Information Technology and Communication Services sectors together now make up about 40% of the overall S&P 500, around the same as at the peak of the dotcom bubble, their companies are much more fundamentally sound today than back then.

"These two sectors account for more than a third of the S&P 500's forward earnings today versus less than a quarter in 2000 (*Fig. 13*). We also believe that these days all companies can be thought of as technology companies. Technology isn't just a sector in the stock market but an increasingly important source of higher productivity growth, lower unit labor costs inflation, and higher profit margins for all companies."

By the way, collectively, the forward P/E of the S&P 500 Information Technology and Communication Services sectors is currently 25.8, well below the record 41.0 peak in early 2000 (*Fig. 14*).

(5) *Valuation and resilient economic growth.* Often missing in discussions of valuation is the outlook for economic growth. The P/E multiple of the stock market is likely to be higher the more that investors believe that the economy will grow at a solid pace for a longer period of time. It will be lower if they are fretting about an imminent recession. When investors anticipate a recession, the P/E often falls because investors are uncertain about how long it will be before a recovery starts and how strong (or weak) the recovery will be (*Fig. 15*). Once a recession occurs, the P/E tends to rise when investors start anticipating a recovery.

This accounts for the inverse correlation between the stock market's valuation multiple and inflation rates and interest rates. Rising inflation forces the Fed to raise interest rates, thus increasing the odds of a recession, which depresses the P/E. Low inflation and interest rates have the opposite effect on the P/E, raising it because the odds of a Fed-led recession are relatively low.

So not surprisingly, there's a close correlation between the S&P 500's forward P/E and analysts' consensus expected long-term earnings growth (LTEG) over the next five years (*Fig. 16*). LTEG and S&P 500 forward earnings per share are available only since 1985. Nevertheless, the P/E tends to rise (fall) when LTEG is rising (falling).

Here's one more very important point regarding the relationship between valuation and expected economic growth: Valuation of an individual stock is more a function of how long investors expect it to take for earnings to catch up with valuation. That's why rapidly growing companies have higher-than-average P/Es. Maturing companies have lower-than-average P/Es because they are expected to grow more slowly. The Magnificent-7 companies refuse to mature, continuing to deliver surprisingly strong earnings growth. So they get a higher P/E. Perhaps in the future, they will stay that way and perhaps there will be more such companies.

(6) *Bottom line*. The latest *Briefings from Goldman Sachs* concludes: "US stocks will face stiff competition from other assets at such low levels of return, according to our strategists. Their forecast suggests the S&P 500 has roughly a 72% probability of underperforming bonds and a 33% likelihood of lagging inflation through 2034."

So what's an investor to do? Open an account at Goldman and buy the firm's alternative investments promoting higher returns for the next 10 years! Or else rely on our more optimistic outlook for the S&P 500, which should continue to rise by 6% per year on average and deliver an 11% annual total return over the next 10 years. If our Roaring 2020s scenario continues to play out, the return should be even greater as technology-led productivity gains boost economic growth and profit margins (*Fig. 17*).

Movie. "Monsters" (*link*) is a 2022 Netflix docudrama series about the Menendez brothers, who were convicted in 1996 of the brutal murders of their parents in their Beverly Hills mansion in 1989. It is especially relevant today because they might soon be resentenced, opening the possibility of parole instead of serving out their life sentences. The unanswered question is whether the monsters were the two brothers or their two parents. The dialogue about the abuse that the parents allegedly committed against their two sons is intensely graphic and unsettling. The actors portraying all four of the dysfunctional family members did a great job of portraying their characters as monsters. The directing and editing are superb too.

