Equity Insight
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Monthly Equity Market Topics

Author

Ross Cartwright
Lead Strategist,
Strategy and Insights Group

In brief

- A Tale of Two Timeframes: The contrasting market leaders from the August lows compared with the July peak
- Mega-cap tech's eroding earnings dominance and a reality check on valuations
- Historical insights on the evolution of the market's composition

Defensive Sectors: The Unassuming Market Leaders

The recovery from the August 5 low has been led by technology hardware and higher-beta industries like travel and leisure, consumer products and autos. However, going back to the market peak on July 16, the market tells a different story. It's the more defensive industries like tobacco, health care, food retailing, real estate and utilities that weathered the rotation and lead the market.

Our view is that this isn't purely a change in the market's outlook, namely equity investors showing increased caution and favoring the defensive sectors. Rather, it's a combination of softer expectations for returns on AI capex spending and central banks globally (except Japan) cutting rates or signaling they soon intend to do so. AI-related and higher-beta stocks have not recovered their peaks, but high-yielding stocks, which have also tended to be defensive, are benefiting from the belief that the rate cycle has now turned.

In our view, lower rates should be a tailwind for higher-yielding stocks if the rate decline is part of a policy normalization process and not a response to a rapid deterioration in economic growth or rise in unemployment. Here's why:

- Such stocks would offer an increasingly attractive yield relative to falling bond yields.
- A soft landing could inspire greater market breadth and earnings support.
- A modest slowdown would make dividend cuts less likely.
- Many of these stocks have been neglected and offer attractive valuations.

Higher-yielding stocks have also tended to be value stocks, and they've been a driver of value factor performance over the past month. Lower rates in a stable growth environment may continue to support higher-yielding stocks and rate-sensitive sectors. It may well be that the US Federal Reserve needs to be more aggressive in cutting rates to stimulate growth, further supporting yields, not due to recession fears, but because the US economy has shown in recent years to not be very sensitive to rates. Many of the same reasons why the rate cycle did not severely impact the economy on the way up should largely apply on the way down.

Fading dominance of mega-cap tech as earnings broaden

Price-to-earnings (PE) multiples have re-rated after the late-July growth scare and we believe the trade-off between GDP growth and inflation looks unlikely to improve materially. Second quarter earnings reports highlighted how the earnings and margin story is broadening out. As a result, we would expect to see a fading reliance on a few mega-cap tech names to drive earnings growth. While the tech sector continues to have the highest margins, it's one of the few to see margins fall over the last two quarters, while the rest of the S&P 500 has seen them improve.

The S&P 500 Index forward PE is 23.6x, as of 1 September 2024, significantly above its average for the past 35 years of 17.7x.[1] From our perspective, the market is pricing in a soft landing. This view is supported by the street's forecast of 15% EPS growth next year, more than double the long-term average of 7%.[2]

With GDP growth in the United States potentially set to slow next year, it seems to us that earnings expectations may need to be tempered and there isn't a lot of upside given both valuations and lofty earnings expectations. Falling rates may help, but maybe not as much as people expect — or hope. Clearly some industries, as we've pointed out, benefit, but much will be company-specific and based on debt profiles, cash balances and how rates impact their end customers.

Take Walmart. Last quarter, it produced a good set of results, and the stock has done very well. This was broadly taken as a sign that the consumer is healthy despite pockets of weakness evident in the lower-end and younger cohorts. This could be viewed differently; Walmart primarily sells everyday essentials, goods we consume regularly, and this spending tends not to be particularly volatile, even as the economy weakens. So maybe consumer spending at Walmart is a sign of weakness, not strength since part of its recent sales strength is a result of affluent shoppers trading-down from pricier retailers?

We would expect equity markets to grow in line with their earnings. Bond markets have already fallen on rate-cut expectations and we've not seen any recovery in housing or mortgage applications, supporting our view that this is not a risk-on environment. However, an improving labor market would change that outlook. On a near-term view, we continue to favor large-cap, higher-quality and defensive stocks.

Food for Thought: Reflecting on Market Composition Changes

As investors, we often look to the past to help inform us about what may happen in the future. One common form of analysis is to look at a particular event to tell us what to expect if the event were repeated. While this can be helpful, one should be cautious in terms of what drives the event and how equity market composition has changed over time.

The S&P 500 as we know it did not exist until 1988. The index was developed in 1923 but increased from 90 stocks to 500 in 1957. The index originally contained exactly 425 industrials, 25 railroads and 50 utilities. In 1976, 40 financial stocks were added, and the industrial, transportation and utility groups were reduced to 400, 20 and 40, respectively. In 1988, Standard and Poor's eliminated fixed sectors, with the goal of achieving a diversified and representative portfolio of all stocks trading in US markets. In July 2002, all foreign-based companies, which comprised 1.3% of the market capitalization of the index at that time, were eliminated and replaced by US-based firms.[3]

The Global Industry Classification Standard (GICS®) was developed by MSCI and Standard & Poor's in 1999.[4] All GICS sector data prior to 1999 is therefore backfilled. The rise of mega-cap stocks has also changed the composition of benchmarks. They dominate their respective sector-level performance and due to their size, skew benchmark characteristics. For example, traditional cyclicals such as financials, industrials, energy and materials have halved from approximately 60% of the index in the early 80s to under 30% today.[5] When assessing past index performance, we believe investors should be mindful of how dramatically the benchmark has changed when deciding how likely the past might repeat itself.

Endnotes

[1] Bloomberg, 1 September 2024.

[2] Morgan Stanley.

[3] The Long-Term Returns on the Original S&P 500 Firms, by Jeremy J. Siegel and Jeremy D. Schwartz.

[4] MSCI – frequently asked questions about GCIS.

[5] Piper Sandler.

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