The Forward 12-Month P/E is a Good Barometer

The S&P 500's forward 12-month P/E ratio is now below its 5-year average

Corporate earnings are the lifeblood of the stock market and stock prices move in response to real or perceived earnings changes. The trick is to find those whose earnings growth is strong, and should remain strong.

Understanding Earnings

Each quarter, public companies open their books and disclose to the world how they performed during the past three months. It can be a time of great stress and great jubilation for shareholders. The move in a company's share price following an earnings announcement often stems from whether the company beats or misses the expectations set by Wall Street.

In addition, during earnings season, volatility often also ramps up as individual stocks can have some of their biggest moves of the year on the days they report.

Understanding P/Es

Investors use the "price-to-earnings ratio" (P/E ratio) as one tool to help value a company. It is one way of measuring different companies as well as measuring a company against its historical record.

Mathematically, the P/E ratio measures a company's current share price versus its earnings per share. So generally speaking, the lower the P/E ratio is, the better it is for the business and its shareholders.

For example, assume that a company has a current share price of $100 and this year's earnings per share are $5. The company has a current P/E ratio of $100 / $5 = 20x.

But when calculating forward P/E, we need to take into account how much earnings might grow in the next year.

Using the same example as above: assume that a company has a current share price of $100 and this year's earnings per share are $5. But then assume that analysts estimate that the company's earnings will grow by 10% over the next fiscal year.

- The company still has a current P/E ratio of 20x ($100 / $5 = 20x).
- But the company's forward P/E ratio is calculated as $100 / ($5 x 1.10) = 18.2x. The forward P/E is smaller than the current P/E since the forward P/E accounts for future earnings growth in relation to current share price.

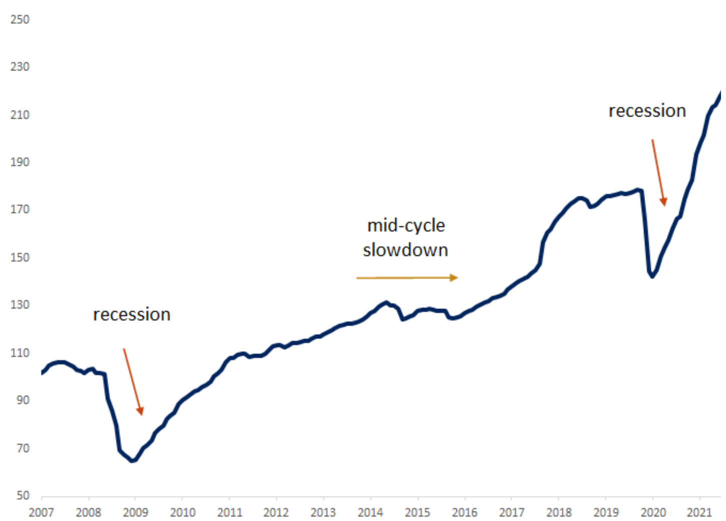
Understanding the Earnings of the S&P 500

As of mid-May 2022, the closing price for the S&P 500 stood at just north of 4,000, after peaking at about 4,700 at the end of 2021.

And with that decline in price, the forward 12-month P/E ratio for the S&P 500 fell to about 17.6x.

But, earnings are still well above pre-pandemic levels.

S&P 500 earnings are 33% above their pre-pandemic level



Source: Factset

How Much Did the S&P 500 Forward P/E Ratio Change as of Mid-May?

According to research firm FactSet:

- The forward 12-month P/E ratio of 17.6x was below the five-year average of 18.6x.
- However, it was still above the next four most recent historical averages: 10-year (16.9x), 15-year (15.5x), 20-year (15.5x), and 25-year (16.5x).

In other words, the stock market is cheaper now relative to where it was 5 years ago, but more expensive relative to where it was 10, 15, 20 and 25 years ago. Remember, that's in aggregate, so individual stocks will of course vary.

And in case you're wondering, the lowest P/E ratio of the past nine years was 13.1x – and that was recorded on March 23, 2020.

At the sector level, five sectors had forward 12-month P/E ratios below 18.0x, including the Energy (10.3x) and Financials (12.8x) sectors. The most expensive sector was the Consumer Discretionary (25.0x) sector.

Source: factset.com

-