Are U.S. stocks worth the price?

From the Field
November 2023

Key Insights
- At first glance, the S&P 500 Index's elevated valuation could be concerning given the numerous headwinds facing equity markets.
- A deeper analysis reveals that a handful of mega-cap stocks in the S&P 500 Index have distorted U.S. equity valuations, but their prices may not be unreasonable.

The resilient U.S. economy has led to an improved earnings outlook for U.S. stocks, but many investors worry that valuations—represented by the forward price-to-earnings (P/E) ratio—are too expensive given the uncertainty surrounding interest rates and the economy. U.S. stock valuations seem elevated relative to historical averages and to stocks in other regions of the world (Figure 1). But a deeper analysis of the S&P 500 Index reveals that a handful of mega-cap stocks that account for a large share of the index are responsible for the high valuations. This group of stocks—which includes Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla—has become widely known as the Magnificent 7.

U.S. stocks look expensive (Fig. 1) P/E ratio of U.S. stocks relative to history and compared to other regions

As of October 23, 2023
Actual outcomes may differ materially from forward estimates.
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U.S. stocks are represented by the S&P 500 Index.

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Collectively, the Magnificent 7 hold a P/E ratio that is considerably higher on a market cap-weighted basis than the S&P 500 Index. Without these seven stocks, the P/E ratio of the index is relatively modest (Figure 2). In other words, the broader U.S. stock market does not look expensive through this lens; however, valuations for the Magnificent 7 look expensive.

Whether these elevated valuations are warranted is a difficult question to answer, but one simple way to provide a sanity check is to compare the P/E ratio of an index to its return on equity—a measure of how profitable and efficient a company has been over the past year. For the Magnificent 7, their high valuations were accompanied by similarly high market cap-weighted returns on equity as of October 23. Whether these seven companies can sustain the level of profitability and efficiency that they have thus far exhibited remains to be seen.

When taken in context, the elevated valuations of U.S. stocks in general and the Magnificent 7 collectively do not appear unreasonable. As a result, our Asset Allocation Committee currently holds a broadly neutral allocation to U.S. equities despite elevated valuations amid an uncertain environment.
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