Market Update

December 2024

Important Topic: Is the market over valued?

Valuation metrics, like the price-to-earnings (P/E) ratio, help us gauge whether the stock market (or a specific stock) is cheap or expensive relative to history.

While one metric is never sufficient to capture the complexity of the market, there is value in understanding the P/E Ratio.

The price earnings ratio is simply the current price (P) divided by the current earnings (E). This reflects the price one is paying for every dollar of earnings. If the price is $36 and the earnings are $2 that year, the price earnings ratio is 18 ($36/$2).

Historically, current P/E ratios have averaged 16-18x. When investors are encouraged, and optimistic, market price to earnings can rise to 22-26. When investors are disappointed, and pessimistic, the ratio can fall to 8-12.

These are, of course, generalizations. There are many times when higher P/E ratios are justified by external factors such as lower interest rates, lower commodity prices, better economic backdrops, etc. There are also times when higher ratios are justified by company specific events such as a blockbuster new product, extraordinary growth, a specific new hire, an acquisition etc. Therefore, while P/E ratios serve as a useful guide, they are just that.

Investors become fearful when the P/E ratio gets stretched higher. A higher P/E is taken as a sign that investors are expecting higher earnings. And as long as the earnings prove to be higher, the price will be proven to be fair. But if earnings falter, such investments can fall far and quickly. Therefore, higher P/E ratios are viewed as higher risk as the future success of any business is rarely if ever assured.

Conversely, investors are more confident buyers when P/Es become low. A low P/E is taken as a sign that investors are expecting low earnings. As long as the earnings prove to be poor, the price was fair. But if earnings rise, such investments can rise far and quickly. Therefore, lower P/E ratios are viewed as lower risk. Such investments can be great bargains.

The market determines Price by combining the earnings and the multiples (P/E Ratios). At any time, a prudent investor must consider the direction of earnings and the multiple.

The best outcome is when both the earnings and the P/E ratio are increasing. The worst outcome is when both are falling.

When one wonders how can the stock market keep going up in 2025? The answer is that the earnings of the companies, and the future earnings expectations, are increasing. Such increases have resulted in higher prices even as the P/E ratios have fallen.

The chart below, from our friend Matt Cerminaro at Ritholtz Wealth Management, and who has allowed us to use it for our monthly letter, clearly shows this.

The chart shows that in 2020 the US Market (S&P500) was at 3,581 points and the price earnings ratio was 24.1 times earnings. This means that earnings for the index was $4.15 for every $100 of price ($100/24.1x).

By November 2024, the market was at 6,002 and the price earnings ratio was 22. times earnings. This means that earnings had risen to $4.44 per $100 of price ($100/22.5).

Therefore, earnings grew almost 80% but the fall in P/E ratio of almost 7% combined to produce a 70% increase in price.

Source: The Compound Media, S&P 500 (Standard & Poor's) used for pricing data and Forward P/E Ratios are consensus estimates from Bloomberg.

Although the market increased 70% over this period , an investor is buying stocks at cheaper valuations now than in September 2020.

Adding to the optimism about the future is that the quality of the companies, the quality of the earnings and several market forces (including AI, data sciences, faster response times, efficiencies) can all justify higher P/E ratios than in the past.

Looking forward, if earnings again increase 80% over the next four years and P/E ratios again fall 7%. We would be looking at a P/E ratio of 20.9 and an S&P500 price of 10,000, a 65% gain.

This does not mean we cannot or will not fall before rising. But what it does mean is that higher P/E ratios (higher valuations) do not preclude very attractive returns over time.

We remain invested and are watch the earnings carefully.

Market Update: December 2024 – Markets Were Mixed

December proved to be a volatile month with most markets moving down with the exception of the large cap markets.

Overall, 2024 was a terrific year with most client portfolios providing 2-3x the expected average annual return. The gains are even more impressive when compared to the low expectations of most market analysts at the beginning of the year.

The key driver, as discussed above, was earnings. They continued to rise, strongly. And in 2024 the P/E ratio increased as well. This one-two punch of growing earnings and rising P/E ratios provides strong rallies, as seen in 1995 and 2016.

How long can this last? The median bull market lasts 30 months and produces a 90% gain, so by that measure we are in the 7th inning or so. Valuations are slightly elevated, with a P/E ratio of 22, but all depends on earnings.

We continue to believe that the economy will continue to push forward, likely a tad slower, but that a real recession is unlikely in the near future. Earnings continue to grow, consumers continue to defy expectations and spend, wages remain strong, jobs are available, and there are still several trends, such as technology and health care, that are stimulating much change.

We remain cautiously optimistic about the short term and positive and optimistic about the medium, and long term. Most importantly, we are confident that working together we are able to meet your, our client's, objectives. At the end of the day this is all that truly matters.

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