Do Good Times Make Bad Times? P/E Ratios and Forward Returns

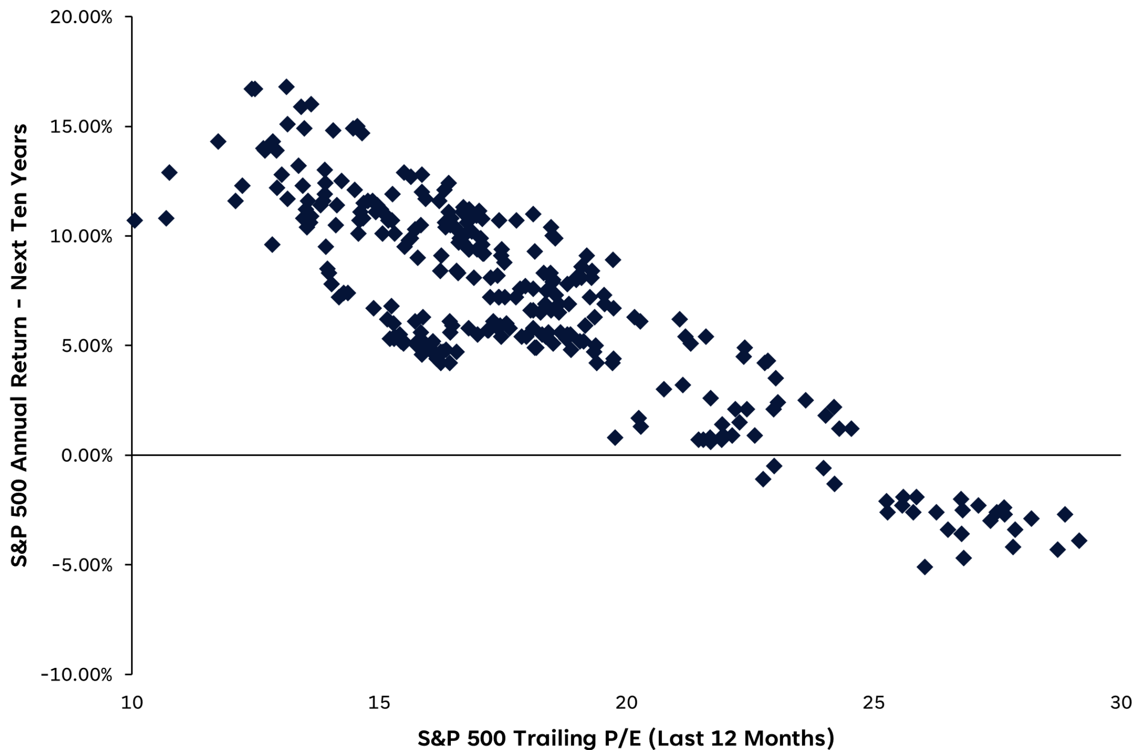
Jeff Buchbinder | Chief Equity Strategist
Last Updated: October 29, 2024

Additional content provided by Brian Booe, Analyst, Research.

It's been a fun year for stock market investors. The S&P 500 has rallied over 22% this year, setting nearly 50 record highs as the current bull market recently celebrated its second birthday. Throughout the record-setting rally this year, even as corporate profits broadly backed lofty valuations, market watchers from Wall Street to Main Street have cited stretched valuations. But, as valuations get even more stretched following the latest rally, we ask, does today's fun signal a dimmer decade ahead?

When comparing the subsequent 10-year forward returns for the S&P 500 with the benchmark equity gauge's trailing 12-month price-to-earnings (P/E) ratio, the resulting relationship is eerily tight. Based on data since 1990, 10-year stock returns tend to be more modest if the starting point for valuations is high (and vice versa). Currently, the S&P 500 is selling for 21.8 times, well above recent and historical averages, such as the five-year average of 19.8. Recent studies have drawn investors' attention to this relationship, including a recent publication from Goldman Sachs stating elevated P/E ratios and market concentration, among other factors, signal annualized returns over the next 10 years could be around 3%, well below the 11% average since 1950.

