Are fundamentals supporting current valuations?



The first three themes of this Annual Outlook examined how capital is being redirected, how investment is reshaping the economic environment and whether financial markets can continue funding this new investment cycle. The final test is whether this capital is generating sufficient economic value.

Ultimately, asset valuations depend on the ability of investment to translate into productivity gains, earnings growth, cash-flow generation and attractive returns on capital. This matters because the durability of the current cycle will depend not only on how much capital is deployed, but on whether that capital delivers the economic outcomes that investors expect.

SANTANDER PRIVATE BANKING VIEW

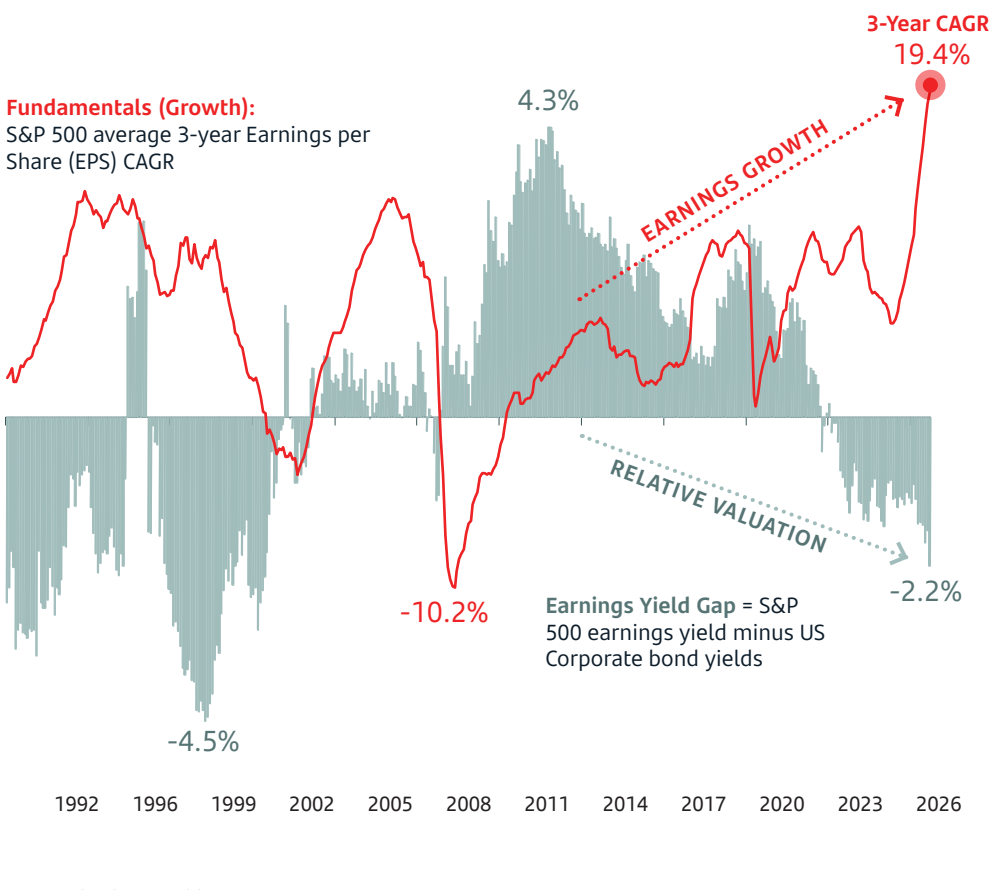
Our central scenario remains favourable, provided the economic, policy and financing conditions explored in the preceding themes remain broadly supportive. Against this backdrop, the key question is whether earnings and other fundamental factors can continue to validate current market expectations.

Corporate earnings continue to benefit from resilient profitability, innovation and improving productivity. At the same time, the cost of capital is no longer negligible. Higher interest rates and more attractive fixed income yields have increased the level of return that all investments must generate to justify their valuations.

The chart highlights one of the most unusual features of today's market. Earnings growth is at one of its strongest levels in decades, while valuations remain demanding, although they appear less stretched than in recent periods as fundamentals have improved faster than prices. Meanwhile, higher bond yields have made bonds more attractive relative to equities than at almost any point since the dot-com bubble.

Our central scenario remains constructive. Strong earnings momentum should continue to support equities, while higher yields have restored the role of fixed income as a meaningful source of return. Unlike recent cycles, investors do not need to choose between growth and income. In our view, the coexistence of robust fundamentals and attractive bond yields supports a diversified allocation across both asset classes.

Strong fundamentals, demanding valuations
Earnings growth is the strongest in decades, but higher bond yields have reduced the relative valuation appeal of equities and raised the threshold for future returns.



Source: Bloomberg, own elaboration

FIVE SIGNALS TO WATCH



EPS Acceleration

Strong market performance has been supported by exceptional earnings growth. Sustained earnings momentum would confirm that current market gains continue to be driven by realised results rather than rising expectations.

