

Is CAPE fear warranted?

This vaunted valuation metric is useful, but it's not destiny.



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The stock market continued its upward trajectory in October. The S&P 500 advanced 2.27%, and the Nasdaq Composite rose 4.7%. For certain investors, recent gains exacerbated worries about elevated valuations. Some investors have pointed to the market's historically high cyclically adjusted price-to-earnings (CAPE) ratio as a possible warning sign.

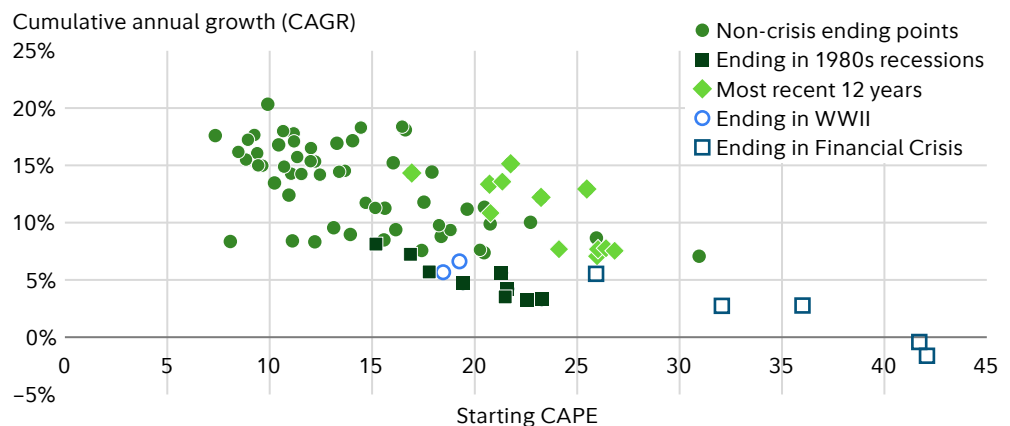
CAPE compares a stock's price with its earnings per share over the prior 10 years, adjusted for inflation. Historically, when the market's CAPE has been high, stocks have posted low average returns over the next 10 years. The relationship between high CAPE and low subsequent returns can seem ironclad—but our analysis suggests it may not be, and investors should be thinking carefully before betting on it.

High CAPE, lost decade? Not necessarily.

Since 1932, many 10-year periods that started with high CAPE ratios produced poor returns. But the worst of these periods also had something else in common: All of them ended during major market crises. The connection between high starting CAPE and poor 10-year returns becomes less clear if you remove the 10-year periods that ended in World War II, the inflationary recessions of the early 1980s, and the 2008 financial crisis. Many of the remaining 10-year stretches with high CAPE ratios produced solid returns, including 7 of the last 12 periods (Exhibit 1).

Exhibit 1: Most 10-year periods that did not end in crisis produced strong returns.

Starting CAPE ratios and forward 10-year CAGR, 1932–2024



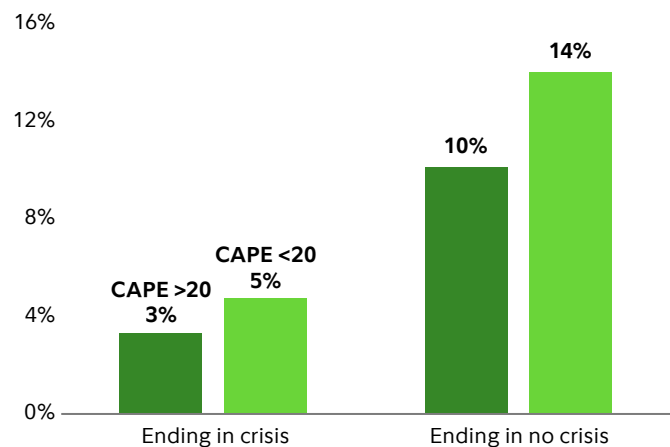
Past performance is no guarantee of future results. CAPE: Cyclically adjusted price-to-earnings, a stock market valuation metric defined as price divided by average inflation-adjusted 10-year earnings. CAGR: Compound annual growth rate. All data gathered and analyzed annually from 1932 to 2024. Analysis based on the S&P 500. Sources: Haver Analytics and Fidelity Investments, as of 12/31/24.

Ending in crisis may have a bigger influence than starting CAPE

Which was worse for 10-year returns: starting with a high CAPE ratio or ending in a crisis? The latter, according to our analysis. Ten-year periods that ended outside the three crises listed above delivered strong average 10-year returns, even when CAPE began in the top quartile of its historical range (Exhibit 2). By contrast, periods that concluded with a crisis had poor results, whether their starting CAPE was high or not. CAPE did matter: High starting CAPE was associated with lower returns in both crisis and non-crisis periods. But the crises seemed to matter more.

Exhibit 2: Outside crises, 10-year periods with high starting CAPE had strong average returns.

