# U.S. Equities: Surprising Strength Gives Way to Macro Risks

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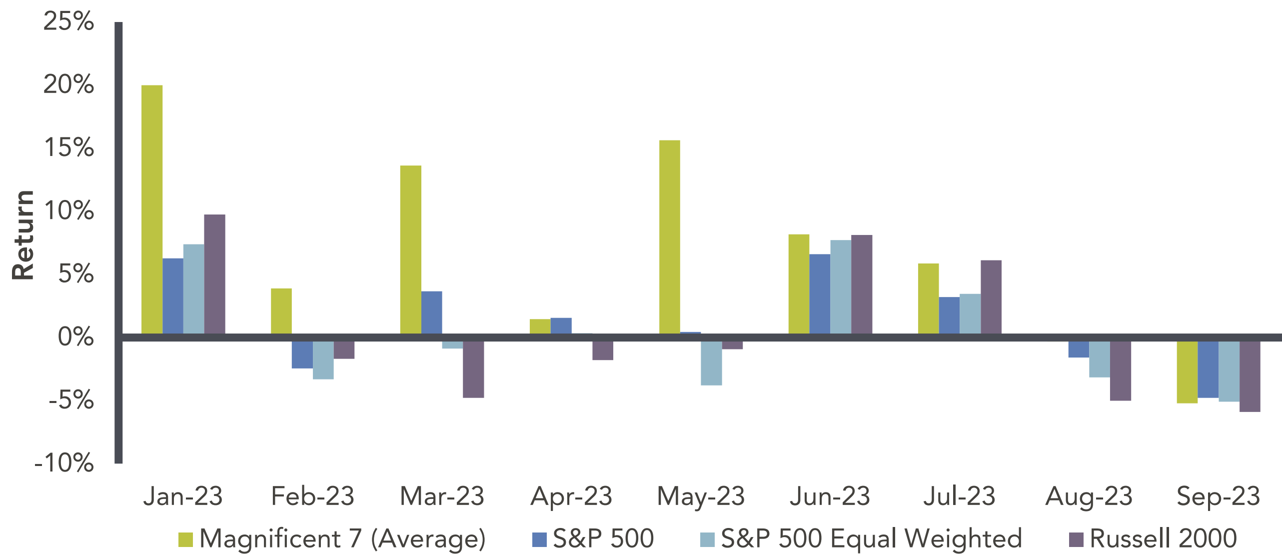
**Equity market strength through the third quarter continues to challenge the common expectation going into the year. Cumulatively through September 30, the slowdown many investors anticipated has been averted thus far as the strength in certain segments of the market has more than offset the weakness in others. Following the strength of value equities — with Energy the lone positive sector in 2022 — markets experienced a shift in leadership to begin 2023. Companies that were challenged by supply chain issues and wage pressures rebounded to begin the year, primarily within growth-oriented sectors including Communication Services, Information Technology, and Consumer Discretionary. Overall, markets were strong through the first nine months of the year, as the S&P 500 rose 13.1%. However, September — historically the worst month of the year for equity markets — saw a somewhat unsurprising pullback. As we enter the final quarter of the year, we feel it is important to examine the underlying market dynamics driving performance and highlight the risks of a narrow market as well as the opportunities available on the sidelines.**

Market strength has been driven primarily by a select few companies, dubbed the Magnificent Seven. These companies — Apple, Microsoft, Tesla, NVIDIA, Amazon, Alphabet, and Meta — drove the majority of the S&P 500 return through the first nine months of the year, while comprising nearly 28% of the index. The uncertainty that has plagued markets since the Federal Reserve embarked on a historic interest rate hiking cycle has led investors to favor the perceived safety and defensiveness of these mega-cap companies. In addition to such characteristics, these companies, namely NVIDIA, have benefited from the artificial intelligence (AI) fervor that has dominated the market narrative throughout 2023.

