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Tis the Earnings Season

By Michael Crook, Chief Investment Officer

The end of the third-quarter earnings season provides an opportunity to evaluate the current state of the US equity market. In short, the US market:

- Remains supported by strong earnings growth,
- Continues to trade at a high valuation relative to history,
- Is concentrated from a market capitalization perspective, and
- Has priced in somewhat high expectations priced in about the future.

S&P 500 earnings continue to grow in the high single digits (Fig. 1), and equity analysts now expect additional earnings growth of 13% over the next 12 months. Earnings growth expectations have also broadened out from technology and the Magnificent Seven (Mag 7).

Fig. 1: S&P 500 Earnings Growth

Source: Bloomberg, Mill Creek.

Earnings growth for the Mag 7 was a remarkable 60% year-over-year at the end of the third quarter. However, such growth rates were bound to slow, at least until the large capital expenditures in AI during 2023 and 2024 show some return on investment. Analysts now expect 20% earnings growth for the next 12 months for the Mag 7.

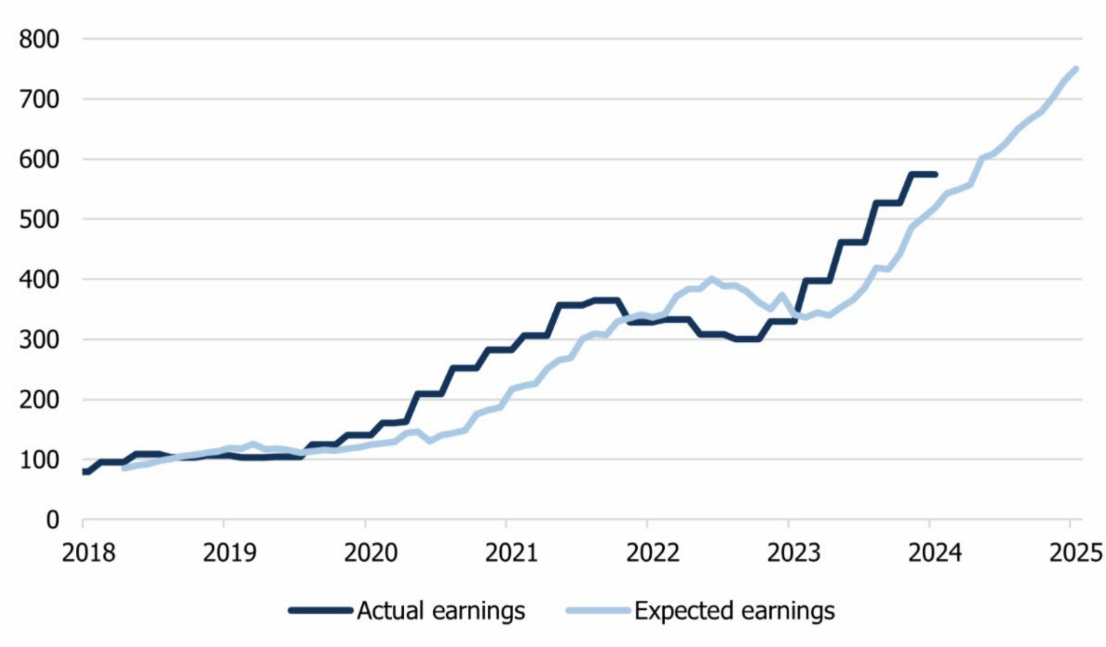
The 12-month forward price-to-earnings ratio (P/E) for the S&P 500 is just over 21x. For perspective, the 1990-October 2024 average P/E has been 16.6x. We can conclude that the US market is, therefore, somewhat expensive, but the forest hides the trees. An equal-weight version of the S&P trades at just 17x earnings – essentially in-line with long-term valuations (Fig. 2). The Mag 7, which make up one-third of the S&P 500 by market cap, trade at a P/E of 30.

Fig. 2: Price-to-earnings

Source: Bloomberg, Mill Creek.

While it's easy to look at these numbers and conclude that the Mag 7 is the place to be (e.g. better recent returns, better recent earnings growth, and higher expected earnings growth), investing is an expectations game. NVIDIA has performed well because earnings have far exceeded analyst expectations (Fig. 3), but expectations for the Mag 7 are increasingly high and ripe for disappointment.

Fig. 3: Equity Analysts Have Consistently Underestimated Mag 7 Earnings



Source: Bloomberg, Mill Creek.

The ongoing strength of the US economy is reflected in solid corporate profit growth. We remain constructive on US equity market performance, and we continue to hold an overweight to US equities in our target equity allocations. However, we also believe maintaining small cap and international exposure is important for mitigating the "expectations risk" inherent in the US market.

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