Calendars

US: Mon: Dallas Fed Manufacturing Survey. **Tues:** JOLTS Job Openings 7.92m; Consumer Confidence 99.2; Goods Trade Balance -$96.1b; Atlanta Fed GDPNow 3.3%; Wholesale Inventories 0.2%; S&P/CS HPI Composite 0.2%m/m/4.6%y/y; Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Mon: UK CBI Distributive Trade Survey -9; Japan Unemployment Rate 2.5%; De Guindos; Macklem. **Tues:** Australia CPI 0.3%q/q/2.3%y/y; Macklem; Rogers. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index fell 1.0% last week from its record high a week earlier on October 18. The AC World ex-US index dropped 1.9% w/w to 5.3% below its June 15, 2021 record high. EMEA was the best performing region last week, albeit with a decline of 0.9%, followed by EM Latin America (-1.0%), Europe (-1.4), EMU (-1.4), EM (-1.8), and the AC World ex-US. EAFE was the worst regional performer, with a drop of 2.0%, followed by EM Asia (-1.9). None of the 18 major selected country markets that we follow rose last week. Sweden and Brazil performed the best, albeit with drops of 0.4%, followed by South Africa (-0.7), Taiwan (-0.9), and the US (-1.0). Japan was the worst performer, falling 4.0%, followed by India (-3.7), Mexico (-3.1), and Korea (-2.3). The US MSCI's 21.5% ytd gain remains well ahead of the AC World ex-US index's (7.6). EM Asia is still ahead of the pack as the leading region ytd with a gain of 15.8%, followed by EM (10.9) and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-18.6), EMEA (3.0), EAFE (5.6), EMU (5.8), and Europe (6.1). Looking at the major selected country markets that we follow, Taiwan is the best ytd performer with a gain of 35.8%, followed by the United States (21.5), China (20.9), South Africa (17.9), and India (15.1). The worst performing countries ytd: Mexico (-22.0), Brazil (-20.6), Korea (-12.9), France (-1.6), and Hong Kong (1.5).

US Stock Indexes (*link*): Just three of the 48 major US stock indexes that we follow rose w/w, down from 45 rising a week earlier. The Nasdaq Industrials index was the best performer, with a gain of 0.9%, ahead of Nasdaq Composite (0.2%), Nasdaq 100 (0.1), Russell 1000 Growth (0.0), and S&P 500 LargeCap Growth (0.0). The S&P 600 SmallCap

Pure Value index was the worst performer, with a decline of 3.8%, followed by S&P 600 SmallCap Value (-3.3), Russell 2000 Value (-3.3), and S&P 600 SmallCap Pure Growth (-3.2). Looking at their ytd performances, all but one of the 48 indexes are now positive so far. The S&P 500 LargeCap Growth index remains in the top spot as the best performer so far in 2024, with a gain of 29.8%, ahead of Russell 1000 Growth (26.4), Russell 3000 Growth (25.7), S&P 100 MegaCap (25.7), and S&P 500 LargeCap Pure Growth (25.1). The worst performing major US stock indexes ytd: S&P 600 SmallCap Pure Value (-0.7), S&P 400 MidCap Pure Value (1.3), Dow Jones 20 Transports (1.3), S&P 600 SmallCap Value (2.2), and S&P 600 SmallCap Equal Weighted (2.5).

S&P 500 Sectors Performance (*link*): Two of the 11 S&P 500 sectors rose last week, and four were ahead of the S&P 500's 1.0% decline. That compares to nine sectors rising a week earlier when five were ahead of the composite index's 0.9% gain. The outperformers last week: Consumer Discretionary (0.9%), Information Technology (0.2), Communication Services (-0.1), and Energy (-0.6). The underperformers last week: Materials (-4.0), Health Care (-3.0), Industrials (-2.8), Financials (-2.1), Utilities (-1.9), Real Estate (-1.5), and Consumer Staples (-1.0). The S&P 500 is up 21.8% ytd, with all 11 sectors in positive territory and four sectors ahead of the index. During the September 6 week, a ytd high of five sectors were ahead of the index for the first time since mid-May. Information Technology is the best ytd performer, with a gain of 33.5%, ahead of Communication Services (28.1), Utilities (26.8), and Financials (23.8). These sectors are lagging the S&P 500 so far in 2024: Energy (7.9), Health Care (8.9), Materials (9.8), Real Estate (9.9), Consumer Discretionary (13.6), Consumer Staples (14.5), and Industrials (18.7).

US Economic Indicators

Durable Goods Orders & Shipments (*link*): Durable goods fell for the second month in September, but not as much as expected, led by a sharp drop in transportation equipment orders. *Orders* slipped 0.8% (vs -1.1% expected), matching August's decline, following a 9.8% jump in July following June's 6.9% drop. *Transportation equipment orders* fell 3.1% in September following August's 3.4% shortfall. Sectors such as autos and aerospace, which make up a significant portion of transportation equipment, have been vulnerable recently. However, stable growth in other durable goods categories, such as machinery and electrical equipment, indicate underlying strength. *Excluding transportation*, orders rose an unexpected 0.4% (vs -0.1% forecast) in September, after climbing 0.6% in August—remaining at record readings. Meanwhile, *nondefense capital goods orders excluding aircraft* (a proxy for future business investment) jumped a larger than expected 0.5% (vs

0.1% forecast) in September, following August's unrevised 0.3% increase, continuing to bounce around record highs. *Nondefense capital goods shipments excluding aircraft* (used in calculating GDP) has drifted lower, falling 0.3% in September after dipping 0.1% in August; it's within 2.1% of January's record high.

