SECOR | ASSET MANAGEMENT

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Public Equities in Focus - Impact of Technology on Valuations

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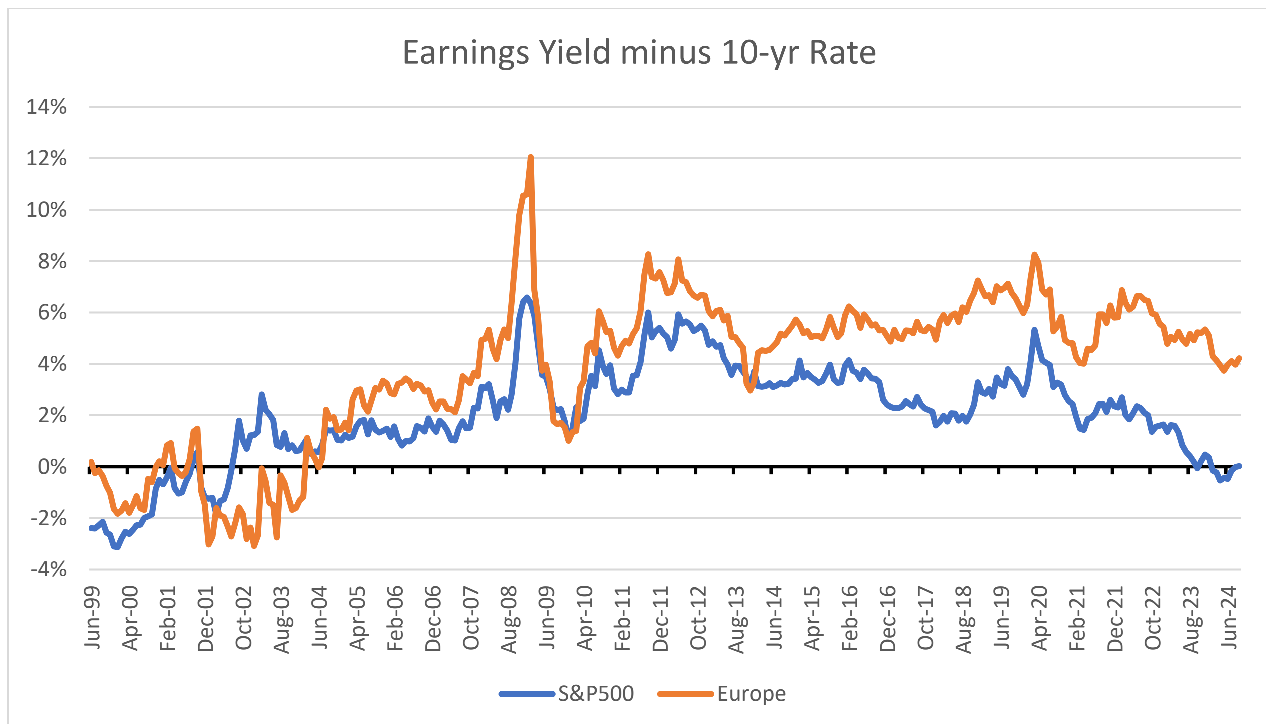
Executive Summary

Whether we examine equity or credit markets, valuations have undoubtedly reached elevated levels, particularly in the U.S. The chart below indicates that U.S. equity valuations are at highly elevated levels, particularly in comparison with current bond yields.

