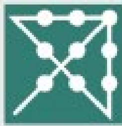
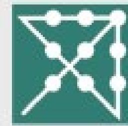
 Yardeni Research 

December 3, 2024

Morning Briefing

Does The Stock Market Have A Valuation Problem?

Check out the accompanying chart collection.

Executive Summary: A key driver of P/E expansion is investors' perception of how far off the next earnings-crippling recession is. As recent recession fears have dissipated, stock market valuations have risen impressively. Ed walks us through the fluctuations in the S&P 500's forward P/E during this bull market, highlighting how investors' beliefs about the economy affect the multiples they'll pay. … Are valuations overextended now? By historical standards, yes. If they expand much more, we might have to raise our subjective odds of a meltup scenario from the current 25%. … Also: Eric explains why we remain bullish on the outlook for consumer spending.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy I: Valuation & Growth. As we've seen over the past three years, stock investors don't like recessions, not even the no-shows. There was much anxiety about an imminent recession from January 3, 2022 through October 12, 2022, as reflected by the 25.4% drop in the S&P 500 over that period. Over that period, industry analysts confirmed investors' fears by lowering their consensus expectations for the operating earnings per share (EPS) of the S&P 500 companies by 0.2% and 1.9% for 2022 and 2023. These were very modest cuts, so the forward earnings estimate based on the analysts' annual estimates rose 5.8% (*Fig. 1*). ("Forward" earnings is the time-weighted average of the analysts' consensus estimates for the current year and following one; the forward P/E is the multiple based on forward earnings.)

Nevertheless, recession fears caused investors to slash the forward P/E for the S&P 500 from 21.7 at the start of 2022 to 15.3 on October 12, 2022 (*Fig. 2*). That was a 29.5% drop that was only partially offset by the 5.8% increase in forward earnings. The result was a P/E-led bear market.

Bear markets tend to bottom with forward P/Es well below the historical average of 15.8

(*Fig. 3*). But the latest one bottomed at a relatively high forward P/E because investors started to anticipate that recession fears might start to abate, as the economy proved remarkably resilient in the face of the significant tightening of monetary policy from March 2022 through August 2023.

So from 15.3 on October 12, 2022, the forward P/E rebounded impressively to 22.3 during the final week of November this year. That 45.8% increase in the S&P 500's valuation multiple was bolstered by a 15.5% increase in the forward EPS. The result has been a solid bull market, so far, that has kept pace with the previous eight bull markets (*Fig. 4*).

The point of this walk down Memory Lane is that the valuation multiple is a significant determinant of the stock market's gains and losses. Through investors' willingness to buy and sell at particular valuation levels, they amplify and anticipate changes in the consensus analysts' expectations for EPS.

In our opinion, the key driver of the forward P/E is investors' perception of how much and for how long earnings can grow before the next recession depresses earnings and the valuation multiple. Economic growth drives earnings growth, and investors' expectations for both drive the forward P/E.

Investors will pay a higher P/E the longer they believe that the economic expansion will last. That's because time is money. The longer the expansion, the longer that earnings have to grow to justify the current multiple (*Fig. 5* and *Fig. 6*). That helps to explain the dramatic rebound in the forward P/E during the current bull market. When fears of a recession during 2022 became recognized as unfounded over the past three years, the rapid rise in the valuation multiple reflected investors' increasing confidence that the economy and earnings would continue to grow despite the tightening of monetary policy.

So now what? The Fed has been cutting the federal funds rate since September 18. That certainly reduces the risk of a recession caused by the tightening of credit conditions and increases the odds of a long expansion.

If the tightening of monetary policy is no longer a risk to economic growth, what else might be? Perhaps a geopolitical crisis that causes oil prices to soar, as happened a couple of times during the 1970s? So far, the geopolitical crises since 2022 haven't boosted the price of oil, which has been mostly falling since then.

That leaves a tariff war as a potential cause of a recession now that President Donald

Trump is back and ready to slap tariffs on all of America's trading partners. So far, stock investors aren't fazed by Tariff Man, whom they believe is speaking loudly and carrying a big stick as a negotiating tactic. We agree.

Strategy II: Stretched Valuations. So now that we have explained why today's high valuations might be justified, we must acknowledge that they are stretched by historical standards. We wouldn't like to see them go any higher because that would force us to raise the odds of a 1990s meltup scenario from our current subjective probability of 25%.

