



4 January, 2021

Don't forget "Valuation Issue" in 2021

After the existence and usage of vaccine, the investment world had become very bullish on the economy recovery and the earnings growth in 2021. Indeed, we totally agreed that the vaccine is a "game changer" and it will significantly boost economic recovery and lead to a brighter outlook to the stock market. However, we ought not to forget the "Valuation Issue" at all time. Let's us have a look on what is the valuation for the stock market right now and what is the market expectation for earnings growth in the coming year?

Let's have a look at the Historical P/E ratio

- US stock market: 29.9x (at least the highest since 2000, the average in the past 20 years is 18.7x)
- European stock market: 49.2x (record high since 2010, the average in the past 20 years is 22.4x)
- Asian stock market: 25.7x (record high since 2010, the average in the past 20 years is 14.5x)

Let's have a look at the Forward P/E ratio

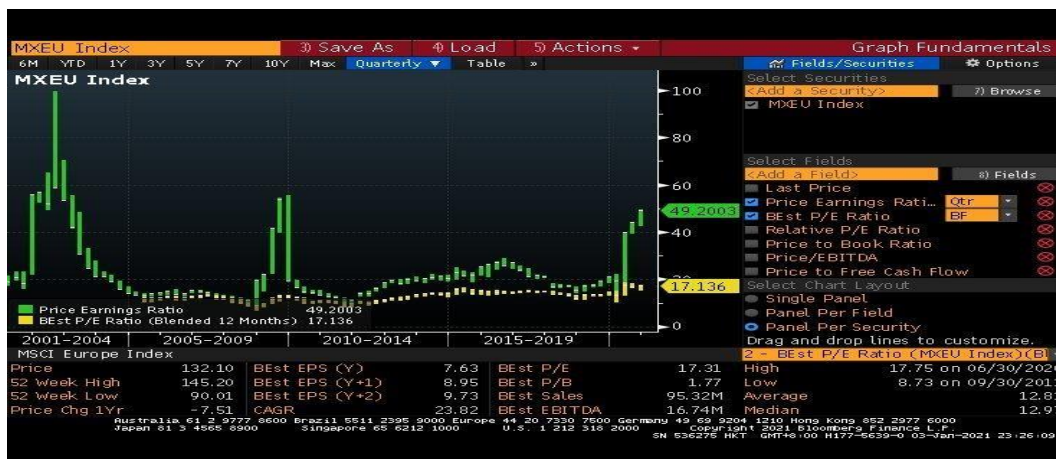
- US stock market: 22.6x (Near 20 years high, the average in the past 20 years is 15.5x)
- European stock market: 17.1x (Record high since 2005, the average in the past 20 years is 12.8x)
- Asian stock market: 16.3x (Record high since 2010, the average in the past 20 years is 12.4x)

US stock market: Historical P/E ratio (green) and Forward P/E ratio (yellow)



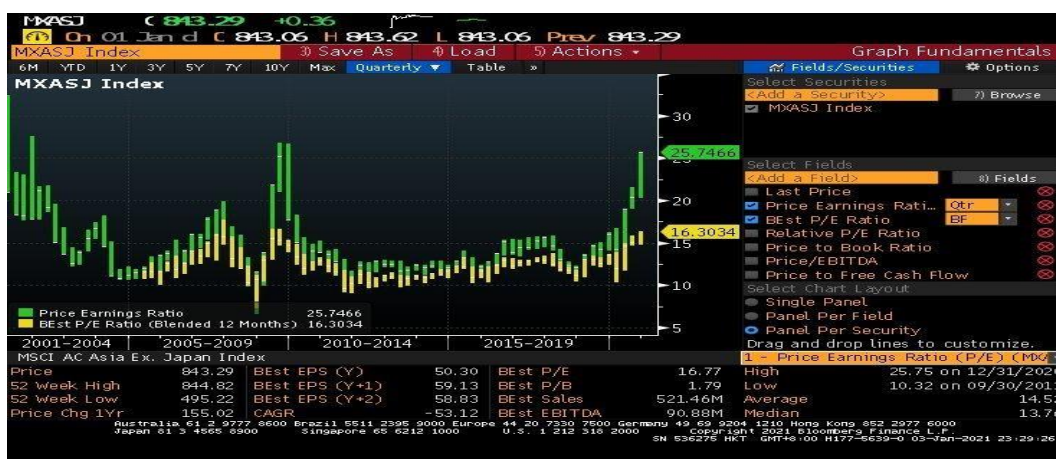
Source: Bloomberg

European stock market: Historical P/E ratio (green) and Forward P/E ratio (yellow)



Source: Bloomberg

Asian stock market: Historical P/E ratio (green) and Forward P/E ratio (yellow)



Source: Bloomberg

Vaccine is the "Game Changer"

In 2020, the outbreak of Covid-19 has brought upon unprecedented challenges across the global, stymied economic activities, affected business operations and performance of many industries. One of the reasons

for stock markets regained much of the losses likely due to rollout of vaccines in the late 2020 have sharply improved market sentiment (the other major one must be the ultra-loose monetary policy implemented by the central banks around the world). With the vaccine, we expect the economy will continue to recover in 2021, but the pace of recovery will likely depend on how the world tackles the global public health crisis, a new US presidential administration, any change in the US-China relationships, any further stimulus from the US Fed or from the ECB, etc. Despite all these uncertainties persist, the market tends to have a more positive outlook for 2021 and believes that would send the corporate profit up.

