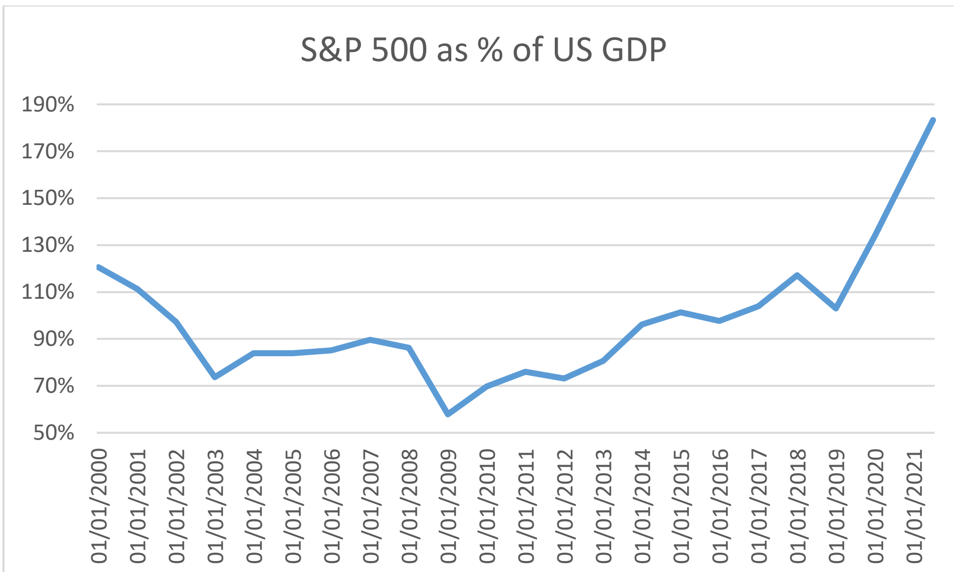
Are World Equity Valuations at a Turning Point?

As we have Richard Branson and Jeff Bezos taking their spaceships out into space, equity markets seem to have reserved a seat on one of their rockets. Warren Buffett once infamously said that his favourite gauge for equity valuations is to compare the S&P 500 market cap with US GDP. This ratio is on red hot alert after breaching the previous highs of the DotCom bubble already in 2020 and is now at dangerously high levels.



Source: Bloomberg, FRED St. Louis

However, given that most large corporations are global corporations and hence make a large chunk of their profits abroad, we need to weigh the valuation not only vs. US GDP, but vs. global GDP. Until 2020 the picture looked fairly valued, but since the pandemic struck, GDP has basically not moved (in many countries it is still lower than in 2019), and the S&P 500 has meanwhile shot up like a rocket. S&P 500 valuations have now reached a valuation equivalent to 45% of global GDP (previous record was 37% in 2000). Different from the year 2000, nonetheless, US GDP only makes up 25% of global GDP (31% in year 2000).