Average S&P 500 CAGR during 10-year periods beginning with CAPE in top quartile or not and ending in crisis or not, 1932–2024



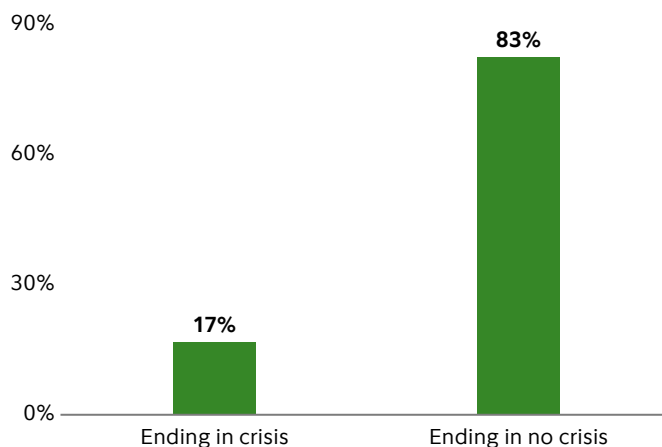
Past performance is no guarantee of future results. CAPE: Cyclically adjusted price-to-earnings ratio. A stock market valuation metric defined as price divided by average inflation-adjusted 10-year earnings. CAGR: Compound annual growth rate. Crisis defined as periods ending during World War II, the inflationary recessions of the early 1980s, and 2008 financial crisis. All data gathered and analyzed annually from 1932 to 2024. Analysis based on the S&P 500. Sources: Haver Analytics and Fidelity Investments, as of 12/31/24.

Crises have been relatively rare

Based on this analysis, investors who reduce their equity allocations based on fears of weak 10-year returns are effectively betting that the market will be in crisis 10 years from now. That bet has poor odds, historically. Only 17% of 10-year periods since 1932 ended during the three influential crises noted above—WWII, the inflationary 1980s recessions, and the Great Financial Crisis (Exhibit 3).

Exhibit 3: Major crises occurred less than one-fifth of the time.

10-year periods that ended in WWII, inflationary 1980s recessions, or the Great Financial Crisis, 1932–2024



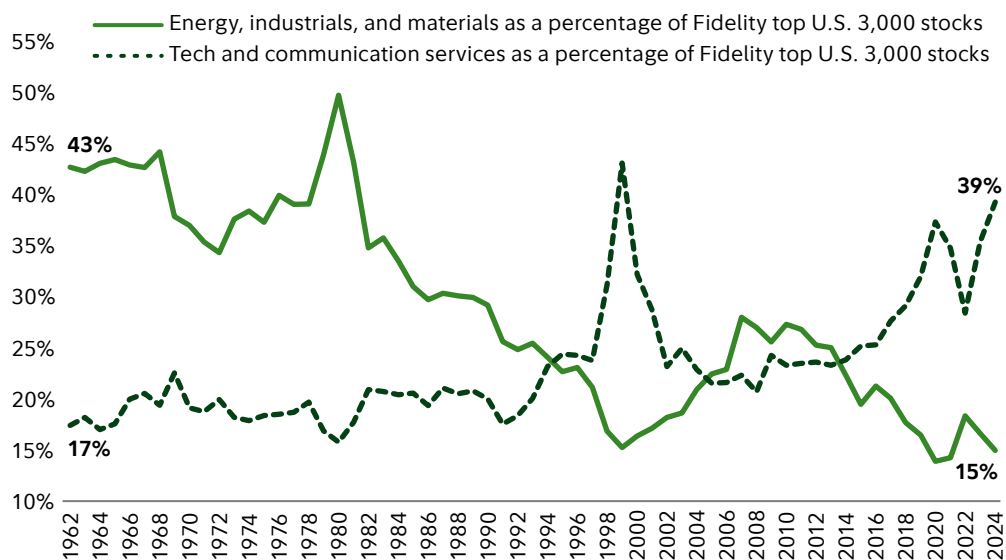
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Today's high valuations may stem from long-term market shifts

CAPE is a useful metric, but it should be considered in context. Today's historically high CAPE ratio is partly a natural result of long-term shifts in the composition of the stock market. Energy, materials, and industrials stocks dominated the U.S. stock market before the mid-1990s; those sectors' relatively low margins and slow growth warrant modest valuations. Today, tech and communication services make up nearly 40% of the index. Their higher margins and stronger growth prospects deserve higher valuations (Exhibit 4).

Exhibit 4: The market may deserve a higher valuation than it used to.

Sector composition shift, 1962–2024



Past performance is no guarantee of future results. All data gathered and analyzed annually from 1962 to June 2024. Analysis based on Fidelity top U.S. 3,000 stocks by market capitalization. Sources: Haver Analytics and Fidelity Investments, as of 12/31/24.

Conclusion

Buying at lower CAPEs has led to higher long-term returns, all else being equal. That said, since 1932, 10-year periods that did not end in crisis generally produced strong returns even when they began with high CAPE ratios. What's more, today's historically high CAPE ratios can be explained at least partly by shifts in the composition of the market. The upshot: Investors may want to think twice before underweighting equities because CAPE is higher than it used to be.

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