

Causes of changes in price to earnings ratio with special emphasis over earning growth expectations and market sentiments

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Abstract: The Price-to-Earnings (P/E) ratio is a key financial metric used to evaluate the valuation of a company's stock, representing the ratio of its current share price to its earnings per share (EPS). Changes in the P/E ratio can be driven by various factors, reflecting both company-specific events and broader economic conditions. **1. Earnings Growth Expectations:** A primary driver of changes in the P/E ratio is the market's expectation of future earnings growth. If investors anticipate higher future earnings, they may be willing to pay more for the stock today, increasing the P/E ratio. Conversely, if earnings expectations decrease, the P/E ratio may fall. **2. Interest Rates:** Interest rates play a significant role in the valuation of stocks. Lower interest rates tend to increase the P/E ratio because they reduce the discount rate applied to future earnings, making future profits more valuable in present terms. Conversely, rising interest rates can decrease P/E ratios as they increase the discount rate and reduce the present value of future earnings. **3. Market Sentiment and Investor Confidence:** Market sentiment, driven by factors such as economic outlook, geopolitical events, and investor confidence, can influence P/E ratios. In a bullish market, investors may be willing to accept higher P/E ratios, anticipating continued growth. In a bearish market, P/E ratios may decline as investors become more risk-averse. **4. Inflation:** Inflation affects the P/E ratio by influencing both earnings and the discount rate. High inflation can erode corporate profits, leading to lower earnings and, therefore, lower P/E ratios. Additionally, higher inflation often leads to higher interest rates, further depressing P/E ratios. **5. Corporate Performance and Strategy:** Company-specific factors such as changes in management, strategic shifts, and operational performance can also impact the P/E ratio. Positive developments, such as successful product launches or mergers, can boost investor confidence and raise the P/E ratio. Conversely, poor performance or unfavorable strategic decisions can lead to a decrease. **6. External Economic Factors:** Broader economic factors, including GDP growth, unemployment rates, and fiscal policies, can influence market-wide P/E ratios. During economic expansions, P/E ratios tend to rise as corporate earnings grow and investor confidence increases. During

recessions, P/E ratios often fall as earnings decline and investors become more cautious.

The P/E ratio is a dynamic metric influenced by a combination of microeconomic and macroeconomic factors. Understanding the causes of changes in the P/E ratio is crucial for investors, as it helps them make informed decisions about stock valuation and market trends. Here in this paper researcher attempted to explore more on subjective and qualitative aspects of research for the subject.

Key Words: Investor Confidence, Price Earnings Ratio, Macro Economic Factors, Gross Domestic Product, Stock Valuation.

INTERPRETATION AND QUALITATIVE FACTORS ANALYSIS

The Price to Earnings (P/E) ratio is a fundamental metric used in finance to evaluate the valuation of a company relative to its earnings. It is calculated by dividing the current market price of a company's stock by its earnings per share (EPS). Changes in the P/E ratio can be driven by several factors, which can broadly be categorized into the following:

A. Earnings Growth Expectations

Positive Growth Expectations: If investors expect a company to experience significant earnings growth in the future, they might be willing to pay a higher price for the stock today, driving up the P/E ratio. High growth companies, especially in the technology sector, often have higher P/E ratios because of these expectations.

Negative Growth Expectations: Conversely, if a company is expected to have slow or negative earnings growth, the P/E ratio might decrease as investors are less willing to pay a premium for future earnings.

Earnings growth expectations are a key driver of changes in the Price to Earnings (P/E) ratio. Investors use the P/E ratio as a measure of how much they are willing to pay for a company's earnings, and this willingness is heavily influenced by their expectations for future earnings growth. Here's how changes in earnings growth expectations can impact the P/E ratio:

1. Positive Earnings Growth Expectations

- **Increased Future Earnings Projections:** When investors anticipate that a company will experience significant earnings growth in the future, they may be willing to pay a higher price for the stock today, driving up the P/E ratio. This often occurs in high-growth industries like technology or biotechnology, where companies may not yet be highly profitable, but future growth potential is substantial.
- **New Product Launches or Market Expansion:** Expectations of strong earnings growth can arise from a company's plans to launch new products, enter new markets, or expand its operations. These initiatives can increase future revenue and profits, leading to a higher P/E ratio.
- **Technological Innovation:** Companies that are perceived as leaders in innovation, particularly in fast-growing sectors, can see their P/E ratios rise as investors expect these innovations to drive future earnings growth.