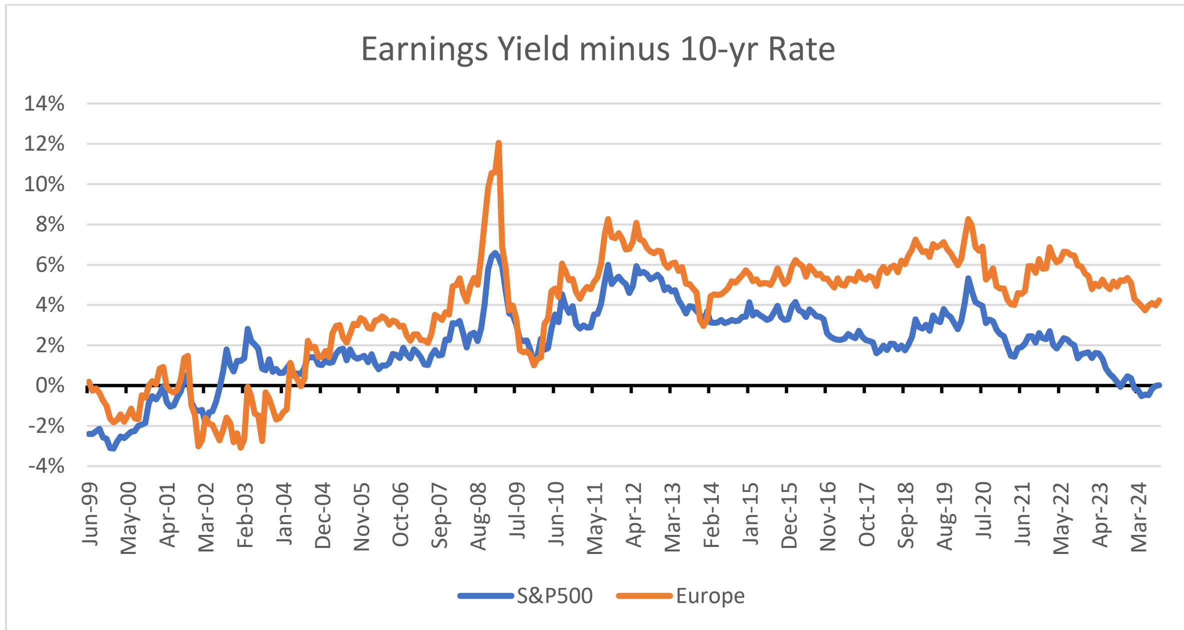


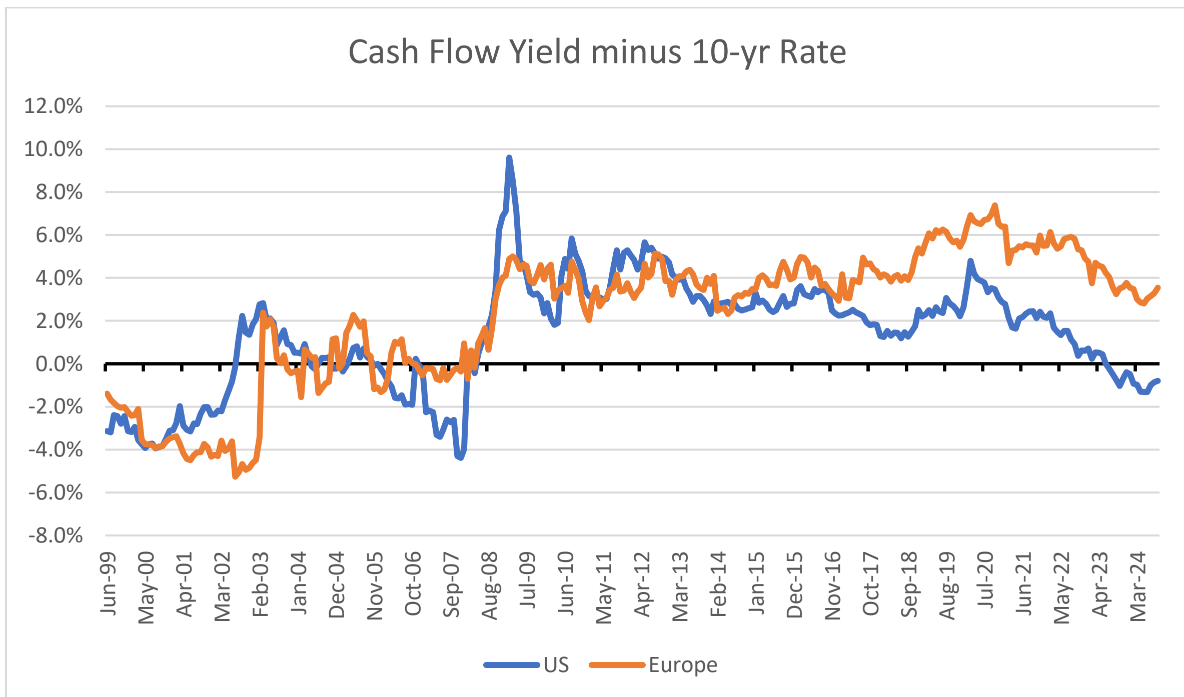
Source: Bloomberg. As of June 2024.

