Flash Economics

N° 55
December 17th, 2024

Are US equities overvalued relative to European equities?

The valuation of US equities (forward P/E, based on next year's results, of 22.2) is significantly higher than the valuation of European equities (forward P/E of 13.9).

Is this valuation gap consistent with the economic situation in the two regions, or is it abnormally high?

One can look at:

- Nominal interest rates;
- GDP or corporate profit growth rates;
- Future growth prospects.

This shows us that the valuation gap in favour of US equities is largely justified by the decline in European corporate profits. The difference between the theoretical P/E calculated for US equities and European equities is 10.2 (compared with 8.3 for the observed difference between P/Es).

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A very wide valuation gap between US and European equities

If we look at the forward P/Es (calculated on the basis of expected profits for the following year) of the S&P 500 Index and the Euro Stoxx 50 Index, **one can see a very wide valuation gap in favour of US equities** (**Charts 1A/B**).

Chart 1A
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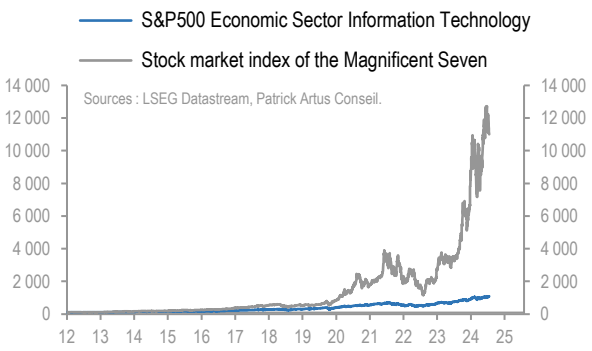


Chart 1B
Forward P/E ratio



We wonder whether this **valuation gap is fundamentally justified** or whether it is the result of an irrational attraction to US equities, particularly technology stocks (**Chart 2**).

Chart 2
United States: Stock market indices (01.06.2012 = 100)



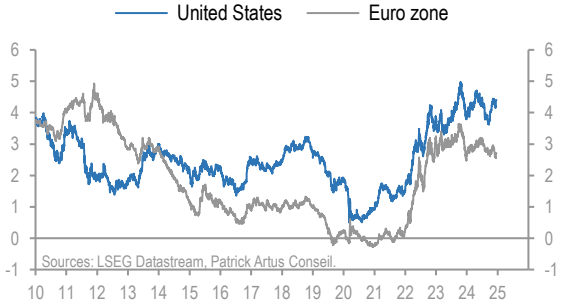
* Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, Tesla

Fundamental determinants of stock market valuation

Stock market valuation depends on the spread between:

- **Nominal long-term interest rates (Chart 3)**;

Chart 3
Interest rate on 10-year government bonds (as %)



- **And the growth rate of corporate profits (Charts 4A/B)**;

Chart 4A
Profits after tax and interest of non-financial corporations (Y/Y as %)

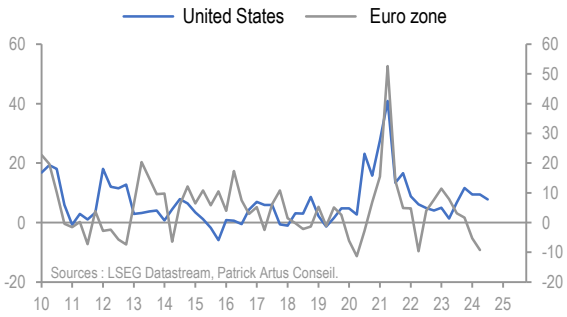
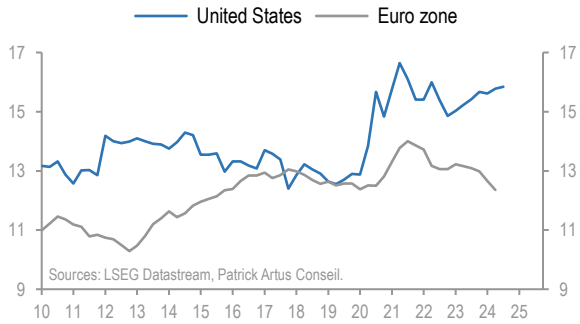


Chart 4B
Profits after tax and interest of non-financial corporations (as % of nominal GDP)



- Or, equivalently, **the gap between long-term real interest rates (Chart 5) and profit growth in real terms (Chart 6)**.

