ClearBridge Investments

Recovery Indicators Update: Valuations Not a Headwind

December 1, 2020

Key Takeaways

- The economy continues to mend with strength in Housing Starts one of several indicators supporting a solid green overall signal for the ClearBridge Recovery Dashboard.
- The robust rally from pandemic lows has pushed equity valuations well above historical averages, yet we believe valuations are supported by the makeup of the U.S. market and the current level of interest rates.
- While much of the rally so far has been powered by multiple expansion, we believe a recovery in earnings will have a greater impact on equity performance in 2021.

Greater Clarity Underpins Latest Leg of Equity Rally

Equity markets rallied 10.8% in November (the 10th best month in the last 75 years) as progress was made toward clarifying two major points of uncertainty: the U.S. presidential election and prospects for a COVID-19 vaccine. While neither of these have been fully resolved, financial markets appear to be treating them as such with the VIX – a measure of expected volatility – falling from 38.0 to 20.5 and investor sentiment surveys showing an uptick in bullish responses. Some investors remain cautious, however, with several components of the CARES Act stimulus programs set to expire in late December. Unless a new stimulus bill is passed, over 65% of the 20.5 million workers who remain out of work are set to lose unemployment benefits, which some fear could lead to a double-dip recession.

The good news is this appears unlikely. While a policy error remains possible, Americans have over $1 trillion in additional savings accumulated relative to pre-pandemic levels which should provide a buffer in the event additional stimulus is not delivered. With several vaccine candidates likely nearing approval, individuals may not need to rely on their savings much longer as the economy begins to normalize.

Perhaps most importantly, however, the economy continues to show signs of an ongoing recovery. Housing has been a bright spot, not abnormal in an economy recovery outside of the global financial crisis (GFC) where the after-effects of the housing bubble needed to be worked off. Housing Starts are up 14% year-over-year and 64% from their April lows, and remain a solid green signal on the ClearBridge Recovery Dashboard. Further upside exists too, with the latest National Association of Home Builders (NAHB) Housing Market Index (HMI) – which is designed to lead Housing Starts by six months – reaching an all-time high in November. Against this backdrop, it isn’t surprising that the ClearBridge Recovery Dashboard continues to show economic expansion with no changes this month and a continued overall green signal.

Exhibit 1: ClearBridge Recovery Dashboard

		Nov. 30, 2020	Oct. 30, 2020	Sept. 30, 2020
Confidence	Consumer Confidence	↑	↑	↑
	Business Confidence (ISM)	↑	↑	↑
	Investor Sentiment	✕	✕	✕
Economic	Housing Starts	↑	↑	↑
	Initial Jobless Claims	●	●	●
	Philly Fed	↑	↑	↑
Financial	Credit Spreads	↑	↑	↑
	Fed Policy	↑	↑	↑
	Financial Conditions	↑	↑	↑
	Overall Signal	↑	↑	↑

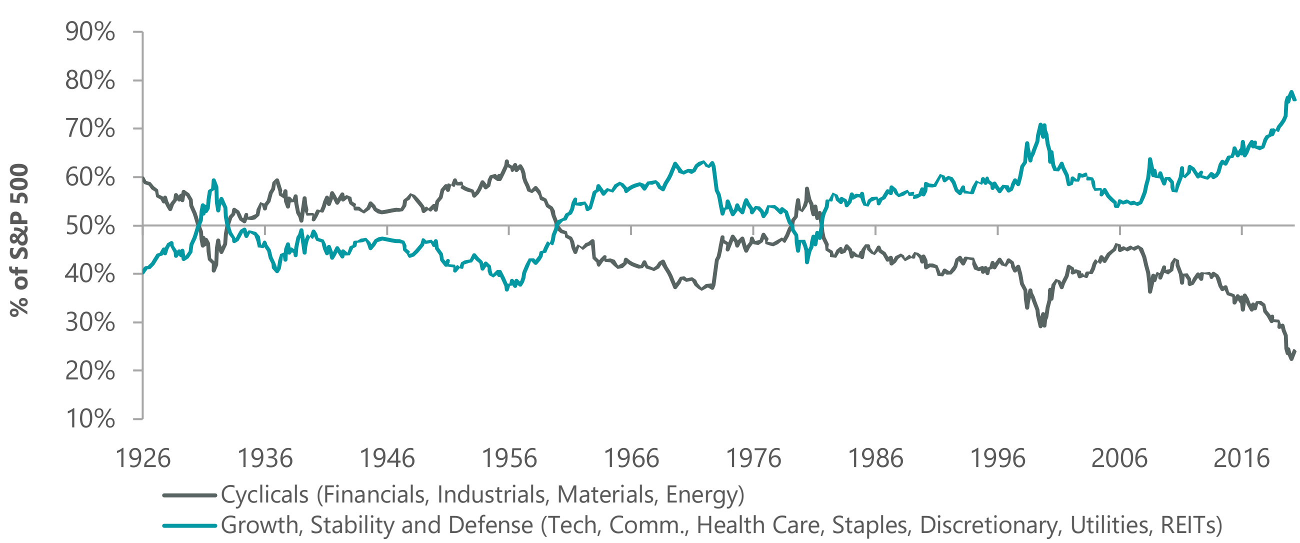
↑ **Expansion** ● **Improvement** ✕ **Recession**

Source: ClearBridge Investments.