Although these valuation levels are high, they reflect assumptions that the current economic environment may persist and that companies may sustain strong earnings growth. Our conclusion is that environments similar to the current one are typically associated with a high dispersion of returns: if earnings expectations are met and external shocks are absent, equity returns may be strong. However, earnings disappointments or significant changes in economic conditions could lead to a substantial adjustment.

Equity Valuations

Traditional measures of equity valuations have reached very elevated levels in the US. The following two charts compare the current levels of earnings yields (EY) and cash flow yield (CFY) with bond yields.





Source: Bloomberg. As of June 2024.

Based on these metrics, the current level of equity valuations is close to peak levels historically associated with poor, or at least volatile, future returns. Reflecting this, a recent paper by Goldman Sachs argues that current valuations, coupled with high market concentration, are likely to yield lower-than-expected long-term returns. Goldman Sachs projects an annualized return of just 3% for the S&P 500 over the next 10 years:

Exhibit 1: S&P 500 annualized trailing 10-year returns: modeled vs. realized (1930-2024) and forecast (2024-34E)

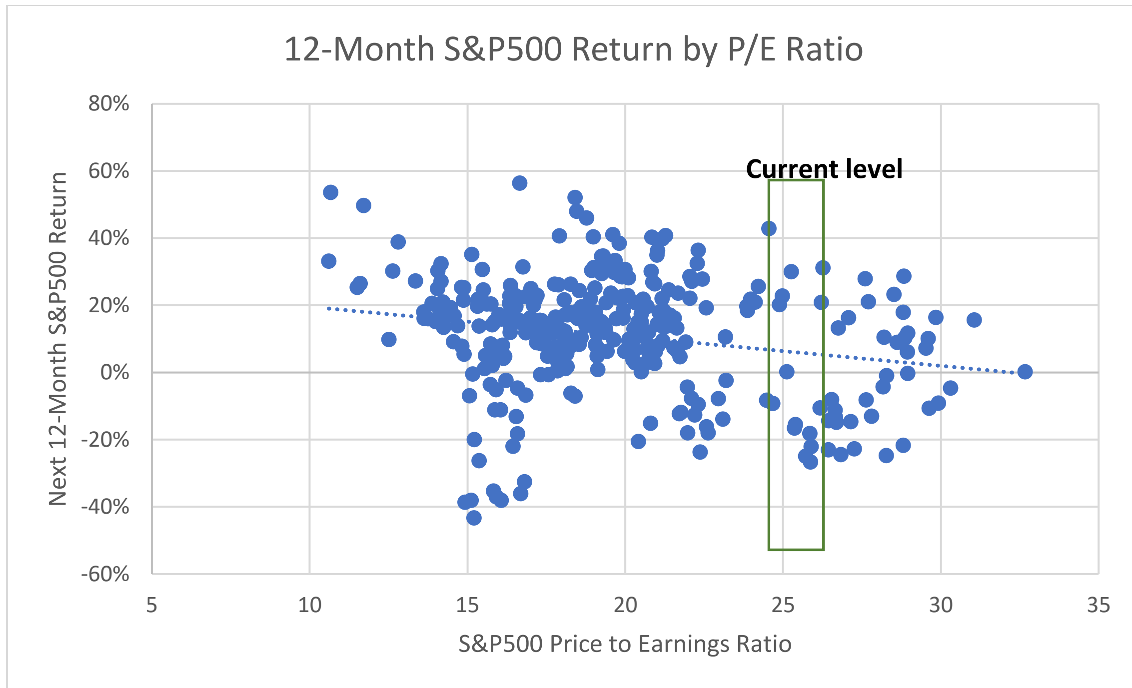
Source: Robert Shiller, Goldman Sachs Global Investment Research