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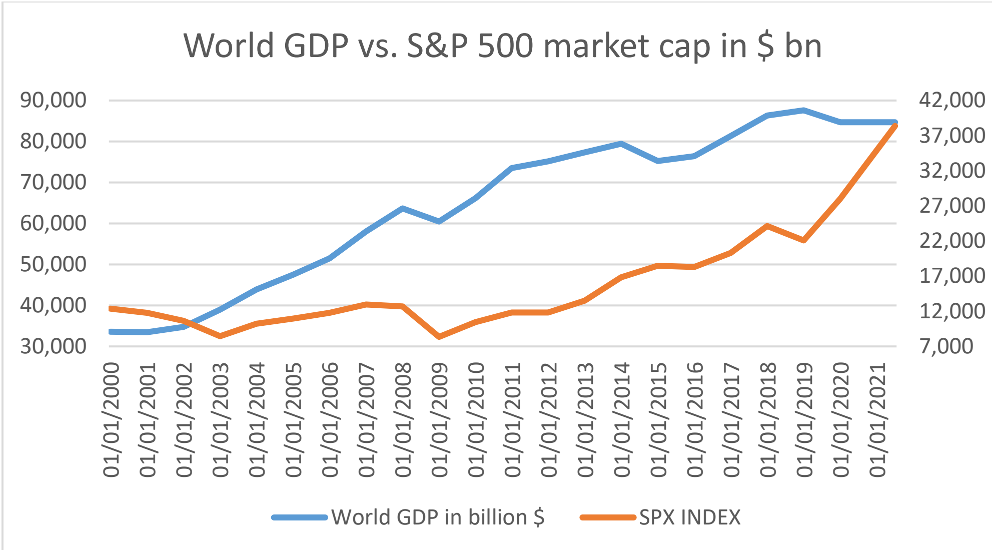
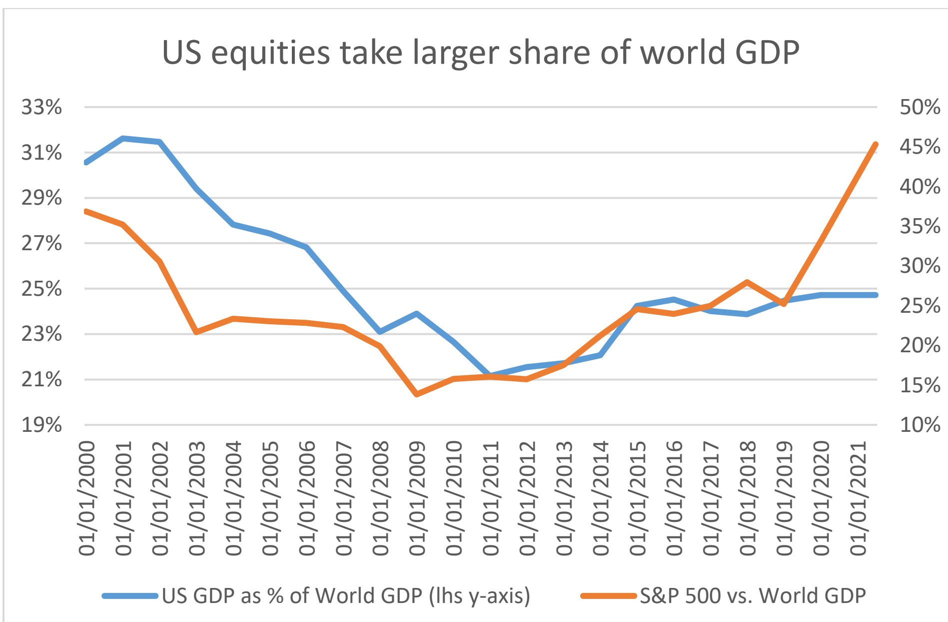
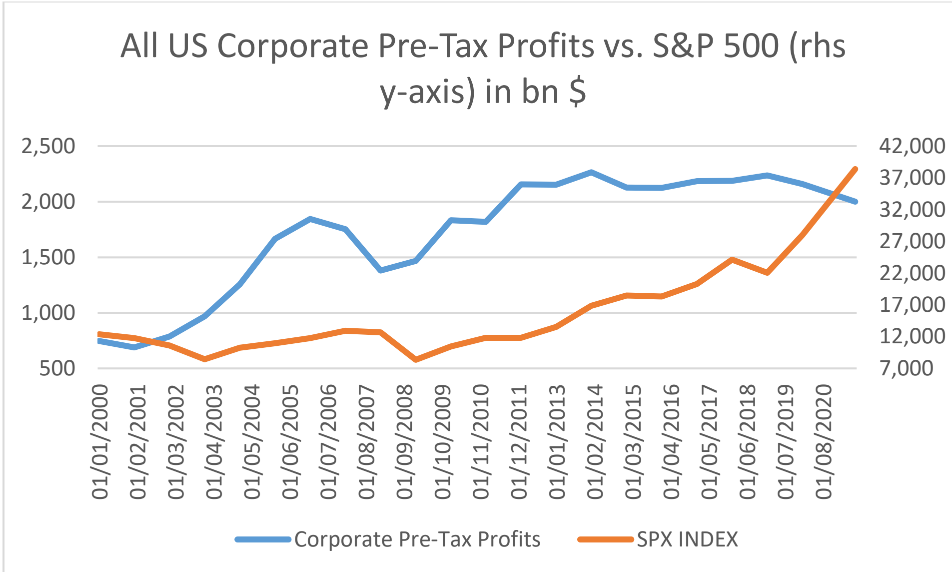


