Is the Market Overvalued? A Look at the Consumer Staples Sector

Description

With the TSX showing an impressive one-year return of 18% a five-year return of 26% and trading at all-time highs, investors should be feeling nervous. Are valuations getting ahead of themselves or is there room to go higher?

I prefer to answer this question by looking into the different segments of the market and making a case-by-case conclusion, and hopefully finding the areas with the most value.

Let's look at the consumer staples sector and delve a little deeper. The Consumer Staples Index is pretty much flat compared to a year ago, and it has a five-year return of 146%. With all the volatility in commodity prices and uncertainty about the economy, the staples sector has been a good place for investors to achieve relative peace of mind and security with investments that are more immune to the cycles of the economy.

Let's compare these returns against economic fundamentals and market valuations to formulate an opinion on whether the market is overvalued or not. From a macroeconomic perspective, the consumer staples sector is still looking good, as interest rates have begun to rise to normalize the interest rate environment, and there remains much geopolitical uncertainty.

Looking at valuations in this space, however, should cause investors to pause.

Alimentation Couche Tard Inc. (TSX:ATD.B) is a prime example of the issue at hand. The stock is pretty much flat on a one-year basis, which I think speaks to the fact that it has been very richly valued for a while now. Its five-year return is 483%, and the stock trades at a P/E of 26 times this year's earnings with a growth rate of 14%. While there is no denying that the company has been wildly successful, this valuation has shifted the risk/reward relationship into a riskier territory.

Saputo Inc. (TSX:SAP) is another example of companies in this space whose shares have gotten so richly valued that they are priced for perfection and will be highly vulnerable. The stock has a one-year return of 18% and a five-year return of 116%, and the stock trades at a P/E ratio of 24.4 times this year's earnings.

In summary, I think that, in general, valuations in this sector have gotten too high and that, in the short term, at least, there are better places for investors to invest that will give better returns. Longer term, when valuations come down to more reasonable levels, many of these companies will be great places for investors to park their money.

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