

A new way to look at crazy stock valuations

(<http://www.todayevery.com/share/rJg5dxjG5e?>

hint=SB11849978673534134861004582647572763749082?

responsive=y/articles)

^{WSJ} www.wsj.com // Created: 10hr // Updated: new

Life - Entertain

Share (<http://www.todayevery.com/share.fb/rJg5dxjG5e?hint=SB11849978673534134861004582647572763749082?responsive=y/articles>)

The swinging price of oil has [played](#) havoc with forecasts for the economy and inflation over the past two years. Now it may also be messing with the heads of investors by pushing the most popular tool for U.S. stock-market valuation to the highest in more than a decade.

By

James Mackintosh

The S&P 500 stands at almost 18 times estimated operating earnings, the highest forward PE ratio since 2004 and a figure which was higher before that only during the late 1990s dot-com bubble and its aftermath.

Yet, the valuation has been inflated by a collapse in profits for oil companies. Because analysts expect little in the way of earnings over the next year, [but a recovery later, the ratio of price to year-ahead earnings for oil stocks is elevated.](#) The energy sector stands at more than [30](#) times Thomson Reuters IBES's estimate of operating earnings over the next 12 months, [higher than any time from when the sector data started in 1995 up to last year—when it briefly reached an extreme of almost 60 times.](#)

Related

- [Bond Market](#) Is Flashing Warning Signal on Trump Reflation Trade

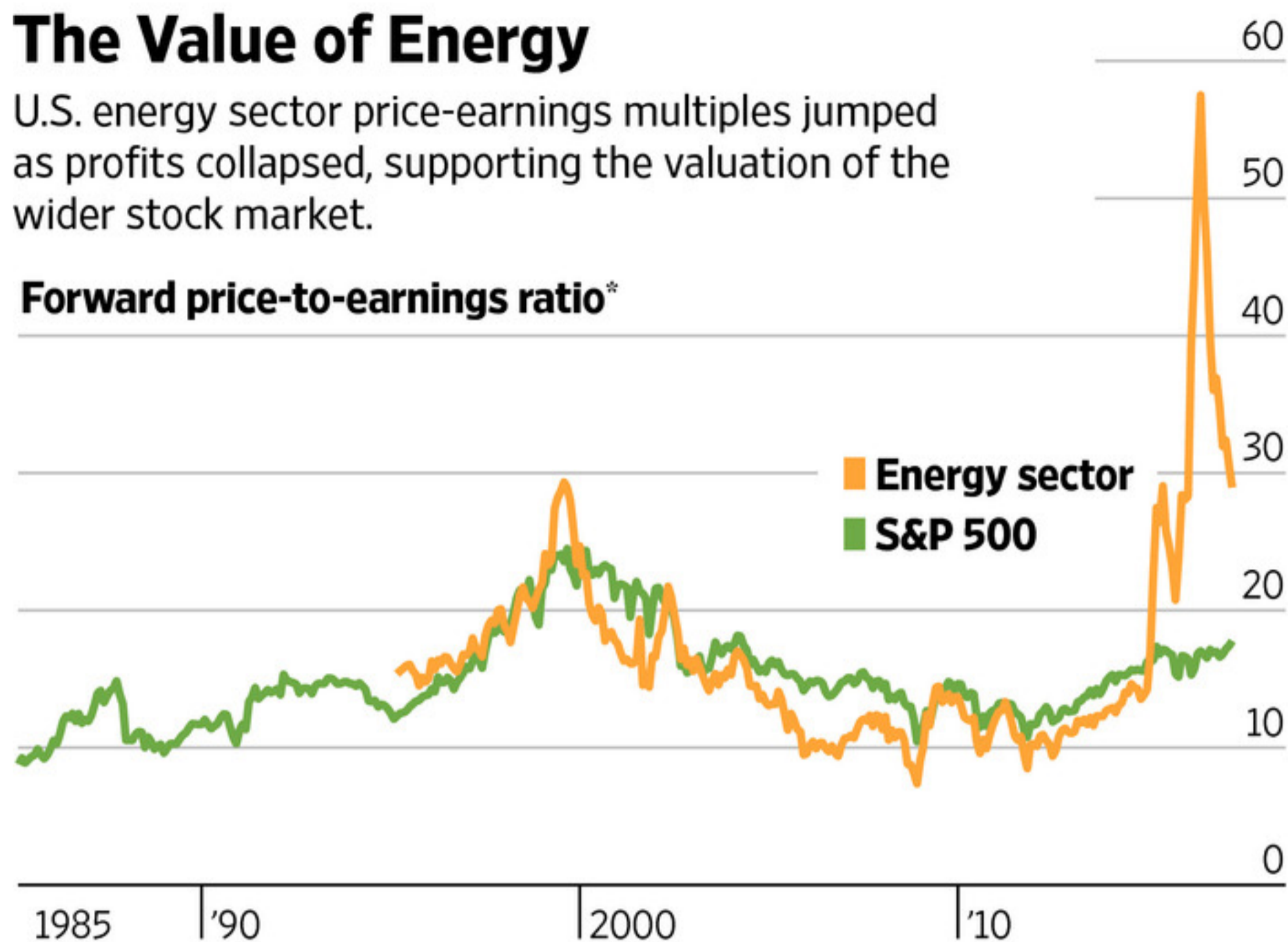
[There are other reasons to think future returns from stocks might be low, but investors who rely on the overall valuation of the index as a signal for future returns would be misled if they ignored the collapse in oil-sector profits.](#)