INDICATORS

EPS growth, revenue growth and earnings guidance.



Productivity and Margins

Exceptional earnings growth ultimately requires productivity gains to translate into profitability. Stable margins would indicate that investment spending continues to generate economic value despite higher capital costs.

INDICATORS

Operating margins, gross margins and profitability guidance.

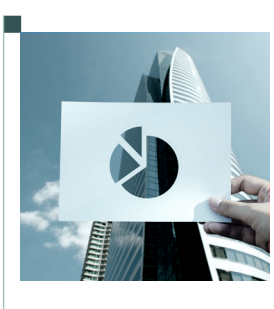


Analysts' Expectations

Analyst revisions provide an early indication of whether exceptional earnings growth can be sustained and whether market expectations remain aligned with fundamentals.

INDICATORS

Consensus EPS forecasts, upgrades vs. downgrades and target-price revisions.



Concentration Risks

The durability of the current cycle depends on earnings and investment broadening beyond a narrow group of companies and themes. Greater concentration would make the market more vulnerable to disappointments.

INDICATORS

Capex concentration, vendor financing activity and related-party funding relationships.



Cross-Asset Valuation

Strong fundamentals continue to support equities, but higher bond yields have materially improved the attractiveness of fixed income. The key question is whether earnings strength can continue to offset increasingly competitive alternatives.

INDICATORS

Equity earnings yield, investment-grade bond yields and equity risk premium.

THREE INVESTMENT CONCLUSIONS

01

Prioritise earnings delivery

As equity performance has been driven primarily by earnings delivery rather than valuation expansion, future returns are likely to depend on companies' ability to sustain revenue growth, profitability and cash-flow generation. We focus on businesses that have demonstrated the ability to convert investment into durable earnings and attractive returns on capital.

02

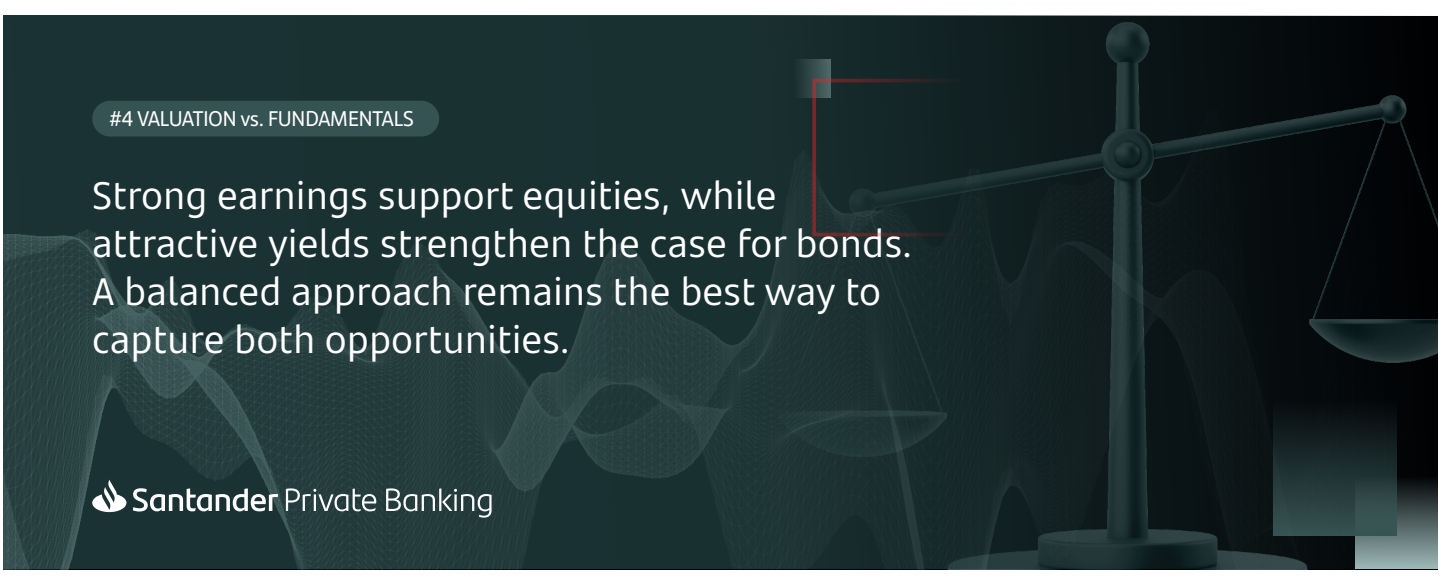
Rebuild income as a strategic allocation

Higher bond yields have restored fixed income as a meaningful source of return. With relative bond valuations appearing more favourable than in recent historical periods, income once again becomes a strategic portfolio building block rather than simply a defensive allocation.

03

Balance growth with resilience

Today's market offers an unusual combination of exceptional earnings momentum and attractive bond yields. Rather than choosing between growth and income, investors can build more resilient portfolios by combining exposure to both return drivers.



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