**Exhibit 1:** Narrow market leadership in 2023

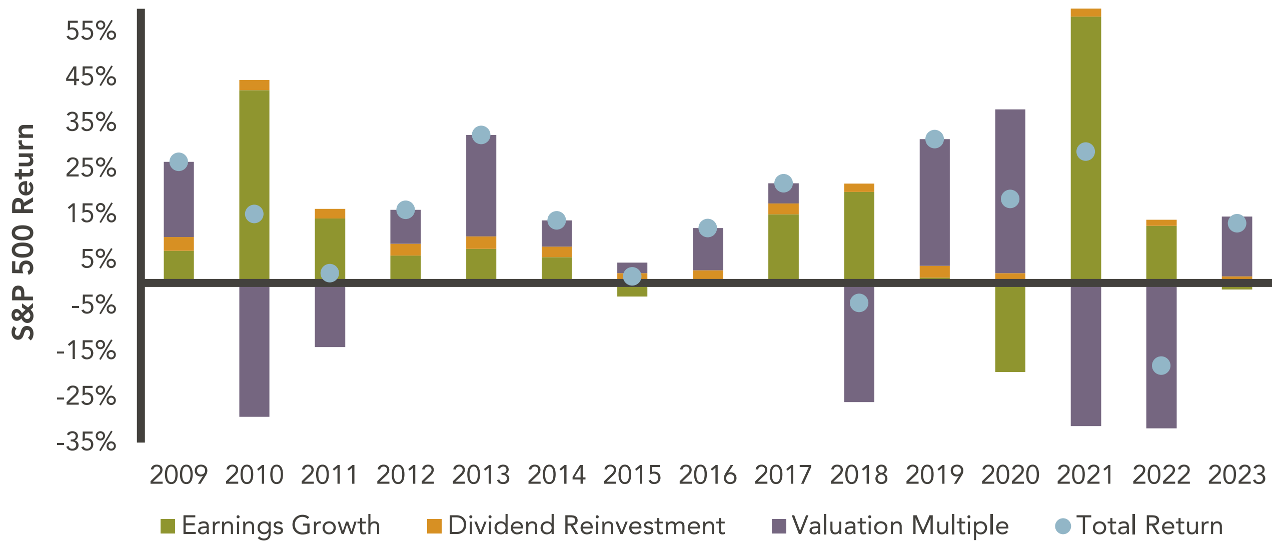



Source: Bloomberg as of September 30, 2023

A consequence of this market strength is these companies trade at hefty valuations relative to the S&P 500. As of September 30, the forward price/earnings ratio for the Magnificent Seven was 37.5x, while the S&P 500 traded at 19.3x. The valuations assigned to these companies are likely dependent on the historically low interest rate environment that preceded 2022, making future earnings projections appear more attractive. As we progress through a period of higher for longer interest rates, this may lead to elevated volatility. For September, the average return for this group of companies was -5.2%, trailing the S&P 500 return of -4.8%. A similar trend was also seen in 2022, as these companies were the top detractors in the index. Trading at a significant premium to the S&P 500 and with an average weight of 24.1%, these companies experienced an average decline of 45.2% last year. Additionally, during the Dot Com Bubble in the early 2000s — although the largest companies in the index were different — the subsequent market sell-off saw many of the top constituents fall over 45%. Cisco Systems is a prime example, as it traded at a lofty valuation at the peak of the Dot Com Bubble but fell over 85% from its all-time high.

Through September 30, valuations have driven a majority of the returns for the S&P 500, as earnings have lagged. The Magnificent Seven, however, continue to post stable EPS growth, surprising to the upside through second quarter earnings season. Notably, NVIDIA, a supplier of artificial intelligence hardware and software, experienced significant stock price appreciation leading up to its second quarter earnings report, as the stock was up over 222% through August 23. Despite blowing past earnings estimates, surprising to the upside and issuing positive guidance for the remainder of the year, the stock has since fallen, posting the worst performance of the Magnificent Seven stocks in September. While growth remains strong — especially given the tailwinds from the AI hysteria — investors may be acknowledging the lofty valuations required to support this level of growth. As of September 30, NVIDIA traded at 41.0 times next fiscal year's earnings estimates.