Let's review the latest readings on various valuation metrics:

(1) *Trailing P/E*. The four-quarter trailing P/E of the S&P 500, using reported earnings, rose to 27.1 during Q3-2024, well exceeding the 19.6 average since the late 1930s (*Fig. 7*). It bottomed at 20.5 during Q3-2022, above its historical average. It's not a useful valuation measure, though, since it tends to soar during recessions as earnings fall faster than stock prices.

(2) *Buffett Ratio*. Many years ago, Warren Buffett mentioned that he likes to follow the ratio of the total value of US corporate equities at market value divided by nominal GDP (*Fig. 8*). The Buffett Ratio rose to a record-high 2.96 during Q2-2024. A useful weekly proxy ratio is the price of the S&P 500 index divided by the forward revenues per share of the index (i.e., forward P/S) (*Fig. 9*). It rose to a record 2.99 during the final week of November. Previously, Buffett noted that readings above 2.0 suggest that the market is getting overvalued. That might explain why he has been raising so much cash in the portfolio he manages for Berkshire Hathaway.

(3) *Forward P/E*. The forward P/E of the S&P 500 rose to 22.3 at the end of November (*Fig. 10*). That's not at a record high, unlike the forward P/S ratio, because the S&P 500's forward profit margin has been rising, boosting the growth of earnings relative to sales. Nevertheless, it's closing in on the record high of 25.0 recorded during the Tech Bubble of 1999.

The S&P 500's forward P/E has been boosted by the collective forward P/E of the Magnificent-7, currently 29.1, while the forward P/E of the remaining S&P 493 companies is at 19.5. Similarly, the median forward P/E of the S&P 500 was 19.8 during November (*Fig. 11*).

(4) *Fed Model.* The Fed's Stock Valuation Model compares the forward earnings yield of the

S&P 500 to the 10-year Treasury bond yield. The two were highly correlated from the mid-1980s through the late 1990s (*Fig. 12*). They've diverged greatly since then. The model may be worth monitoring again now that the forward earnings yield at 4.46% is almost identical to the 10-year Treasury bond yield.

(5) *Real earnings yield.* The spread between the S&P 500 earnings yield based on reported earnings and the Consumer Price Index inflation rate tends to be negative during recessions and bear markets (*Fig. 13*). It has been slightly positive for the past six quarters.

Strategy III: Overweight the US Consumer. Wagering against the US consumer tends to be a bad bet. Americans spend during boom times and even spend to feel better when their financial situation is worsening. But many investors and strategists have staked their chips against the consumer since the Fed began raising interest rates in 2022. They thought that the federal government's pandemic-time stimulus sent directly to consumers had padded consumers' pockets enough to fuel a spending deluge. Once those "excess savings" ran out and rates rose, surely delinquencies would follow. Even the credit-worthiest of consumers would be forced to retrench. Or so the thinking went.

That scenario never materialized, despite dire warnings that it would derail the economy and cause a recession. We saw a different narrative playing out: Rising real wages, increased income from higher rates, and a very positive wealth effect would allow consumers to keep spending. Baby Boomers in particular would "dissave" as they retired during the pandemic, and soaring home and stock values emboldened them to spend more.

A number of indicators have suggested consumers would soon run out of gas. The Citigroup Economic Surprise Index even turned lower recently, largely due to weaker-than-expected consumer spending data (*Fig. 14*). This lowered the 10-year Treasury bond yield by some 20bps to around 4.20%. However, we think this soft patch resulted from bad October weather and should be reversed in the coming months. We remain bullish on the outlook for consumer spending, particularly as a result of lower taxes under Trump 2.0. In addition, we expect that wages will continue to rise faster than prices as productivity growth remains robust.

Consider the current state of the consumer as we prepare for those tailwinds:

(1) *Consumer sentiment*. Consumer expectations for business conditions in the University of Michigan's Consumer Sentiment Index (CSI) have been extremely downbeat since April 2021. The CSI plummeted during the pandemic, then rebounded through Q1-2021 before

cratering to historical lows. While most indicators became depressed once the Fed began tightening monetary policy, the CSI is heavily tied to inflation. Consumer price inflation rose to 4.1% by April 2021 and continued climbing from there.

Now as inflation is falling and the real wages growth is continuing, the CSI is starting to rise (*Fig. 15*). Online survey methods and partisanship may keep the index lower than usual during this cycle, but the future expectations component could rise from November's current 76.9 closer toward its pre-pandemic average of around 85.0 in Q1-2025.