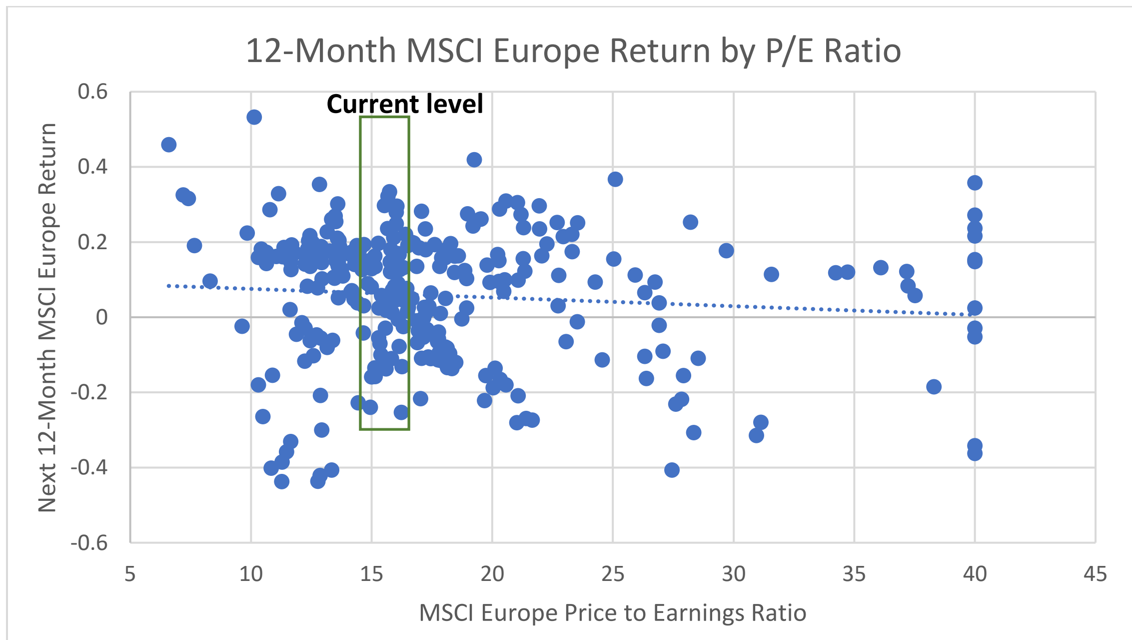
At the same time, Goldman Sachs researchers acknowledge in their paper that the analysis focuses on a long-term horizon, while returns over a cyclical horizon are more difficult to predict. Furthermore, as illustrated in the chart above, markets do not typically revert to long-term averages immediately, as demonstrated by the sustained strong returns during the 1990s.

Cyclical Outlook

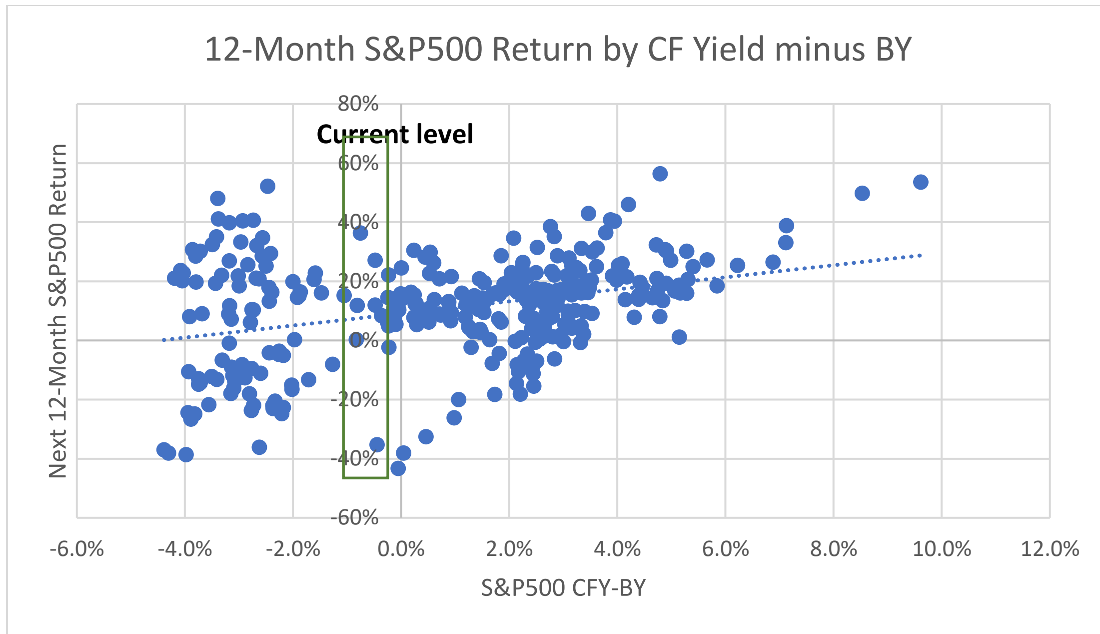
In the analysis below, we aim to examine the implications of current valuations for the upcoming 12-month horizon. Comparing valuations between the S&P 500 and MSCI Europe may also offer insights into the unique characteristics of the current environment.

