TSX Stocks Overvalued? Mr. Market Seems Not to Care

Description

We have come a long way since the pandemic-led crash last year. The **TSX Composite Index** has soared more than 55% since then and looks in great shape. As well, global equities, including TSX stocks, have consistently rallied, even though full reopenings still look uncertain and far. So, do you think markets are overplaying the recovery card?

TSX stocks and their valuations

If we look at the valuations, stocks do not seem exorbitantly expensive. Among the 230 constituents of the TSX Composite Index, excluding companies with negative EPS, 33% of stocks have price-to-earnings (P/E) multiples beyond 30. A majority of TSX stocks fall in the middle range with P/E ratios between 15 and 25. So, things certainly do not look as gruesome as some depict.

Interestingly, the top 10 constituents of the TSX Index collectively form a robust 40% weight in the Index. The average P/E of these largest Canadian companies is around 25. Now, that's a tad overvalued against the historical average. However, it's not that terrible that you have to anticipate a big crash.

Undoubtedly, Canadian tech titan **Shopify** (TSX:SHOP)(NYSE:SHOP) makes the average skewed upwards, with its P/E at 78. However, if we exclude SHOP from the top 10 constituents, the average P/E falls down to 20, even indicating a decent upward potential.

According to S&P Global, TSX Composite Index has a historical P/E of 23 and a forward P/E of 17.

Shopify never disappoints: SHOP is up 30% YTD

In addition, tech companies indeed deserve a higher valuation multiple. They grow relatively faster against broader markets due to their superior profit margins and growing markets. Shopify has been doubling its top line almost every year since 2015.

As the company achieves firmer footing in the retail e-commerce space, it will likely continue its uncompromising growth in the next few years. So, even if SHOP stock looks way overvalued by traditional valuation metrics, market participants believe that this growth will materialize in its stock price in the future.

At the same time, Canadian fintech player **Nuvei** (TSX:NVEI) dons a P/E of an insane 180. Investors seem to not care about an unreasonable valuation with some growth stocks. Agreed, the company has shown aggressive growth recently, and its strategic acquisitions place it in an even better position for the long term. However, the stock seems to have gone too far, too soon. After a steep run, NVEI stock is up almost 190% since September 2020.

Growth investors seem to shrug off valuation concerns

Notably, a majority of the chunk of TSX stocks lie in between 15 and 25, which looks fairly valued. Canadian bank stocks belong to this group and could unlock decent value for shareholders in the long term.

As we know, markets are forward looking and generally trade two to three quarters ahead. So, unsurprisingly, earnings growth will likely accelerate in the latter half of 2021, driven by vaccinations and gradual reopenings.

In addition, many businesses have become more cost efficient, thanks to the pandemic. So, we might see profit margin expansion continuing for the next few quarters, which could not have been possible in the regular course of business.

Bottom line

Inflation and growth stocks generally trade inversely to each other. If inflation keeps climbing upwards, notably overvalued TSX stocks might see some weakness. However, Canadian stocks at large do not seem significantly overvalued, and the rally could continue, as earnings growth gathers steam later in 2021.

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