2. Negative Earnings Growth Expectations

- **Declining Earnings Projections:** If investors believe that a company's earnings will decline in the future, they are likely to assign a lower P/E ratio. This could be due to various factors, such as increased competition, market saturation, or declining demand for the company's products or services.
- **Economic Downturns:** During economic recessions or slowdowns, earnings growth expectations for many companies typically decrease. This can lead to a lower P/E ratio as investors become more cautious and less optimistic about future earnings prospects.
- **Increased Costs or Operational Challenges:** If a company faces rising costs (e.g., raw materials, labor) or operational challenges (e.g., supply chain disruptions, inefficiencies), investors may expect these issues to erode future earnings, resulting in a lower P/E ratio.

3. Changes in Growth Rate

- **Acceleration in Growth Rate:** When a company shows signs that its earnings growth rate is accelerating, perhaps due to effective management, successful product development, or favorable market conditions, the P/E ratio can increase as investors price in the potential for higher future earnings.
- **Deceleration in Growth Rate:** Conversely, if a company's growth rate begins to slow, perhaps due to market saturation or increased competition, the P/E ratio might decrease as investors reassess the company's long-term growth potential.

4. Long-Term vs. Short-Term Growth Expectations

- **Short-Term Growth Expectations:** In some cases, short-term factors like a temporary boost in earnings due to favorable market conditions or a one-time event can lead to a temporary increase in the P/E ratio. However, if these earnings are not sustainable, the P/E ratio may eventually decrease once short-term expectations are adjusted.
- **Long-Term Growth Expectations:** Companies with stable and long-term growth prospects often maintain higher P/E ratios. Investors are willing to pay a premium for the predictability and sustainability of earnings over time. Conversely, a downgrade in long-term growth expectations can lead to a reduced P/E ratio.

5. Investor Sentiment and Speculation

- **Over-Optimism:** Sometimes, investors may become overly optimistic about a company's growth prospects, leading to an inflated P/E ratio. This can occur during speculative bubbles where the actual earnings potential is overestimated.
- **Correction in Expectations:** When investor sentiment corrects, often after the realization that earnings growth may not be as strong as expected, the P/E ratio can drop significantly as the stock price adjusts to more realistic earnings expectations.

Earnings growth expectations are a fundamental factor in determining the P/E ratio. Positive growth expectations generally lead to higher P/E ratios as investors are willing to pay more for future earnings potential. Conversely, negative growth expectations can lower the P/E ratio as investors become less willing to pay a premium for a company's stock. Understanding these dynamics is essential for assessing stock valuations and making informed investment decisions.

B. Market Sentiment

- **Investor Confidence:** Market sentiment, which reflects the overall mood of investors, can significantly impact the P/E ratio. In a bullish market where investor confidence is high, P/E ratios tend to rise as investors are more optimistic about future earnings.
- **Economic Uncertainty:** During periods of economic uncertainty or recession, P/E ratios may decline as investors become more risk-averse and demand higher returns to compensate for perceived risks.

Market sentiment plays a crucial role in influencing the Price to Earnings (P/E) ratio, as it reflects the overall mood and outlook of investors towards the stock market or specific stocks. Market sentiment can drive changes in the P/E ratio independently of a company's actual earnings performance, based on how investors perceive future risks and opportunities. Here's how changes in market sentiment can impact the P/E ratio:

1. Bullish Market Sentiment

- **Increased Investor Confidence:** In a bullish market, where investors are generally optimistic about the economy and future corporate earnings, P/E ratios tend to rise. Investors are willing to pay a higher price for stocks because they expect companies to perform well and generate higher future earnings.
- **Risk Appetite:** During periods of strong market sentiment, investors may have a higher risk tolerance and are more likely to invest in growth stocks with higher P/E ratios. They are willing to accept higher valuations due to the belief that future earnings will justify these prices.
- **Positive Economic Indicators:** Favorable economic data, such as low unemployment, rising GDP, and strong consumer confidence, can boost market sentiment. This optimism can lead to higher P/E ratios as investors expect continued economic growth to drive corporate earnings.

2. Bearish Market Sentiment

- **Decreased Investor Confidence:** In a bearish market, where investors are pessimistic about the economy or the stock market, P/E ratios tend to decline. Investors become more cautious and may demand lower prices for stocks relative to earnings due to concerns about future earnings growth.

- **Flight to Safety:** During periods of negative sentiment, investors may shift their portfolios towards safer assets like bonds, gold, or cash. This reduced demand for equities can lead to lower P/E ratios, especially for riskier stocks.

- **Fear of Recession:** Concerns about an economic downturn or recession can drive bearish sentiment. Investors may expect declining corporate earnings, leading them to pay less for stocks and driving P/E ratios down.

3. Market Volatility

- **High Volatility:** During periods of high market volatility, investor sentiment can swing rapidly between optimism and pessimism. This can lead to significant fluctuations in P/E ratios as stock prices react to the latest news or events. For instance, unexpected geopolitical events or major economic announcements can cause sudden changes in sentiment.