Source: Bloomberg, FRED St. Louis



Source: Bloomberg, FRED St. Louis

Between 2000 and 2021, the world has changed dramatically. Today's corporations are a lot more global than they used to and generate a higher share of their profits abroad. The World Wide Web has helped in globalising trade and China was a major contributor. After an initial bump in US corporate profits in the first 10 years of 2000s, the most recent 10 years have seen overall pre-tax profits for US corporations stagnate somewhat. At the same time, we have seen corporate tax rates in OECD countries plummet from over 30% in the year 2000 to just below 22% in 2021.



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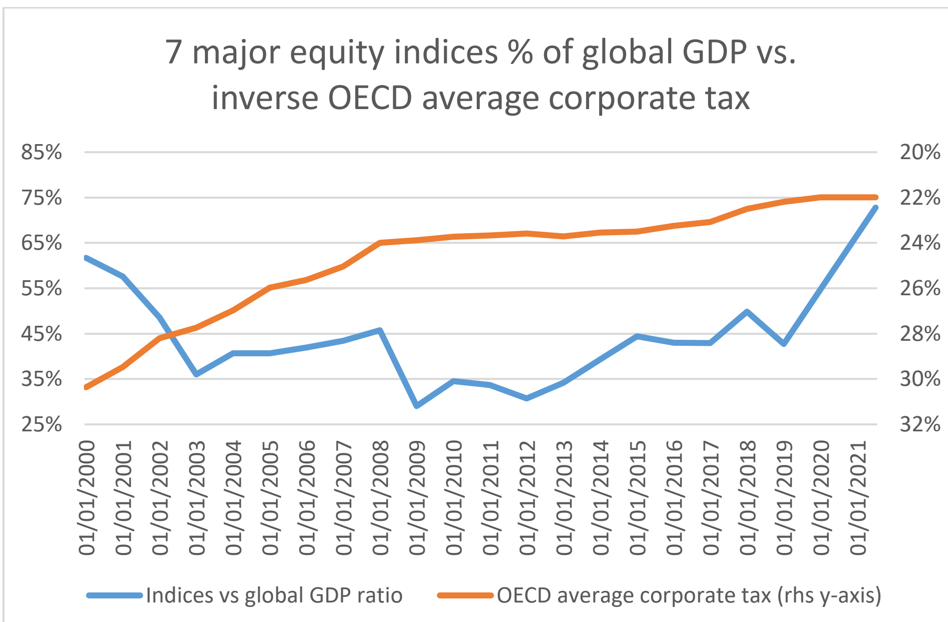

Source: Bloomberg, FRED St. Louis, OECD

Next to lower tax rates, central banks have lowered their interest rates continuously, and the US 10yr yield is now at 1.35% vs. more than 6% in the year 2000. In the Eurozone we are even seeing certain high yield bonds yielding negative rates.

