Market fundamentals:
2000 versus 2007

Whither the S&P 500? Comparing the market’s recent turmoil with its decline at the end of the dot-com boom can help investors assess what might come next.

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Article at a glance
When the S&P 500 peaked above 1,500 in July 2007, it returned to levels not seen since the tech bubble in 2000. While it has since subsided, at this writing it is still quite strong.

Given some notable similarities between 2007 and 2000—growth during both periods was concentrated largely in a couple of sectors, for example—managers and investors may wonder if the market is again out of line with fundamentals. Our research finds that it isn’t.
Talk about summertime blues. After peaking above 1,500 this July, the S&P 500 suffered an abrupt 10 percent correction before ending the month of August at 1,475. As McKinsey on Finance goes to press, the broad market has rebounded following interest rate cuts by the US Federal Reserve bank in mid-September. But stocks remain buffeted by a volatile credit market and by concerns that current high price levels might succumb to the same economic forces. Forces that caused the markets to plunge more than 40 percent in the three years after the last peak, in 2000.

As central bankers warily eye credit markets and ponder further interest rate cuts, no one can really anticipate what might happen next in a market wracked by volatility and skittish investors. Nonetheless, a comparison of the fundamentals underpinning the S&P’s recent performance and those at the time of the 2000 peak offers insights about the parallels and divergences between the two periods. These insights can give investors a better feel for where the market is now—and where it might head next.

First, the similarities. At one level, during both the run-up to the recent peak and the earlier dot-com market surge, most of the growth in market values was concentrated in a few sectors. Performance during the subsequent decline also varied by sector. However, the peak in 2007 differed considerably from the one in 2000. During the 1990s investor euphoria and a highly speculative atmosphere overtook the market, raising P/E ratios to heights that made valuations unsustainable. In contrast, this year the market rode to its July peak on the back of exceptional corporate earnings, healthy GDP growth, a fast-paced M&A boom, and amazing consumer resilience despite a slump in the US housing market.

To get a better look at what exactly was driving the broad market during these periods, we analyzed two components of the market value of companies in the S&P 500—earnings and P/E ratios—assessing the performance of both over the past four decades at the market and the industry level.

As a first step we analyzed recent P/E levels. In an earlier article we described our simple P/E model,

\[ P/E = \frac{Earnings}{Price} \]

 driven by a few fundamental factors that explain these ratios: long-term returns on capital, long-term real growth, the cost of capital, and expectations of inflation (Exhibit 1). Our model does a good job of explaining aggregate-market P/E ratios over the past 45 years—except during the speculative period around 2000. In that year overoptimism about the prospects of the technology, media, and telecom sectors and of megacompny stocks led the overall market P/E ratio to unsustainably high levels disconnected from the fundamental value creation potential of companies. The earlier article also shows that interest rates (and investors’ expectations of inflation) are inversely related to P/E ratios and
have driven most of their fluctuations over the past 45 years.

**EXHIBIT 1**

**Reasonable valuations**

The current market P/E, in 2007, is about 35 percent lower than it was in 2000 and in line with our modeled P/E. In other words, the current ratio is consistent with current levels of interest rates, inflation, and long-term growth. Note that the current P/E also resembles the P/E of the 1960s, when inflation and interest rates were low, as they are now. If today’s corporate earnings can be sustained, and interest and inflation rates stay low, the current P/E level is reasonable.

Since today’s P/E is in line with economic conditions, it is reasonable to conclude that exceptionally strong corporate earnings must have been responsible for this year’s peak in the S&P 500. Indeed, the ratio of total profits to GDP soared in 2006, to an unprecedented 5.7 percent—much higher than the historical average, about 3.2 percent, and easily surpassing the previous record of 4.5 percent, set in 2000. This level of performance isn’t limited to S&P 500 companies, though they might have benefited disproportionately from a weakening dollar. The analysis of all publicly listed US companies shows a strikingly similar pattern of record high profits.

What’s more, returns on equity (ROE) are strong (Exhibit 2). Aggregate S&P 500 earnings grew at a compounded annual rate of 9.5 percent from 2000 to 2006, though total productive capital grew by only 5 percent each year. As a result, the aggregate ROE shot up to 23 percent, from 20 percent, for the same period—well above the 13.6 percent median ROE from 1962 to 2006.
Can such extraordinary earnings last? For indications, look at whether the current earnings strength is broadly based. Such advances tend to prove more sustainable than those driven only by individual sectors, since it is easier for weakness from one or a few sectors to be offset by enduring strength in others. A sector-specific analysis of the S&P 500 index finds that while for most sectors earnings growth from 2000 to 2006 resembled its growth during the entire past decade, two broadly defined sectors grew much more quickly during the past six years, the period from peak to peak: the financial sector and the energy, utilities, and materials sector (Exhibit 3). Higher oil and gas prices clearly drove earnings in the latter, low interest rates and loose credit drove the former. The sharp increase in these two sectors elevated their share of total S&P earnings from 41 percent in 1997 to 51 percent in 2006. In contrast, earnings growth from 1997 to 2000—the run-up to the previous peak—was more balanced across a number of sectors.
In the end, whether or not the S&P 500’s current level is sustainable depends entirely on corporate earnings, particularly in the energy and financial sectors. If these two sustain their level of profits, the current peak in the S&P 500 could be the new base level for future growth. However, if corporate earnings as a whole revert to their historical relationship with GDP, a return to the recent peak of the S&P 500 may take some time.


2 Median forward P/E as of the end of August 2007.

3 Defined for the companies on the S&P 500 index as total net income before extraordinary items.

4 In addition, we have examined similar ratios of the profits of top European companies (FTSE 300) to the total GDP of all Western European economies. The pattern is similar, with a more pronounced upward trend. For the US economy, we have also used the corporate-profit measures published by the US Bureau of Economic Analysis (BEA) and found a pattern similar to that of the S&P 500.

5 Aggregated using the Global Industry Classification Standard (GICS), developed by Standard & Poor’s and Morgan Stanley Capital International. The financial sector includes banks, diversified financials, insurance, and real-estate industry groups. The energy, materials, and telecom sector includes the energy, materials, and utilities industries. The consumer sector includes automobiles; consumer durables; apparel; consumer services; retailing; the retailing of food and staples; foods, beverages, and tobacco; and household and personal products. The health care sector includes...
health care equipment and products, as well as pharmaceuticals, biotechnology, and life sciences. The IT sector includes technology hardware and equipment, as well as semiconductors and semiconductor equipment. The industrial sector consists of capital goods, transportation, and commercial supplies and services.

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