S&P 500 Ten-Year Returns vs. S&P 500 P/E

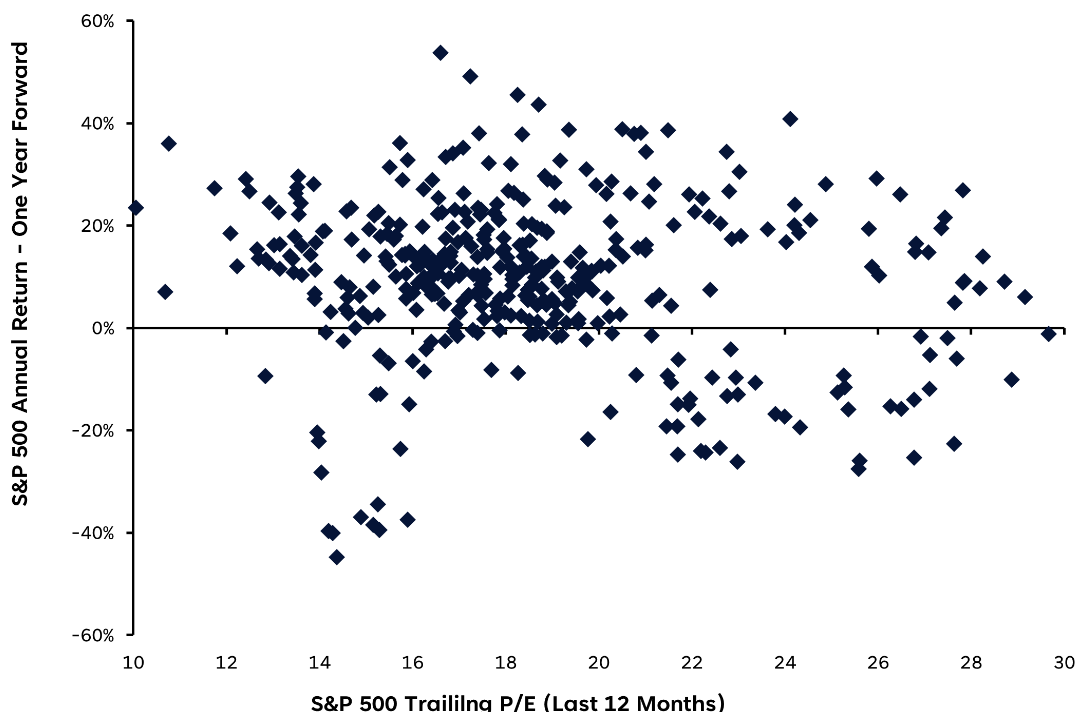


Source: LPL Research, FactSet, Haver Analytics, Yahoo Finance, 10/28/24
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Near-Term Results May Vary

The correlation between 10-year returns and valuations is compelling, but it does not mean stocks are set up for lackluster performance every month, quarter, and year for the next decade. For example, shorter time frames have historically displayed a weaker correlation between P/E ratios and annualized forward returns (which is why we often say valuations are not good timing tools). When running the same test for one-year returns, there is virtually no correlation between the index's 12-month trailing P/E and its subsequent one-year return. As shown below, the S&P 500 has returned upwards of 20% multiple times at valuation levels higher than current levels. On the other hand, the index has experienced negative returns when at lower valuation levels, indicating this index is not sentenced to poor returns solely due to an elevated P/E ratio.

S&P 500 One-Year Returns vs. S&P 500 P/E



Source: LPL Research, FactSet, Haver Analytics, Yahoo Finance, 10/28/24
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Potential Productivity Could Buoy Longer-Term Returns

Again, there's no denying the stark relationship between P/E ratios and long-term forward returns, but an annualized return of 3% over the next ten years is likely too low. Productivity gains from technology investments (artificial intelligence and otherwise) are likely to boost the profitability of S&P 500 companies and support both earnings growth and valuations. In fact, based on historical data since the inception of the S&P 500 and its predecessor index, the S&P 90, the probability of achieving better than a 3% annualized return over a 10-year rolling period is about 90%. And the index suffered losses over any 10-year period during only the Great Depression and the Great Financial Crisis. So, while below-average returns are likely over the next decade because of high valuations, we would expect productivity gains to help drive profitability in support of mid-to-high-single-digit returns — still a few points below the long-term average.

Even short-term returns could easily be above 3%, While earnings growth for the Magnificent Seven (Mag 7) stocks, which have largely driven the current bull market, are expected to ebb as year-over-year comparisons grow more difficult

and artificial intelligence (AI) related themes remain resilient. Despite some skepticism around AI, recent earnings and guidance updates have continued to support the theme and growth expectations as AI spending and adoption remain on the rise. Furthermore, growth for the other 493 index constituents is forecasted to ramp up, as Wall Street expects double-digit earnings growth over the next five quarters, helping close the gap between the 493 and the Mag 7.

Summary

Historical trends point to the possibility of below-average long-term returns, however, short-term trends are harder to predict when only using P/E ratios. Nonetheless, the more a market inflates during good times, the bigger downside moves tend to be once the good times end.

LPL's Strategic and Tactical Asset Allocation Committee (STAAC) maintains its tactical neutral stance on equities. High valuations introduce risk if earnings don't come through, but market momentum remains strong and seems to be telling us earnings will deliver. That said, the Committee acknowledges the potential for short-term weakness, especially with lingering geopolitical threats in the Middle East and as the U.S. presidential election quickly approaches. Equities must also readjust to what we expect will be a slower and shallower Fed rate-cutting cycle than markets are currently pricing in, although both post-election seasonality has historically been favorable for stocks.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors. To determine which investment(s) may be appropriate for you, please consult your financial professional prior to investing.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk.

Indexes are unmanaged and cannot be invested into directly. Index performance is not indicative of the performance of any investment and does not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

This material was prepared by LPL Financial, LLC. All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

Unless otherwise stated LPL Financial and the third party persons and firms mentioned are not affiliates of each other and make no representation with respect to each other. Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services.

Asset Class Disclosures –

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

Bonds are subject to market and interest rate risk if sold prior to maturity.

Municipal bonds are subject and market and interest rate risk and potentially capital gains tax if sold prior to maturity. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

Preferred stock dividends are paid at the discretion of the issuing company. Preferred stocks are subject to interest rate and credit risk. They may be subject to a call features.

Alternative investments may not be suitable for all investors and involve special risks such as leveraging the investment, potential adverse market forces, regulatory changes and potentially illiquidity. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Mortgage backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

High yield/junk bonds (grade BB or below) are below investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Precious metal investing involves greater fluctuation and potential for losses.

The fast price swings of commodities will result in significant volatility in an investor's holdings.

Securities and advisory services offered through LPL Financial, a registered investment advisor and broker-dealer. Member FINRA/SIPC.

Not Insured by FDIC/NCUA or Any Other Government Agency | Not Bank/Credit Union Deposits or Obligations | Not Bank/Credit Union Guaranteed | May Lose Value

For Public Use – Tracking: #651142

Jeff Buchbinder

Jeff Buchbinder, CFA, provides the top-down view of the stock market for LPL Financial Research. He has over 25 years of experience in equities.

© 2020 LPL Financial | Member FINRA/SIPC.