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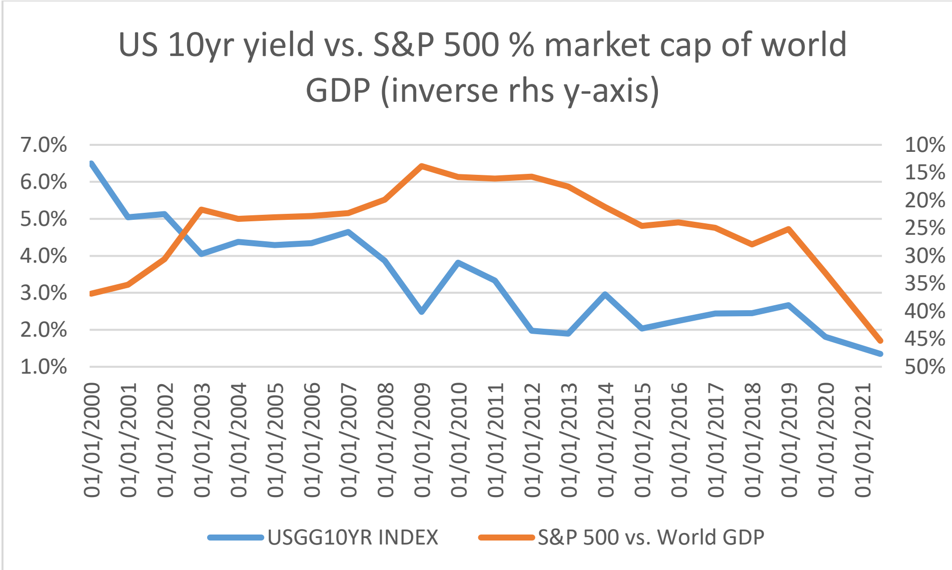
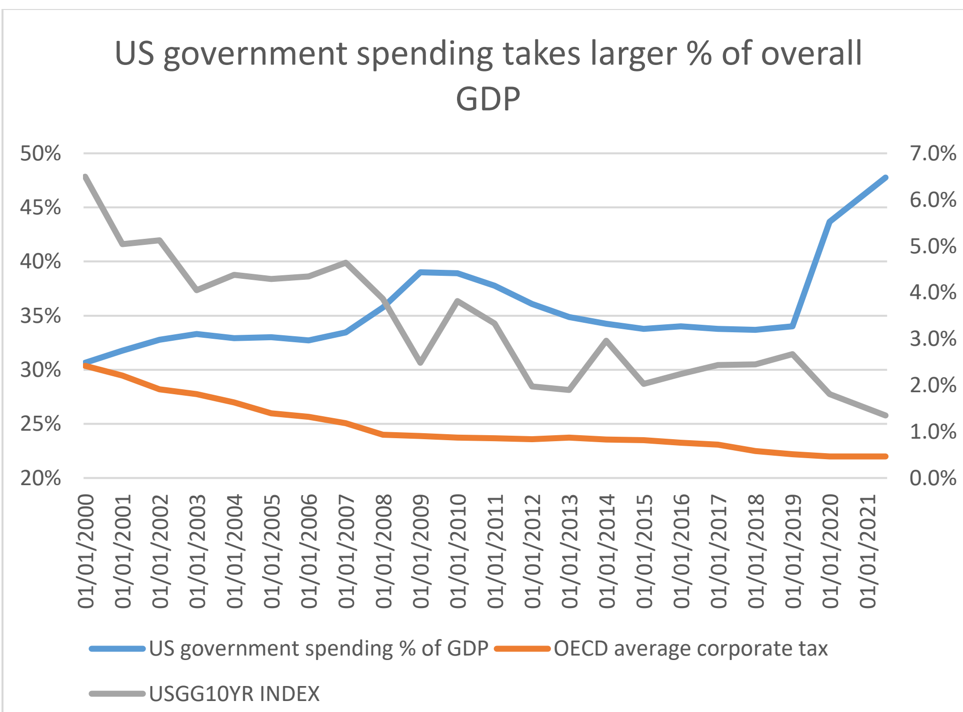


Source: Bloomberg, FRED St. Louis

Last but not least, we have had higher government spending than during any other time since World War 2, which brings me to the final chart that demonstrates the total impact of higher government spending, lower taxes and lower interest rates. All of this has supported equity prices, valuations and profits, and ultimately, pensions, investments and hiring.