With few signs of a double-dip emerging and consensus expectations of over 20% EPS growth for the S&P 500 Index in 2021, valuations have begun to emerge as a primary concern for many investors. Equities are currently trading at 21.8 times next-twelve-month expected earnings, well above the 16.1 times historical average. While worrisome, there are several reasons why valuations may be better supported than is commonly believed.

The first of these is the makeup of the index itself. The share of cyclical groups, which tend to be more volatile and trade at lower valuations, is at the lowest level in nearly 100 years. By contrast, less-volatile sectors that demonstrate higher growth, greater stability and more defensive traits make up the largest share of the benchmark in history. In a low economic growth and interest rate environment, these characteristics are sought out by investors given the dearth of other options, rewarding these groups with higher multiples. With a smaller weight in lower P/E companies and a larger weight in higher P/E companies relative to history, comparisons to average benchmark valuations may be less relevant today.

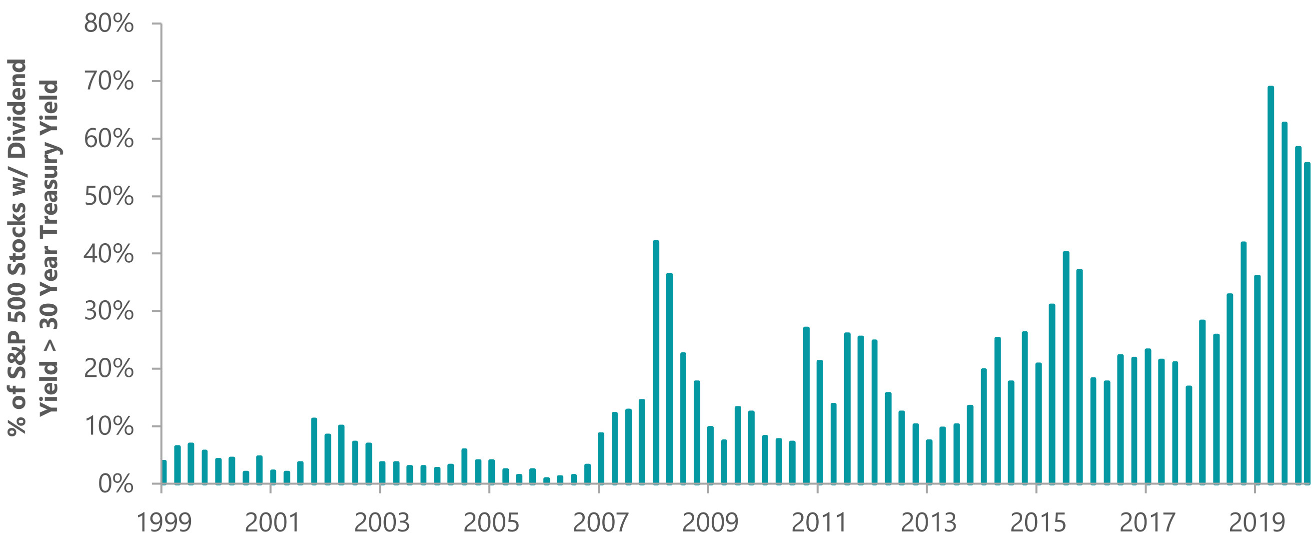
Exhibit 2: Index Composition Supports Higher P/Es



As of Nov. 30, 2020. Source: Cornerstone Macro.

A second consideration is the valuation of equities in the context of the broader investment landscape. Interest rates are historically low with 10-Year U.S. Treasurys yielding just 0.84%. This has important ramifications as it can push some investors out of bonds and into stocks, particularly with the S&P 500 offering a dividend yield of 1.7%, comparable to corporate bond benchmarks. In fact, over half of the stocks in the S&P 500 offer a greater dividend yield than the 30-Year Treasury. As more investors move into equities in search of yield, this has the effect of pushing up equity valuations, with rising prices but no change in underlying earnings. Low interest rates can also impact equity valuations at a theoretical level, with low rates equating to a lower hurdle rate. From a capital allocation perspective, corporate managers should be able to invest in a greater number of profitable initiatives, which should increase the value of equity ownership in the company.