The Conference Board's Consumer Confidence Index (CCI) tends to be more sensitive to labor market conditions. The CCI rose to a 16-month high in November, increasing from 109.6 to 111.7 (*Fig. 16*). That's consistent with our long-held belief that the labor market remains in good shape. Many false alarms of labor market weakening this year were due to its normalization from record tightness during the pandemic.

Speaking of records, an all-time-high 56.4% of consumers expect stock prices to increase over the next year, per the CCI (*Fig. 17*). We expect Trump 2.0 and the stock market's performance to boost consumer sentiment through Q1-2025 and beyond (*Fig. 18*).

(2) *Consumer spending*. October's real personal consumption expenditures increased just 0.1% m/m. Spending on goods rose less than 0.1% m/m, and spending on services increased 0.2% m/m. We're expecting this to rebound in November owing to the improvement in sentiment as well as the return to work of striking and weather-impacted workers.

Meanwhile, real retail sales rose 0.4% in October to a new record high from an upwardly revised 0.8% increase in September (*Fig. 19*). Falling gas prices and a 0.2% m/m decline in goods prices further boosted real purchasing power (*Fig. 20*). We expect Trump's deregulatory agenda and drill-baby-drill energy policies to further support this trend. The anticipatory animal spirits are already kicking in—the Atlanta Fed's *GDPNow* model is currently estimating Q4 real consumption growth of 3.4%.

(3) *Consumer income*. Real disposable personal income rose 0.4% m/m during October. Because a large portion of that income was saved, consumer spending didn't increase as much. We believe the trend of rising real wage growth and nonlabor income supporting more spending remains intact (*Fig. 21*).

(4) *Consumer credit*. Consumer delinquencies are rising, but just to pre-pandemic levels

that are historically low (*Fig. 22*). Consumers broadly have been able to clean up their balance sheets since the pandemic, while rising incomes have lessened their relative debt load. As a percentage of disposable personal income, consumer credit outstanding remains well below pre-pandemic levels (*Fig. 23*). We aren't worried about a reacceleration in credit-fueled spending, particularly as consumer credit growth is falling back toward pre-pandemic levels of around 5% y/y (*Fig. 24*).

While layoffs have remained low, hiring has fallen in recent quarters. We mostly attribute this to a normalization from the wave of job changes. However, as business owners become more certain and optimistic, we expect animal spirits to boost job openings, hiring, and therefore more consumer spending. Our bullishness on the consumer, labor market, and broader economy reflects our Roaring 2020s thesis, which we continue to believe is the most likely outcome in the coming years.

Calendars

US: Tues: JOLTS Job Openings 7.49m; API Weekly Crude Oil Inventories; Goolsbee. **Wed:** ADP Employment Change 166k; ISM NM-PMI 55.5; Factory Orders 0.3%; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; Powell. (FXStreet estimates)

Global: Tues: Spain Unemployment Change 29.3k; Australia GDP 0.5%q/q/1.1%y/y; Japan NM-PMI 50.2; China Caixin NM-PMI 52.5. **Wed:** Eurozone, Germany, and France C-PMIs 48.1/47.3/44.8; Eurozone, Germany, and France NM-PMIs 49.2/49.4/45.7; Eurozone PPI 0.4%; UK C-PMI & NM-PMI 49.9/50.0; Lagarde; Nagel; Bailey. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings moved simultaneously higher for all three of these indexes for a second straight week after mostly stalling for the SMidCaps since mid-September. LargeCap's forward earnings rose for a ninth week to a record high after falling for two straight weeks for the first time since December (when it fell for three straight weeks). LargeCap had snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit

record highs for 42 straight weeks). MidCap's improved to 1.8% below its record high in early June 2022. SmallCap's edged up to 12.3% below its mid-June 2022 record. Through the week ending November 29, LargeCap's forward earnings has soared 20.7% from its 54-week low during the week of February 1, 2023; MidCap's is 6.9% above its 55-week low during the week of March 10, 2023; and SmallCap's is 1.5% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.1%, 12.8%), MidCap (-0.6, 13.6), and SmallCap (-12.3, 17.6).