Source: Bloomberg, FRED St. Louis, OECD

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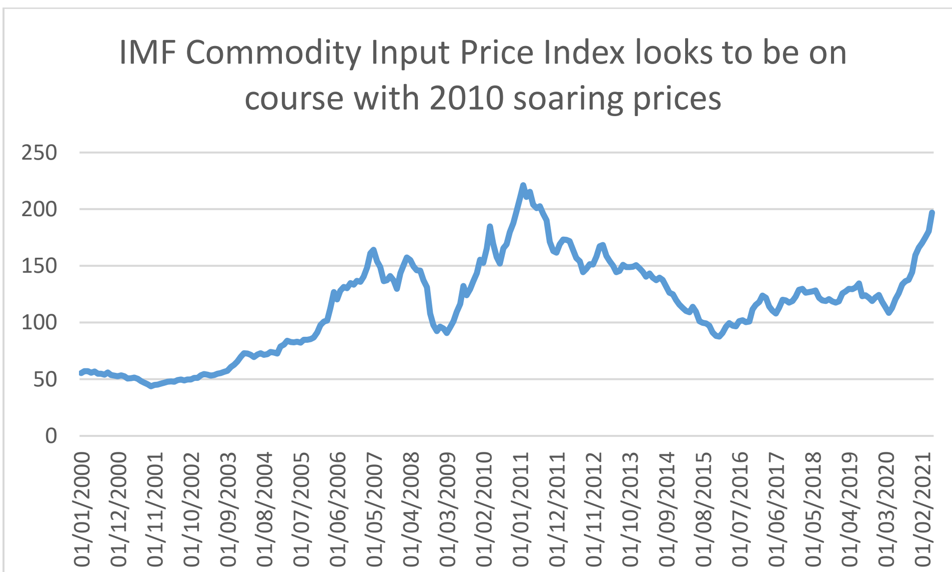
As we had the G20 finance ministers circling in on finalising a global corporate minimum tax of 15% for global corporations with profit margins of 10% or more in Venice this weekend (although only $150bn expected to be raised annually), government spending to GDP levels that are close to the period post World War 1 and China stepping up its influence with its different, communistic political system, risking the end of globalisation, you start to wonder whether we are reaching the end of high equity valuations. Overall, the outperformance of the US equity market vs. other markets can in some aspect show where the power of the world lies. The S&P 500 has a valuation of $38trn vs. a combined valuation of $23trn of the major indices of UK, Germany, Europe, Japan, HK and China. All these markets have benefitted from the above mentioned factors, but valuations from non-US equities look certainly more in line with historic valuations. The UK's FTSE 100, for instance, has had a higher valuation in 2008 than right now.

If we have reached a bottom in global corporate taxations and governments start reducing their spending, while at the same time we have monetary tightening amid soaring commodity input prices, freight costs and potential de-globalisation, we certainly sit on shaky grounds. At this stage, it is hard to see any easing in any of these three categories and we will be left with innovation as one key bright spot. Investing in domestic, smaller/mid-cap firms that are less dependent on global supply chains should hence be the best option available.