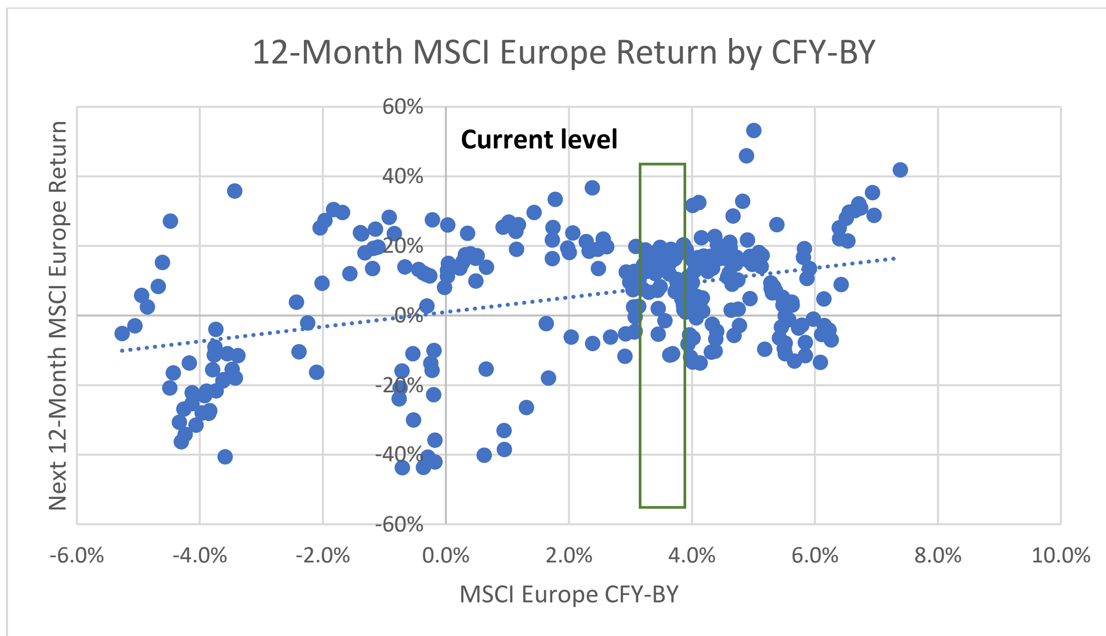
Investors use various valuation metrics, with some of the most popular being the Price-to-Earnings (P/E) ratio, the Price-to-Cash Flow (P/CF) ratio, and their inverses—Earnings Yield and Cash Flow Yield—after adjusting for the current 10-year bond yield. The charts below illustrate that, while these metrics exhibit some relationship with subsequent 12-month returns, this relationship is not particularly strong. Nonetheless, current valuation levels are historically associated with returns below the long-term averages.





