Equity Valuations in Volatile Markets

Notwithstanding recent volatility, a check on long-term fundamentals shows some support for current valuations.

Featured Manager

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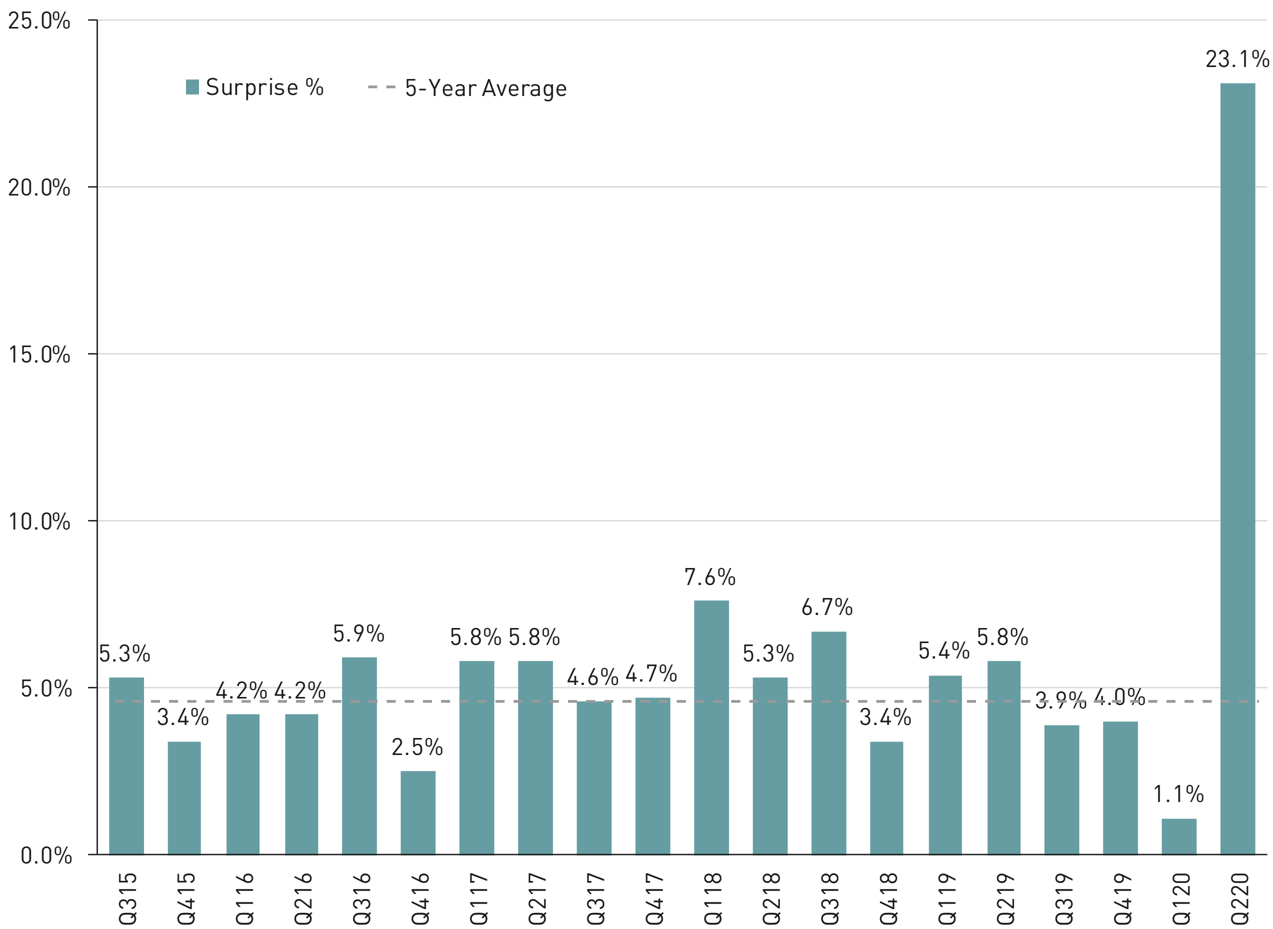
Figure 1. The Size of Earnings Surprises Soared in the 2020 Second Quarter
S&P 500 earnings surprises, Q3 2015–Q2 2020