S&P 500/400/600 Valuation (*link*): Valuations edged higher w/w across the board for these three indexes during the November 29 week and were at multi-year highs for the SMidCaps. LargeCap's forward P/E rose 0.1pt w/w to 22.1, and is just 0.1pt below its 43-month high of 22.2 during the November 8 week. It's up 5.1pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.9pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose less than 0.1pt higher w/w to a 40-month high of 17.1. It's up 4.8pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.2pt higher w/w to a 41-month high of 17.1. It's up 6.5pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 22% discount to LargeCap's P/E is the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 23% discount is the lowest since the March 9, 2023 week and is up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 1% discount to MidCap's is among the smallest since July 2021. Prior to that from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

US Economic Indicators

US Manufacturing PMI (*link*): The ISM M-PMI in November continued to point to a contraction in manufacturing activity for the eighth successive month and 24th time in the past 25 months, though did show a slowing in the rate of contraction last month. November's *M-PMI* increased to 48.4 (beating the 47.4 forecast) from 46.5 in October—which was the lowest level since July 2023. It remains below its recent high of 50.3 in March. "Demand remains weak, as companies prepare plans for 2025 with the benefit of the election cycle ending," noted Timothy Fiore, chairman of the ISM survey. According to ISM, the *overall economy* continued its expansion for the 55th month after a one-month contraction in April 2020. (A manufacturing PMI above 42.5% over a period of time generally indicates an expansion of the overall economy.) The new orders (to 50.4 from 47.1) measure returned to expansion in November, though barely, edging just above the breakeven point of 50.0, while production (46.8 from 46.2) continued to contract, though at a slightly slower pace. Meanwhile, factory employment (48.1 from 44.4) also declined at a slower rate last month, remaining in contractionary for the fifth successive month. The supplier deliveries (48.7 from 52.0) measure fell back below 50.0—a reading that indicates faster deliveries. (The supplier deliveries index is inversed; a reading above 50.0 indicates slower deliveries, which is typical as the economy improves and customer demand increases.) Meanwhile, companies liquidated inventories (48.1 from 42.6) at a slower pace, nearing the 50.0 breakeven point. *Turning to prices,* manufacturers faced slower input (to 50.3 from 54.8) prices in November.

Construction Spending (*link*): Construction spending beat expectations in October, boosted by residential investment. *Total construction* spending rose 0.4% to a new record, double the consensus estimate of a 0.2% gain, following September's unrevised 0.1% uptick. Spending was 5.0% above a year ago. *Private construction* spending climbed 0.7% m/m and 5.1% y/y, led by *residential* construction, which climbed 1.5% m/m and 6.4% y/y, while *nonresidential* building fell 0.3% in October, though was 3.5% above a year ago. Within *residential construction*, *single-family* building rose 0.8% m/m and 1.3% y/y, while *multi-family* edged up 0.2% in October but was 6.8% below a year ago. Within *nonresidential construction*, the biggest declines occurred in healthcare (-1.4%), educational (-1.3), amusement & recreation (-1.2), and commercial (-1.1) facilities. Partially offsetting these declines was a big 4.0% jump in religious building. Meanwhile, *public construction* expenditures fell 0.5%, with both residential and nonresidential building also contracting 0.5% during October; versus a year ago, they were up 4.5%, 6.4% and 4.5%, respectively.

Global Economic Indicators

Global Manufacturing PMIs (*link*): The global manufacturing sector stabilized in November. The *JP Morgan Global M-PMI* rose to the breakeven point of 50.0 in November, after four months below. It peaked recently at 51.0 in May, falling to a recent low of 48.7 in September. *China's* M-PMI moved to a five-month high of 51.5 last month, with the M-PMI for the *rest of Asia* averaging 51.1, while conditions in the *US* came close to stabilizing—climbing to a five-month high of 49.7. Meanwhile, the downturn in the *Eurozone* deepened, with the M-PMI sinking from 46.0 in October to 45.2 in November, near September's nine-month low of 45.0. Germany, France, and Italy contracted at the steepest rates among all the countries in the survey, in that order. Three of the five *PMI sub-indexes* were at levels consistent with expansion, with both output and new orders posting modest growth and average vendor lead times lengthening; employment and purchase of stocks were drags on the overall index. *Incoming new business* rose for the first time in five months, though only slightly. Price pressures increased in November, posting mild pick-ups in both *input* and *selling prices*—reflecting "supply chain stresses, as average vendor performance deteriorated for the sixth month in a row," according to the report.

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