Source: Bloomberg, Each dot represents a 12-months return corresponding to price-Earnings ratio. Overlapping periods with monthly frequency were used in this analysis. Time periods: US: 1996-2024; Europe: 2001-2024. To improve visualization, for MSCI Europe we forced P/E ratio to be limited to 40, i.e. all observations with values greater than 40 were assigned a value of 40. Higher than 40 P/E values appeared during the period after earnings for majority of European companies fell dramatically in the aftermath of GFC.

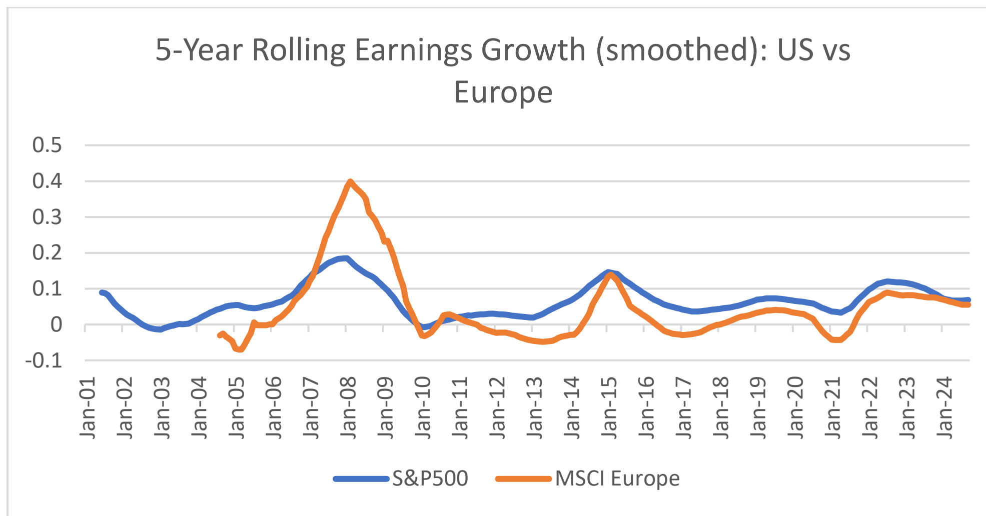




Source: Bloomberg. Each dot represents a 12-months return corresponding to price-Earnings ratio. Overlapping periods with monthly frequency were used in this analysis. Time periods: US: 1996-2024; Europe: 2001-2024

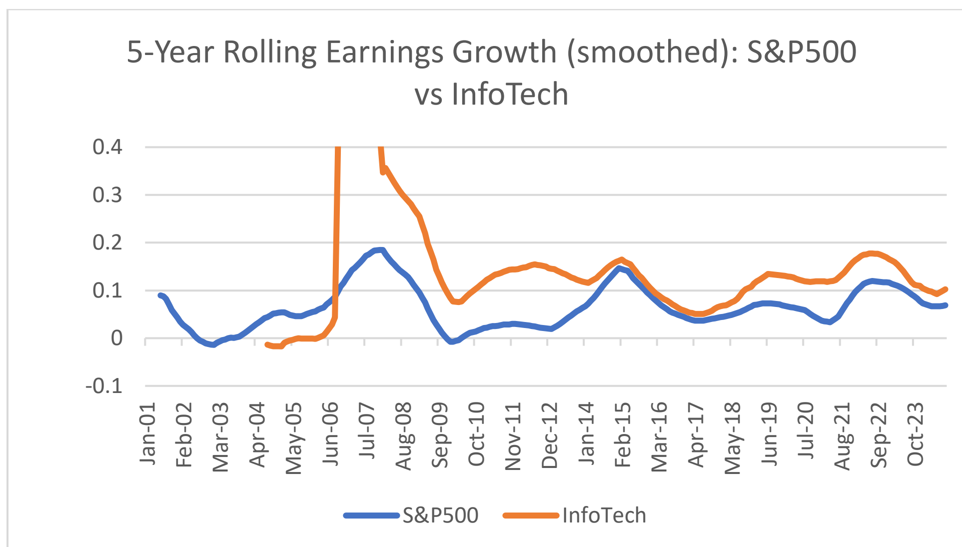
In the charts above, we selected a subset of available valuation measures, yet they all convey a similar message: current U.S. valuations are elevated, and historically, this level of valuation has been associated with below-average, though not necessarily negative, returns. Additionally, as illustrated in the charts, the present valuation levels coincide with a high dispersion of potential returns. This is to be expected; high valuations often reflect market expectations for robust earnings growth. When these high expectations are met, markets can deliver strong returns. However, the price of disappointment can be substantial.