Regional M-PMIs (*link*): The *Kansas City Fed*, the fourth regional Fed bank to report on manufacturing activity for October, showed the region's manufacturing activity decline modestly, while expectations for future activity remained positive. Its *composite* index (to -4 from -8) moved closer to expansionary territory in October. Most of the components of the composite index were higher than last month though still in negative territory; only inventories were not, and they fell markedly. Volume of *shipments* (7 from -12) and *new orders* (-5 from -14) improved moderately, while *production* (0 from -18) jumped back up to the breakeven point of zero. The two *employment* measures improved, though both remained in negative territory: *number of employees* (-2 from -11) and the *average workweek* (-7 from -15). The future composite (to 7 from 9) index eased slightly, while the production (27 from 19), shipments (21 from 10), and new orders (14 from 12) measures all increased at a faster pace. Previously, the *New York Fed* (the first to report on October manufacturing activity in its region) revealed that the sector fell back into contractionary territory after a brief move above in September. The *Philadelphia Fed* (second to report) showed improved activity, posting its second successive gain, while manufacturing in the Richmond Fed (third to report) remained depressed—with its composite index remaining in contractionary territory, though there were signs of life in the three main future indexes, which moved further into expansionary territory.

Consumer Sentiment Index (*link*): Consumer sentiment is showing some signs of life, moving higher for the third straight month. *Consumer sentiment* climbed from 66.4 in July to a six-month high of 70.5 in October—considerably higher than the 68.9 expected reading. Sentiment is now more than 40% above June 2022's trough, reflecting modest improvements in buying conditions and an easing in interest rates. *Current conditions* rose from 61.3 in August to 64.9 in October, while *expectations* was little changed at 74.1, after climbing 68.8 in July to 74.4 in September. *Turning to inflation*, *year-ahead* inflation expectations were unchanged at 2.7% this month, with the current readings falling within the 2.3%-3.0% range seen in the two years prior to the pandemic. Expectations for inflation over the *next five years* edged down to 3.0% this month from 3.1% last month—remaining modestly elevated relative to the range of readings in the two years pre-pandemic. *Turning to politics*, The Conference Board reported that sentiment among Republicans jumped later this month, reflecting rising bets that Trump will win the upcoming election, while sentiment among Democrats soured.

New Home Sales (*link*): New home sales (counted at the signing of a contract) beat estimates in September, climbing to the highest level since May 2023 as buyers took advantage of a decline in interest rates during September. *New home sales* rebounded 4.1% last month to 738,000 units (saar) after tumbling a revised 2.3% in August (first reported down 4.7%) to 709,000 units from the preliminary estimate of 716,000 units. Sales were 6.3% above a year ago. At September's sales pace, it would take 7.6 months to clear the *supply of houses* on the market, down from 7.9 months in August. *Regionally*, sales rose in two of the four regions last month, fell in one, and was unchanged in the West: Northeast (+21.7% to 28,000 units), South (+5.8 to 477,000), Midwest (-2.5 to 77,000), and West (0.0 to 156,00). Of the 738,000 *homes sold* in September, 344,000 were completed, 279,000 were under construction, while 115,000 weren't started. Of the 470,000 *homes for sale* during September, 108,000 had been completed, 258,000 were under construction, and 104,000 hadn't yet broken ground. The Fed's Beige Book last Wednesday showed "uncertainty about the path of mortgage rates kept some buyers on the sidelines, and the lack of affordable housing remained a persistent problem in many communities" in early October.