Howard Silverblatt, senior index analyst at S&P Dow Jones [Indices](#), puts the overall market at 18.1 times this year's estimated operating earnings. [When the energy sector—containing six of the seven S&P companies forecast to lose money this year—is excluded, the forward PE stands at 16.6, a much less frightening figure.](#)

The Value of Energy

U.S. energy sector price-earnings multiples jumped as profits collapsed, supporting the valuation of the wider stock market.

Forward price-to-earnings ratio*



*Ratio of price to 12-month forward operating earnings

Source: Thomson Reuters IBES

THE WALL STREET JOURNAL.

There are lots of ways to compute the forward PE, and the gap is slightly narrower on IBES figures used by Société Générale's quantitative equity team. But either way, valuations are lower when the oil sector is stripped out, and look little different to two years ago.

There are both conceptual and practical objections to taking this as a signal that stocks are at a reasonable level. The conceptual problem is that it looks like manipulation of the figures to justify buying shares, a practice with a long and dishonorable history on Wall Street.

In reality, whether to include or exclude the oil sector amounts to a question about whether its profits will recover. If oil prices and profits plunge again, then the sector is truly expensive, and it should be included in the overall figures. Excluding energy from valuations amounts to an assumption that oil sector profits will recover, implying prices won't fall much below \$50 a barrel.

The practical issue is more worrying. Even without energy, valuations are pretty high. Stocks were expensive two years ago and are still expensive today, with valuations high compared with most of history. Investors are pricing in a lot of good news for earnings, notably U.S. corporate tax cuts, and not a lot of bad news.

The main explanation for pricey shares is the same as it was two years ago, too. Low interest rates tend to lead to higher valuations, since the same future profits are worth more when discounted back into today's money. Profit margins are elevated by cheap debt, and investors think that will continue.

The Federal Reserve may have started raising U.S. interest rates, but it has barely kept up with the rise in inflation, and investors expect money to remain easy pretty much forever.

If today's market is a bubble, it is a particularly joyless one. Cheap money has pushed every sector to be pricey, but none to be extraordinary. Indeed, the most expensive sector after energy is consumer staples, made up of boring-but-reliable earners.

We're promised news on Donald Trump 's "phenomenal" tax cut in his speech Tuesday, which could reverse at least some of the postelection stock rally if the corporate tax plans disappoint. The real threat to valuations, though, would come if it looked like inflation was running out of control, and the Fed were forced to get serious with rate increases.

Investors expect oil to stay calm, energy-sector profits to recover and inflation to be subdued. If any of those turn out to be wrong, high valuations may yet be a problem.

Write to James Mackintosh at James.Mackintosh@wsj.com

You May Like



Warning: Don't Use Probiotics Before You See This

PrebioThrive Supplement

The F-15 Is No Match For This Plane

The Professional

The Root Of All Stomach Problems - Avoid These 3 Foods

BIOX4 Supplement

Classic Westerns Quiz: Can You Rustle Up a 90% Score?

Zoo.com

Just Type in Your Name, Wait 10 Seconds, Then Brace Yourself

TruthFinder People Search Subscription

2 Billion Of These Will Be In Every Home By 2020 [Watch Video]

BIOX 4 Supplement

You May Like



1 Spoon Of This (Before Bed) - Watch What Happens To Your Belly Fat

Sponsored content by Infolinks 