A natural question arises: will this elevated level of valuations ultimately be justified by a higher-than-average pace of earnings growth? The chart below compares the rolling 5-year earnings growth between the S&P 500 and MSCI Europe.



Source: Bloomberg, 1996-2024; data smoothed 6 months

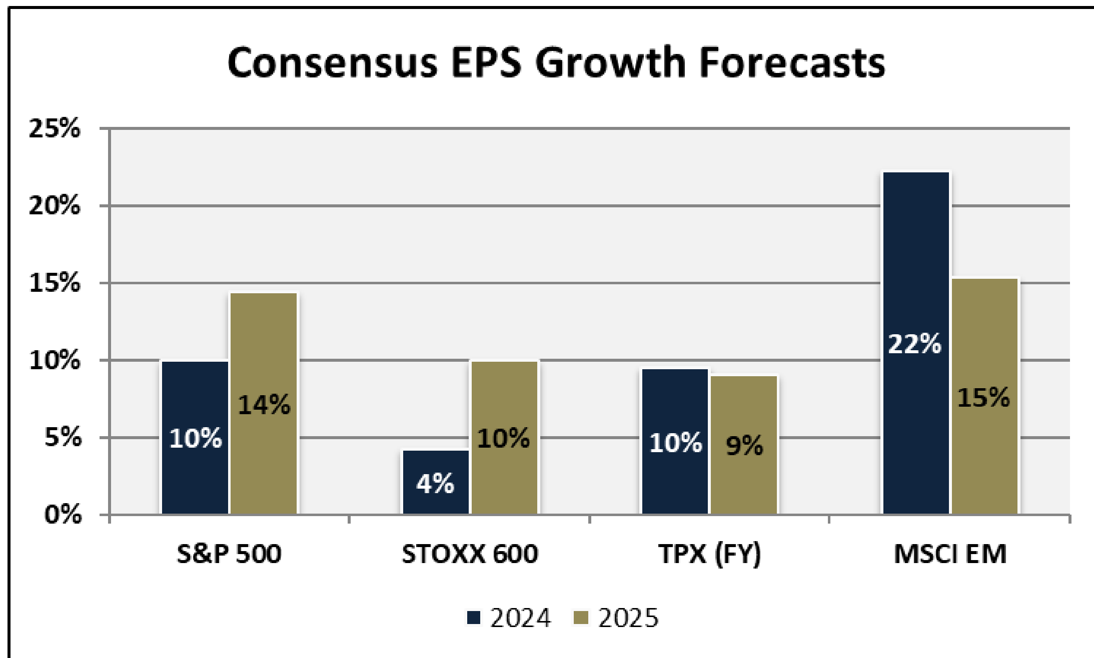
Clearly, since GFC, corporate earnings in the US have been growing at a faster rate than in Europe. The main contributor to this superior growth has been the US technology sector as illustrated in the chart below.



Source: Bloomberg, 1996-2024; data smoothed 6 months

One argument for justifying current valuations is that earnings growth in the technology sector could continue at the current pace—or even accelerate—given the recent surge in AI and other technology-related investments. While this argument has some merit, it is not yet supported by data. AI-related investments remain concentrated within a handful of companies, and the timeline for returns on these investments is still uncertain. That said, the current earnings growth forecast for 2025 aligns with an

