T. Rowe Price

Are U.S. stocks too expensive?

From the Field
August 2024

Key Insights

- U.S. stocks appear expensive, thanks to high valuations for key technology companies.
- The real question is whether current profit levels in the U.S. tech sector can be sustained. The growth path for artificial intelligence will be critical.

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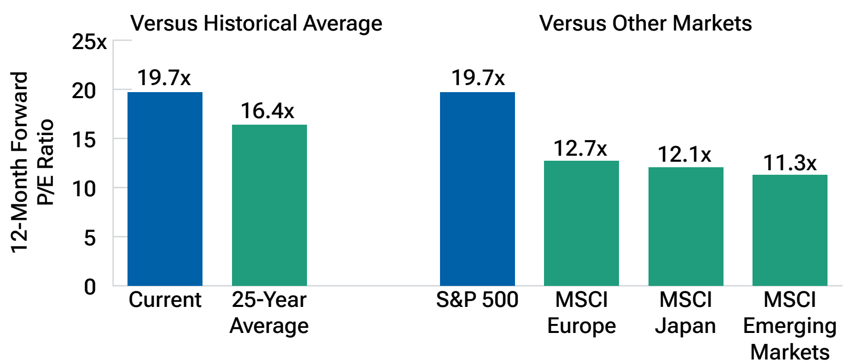
Thus far in 2024, the U.S. economy has surprised to the downside. While the Bloomberg U.S. Economic Surprise Index entered negative territory in March, the S&P 500 Index had delivered a healthy return of 9.6% through August 5th—despite the recent sharp pullback. This disconnect has raised concerns that U.S. stocks are too expensive given the deteriorating backdrop.

U.S. stock valuations do appear high. As of August 5th, the forward price-to-earnings (P/E) ratio for the S&P 500 stood at 19.7 times earnings, still significantly higher than the 25-year average of 16.4. The U.S. market also

U.S. valuations appear high

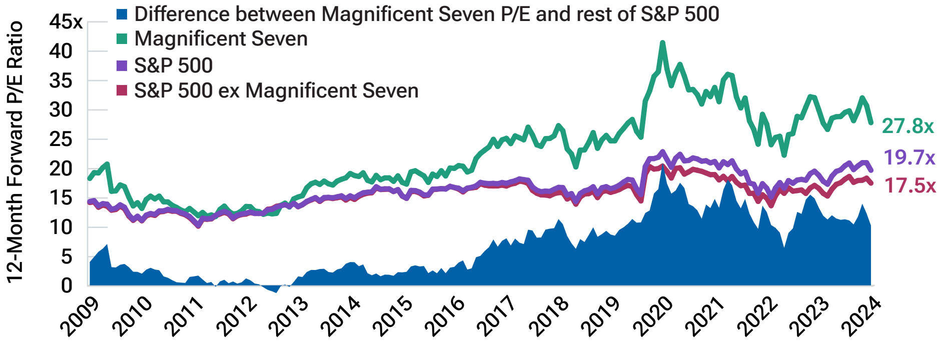
(Fig. 1) Forward P/E for the S&P 500 versus 25-year average and other regional markets



As of August 5, 2024. P/E averages calculated over monthly periods.
Actual future outcomes may differ materially from estimates.
Sources: T. Rowe Price analysis using data from FactSet Research Systems Inc. All rights reserved. Standard & Poor's (see Additional Disclosures).

Impact of mega-cap technology stocks

(Fig. 2) S&P 500 valuations with and without the Magnificent Seven[1]



July 31, 2009, through August 5, 2024.
Actual outcomes may differ materially from forward estimates.
P/E (price-to-earnings) ratios are market cap weighted.
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S&P 500 Index (see Additional Disclosures).

[1] The "Magnificent Seven" stocks are Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla. The specific securities identified and described are for informational purposes only and do not represent recommendations. Not representative of an actual investment. There is no assurance that an investment in any security was or will be profitable.

looked expensive when compared with other regional markets (Figure 1).

The tech sector distorts the picture

A closer look reveals that S&P 500 valuation has been distorted by extremely high P/Es for many U.S. tech companies—especially the mega-cap stocks known collectively as the "Magnificent Seven." This group includes Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.[1]

As of August 5, the Magnificent Seven showed a collective forward P/E of 27.8, versus just 17.5 for the rest of the stocks in the S&P 500 (Figure 2). Those same seven stocks accounted for almost a third (31%) of S&P 500 market capitalization, while the technology sector as a whole made up 32%. Meanwhile, the financials and energy sectors combined accounted for only 16% of S&P 500 market cap at the end of June.

This is notable because, like the Magnificent Seven, technology stocks in general tend to be more expensive than financials and energy stocks. So, comparing the current S&P 500 P/E with its historical average is not really an apples-to-apples comparison.

Return on equity is a reality check

When evaluating individual companies with unusually high valuations, analysts often compare the P/E with the return on equity (ROE), a measure of how profitable and efficient the company has been. This same analysis can be applied to the S&P 500.

As of August 5, ROE was 37.7% for the Magnificent Seven and 31.5% for the S&P tech sector as a whole versus just 16.3% for the rest of the index. Other major regional markets also showed dramatically lower ROEs (Figure 3).

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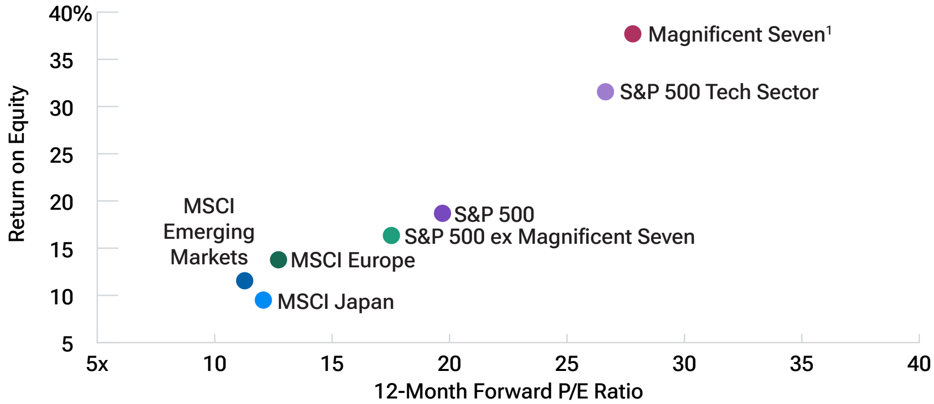
Return on equity is a reality check

(Fig. 3) ROE vs. forward P/E ratios for selected indexes



Past results are not a reliable indicator of future results. These statistics are not a projection of future results or company performance. Actual results may vary significantly.

ROEs are on a market cap-weighted basis calculated for the trailing 12 months as of August 5, 2024.

[1] The "Magnificent Seven" stocks are Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla.

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The bottom line is that valuation premiums for U.S. technology stocks, and for U.S. stocks in general, do not appear unreasonable in the context of profitability. While U.S. economic momentum has slowed, tech sector earnings have remained strong, thanks to the massive buildout of artificial intelligence (AI) infrastructure.

The real question is whether these elevated levels of profitability and efficiency can be sustained. Eventually, evidence will need to emerge that the substantial capital investments being made in AI will yield sufficient profits.

Additionally, if the U.S. economy weakens significantly, mega-cap tech companies may become much less willing to continue increasing their capital spending.

Conclusion

While U.S. stocks may seem overvalued, a deeper analysis suggests that these elevated valuations have been driven by exceptional profitability. However, the sustainability of those profit levels remains an open question. As a result, our Asset Allocation Committee currently holds a broadly neutral allocation to U.S. equities.

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