Source: FactSet. Data as of September 3, 2020. **Earnings surprise** measures the percentage of companies reporting actual earnings per share above analyst estimates.
The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. Due to market volatility, the market may not perform in a similar manner in the future. **Past performance is not a reliable indicator or guarantee of future results.**

EQUITY VALUATIONS

With the S&P 500® Index up sharply since bottoming on March 23, some investors have begun to wonder if the U.S. market has become overvalued and is due for a correction. (Indeed, a bout of renewed volatility that began on September 3 may indicate some growing trepidation.) In addition, a number of observers believe corporate earnings may not soon fully recover, given the continuing effect of the pandemic on economic activity.

We believe these concerns need to be placed into context. Here, we examine three factors which suggest that this market may still be on solid footing, incorporating insights from Lord Abbett Partner and Director of Strategic Asset Allocation Giulio Martini.

Reason 1: The Market May Be Looking Beyond Current Earnings

As of August 25, the forward price-to-earnings (P/E) ratio on the S&P 500 had reached 21.9, its highest level since the tech boom in the late 1990s. But investors may be viewing recent weakness in earnings as temporary and instead valuing stocks on the basis of *normalized earnings*, which attempt to smooth out the effects of cyclicality by using estimates based on a statistical filter whose fit, we believe happens to be extremely robust,. This matters because the U.S. market seems quite pricey when valued on the basis of near-term earnings expectations but is not pricey at all, in our view, when compared to estimated normalized earnings. Figure 2 shows that, based on the latter, the P/E ratio is far below the peak reached in the height of the tech boom.

Figure 2. In Relation to Normalized Earnings, Stocks Do Not Appear Expensive

Price-to-normalized earnings ratio for the S&P 500 (monthly), June 1955–August 2020

Source: Bloomberg. Data as of September 3, 2020. Normalized earnings per share are calculated using a 10-year average of trailing-four-quarter earnings per share.

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IN VOLATILE MARKETS

Reason 2: Earnings Weakness Has Been Narrow, Suggesting a Quick Recovery Is Likely

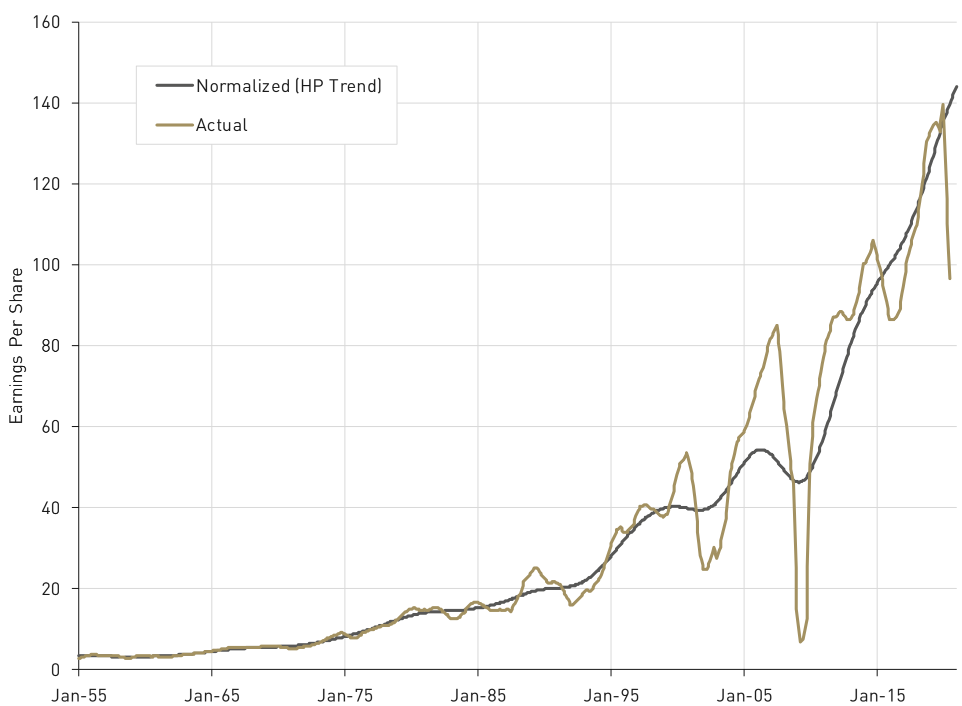
While overall earnings are currently depressed, we see only modest setbacks among most companies. More than three-quarters of the earnings decline in the S&P 500 has been due to losses in airlines and travel-related sectors, in the banking industry, and in the energy sector. Airlines and travel-related companies, more than most others, have borne the brunt of pandemic-related shutdowns, while banks have been hurt by having to provision for potential future losses. In the energy sector, companies continue to struggle with low prices due to low demand attributable to the pandemic. In short, once the economy overcomes the effects of the COVID-19 virus, either through the development of a vaccine and effective therapeutic treatments or through adaptations such as tactics employed by countries that have successfully contained viral spread, earnings have the potential to bounce back to the previous trend.