Source: International Monetary Fund

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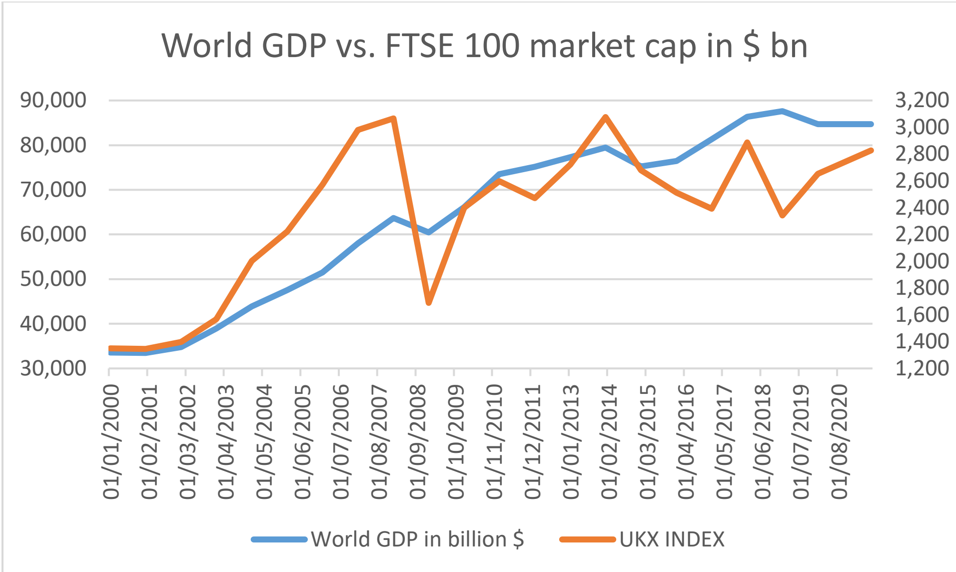
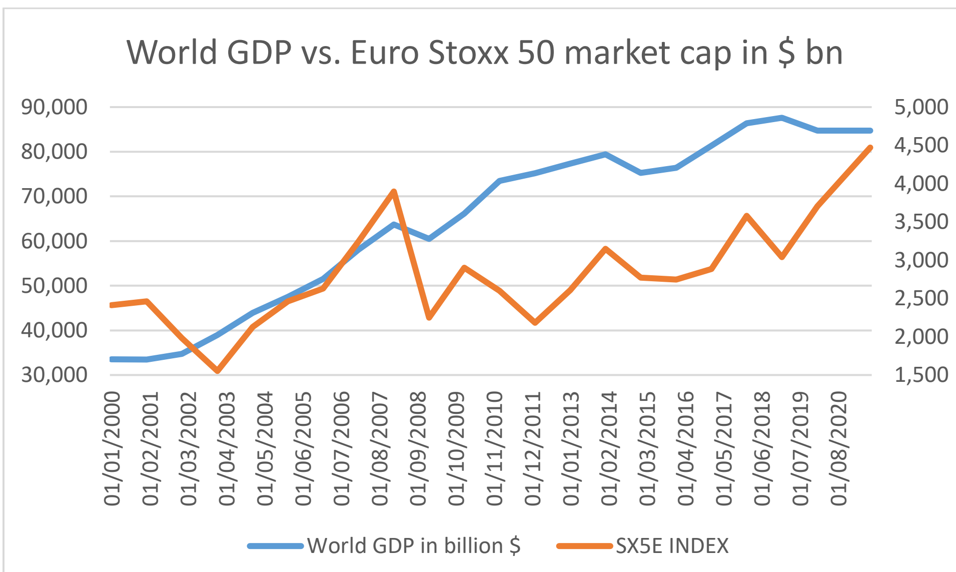


Source: Bloomberg, FRED St. Louis



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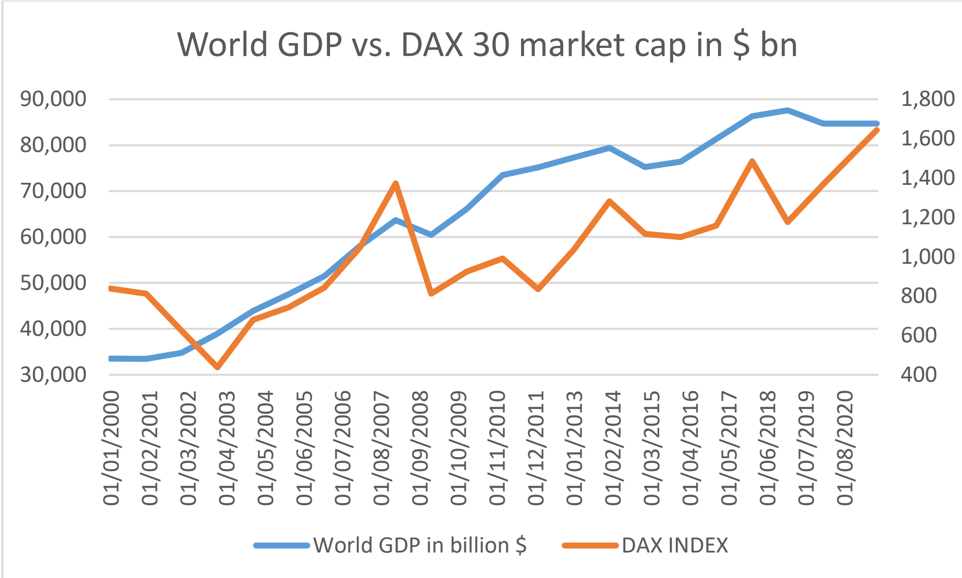