Chart 5
Real interest rate on 10-year government bonds (deflated by 10-year inflation swap, as %)

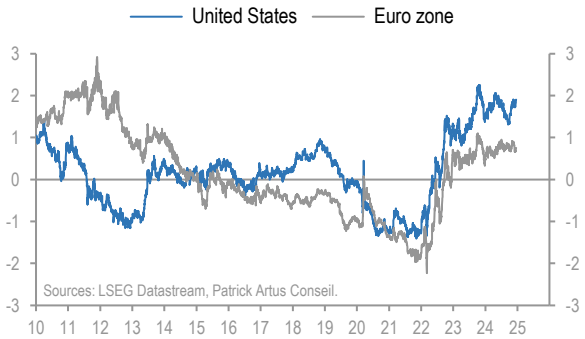
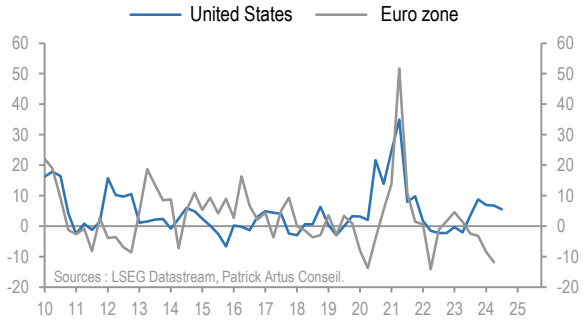


Chart 6
Real profits after tax and interest of non-financial corporations* (Y/Y as %)

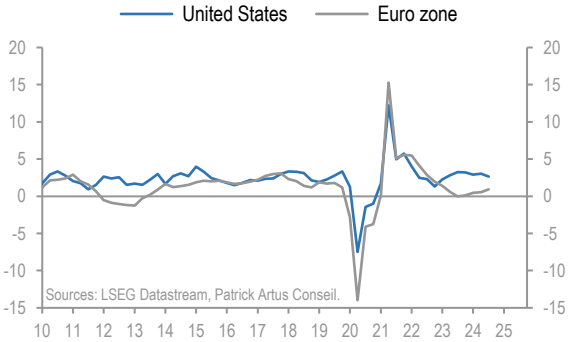


*Deflated by GDP deflator

In principle, it is the **expected growth rate of profits that matters**. It depends on:

- **Expected GDP growth (Chart 7)**;

Chart 7
Real GDP (Y/Y as %)



- **The deformation of income distribution (Charts 8A/B).**

Chart 8A
United States : Real compensation per hour and productivity per hour (business sector, 2010.Q1 = 100)

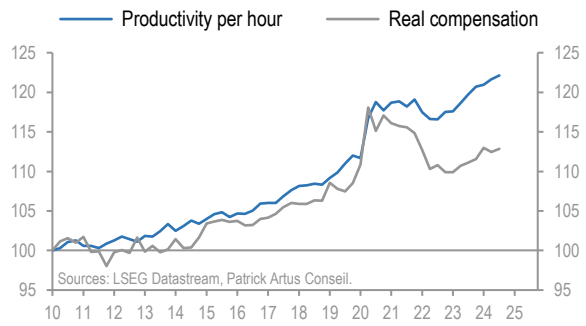
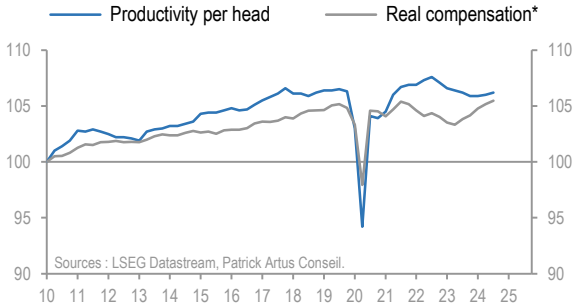


Chart 8B
Euro zone: Real compensation and productivity per head (2010.T1 = 100)



* Deflated by GDP deflator

One can see:

- **In the United States**, since 2021, stabilised growth at a fairly high level and a shift in income distribution in favour of companies;
- **In the euro zone,** weak growth and stable income distribution.

The gap between the growth rate of profits in real terms and the real long-term interest rate has been 6.6 points wider in the US than in the euro zone since 2023. GDP growth in the US will remain higher than in the euro zone. **Income distribution** will remain more favourable to companies in the United States than in the euro zone.

Summary: Overall, is the gap between the valuation of US equities and that of European equities justified?

The starting point should be the spread between the nominal long-term interest rate and the nominal earnings growth rate, or equivalently, the spread between the real long-term interest rate and earnings growth in real terms.

The real long-term interest rate has averaged since 2023:

- 1.6% in the United States;
- 0.7% in the euro zone.

Since 2023, profit growth in real terms has been:

- 4.2% per year in the United States;
- -3.3% per year in the euro zone.

The spread between the real long-term interest rate and the growth rate of profits in real terms is therefore 6.6 points lower in the United States than in the euro zone. If the equity risk premium is of the order of 8%, this difference amply validates the valuation gap between the US and European equity markets, since it explains the difference of 10.2 between the P/E in the US and the P/E in the euro zone.

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