# **Investment Focus:** S&P Valuation - A year on from Covid-19

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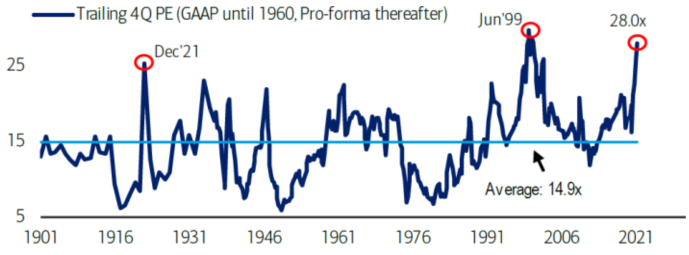
It has certainly been a wild 12 months, so where are we now from a valuation perspective 12 months on, with vaccines been rolled out through the world.

Just over 12 months ago the S&P on trailing PE was certainly expensive and earnings had reached new highs. Now of course trailing earnings are much lower, but the trailing multiple is the 2nd highest on record.

**Figure 1: US trailing PE**

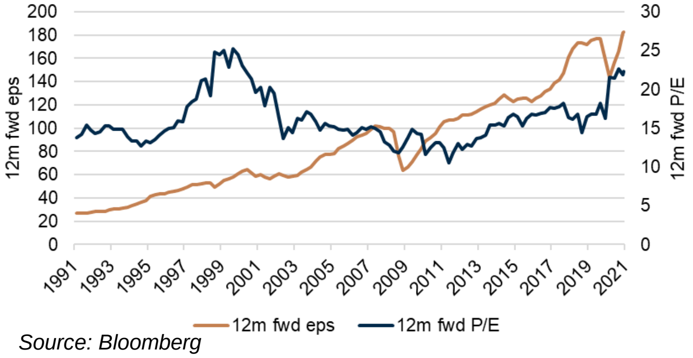



*Source: BofA Global Research*

Of course trailing PE has a very poor record of predicating 12 month returns and that is putting it too kindly. Compared to other techniques it is probably the last indicator one should look at for a 12 month prediction. The simple explanation is that by using trailing PE one is saying the last 12 months explains the future trajectory of earnings. Stated in that way, the flaw of using trailing PE becomes apparent.

The next valuation chart that is a bit more common is the one showing 12-month forward PE. The graph below shows the 12-month EPS line vs. 12-month PE.

**Figure 2: S&P 12-month forward EPS vs. P/E**



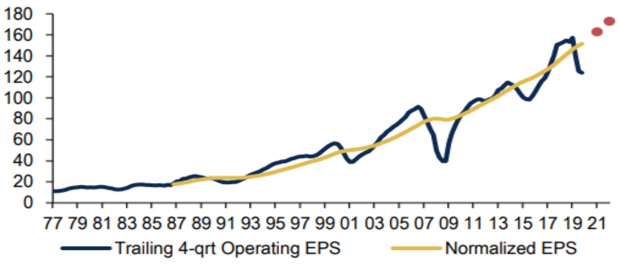

*Source: Bloomberg*

As the world entered the Covid-19 pandemic the 12-month forward PE was 18 (the highest since the 1999 – 2000 Nasdaq bubble) and EPS had reached a new high. In some ways 12-month forward PE is like using a bad torch vs. a candle. It's better than trailing PE but not by much. Back tests show that 12-month forward PE has very low predictive powers over a one year period.

The same problem affects 12-month forward PE, namely we are using one discreet 12-month period of earnings to predict the future of earnings. In June of 2020, the forecasts were for the next 12 months of earnings to be 12% lower than where it had been in February 2020. Of course, now forward earnings are at an all-time high again.

So what does have predictive power for the index? Well, it turns out that the best over a 12-month period happens to be sentiment indicators. But what if we wanted to use a valuation technique? Unfortunately, no valuation technique works over a 12 month period. However, certain valuation methodologies are very good at predicting future returns over a longer period. The best in that category is to normalize the earnings by using a trend line to fit the history. This takes out the cyclicality and shocks such as COVID-19.

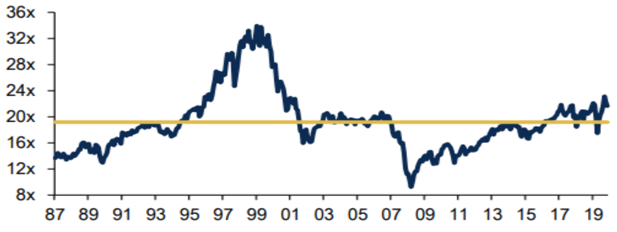
**Figure 3: : S&P 500 Operating and Normalised Earnings**




*Source: BofA Global Research*

If we then put a multiple on that then we get a more useful graph.

**Figure 4: : S&P 500 Normalised P/E Ratio**




*Source: BofA Global Research*

This technique is using a trend line to smooth out the historical cyclicality and then assuming that the future earnings delivered grow at historical trend.

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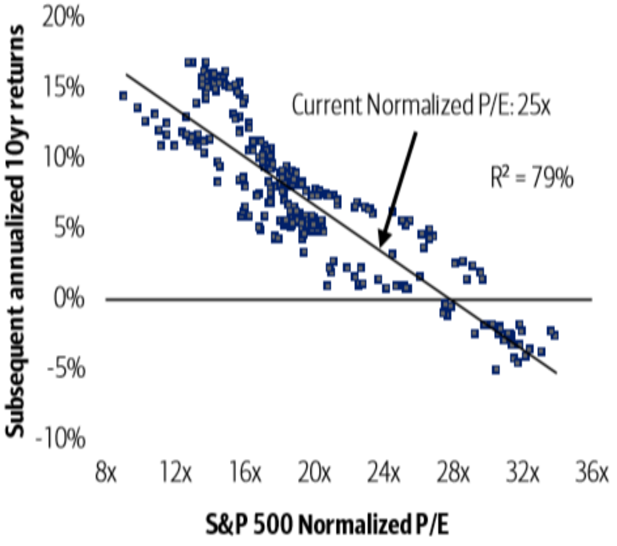
Do we suggest using this for a 12-month view? Actually no, but it does explain 60 % of the S&P return 8 years out and 75% of 10 year returns. Currently this measure is forecasting very low returns for the next 10 years. In the order of 3% to 4% per annum.

**Figure 5: : S&P 500 Normalised P/E vs. subsequent annualised returns (since 1987)**




*Source: BofA Global Research*

So all of them do say that the S&P is expensive, just don't expect that to matter in the short term. And if you are looking for a good valuation technique then stay away from trailing and 12 month forward based techniques and use a trend-based valuation.

One final caution is that the USA trend earnings have been in the 7% p.a. region. Other countries haven't done that. Noticeably Europe has struggled since the GFC and at some point, the USA will too start to grow below trend on a permanent basis. Of course trying to forecast that is the million dollar question.