Global Economic Indicators

US PMI Flash Estimates (*link*): Business activity in the US remained robust in October, according to flash estimates, signaling a strong start to the fourth quarter, while price pressures eased notably. October's *C-PMI* (to 54.3 from 54.0) climbed to a two-month high, led by the service sector. The *NM-PMI* (55.3 from 55.2) continued to show the service sector expanding at a solid pace, while the *M-PMI* (47.8 from 47.3) shows manufacturing activity continued to contract, though at a slightly slower pace this month. The report noted that "companies anticipated greater stability and certainty post-election." *Turning to prices*, the October survey recorded prices charged for goods and services rose at the slowest rate since May 2020, below the pre-pandemic long-run average. The rate for *selling price* inflation eased notably in the service sector—posting its lowest rate in nearly four and a half years, but prices also fell in manufacturing. *Input cost* inflation also slowed, though did remain elevated by historical standards, mainly in the service sector. Although service sector input cost inflation did slow slightly, linked to lower wage pressures, it remained the third highest over the past year and well above the pre-pandemic average. Meanwhile, manufacturing input costs eased to a seven-year low, linked to lower fuel prices.

Eurozone PMI Flash Estimates (*link*): The *Eurozone's C-PMI* (to 49.7 from 49.6) remained just below the breakeven point in October, led by falling demand, with new orders down for the fifth successive month. The NM-PMI (51.2 from 51.4) sank to an eight-month low, though remained in expansionary territory, while both the M-PMI (45.9 from 45.0) and M-PMI Output (45.5 from 44.9) measures continued to contract, though at a slower pace—posting the highest readings in five months and two months, respectively. *Business confidence* continued to deteriorate, sliding to its lowest level in 11 months. The two largest Eurozone economies were the main source of weakness. *Germany's* C-PMI (to 48.4 from 47.5) continued to contract, though edged closer to the 50.0 breakeven point, up from September's seven-month low. The NM-PMI (51.4 from 50.6) climbed further into expansionary territory, while the M-PMI (42.6 from 40.6) fell at a slower pace. Meanwhile, *France* continued to contract at the start of the fourth quarter, with the C-PMI (to 47.3 from 48.6) sinking to a nine-month low, the NM-PMI (48.3 from 49.6) at a seven-month low, and the M-PMI (44.5 from 44.6) and M-PMI Output (42.5 from 44.0) measures the lowest in two months and nine months, respectively. *Growth in the rest of the region* saw output rise at the fastest pace in four months. *Turning to pricing*, inflationary prices eased. *Input* prices in the overall Eurozone increased at a modest pace this month, though inflationary pressures eased further, posting its lowest rate in just under four years, as manufacturing input prices decreased at the fastest pace since March and services input prices continued to increase sharply, though at a rate softer than the series average. *Output* prices rose at the slowest rate since February 2021, as an increase in services charges just offset a fall in manufacturing selling prices.

Japan PMI Flash Estimates (*link*): Private-sector activity in Japan contracted for the first time in four months. The *C-PMI* (to 49.4 from 52.0) fell below the breakeven point between expansion and contraction this month, according to the flash estimate, with the NM-PMI (49.3 from 53.1) showing a contraction in the service sector for the first time since June, while the M-PMI (49.5 from 49.7) output measure held just below 50.0. *Confidence* about business activity over the next 12 months softened this month, posting the weakest result since August 2020, reflecting the weak economic environment along with the stubbornness of higher prices. Firms recorded the strongest rate of output charge inflation for the second straight month, and one that is well above the series average.

Germany Ifo Business Climate Index (*link*): German business confidence rose in October for the first time in five months as both the current situation and expectations components improved this month. The *business climate index* rose to 86.5 in October, after falling the prior four months from 89.2 in May to 85.4 in September, with the *expectations* component increasing to 87.3 this month after falling from 90.1 in May to 86.4 in September. The *current situation* component rose to 85.7, after declining in four of the prior five months from 88.9 in April to 84.4 in September—the lowest reading since July 2020. The downward trend in the *manufacturing* index came to a halt this month, as a noticeably less pessimistic read on expectations helped offset the drop in the current business situation. The lack of orders remains a core problem. Meanwhile, the *service* sector's business climate index returned to positive territory this month, as companies were more satisfied with their current situation, while expectations rose slightly. Logistics, tourism, and IT saw the biggest improvements in sentiment during the month. Turning to *trade*, it also saw a slight improvement in its business climate index, reflecting a slight move up in expectations, which offset the setback in the current business situation. *Construction's* business climate worsened in October, reflecting more pessimistic expectations by these companies, though they did have a slightly better assessment of their current business situation.

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