The rest of the economy accounts for just under a quarter of the corporate earnings decline. In those industries, companies have managed to maintain earnings surprisingly well considering the magnitude of the downturn in GDP by cutting working capital, curtailing capital spending, and reducing labor costs. Thus, while second-quarter gross domestic product (GDP) plunged about 32% on an annualized basis, there has not yet been any appreciable damage to long-term earnings power.

This suggests that although current earnings are depressed, the potential for a bounce-back is probably greater than appreciated. A similar narrow decline in earnings occurred after the 2008–09 Global Financial Crisis (GFC), and earnings rapidly returned to, and even exceeded, the normalized level. In part, this was because the concentration of losses in the financial sector was even greater during the GFC because regulators imposed draconian provisioning requirements on banks.

Figure 3. With Losses Confined to a Few Sectors, U.S. Corporate Earnings Could Bounce Back Quickly

Actual and normalized earnings for the S&P 500 index (monthly), June 1955–August 2020



Source: Bloomberg. Data as of September 3, 2020. Normalized earnings per share are calculated using a 10-year average of trailing-four-quarter earnings per share.

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Another factor working in favor of a quick recovery is U.S. labor productivity. Unlike during most previous economic downturns, productivity growth accelerated in the first and second quarters of 2020. Thus, whereas companies usually hoard labor during downturns in order to get a leg up when the economy recovers, that didn't happen this time around. This would help explain a more rapid and sharper recovery than usual in employment if that continues to play out. It also helps explain why earnings and margins held up much better than expected in the second quarter.

Reason 3: U.S. Earnings Are Recovering More Quickly than those in Other Markets

As of August 28, 98% of the companies in the S&P 500 had reported earnings for the second quarter, according to FactSet, and of these, 84% beat the mean earnings estimate. This is significantly higher than the five-year trailing average of 72%.