- **Low Volatility:** In contrast, periods of low volatility, often associated with stable market conditions, can lead to more stable P/E ratios. Investors may be more confident in their expectations, leading to less dramatic changes in stock valuations.

4. Speculative Bubbles

- **Over-Exuberance:** During speculative bubbles, market sentiment can become excessively positive, driving P/E ratios to unsustainably high levels. Investors may ignore fundamental valuations and bid up stock prices based on the belief that they will continue to rise. This often occurs in rapidly growing industries or during periods of technological innovation.

- **Bubble Burst:** When a speculative bubble bursts, sentiment can quickly turn negative, leading to a sharp decline in P/E ratios. Investors may rapidly sell off stocks as they reassess valuations, often resulting in a significant market correction.

5. Influence of Media and Social Trends

- **Positive Media Coverage:** Media coverage that highlights strong economic performance, successful companies, or favorable market conditions can boost investor sentiment, leading to higher P/E ratios. Positive narratives can encourage more investors to buy stocks, driving up prices relative to earnings.

- **Social Media and Hype:** In the age of social media, hype around certain stocks (e.g., "meme stocks") can create short-term surges in market sentiment, leading to spikes in P/E ratios. However, these increases are often not supported by underlying earnings growth and can be followed by sharp declines.

6. Global Events and Macroeconomic Factors

- **Political Stability:** Periods of political stability can boost investor confidence and lead to higher P/E ratios as the perceived risk of investing decreases. Conversely, political instability or uncertainty (e.g., elections, policy changes) can lower P/E ratios as investors become more risk-averse.
- **Geopolitical Tensions:** Global events such as trade wars, conflicts, or pandemics can significantly impact market sentiment. Negative sentiment due to such events can lead to lower P/E ratios as investors reassess the risks to future earnings.

CONCLUSION

Market sentiment is a powerful driver of changes in the P/E ratio, often reflecting broader investor psychology rather than specific company fundamentals. Positive sentiment can lead to higher P/E ratios as investors are more willing to pay a premium for perceived growth and stability. Conversely, negative sentiment can depress P/E ratios as fear and uncertainty dominate investor decisions. Understanding the impact of market sentiment is crucial for interpreting changes in stock valuations and making informed investment choices.

C. Interest Rates

- **Low Interest Rates:** Lower interest rates generally lead to higher P/E ratios. This is because lower rates reduce the cost of borrowing, making it cheaper for companies to finance growth, which can lead to higher earnings. Additionally, with lower returns available on bonds, equities become more attractive, leading to higher P/E ratios.
- **High Interest Rates:** Higher interest rates tend to lower P/E ratios as the cost of borrowing increases, which can dampen growth prospects. Additionally, as bond yields rise, they become more competitive with stocks, leading to a decrease in P/E ratios.

D. Inflation Expectations

- **Rising Inflation:** When inflation is expected to rise, it can erode future earnings in real terms, leading to a decrease in the P/E ratio. Investors might demand higher returns to compensate for the loss of purchasing power.
- **Low or Stable Inflation:** Conversely, when inflation is low or stable, P/E ratios tend to be higher, as the stability allows for more predictable future earnings.

E. Company-Specific Factors

- **Operational Performance:** Changes in a company's operational performance, such as improvements in efficiency, cost reductions, or new product launches, can lead to higher earnings expectations and thus a higher P/E ratio.
- **Management Decisions:** Strategic decisions made by company management, including mergers and acquisitions, divestitures, or changes in capital structure, can also impact earnings expectations and the P/E ratio.

F. Sector and Industry Trends

- **Cyclical Industries:** Industries that are cyclical in nature (e.g., automobiles, construction) often see fluctuating P/E ratios based on the economic cycle. During an economic upturn, P/E ratios might rise as earnings increase, while in downturns, P/E ratios might fall.
- **Technological Disruption:** Industries experiencing technological disruption may see changes in P/E ratios as companies adapt (or fail to adapt) to new technologies and business models.

G. External Factors

- **Regulatory Changes:** New regulations or changes in existing regulations can impact a company's profitability, leading to changes in the P/E ratio. For example, stricter environmental regulations might increase costs for a manufacturing company, reducing earnings and the P/E ratio.
- **Geopolitical Events:** Events such as trade wars, political instability, or global conflicts can introduce uncertainty, affecting investor sentiment and potentially leading to lower P/E ratios.

The P/E ratio is influenced by a combination of factors, including investor expectations, macroeconomic conditions, and company-specific

dynamics. Understanding these drivers is crucial for investors as they assess the relative valuation of stocks and make informed investment decisions. Changes in the P/E ratio can provide insights into market sentiment and expectations about a company's future performance, making it an essential tool for both fundamental and technical analysis.

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