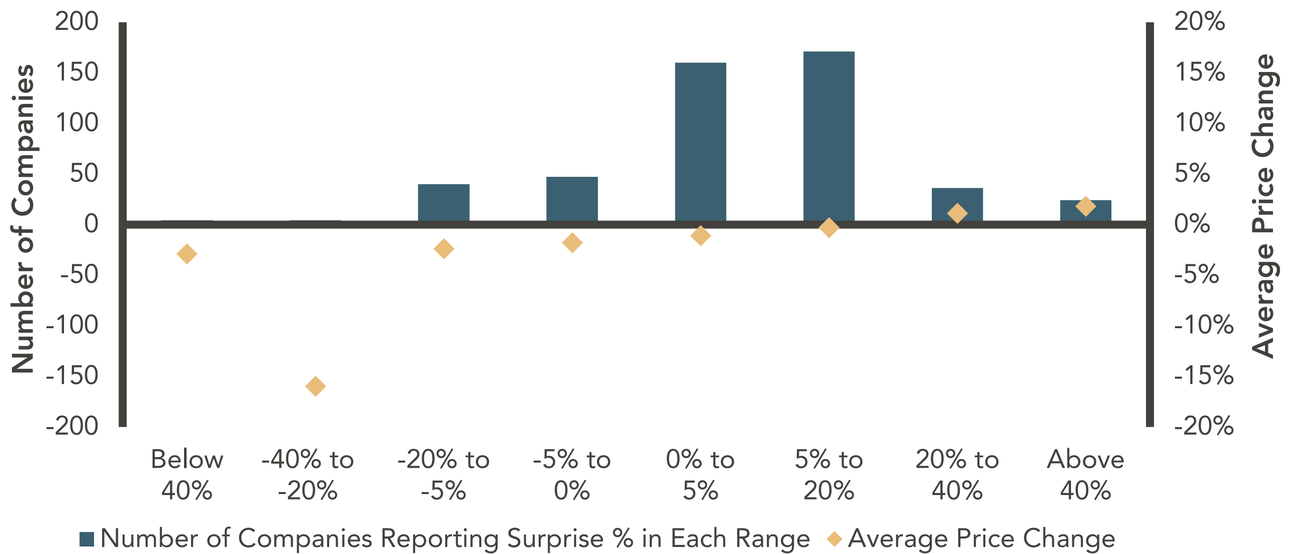
**Exhibit 2:** Multiple expansion drives returns through third quarter




Source: Bloomberg as of September 30, 2023

Stock price weakness in response to better-than-expected earnings reports and guidance, though, was not isolated to any specific sector. Earnings estimates have been revised downwards as companies battle with rising interest rates, elevated inflation, supply chain issues, and wage pressures. As second quarter earnings season unfolded, many companies issued conservative guidance for the remainder of the year, which has kept investors cautious. In this environment, even companies that beat on earnings saw stock prices drop in the two days following the announcements.