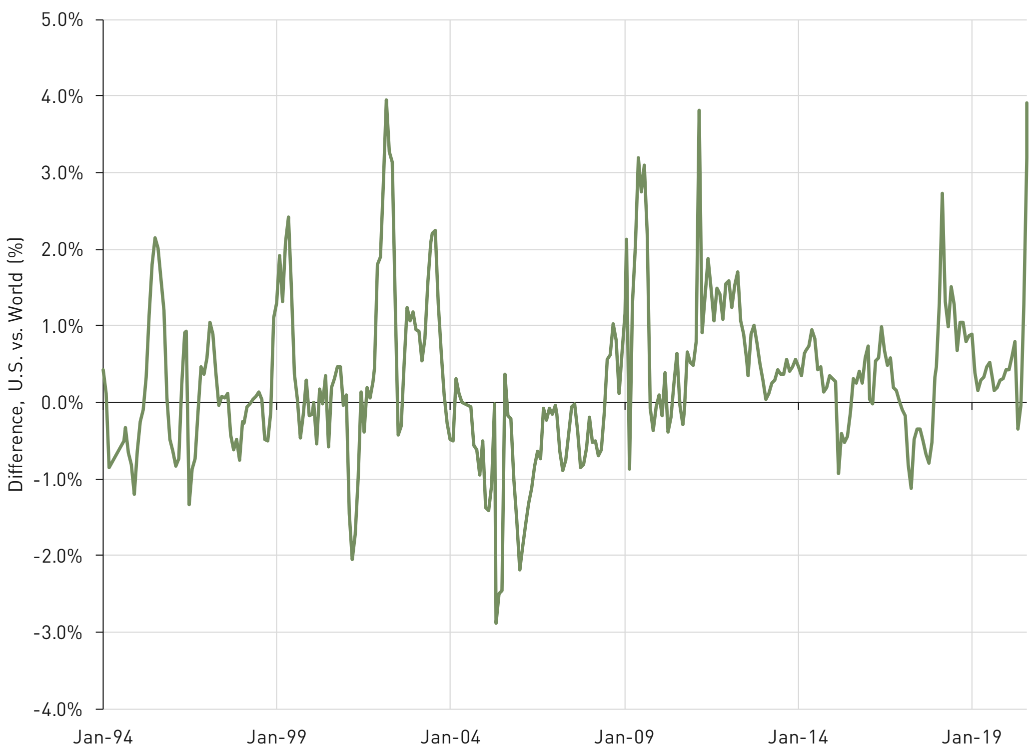
In fact, this was the highest percentage for a quarter since FactSet began tracking the data in the third quarter of 2008. Among sectors, Information Technology (94%), Materials (93%), Health Care (92%), and Industrials (92%) had the most companies beating estimates.

Altogether, second-quarter reported earnings on the S&P 500 were 23.1% above expectations, far above the trailing five-year average of 4.7%. (See Figure 1 on the first page.) Sectors with the biggest earnings beats were Consumer Discretionary (542.6%) and Industrials (78.9%). (FactSet notes that second-quarter earnings estimates had been lowered significantly prior to the second-quarter earnings season.)

These results have contributed to *earnings momentum*. This measure of the magnitude of analyst revisions to earnings estimates also suggests continued strength for U.S. equity markets versus those in other countries. Based on the three-month moving average of revisions to the consensus earnings estimates, earnings momentum for U.S. companies is greater than that occurring in the rest of the world. In our view, this may be a potential justification for at least a portion of the wide valuation premium that is currently being accorded to U.S. stocks.

Figure 4. U.S. Earnings Momentum Exceeds that in Other Markets

U.S. earnings momentum (current fiscal year) versus world equities, January 1994–August 2020



Source: FactSet. Data as of September 3, 2020. Earnings momentum measures of the magnitude of analyst revisions to earnings estimates.

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Summing Up

While recent headlines suggest that U.S. equities markets are overvalued, a closer look indicates that may be a bit of an exaggeration. Investors appear to be viewing the second quarter's earnings decline as temporary. In fact, with most losses confined to certain industries, the narrow nature of the decline suggests that a rebound could happen quickly, much as it did after the GFC. In addition, the number of second-quarter earnings reports that exceeded expectations and the size of the earnings beat (albeit off a reduced base) have led analysts to raise their expectations for 2021. Finally, earnings momentum, and the magnitude of analyst earnings revisions, is outpacing that in other markets, suggesting that higher valuations on U.S. equities are merited.

The forward **P/E ratio** is a current stock's price over its "predicted" earnings per share.

The **S&P 500® Index** is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.