M1 CAPITAL
INVESTMENT MANAGEMENT

Is a 65x PE Multiple Really Too High? – Commentary October 2021

October was a strong month with global markets recovering from the negative returns seen in September. Across markets the trends for the year-to-date were maintained – Emerging Markets once again underperformed Developed Markets – 1.0% vs 5.7%, South Africa outperformed Emerging Markets – 4.1% in USD terms vs 1.0% for EMs - but underperformed Developed Markets slightly. Globally, Value underperformed Growth, at 4.5% vs 6.7%, though both saw good positive returns, and the US provided the strongest returns – 7.0% and 7.9% for the S&P 500 and the Nasdaq respectively, with the Nasdaq marginally outperforming.

These various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for October 2021**

	Oct-21	YTD 2021
FTSE/JSE ALSI (ZAR)	5.2%	18.0%
FTSE/JSE ALSI (USD)	4.1%	14.1%
MSCI World	5.7%	19.4%
MSCI EM	1.0%	-0.3%
MSCI Value	4.5%	18.9%
MSCI Growth	6.7%	19.6%
S&P 500	7.0%	23.6%
Nasdaq 100	7.9%	23.7%

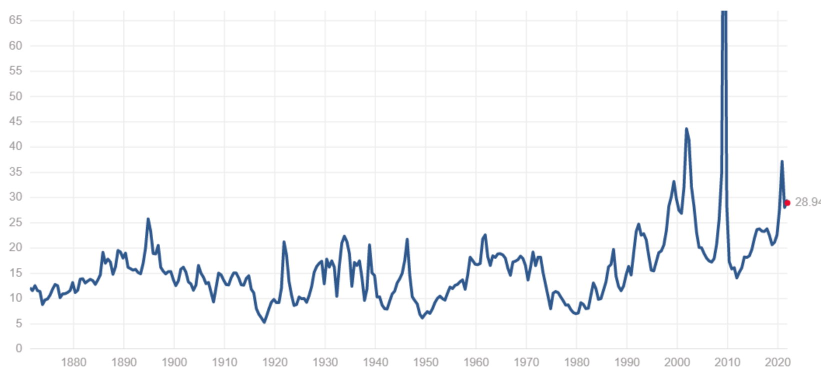
*Total return indices, Source: Factset

Frequently heard commentary about global equity markets, and especially US markets, is that "markets are over-valued" or "valuations are high". Occasionally there is commentary about a new bubble. This month we consider valuations in the US equity market and discuss whether these make sense, or whether values are higher than they should be, and, sooner or later, destined for a correction.

Equity Market PEs

A commonly-used measure of valuation is the PE multiple – a measure of price over historical or forward earnings. Chart 1 below presents the PE of the S&P 500 over 150 years, since 1870.

Chart 1. PE Multiple of the S&P 500 from 1880 to 2021



Source: www.multpl.com

The current PE of 28.9 is evidently high by historical standards. PEs in general, since the year 2000, are also on average higher than at any time in recorded history.

Valuations of US Tech shares are even higher. At the time of writing, the Nasdaq is at 33.9. Some popular constituents include Amazon with a PE of 68.5, Netflix at 60.0, and Nvidia at 97.2.

All Things Relative

At first glance the above numbers are eye-watering. In absolute and historical terms, they are all undoubtedly high. What to make of them?

While high absolute multiples by themselves make for dramatic commentary, valuation metrics in investments are often not a matter of absolute quantities. The PE can be mathematically shown to be a function of an expected growth rate and a discount rate. As the expected growth rate rises and/or the assumed interest (discount) rate declines, so the PE multiple rises, and vice versa. It is the discount rate which is the source of the current high absolute values.

The same commentators who reference high PEs and the threat of a market decline, hardly ever mention interest rates. Specifically, the benchmark interest rate used in financial markets is the US Treasury yield. This has shown consistent decline for the last 40 years. Chart 2 below presents the 10-year Treasury yield for the same 150-year period, since 1870, where the consistent decline since 1980 is evident.

