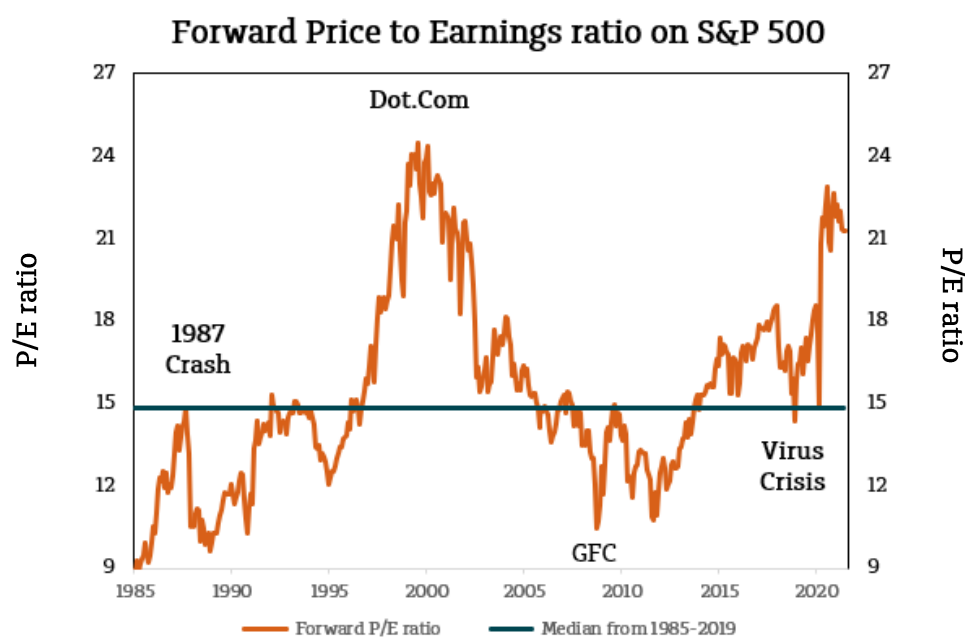


Chart of the week

Flying high on Wall Street

Bob Cunneen, Senior Economist
29 July 2021



Source: Refinitiv for IBES (Institutional Brokers Estimate System) Forward Price to Earnings ratio.

Wall Street's S&P 500 share index is trading around record highs. The S&P 500 has nearly doubled in price terms since its recent low in March 2020. Driving this share price surge has been a number of positive factors. A recent report from the US Federal Reserve (Fed) highlighted that the "strong corporate earnings, optimism about the pace of vaccinations, additional fiscal stimulus, and signs of a faster pace of economic recovery outweighed concerns about high valuations (and) higher inflation"¹.

The "strong corporate earnings" factor has been the key tailwind supporting US shares. US corporate profits are expected to rise by 35% this year and a further 10% next year². Yet the Fed noted that even with this profit tailwind, there are "concerns about high valuations". The Fed highlighted with the above chart that the "ratio of (share) prices to forecasts of earnings remains high relative to its historical distribution". US shares currently have a Forward Price to Earnings (P/E) ratio of 21.3 (orange line) which is high compared to the historical median of 14.8 from 1985–2019 (aqua line). Indeed current high valuations are similar to the elevated levels back in March 2000 just before the 'Dot.Com' technology era imploded and US shares fell sharply for the next three years.

Essentially Wall Street is priced for perfection. The potential for rising interest rates and labour costs as the US economy strengthens suggest that corporate earnings growth could face considerable headwinds over coming years. So while US shares are currently 'flying high', investors need to be mindful of the eventual gravitational effects on valuations.

¹ 'Monetary Policy Report - July 2021' (page 30), US Federal Reserve.

² 'Earnings Insight', FactSet, 23 July 2021.

Important information

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