**Exhibit 3:** Stock prices fall despite earnings surprises

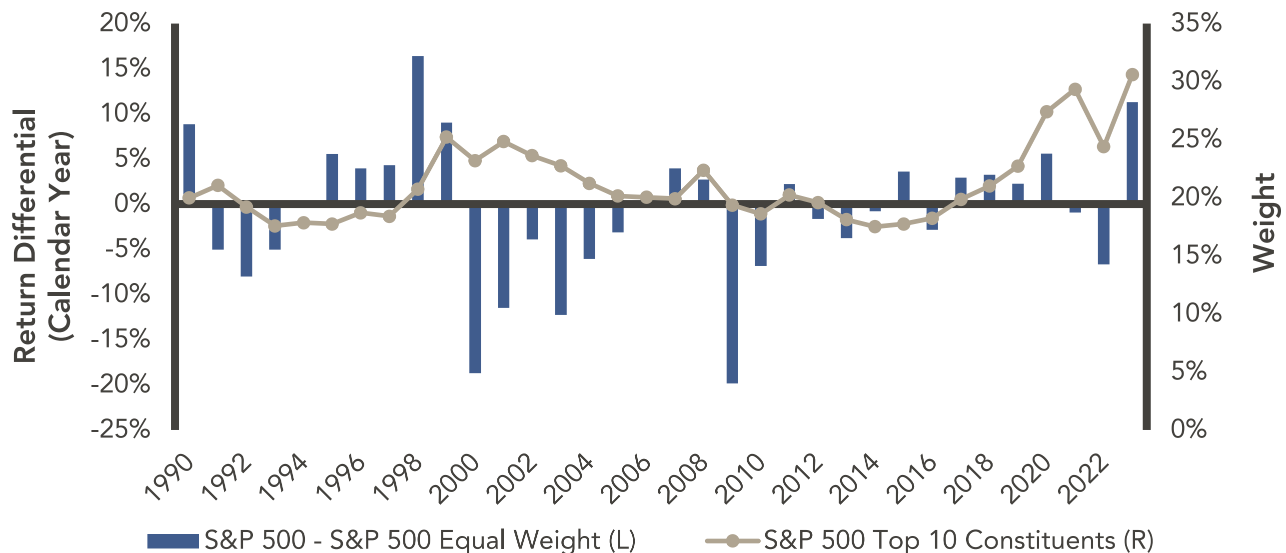



Source: FactSet as of September 1, 2023. Average price change indicates the difference between stock prices two days before and two days after the earnings report.

Additionally, following the narrow market leadership to begin the year, the level of concentration across major large-cap domestic equity indices may be concerning. With these companies trading at lofty valuations, any misstep or elevation of broader economic issues such as a government shutdown, labor strikes, or

geopolitical tensions may culminate in a market sell-off. Market concentration has reached historic highs as Apple, the largest constituent in the index, comprised 7.3% of assets in the S&P 500 at the end of the third quarter, with the top 10 making up over 30% of assets. After periods of overconcentration in the index, the equal-weighted index has typically outperformed, including after the Dot Com Bubble and the Global Financial Crisis. Amid the AI fervor, investors may try to draw parallels to the Dot Com Bubble, when similar fears abounded about excessive valuations and index concentration. A key difference between that market environment and today is the underlying cash flows and profitability of the companies driving the returns of the index, as the Magnificent Seven possess strong balance sheets. Additionally, the NASDAQ 100 initiated a special rebalance in July to help combat concerns of overconcentration. This rebalance brought the weight of the Magnificent Seven in the NASDAQ 100 down over 11% to 43% of assets, where it remains as of quarter end.

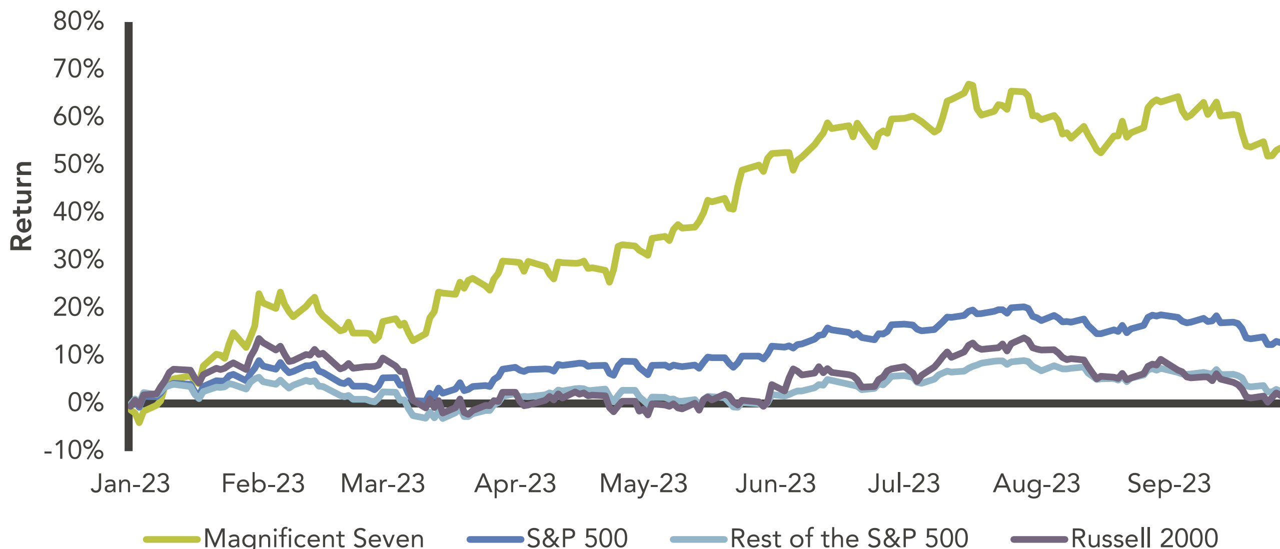
**Exhibit 4:** Top heavy exposures of the S&P 500