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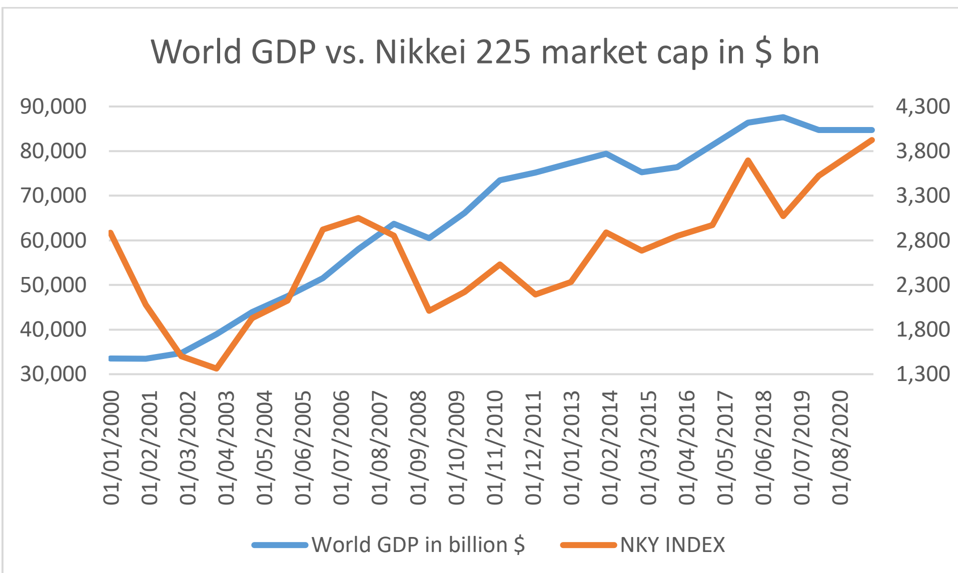

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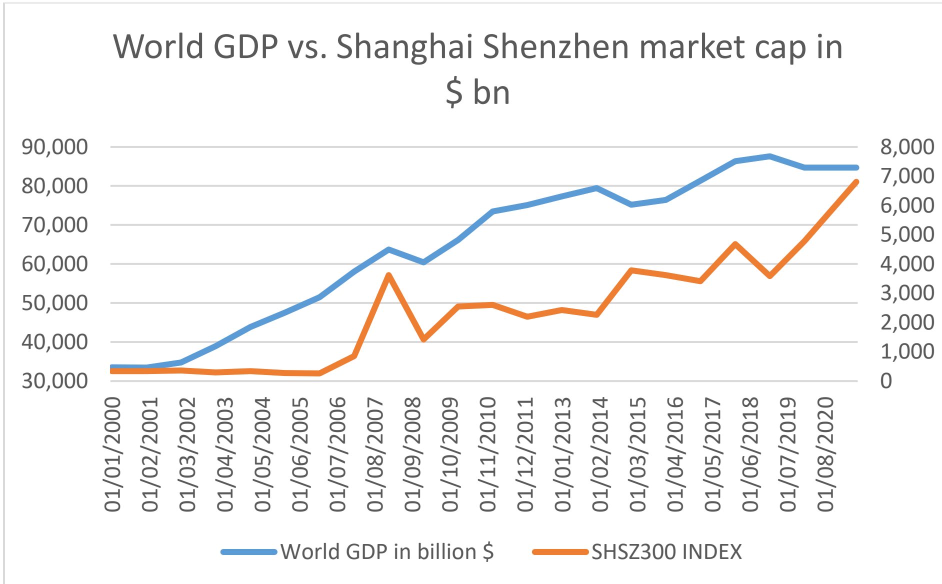