We could ignore historical PE ratio, but we should not totally ignore the “Valuation”

Covid-19 epidemic has greatly affected corporate operations and profits, therefore it is not surprising that the historical P/E ratio for most stock markets are now trading at a very high level. Thus, it is not a fool to ignore the historical P/E ratio at this moment as it was distorted by the epidemic and it is less likely to reflect the actual picture.

However, it does not mean that we should totally ignore the “Valuation”. Instead of looking at historical PE ratio, we should put our focus on forward P/E ratio as it reflects how much the market has priced in the optimism of economic recovery in the coming year, and also the expected return of profitability for companies.

From the forward P/E ratio, there are two things are worth to note.

First of all, the hike in valuation is not without limit, regardless of current interest rate is at an ultra-low level and it is expected the ultra-low interest rate will be maintained in the coming 1-2 years, which is good for the market to accept a higher valuation.

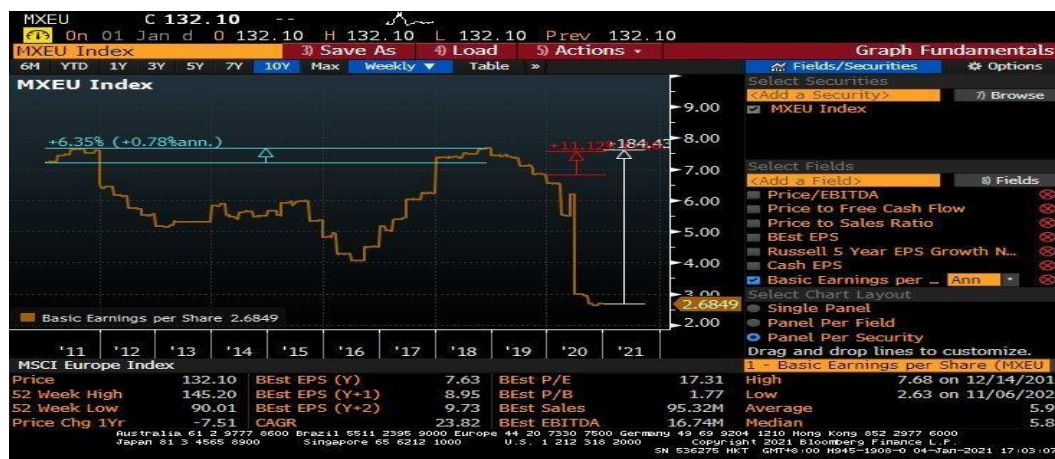
Besides, the market seems to be betting on a good outcome in 2021 and has high expectations for the recovery of corporate profits. For example, in the US, the market expects that corporate profits will rebound by more than 30% in the next 12 months; while In Europe, the market believes that corporate profits will rebound by nearly 200% in the next 12 months.

U.S. corporate earnings: the average annual growth rate in the past 10 years was about 7%; if the profit rises by 30% in the coming year, it will recover the losses in 2020 and even 7% more than the peak recorded in 2019



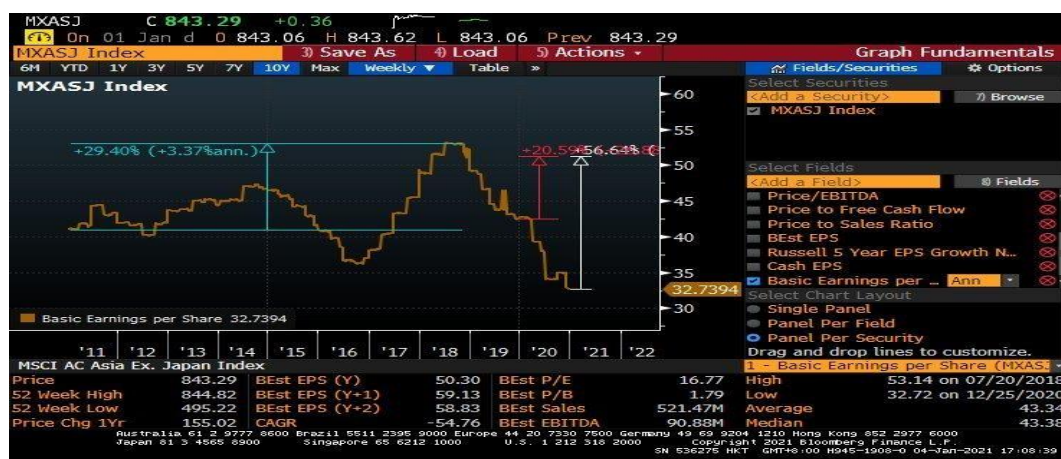
Source: Bloomberg

European corporates earnings: the average annual growth rate in the past 10 years was less than 1%; if the profit in 2021 rises by 200%, not only can regain the losses in 2020, reach the peak of 2018 and also about 11% higher than the level recorded by the end of 2019



Source: Bloomberg

Asian corporates earnings: the average annual growth rate in the past 10 years was about 3%; if the profit in the next year rises by 50%, not only recover the losses in 2020, it is even 20% higher than the end of 2019



Source: Bloomberg

Thus, we need to consider two things. First of all, do the above earnings forecast reasonable or achievable? Second, do the forward PE ratios being overvalued even after the above quite optimistic earnings forecast?

Although investors are more likely to accept higher P/E ratios when the interest rates remain at a low level and global central banks have substantially pumped money into markets, if corporates profitability fail to keep up with the continuous rising P/E ratio, it will only jeopardize the risk-reward profile of the stock market.

Source: Bloomberg, Financial Times, BBC News, Reuters

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