Source: Bloomberg and FactSet as of September 30, 2023

Looking beyond large-cap equities, small-cap equities started the year strong, outperforming the S&P 500 through the first two months of 2023. The regional banking crisis, however, weighed meaningfully on small-cap equities in March, as the value of Apple surpassed the entire Russell 2000 Index. This further highlights the narrow market leadership that has propelled markets higher. Although small-cap equities — including regional banks — rebounded in July, the strong performance of the Magnificent Seven throughout the course of the year continued to support large-cap equities. Excluding these companies, however, the Russell 2000 outpaced the remainder of the S&P 500 leading into September. In September, however, both the Magnificent Seven and the Rusell 2000 lagged, as markets reversed course with value-oriented sectors including Energy and Utilities outperforming. As a result, despite periods of narrow market leadership, diversification across the market cap and style spectrum remains important. Large-cap indices exhibit different sector biases relative to small-cap indices, with the Information Technology sector comprising over 28% of the S&P 500, while the Industrials sector makes up over 18% of the Russell 2000. Predictably, allocations further down the market cap spectrum will help in diversifying an overall portfolio. Additionally, small-cap equities trade at a discount relative to their large-cap counterparts and following periods of overconcentration in large-cap equities, small-cap equities may be in a strong position to outperform.

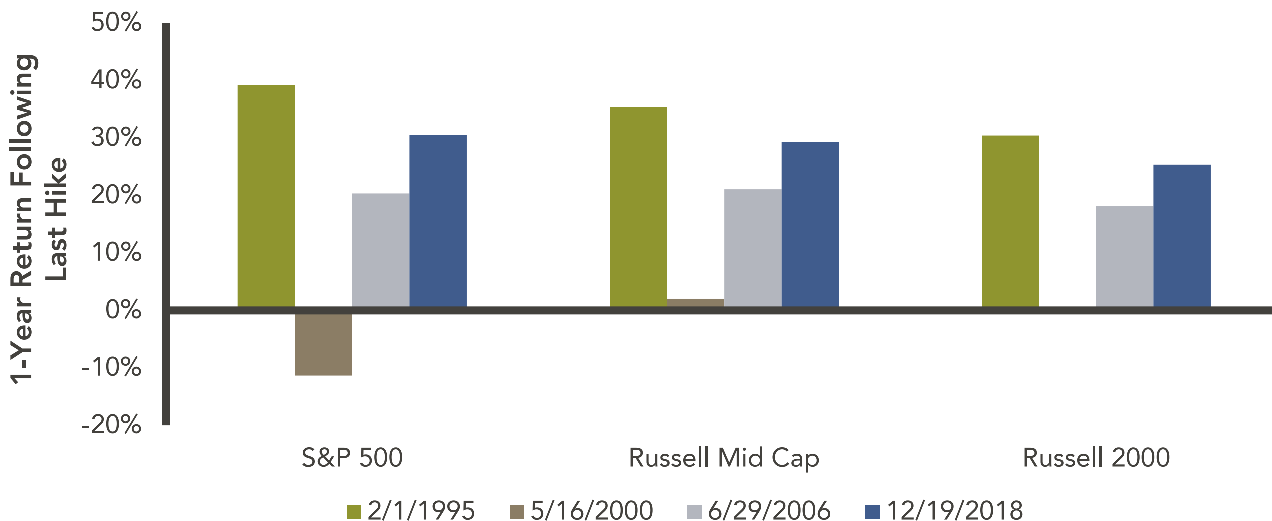
**Exhibit 5:** Magnificent Seven disproportionately carries the S&P 500




Source: FactSet as of September 30, 2023

As the fourth quarter begins, market uncertainty persists. Threats of government shutdowns, ongoing strikes, and geopolitical tensions continue to dominate headlines, while a surprisingly strong labor market cannot eliminate concerns about inflation and the strength of the consumer as student loan payments come due and retailers battle shrink. Historically, markets have averaged positive returns over the subsequent year following the final Federal Reserve interest rate hike, although the timing of this cycle remains unclear as markets are pricing in another potential hike before year-end.