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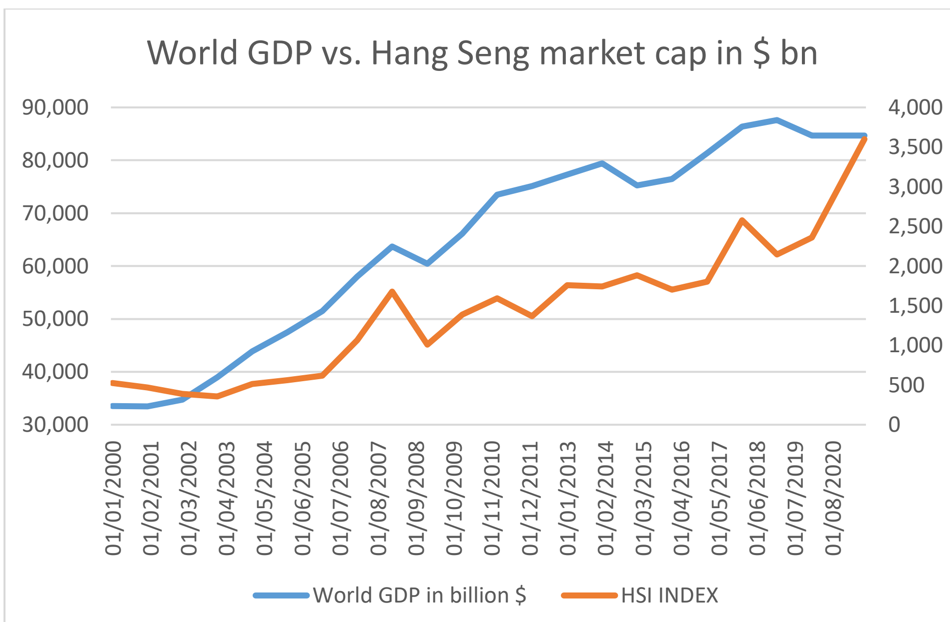

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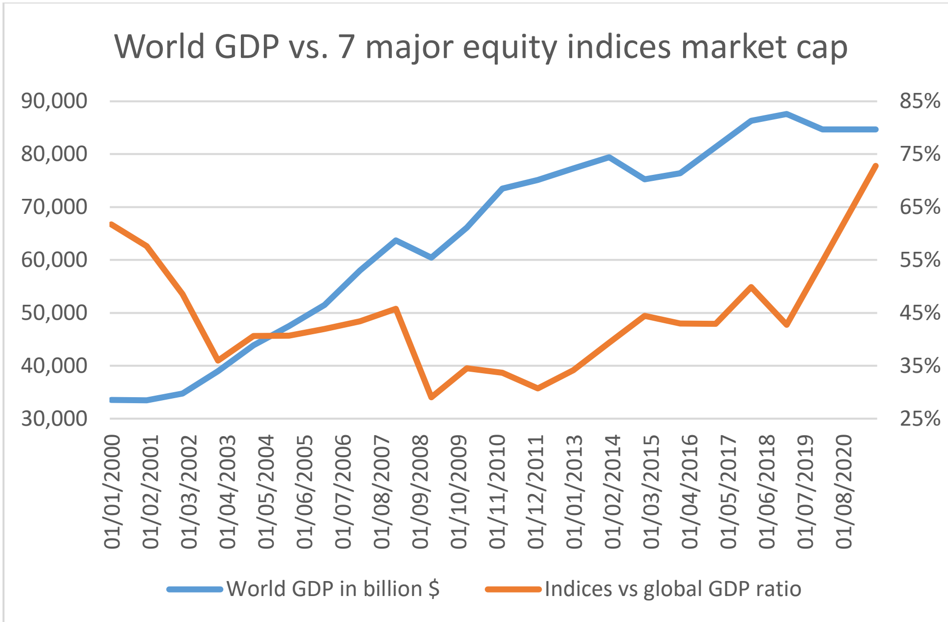

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