Cheap at twice the price?

Earnings keep the S&P 500 in the value zone

It may be hard to fathom how you can be paying less for something after it's nearly doubled in price, but that's the riddle posed by the current price/earnings (P/E) ratio of the S&P 500.

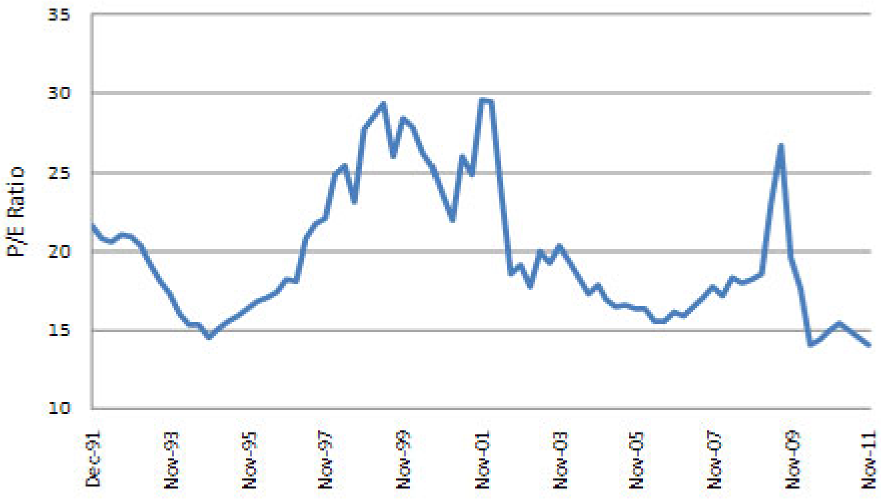
Since its low in March 2009, the S&P 500 has nearly doubled in price[1]. Yet paradoxically, the P/E is lower now than it was two years ago – and it has barely budged over the past year, despite the market's surge[2].

One reason might be the tremendous growth in earnings, which has outstripped the rise in prices[3]. As a result, earnings have become cheaper on a dollar for dollar basis – exactly what's measured by the P/E ratio.

Of course, earnings cannot continue to grow at this blistering pace. But while the pace has already slowed, expectations for overall earnings growth remain solid – which could form a strong foundation for continued equity gains.

S&P 500 earnings haven't been this inexpensive since 1994

S&P 500 Operating P/E (actual and forecasted)



Source: Standard & Poor. The forecasted P/E is based on expected earnings for 2011 and the index price, both as of 22/3/2011. Past performance is no guarantee of future results. Please note an investor cannot invest directly in an index. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment. Forecasts are inherently limited and should not be relied upon as an indicator of future performance.

In fact, S&P 500 earnings are currently forecast to reach a new all-time high by the end of 2011, which would be a gain of nearly 15% for the year[4]. With that rate of growth, P/E levels below 15 times earnings should not be discouraging to investors.

What's more, the economic environment may finally be shifting in favour of equities. Indeed, despite the possibility of growth leading to higher short-term interest rates, ongoing economic expansion could support continued earnings growth.

[1] Source: Bloomberg, as of 3/30/2011. The S&P 500 bottomed at 676.53 on March 9, 2009. At the end of March 2011 it was priced at 1325.83, a rebound of nearly 100%.
[2] Source: Standard & Poors, as of 3/22/11. In March 2009 the S&P500 Operating P/E was 18.6x earnings. In March 2011 it was 15.45x earnings.
[3] Source: Standard & Poors, as of 3/22/11. Annual S&P500 Operating earnings per share (EPS) were $83.76 at the end of December 2010, an increase of 111% from the bottom of $39.61 in 3Q09.
[4] Source: Standard & Poors, as of 3/22/11. Forecasted earnings for the end of 2011 for the S&P 500 are $96.23; the previous all-time high for EPS was $91.47 in 2Q07.

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While rising interest rates can be a hurdle for stock prices, today's low equity valuations arguably provide a reasonable cushion against higher rates – undervalued asset classes can more easily absorb headwinds than overvalued ones. For instance, between June 2004 and June 2006, the S&P 500 produced a cumulative total return of 15.5% even as the US Federal Reserve increased its target rate by 425 basis points[5]. And even if rising short-term rates are viewed as a harbinger of inflation, investors are likely to recall that equities have historically been a better hedge against inflation than bonds.

Of course, under any circumstances, some stocks are always more attractively valued than others, which is why effective security selection plays such a crucial role in long-term portfolios.

[5] Source: Bloomberg and Federal Reserve.

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