Chart 2. PE Multiple of the S&P 500 from 1880 to 2021

Source: www.multpl.com

One can obtain consistency between the equity PE and the Treasury yield by inverting the PE, or alternatively inverting the Treasury yield. If we invert the Treasury yield of 1.48% per Chart 2 above, we obtain 1/1.48% = 67.6 or a "PE" of 67.6 i.e. a benchmark asset with a fixed income stream and no growth in income, returning 1.48% p.a., therefore, comes at an approximate price of 67.6x the income.

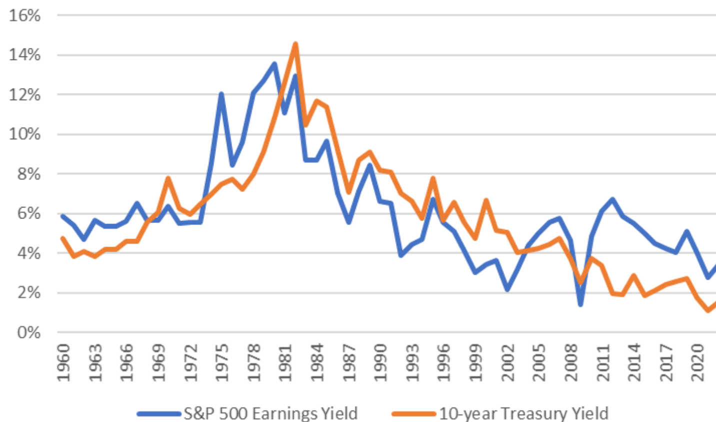
What are the Alternatives?

If one is a US, or a USD-based, investor, what investment options are available and what are the expected returns? There is cash or short-term fixed interest which is effectively at 0% p.a. If the investor wishes to commit capital for 10 years, and assuming no change in yields, the expected return would be the afore-mentioned 1.48% p.a. on US Treasuries. Which brings us to equities. The secure government fixed income asset trades at 67x PE. A large well-established Tech company such as Amazon, for comparison, trades at 69x earnings, or a comparative earnings yield of 1.45% p.a. Except Amazon is not likely to go bankrupt anytime soon (though still subject to recession or other company-specific risks), and has grown revenues at 29% p.a. over the last 5 years, and profits at an average of 131% p.a. So you get security and substantial growth for a similar price. Small wonder

valuations are where they are. There may even be an argument that Amazon should be more expensive than it is …

Extending the argument, consider the earnings yield (reverse of the PE) of the S&P 500 versus the 10-year Treasury yield since 1960 in Chart 3 below.

Chart 3. S&P 500 Earnings Yield vs 10-year Treasury Yield Since 1960



Source: www.multpl.com

The long term perspective of Chart 3 above suggests that equity valuations as measured by earnings yield, or PE, are strongly cognisant of long term interest rates.

Are We in a bubble?

Financial markets over the last 2 years have undoubtedly gained support from the substantial monetary stimulus during the virus crisis. Notwithstanding, however, it would appear current equity valuations (and Tech valuations in particular) are far more likely due to the prevailing interest structure rather than any sort of speculative bubble.

What if Interest Rates Rise?

Increasing rates implies a change in valuations – the earnings yield rises, or the PE declines. This change in interest rate structure will negatively impact all assets. The relative impact in different sub-sectors of the equity market might, however, be different. Amazon at 69x earnings is classified as a growth stock – faster-growing and relatively higher priced. Anheuser-Busch, a global beer company, might be classified as a Value share – facing declines in both revenue and profits and at a PE of 21, or an earnings yield of 4.8%, its price low enough to generate an attractive return on conservative expectations. It is thought that Growth shares might be more impacted due to a greater share of their profits to materialise in the future i.e. what in more technical language is called longer duration, or discounted mean term.

While the above remains correct in theory, two weeks ago the second most senior Fed official suggested monetary policy might be tighter due to inflation concerns. Rates promptly declined, and Tech shares, amongst others, climbed. So the prospect of tighter monetary policy strengthened valuations. In a further turn of events, fears of the latest Omicron variant also returned the 2020 dynamic of strong Tech shares and declining Treasury yields. As usual, forecasting macroeconomic developments is a difficult business.