**Exhibit 6:** Equity market historically strong after rate hiking cycles

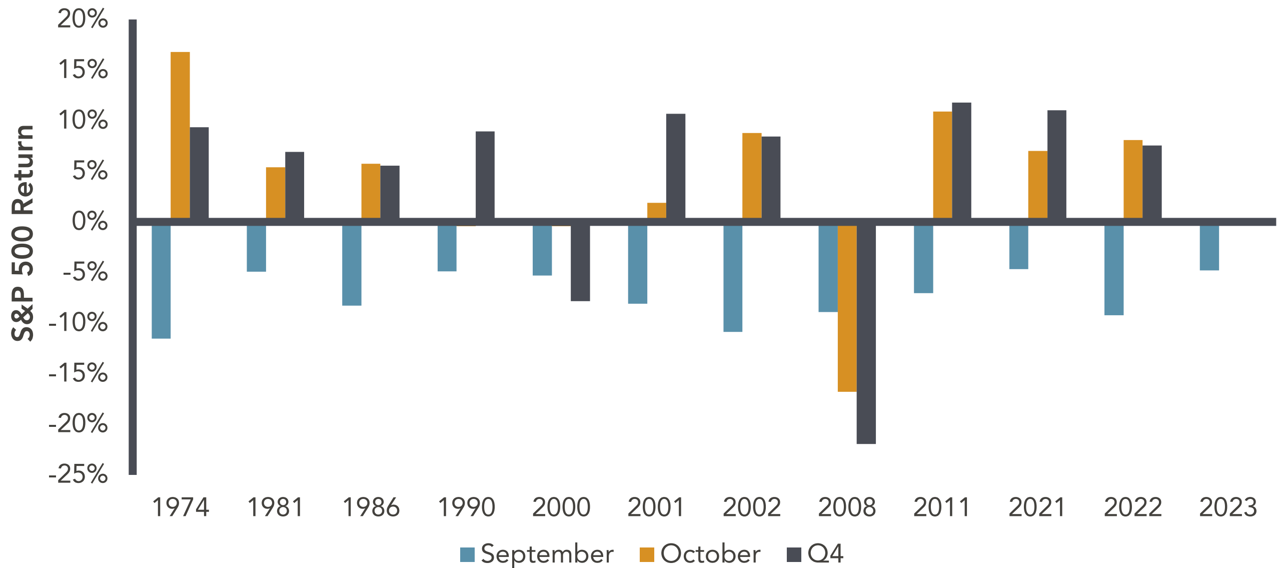



Source: Morningstar as of September 30, 2023

October can be unpredictable and has seen historic market crashes in 1929, 1987, and 2008, but has also been a bear market killer, including in 1974, 2000, and 2011. Following what is historically the worst month of the year for equity markets, October typically brings further volatility. Looking on the bright side, in eight of the past eleven Septembers that have seen a decline greater than 4.5%, the S&P 500 has posted a

positive return in October. Furthermore, in nine of these years, the market has provided a positive return for the subsequent fourth quarter. Unfortunately, September 2023 held up to its moniker as one of the worst months of the year, posting a decline of 4.8%. As markets have been driven by multiple expansion thus far in 2023, third quarter earnings season will be in focus. Earnings growth and positive guidance will be a critical factor to stock market performance to close the year.

**Exhibit 7:** October strength after September weakness




Source: Bloomberg as of September 30, 2023

A narrow segment of the market drove a remarkably strong start to 2023, but many investors expect more muted returns to close the year. Although markets declined in the third quarter amid lingering consumer fears, geopolitical risks, and government woes, it is possible much of the volatility is in the rearview mirror as the rate hiking cycle nears to a close, inflation further abates, and companies show signs of earnings strength. If these trends hold and markets successfully navigate a soft or no landing scenario, history has shown that markets tend to deliver positive returns at volatility levels consistent with long-term averages. As always, the optimal recipe for investment success is adhering to long-term target allocations in spite of short-term market volatility. With one quarter left in 2023, there is no reason to deviate from this recipe for success and we will continue to advise our clients accordingly.

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