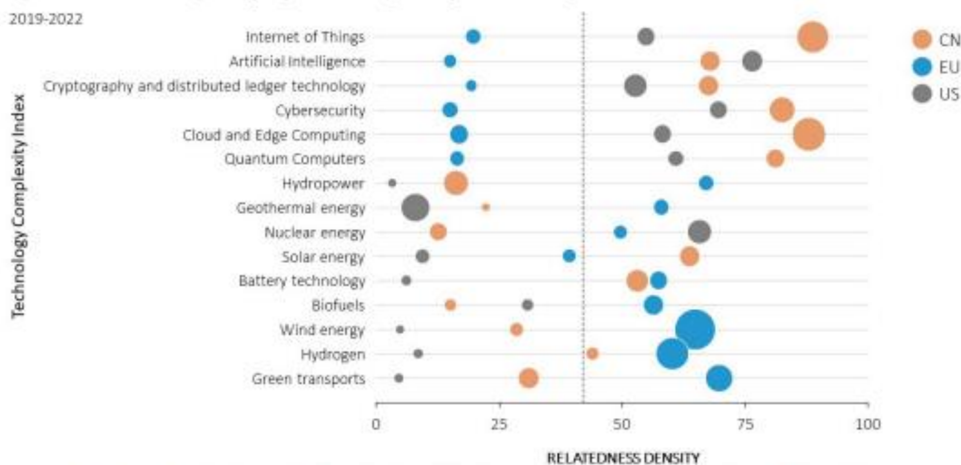
accelerated growth scenario; if companies can meet these projections, the current valuation levels may be warranted.



US-Europe Comparison

Given the significant valuation differences between U.S. and European indices, a natural question arises: is there an opportunity for a relative value trade? We believe the answer is less straightforward than the valuation gap might suggest. The U.S. holds a clear advantage in more advanced, cutting-edge technologies, as recently highlighted in a European Commission report.

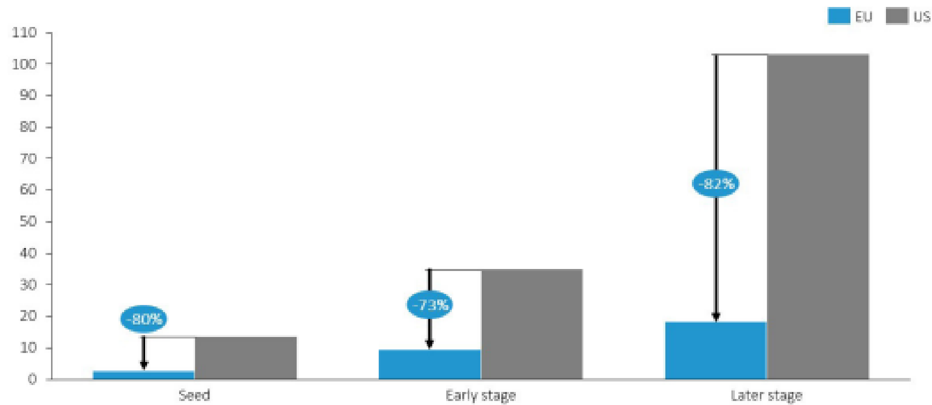
The EU's position in complex (digital and green) technologies



Notes: The results are based on an analysis of patent data to understand the complexity and potential for specialisation in different technology areas. On the y-axis, technologies are ranked according to how advanced or complex they are, with scores ranging between 0 (less complex) and 100 (more complex). The x-axis (showing the relatedness density) represents how easily a country can build comparative advantage in a particular technology, depending on how closely related it is to other technologies the country is already strong in. The size of the bubbles shows how much each country has already specialised in a technology, using a measure of "revealed comparative advantage"(RCA), which reflects their competitive strenght in that field.

Source: European Commission, DG RTD.

Furthermore, venture capital investments, which provide a pipeline of innovation for future growth are dramatically biased towards US companies:



We believe that with this backdrop, the US companies are likely to maintain their growth advantage versus the European counterparts.

Closing Thoughts

It is important to remember that equity markets do not decline solely because valuations are high. High valuations are often supported by beliefs that the future economic or business environment will drive strong earnings growth. Valuations typically adjust only when investors become disappointed—when companies fail to meet expectations for a bright future. Timing such events is notoriously challenging.

At the same time, the current elevated level of equity valuations, paired with expectations of above-average earnings growth, has historically been associated with a high dispersion of equity returns. In such an environment, investors may wish to retain exposure to equity upside while managing the risk of large losses through hedging strategies.

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