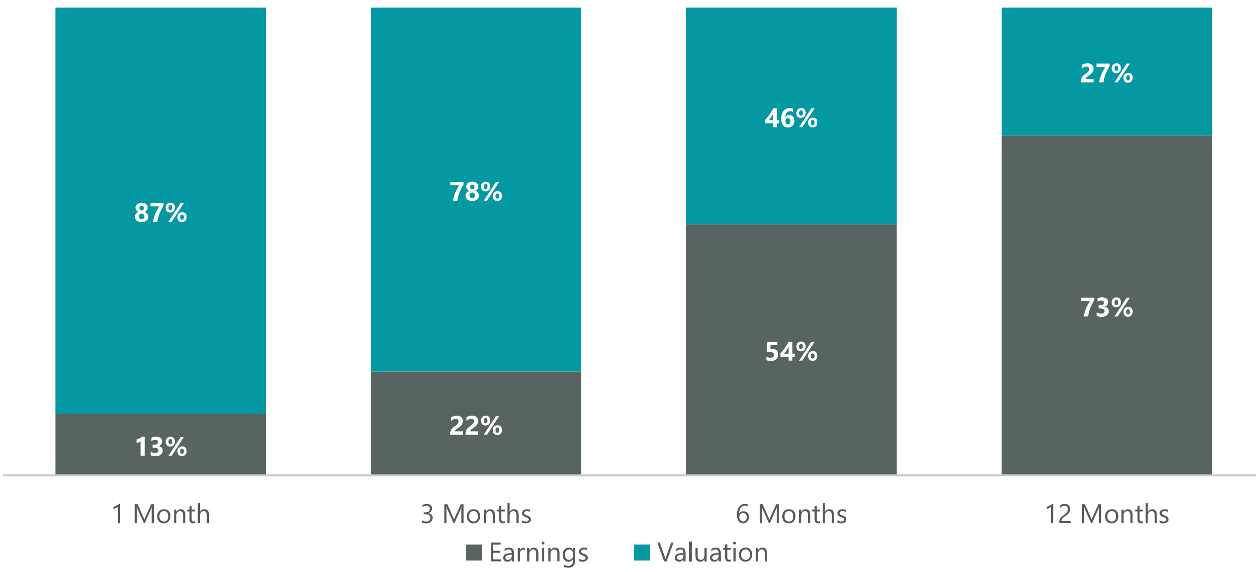
Exhibit 3: Dividend Paying Equities Attractive



As of Nov. 30, 2020. Source: FactSet.

A final consideration for equity valuations is the typical behavior of the stock market. There are three potential sources of return for equity investors: dividends, earnings growth (or loss) and changes in valuation multiples. Dividends tend to be more stable than earnings or multiples and have steadied following a number of high-profile cuts and suspensions earlier in the COVID-19 crisis. Because stock prices tend to respond to new information faster than earnings expectations are revised, short-term returns tend to be more driven by multiples while long-term returns tend to be more driven by earnings. In fact, over 85% of one-month returns can be attributed to changes in valuations, while this figure falls to nearly 25% over a one-year horizon.

Exhibit 4: Earnings vs. Valuations as Drivers of Stock Prices



As of Nov. 30, 2020. Note: % of price return from change in 12-month forward earnings expectations vs. P/E multiple; 1996 to present. Source: FactSet, S&P.

However, coming on the heels of a recession it is not unusual to see multiple expansion drive the first leg of the rally, with earnings coming through later. Much of the rally so far has been powered by valuation, and we believe that as earnings recover in 2021, the typical pattern will play out with a greater contribution from earnings. Put differently, we would expect multiples to gradually work lower in the coming months as earnings recover. As a result, while we continue to monitor valuations closely, we do not see them as an impediment to further upside for long-term investors.

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Definitions

- The **ClearBridge Recovery Dashboard** includes 9 leading economic, financial and market indicators that can provide information about the direction of the U.S. economy.
- **COVID-19** is the World Health Organization's official designation of the current novel coronavirus disease. The virus causing the novel coronavirus disease is known as SARSCoV-2.
- The **“CARES Act”** is short for the ''Coronavirus Aid, Relief, and. Economic Security Act''
- **Global Financial Crisis** refers to the economic disruption that followed the collapse of prominent investment banks in 2007-8, marked by a general loss of liquidity in the credit markets and declines in stock prices.
- **Housing starts** refers to the number of new residential construction projects that have begun during any particular month.
- The **National Association of Home Builders/Wells Fargo Housing Market Index (HMI)** is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The index gauges builder perceptions of current single-family home sales and sales expectations for the next six months as “good,” “fair” or “poor.” The survey also asks builders to rate traffic of prospective buyers as “high to very high,” “average” or “low to very low.” Scores for each component are then used to calculate a seasonally adjusted index where any number over 50 indicates that more builders view conditions as good than poor.
- **Earnings per share (EPS)** is the portion of a company's profit allocated to each outstanding share of common stock. An index EPS is an aggregation of the EPS of its component companies.
- The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.
- **Real Estate Investment Trusts (REITs)** invest in real estate or loans secured by real estate and issue shares in such investments, which can be illiquid.
- The **price-to-earnings (P/E) ratio** is a stock's price divided by its earnings per share.
- **Cyclical goods** (”cyclicals”) are products that are tend to be purchased frequently such as groceries and gasoline.
- **U.S. Treasuries** are direct debt obligations issued and backed by the "full faith and credit" of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity. Unlike U.S. Treasury securities, debt securities issued by the federal agencies and instrumentalities and related investments may or may not be backed by the full faith and credit of the U.S. government. Even when the U.S. government guarantees principal and interest payments on securities, this guarantee does not apply to losses resulting from declines in the market value of these securities.
- The **Institute for Supply Management (ISM)** is an association of purchasing and supply management professionals, which conducts regular surveys of its membership to determine industry trends.

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