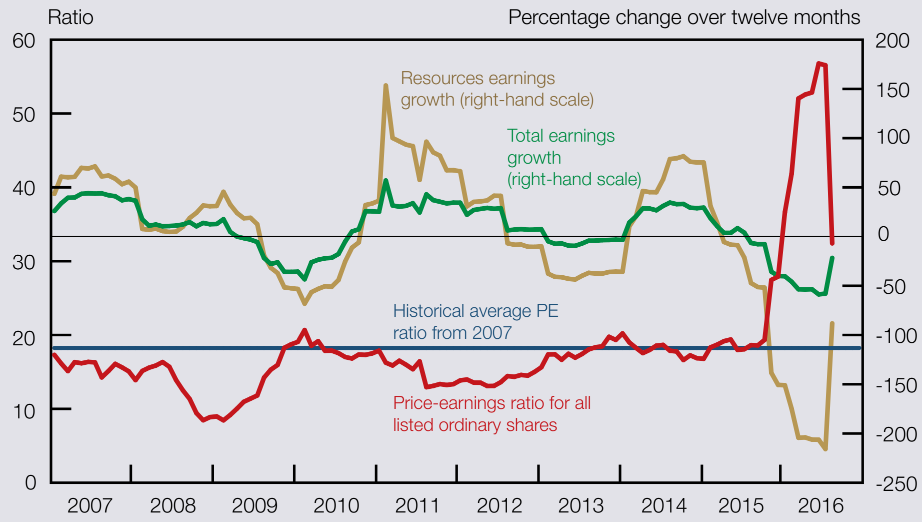
Box 3 Price-earnings ratio of all ordinary shares listed on the JSE[1]

The price-earnings (PE) valuation ratio measures how expensive a company's share is relative to its earnings. It is calculated as the current market price of a company's share divided by its earnings per share. Earnings per share, in turn, is an indicator of profitability, capturing the after-tax profits of the company. The PE ratio indicates the number of years an investor will have to hold the share to recover the current share price at current earnings. A higher PE ratio can be interpreted to suggest that investors anticipate higher future earnings. As a multiple of earnings, it is thus an indicator of over- or undervaluation when compared with historical averages. As stated in the footnote, it is better suited for interpretation on an individual company basis compared with its peers or peer sectors than for the market as a whole.

However, the PE ratio still renders interesting valuation insights when calculated for all ordinary shares listed on the JSE. Over recent months, the reported JSE historical (trailing)[2] PE ratio for the overall equity market has increased significantly from a multiple of 19,3 in October 2015 to an all-time high of 56,8 in June 2016, as shown in the accompanying graph. This resulted from a broadly sideways trend in share prices over this period with simultaneously a sharp decline in company profits. The marked contraction in earnings growth over twelve months rendered a PE ratio well in excess of its historical average of 18,25 from 2007 to date. While total year-on-year earnings contracted by 31 per cent from the end of 2015 to July 2016, share prices have simultaneously been buoyed by, in particular, quantitative easing by central banks in advanced economies and the weaker exchange value of the rand.

The contraction in earnings growth was especially significant for companies in the resources sector, whose performance has been adversely affected by weak global demand for commodities and a marked decline in commodity prices, especially due to the slowdown in the Chinese economy. The mining sector was also negatively impacted by factors related to labour unrest, closures and electricity constraints.

Price-earnings ratio and earnings growth



Sources: JSE and own calculations

According to the latest Bloomberg forecast, the PE ratio is expected to fall below its historical average level by the end of 2017. However, this will depend on investor demand for shares and confidence in the realisation of expected earnings growth in the resources sector in particular. A decline in the PE ratio, for the market as a whole back to its historical average, will largely depend on a recovery in resource sector earnings. This recovery in resource sector earnings started in August 2016 and contributed to a turnaround in total earnings growth and a significant decline in the PE ratio to 32,4.

1 The price-earnings ratio is best suited for comparing a company to its peers individually or peer sector. The ratio for the market as a whole should be interpreted with caution.

2 Current share price divided by earnings per share for the past twelve months.