Global Equity Perspective

Midyear 2024

Trees don’t grow to the sky

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Key points

- **AI has propelled a “magnificent few” to trade at extremely rich valuation multiples, leaving all the rest at much more reasonable valuations.**
- **But they may not be as inexpensive as they appear as heavy investment in AI looks to become a costly price of staying competitive for almost all businesses without any certainty of a profitability payoff.**
- **A soaring S&P 500 price-to-earnings multiple by itself won’t define the limits of the market advance, in our view. But when combined with optimistic/complacent investor sentiment readings and interest rates that are almost double what they averaged in the pre-pandemic decade, a cautious, watchful approach is called for.**

Coming out of the global financial crisis in mid-2009, the U.S. economy was embarking on what turned out to be the longest uninterrupted economic expansion in the country’s history, accompanied by the longest-ever equity bull market. But you might have never known that if you read or watched the financial news outlets. Pundits, investors, and bloggers mostly viewed the roughly 11-year-long advance of the economy, earnings, and stock market with scepticism and trepidation.

Worried and concerned at 15x–18x in the post-financial crisis decade

They worried that the systemic weaknesses revealed first in the global financial crisis followed by the European sovereign debt crisis had not been adequately dealt with. Many fully expected these to re-emerge with potentially disastrous consequences for financial markets. Stock market valuations did not reflect these elevated risks, in their opinion.

The price-to-earnings (P/E) ratio for the bellwether S&P 500 Index ranged mostly between 15x and 18x over that long stretch. Those observers consistently referred to the market as “expensive,” “richly valued,” “priced for perfection,” or “dangerously ahead of itself.”

Fast forward through the pandemic convulsions to today and we find the S&P 500 trading at 24x consensus earnings expectations for this

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All values in U.S. dollars and priced as of market close, June 21, 2024 unless otherwise stated.
Produced: June 26, 2024 16:10 ET; Disseminated: June 26, 2024 17:00 ET;

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year. A P/E ratio of 20x has always been regarded by investors as the line beyond which the market was "overvalued" or "living on borrowed time." And with good reason: the market has rarely traded beyond that level. But now it is.

Calm and confident at 24x today

However, in our opinion, despite today's much higher P/E multiple, the degree of valuation concern expressed by investors and commentators alike has become unusually subdued. It is certainly running at a much lower pitch and volume than during much of the previous decade when the S&P 500 was mostly six to eight multiples cheaper.

The contrast between P/Es in 2012–2019 and where we find them today in 2024 is even starker when interest rates are factored in. The 10-year Treasury yield averaged roughly 2.3% through most of the pre-pandemic decade. Today it's closer to 4.3%. Higher bond yields would normally lead to a lower P/E multiple for the market; instead, we have a markedly higher P/E.

What seems to be lulling investors into a complacent acceptance of today's elevated valuations is the much-discussed idea that P/Es are only high because of the outsized impact of a small, very select group of extravagantly priced mega-cap tech and tech-related stocks, which are seen to be the clearly dominant beneficiaries of fast-emerging developments in artificial intelligence (AI). When the so-called Magnificent 7 (Apple, Amazon, Alphabet/Google, META, Microsoft, NVIDIA, and Tesla) are taken out of the calculation, what remains—the S&P 493 they have been dubbed—are trading at a seemingly more benign 18.4x earnings. (Foreign markets—Canada's S&P/TSX, MSCI UK, and MSCI Europe—are even cheaper nearer 16x.) But 18x earnings was regarded as fully valued back in the pre-pandemic, much-lower-interest-rate world.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	=
United Kingdom	–
Asia (ex Japan)	=
Japan	+

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

AI A-OK?

What's more, if AI turns out to have as dramatic an effect on business and the economy as many expect, then the magnificent few and some others like them might well go on reaping outsized benefits for some time yet. But, in fact, every business will have to spend heavily on AI just to stay competitive within their sector, which might mean little to no improvement in profitability despite the heavy investment. And there will be some businesses that will be unable to keep up in this expensive race and suffer an outright decline in fortunes.

So, 18x earnings may not be such a benign valuation after all for a group of businesses in a world where competitive risks have risen dramatically with the advent of AI and where interest rates have almost doubled.

Not so fast

The way to reconcile this constructively would be to have earnings grow fast enough to offset the heavier drag of higher interest rates. However, faster profit growth would normally require faster GDP growth. Some think that is what AI will make possible. However, not everyone agrees. The Congressional Budget Office (CBO), a non-partisan agency, regularly prepares long-term forecasts of the U.S. economy for the U.S. Congress. Its latest, published in March, sees real GDP growth settling

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on either side of 2.0% for the coming 10 years and slowing to 1.6% after that.

Presumably, the CBO economists are just as aware of the emergence of AI as everybody else and perhaps more informed as to its potential to produce faster GDP growth. Their expectations appear underwhelming to us.

So, faced with the possibility AI won't ride to the rescue, we are left with P/Es ranging between uncomfortably high at 24x for the S&P 500 and fully valued at 18x for the underpowered S&P 493. What does that tell us about equity market prospects from here?

Higher but …

In the near term, the next six to 12 months say, the answer is "not very much." We see no useful correlation between the P/E ratio on a given day and the S&P 500's return over the following year. Very high P/Es can get even higher. In fact, we think that is the most likely path immediately ahead. But in an environment where most investors appear confident, even complacent, about the prospect of future market gains, we believe the most revealing market statistic to watch is "breadth"—are the majority of stocks moving in the same direction as the broad index?

Through all this upward move since the AI stocks took control, the breadth readings for the S&P 500 have been positive. While the Magnificent 7 have accounted by far for most of the value added to the index, the majority of stocks were also moving higher. If that remains the case, we believe this advance has further to run.

… trees don't grow to the sky

Longer term, unusually high market P/E ratios typically point to below-average equity returns measured over the following decade. The fact that the excessive market multiples are attributable to one overwrought sector or a handful of heavyweight favorites has not tended to mitigate that outcome.

Investors have had to contend with substantially overweighted high-fliers in the past, such as the "Nifty Fifty" in the early 1970s, the energy and commodity stocks in the late 1970s, the tech sector leading up to the "tech wreck," and the financials heading into the global financial crisis. Not just the overvalued leaders but the majority of other stocks also suffered when the tide eventually turned.

We don't believe markets are finished moving higher. But thinking about risk appetite and having a plan for becoming more defensive when conditions dictate are things to contemplate in the coming months. We believe stocks are no longer compellingly valued and investor sentiment is increasingly complacent. The combination argues for a cautious, watchful approach on the part of investors.

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