

WEEK IN REVIEW

JUNE 23, 2023

THE U.S. EQUITY MARKET REACHES AN ELEVATED VALUATION LEVEL, BUT OPTIONS EXIST

2023 has seen a strong rally in the U.S. equity markets. However, the increase in stock prices has been driven by valuation metric expansion rather than by growth in underlying fundamentals. The aggregate S&P index is now trading on almost all valuation absolute metrics in the top decile of the historical valuation range and only slightly lower on a relative valuation basis.

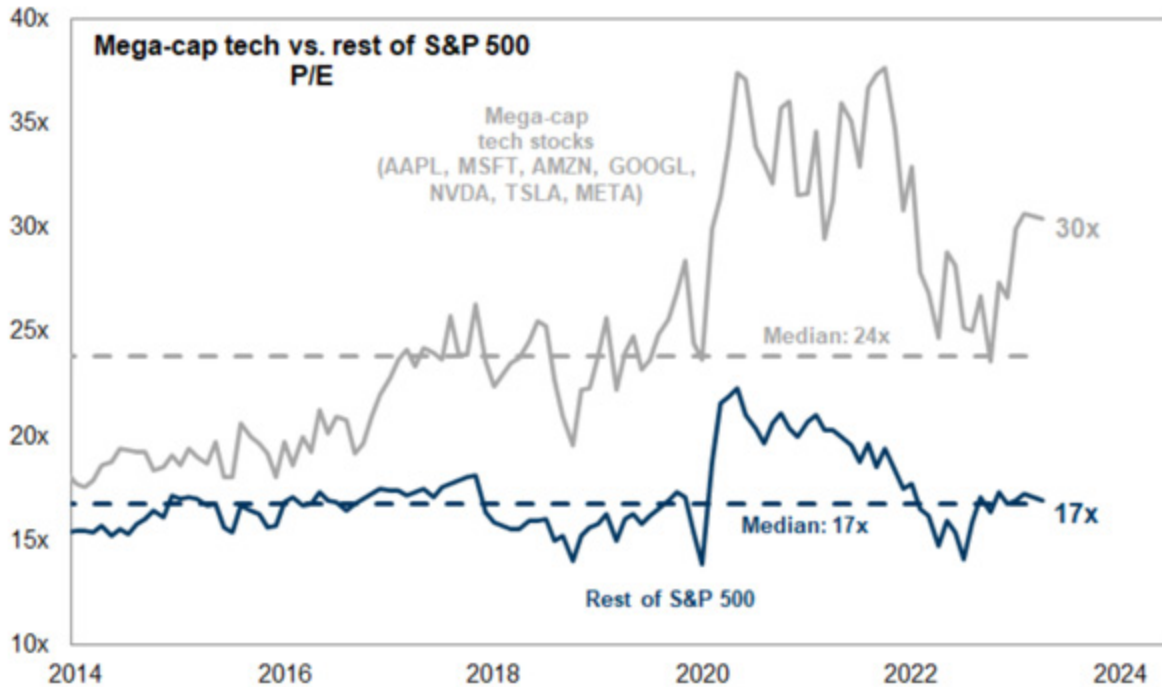
S&P 500 VALUATIONS VS. HISTORY

Valuation metric	Aggregate index		Median stock	
	Current	Historical %ile	Current	Historical %ile
US market cap / GDP	232 %	97 %	NA	NA %
EV / sales	2.7 x	96	3.1 x	96
Price / book	4.4 x	92	3.3 x	94
EV / EBITDA	13.5 x	92	13.5 x	95
Cash flow yield (CFO)	6.2 %	88	5.6 %	NA
Forward P/E	19.3 x	88	18.0 x	89
Cyclically adjusted P/E (CAPE)	27.7 x	88	NA	NA
Free cash flow yield	3.6 %	61	3.5 %	64
Median absolute metric		90 %		94 %
Yield gap vs. real 10-year UST	368 bp	89	406 bp	80
Yield gap vs. IG	-29 bp	83	9 bp	80
Yield gap vs. 10-year UST	146 bp	74	184 bp	50
Median relative metric		83 %		73 %

Source: Goldman Sachs Global Investment Research

However, the market rally this year has been relatively narrow with seven mega-cap stocks driving almost all the positive return. Looking at the current P/E ratio of the seven mega-cap stocks, the ratio at 30X is now trading at a 25% premium to their collective history. Meanwhile, the remainder of the S&P 500 stocks are trading at 17X, which is in line with their 10-year average.

HISTORICAL P/E RATIOS



Source: Goldman Sachs Global Investment Research

The juxtaposition of the performance and valuation of the mega-caps versus the rest of the S&P 500 has created a glass-half-empty or half-full dilemma. From the half-full perspective, an opportunity could be set up for a catch-up trade for the components of the broader market. This took place in June with an improved stock performance from a broader base of stocks. From the half-empty perspective, the seven mega-caps may be set for a pause or reversal in performance given their high relative valuation. The mega-cap tech seven make up 28% of the S&P index and any stall or pull-back in their stock performance may make upward progress in the S&P 500 index difficult.

Valuation, however, is just one component driving the S&P 500 index. Economic and corporate earnings growth and inflation will ultimately determine the trajectory of the markets. Current valuation metric expansion suggests optimism towards growth in fundamentals and falling inflation.

At Pallas, we remain confident that well-run public companies will ultimately see positive fundamental growth over time and through full business cycles. Current aggregate equity valuations do give us cause and reason to pursue a diversified investment mix drawing across opportunities in the US equity market, and international markets as well as sourcing opportunities in fixed-income and private market alternatives.

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