Bull & Bear Bulletin

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Land of the Giants, Home of the Dwarves

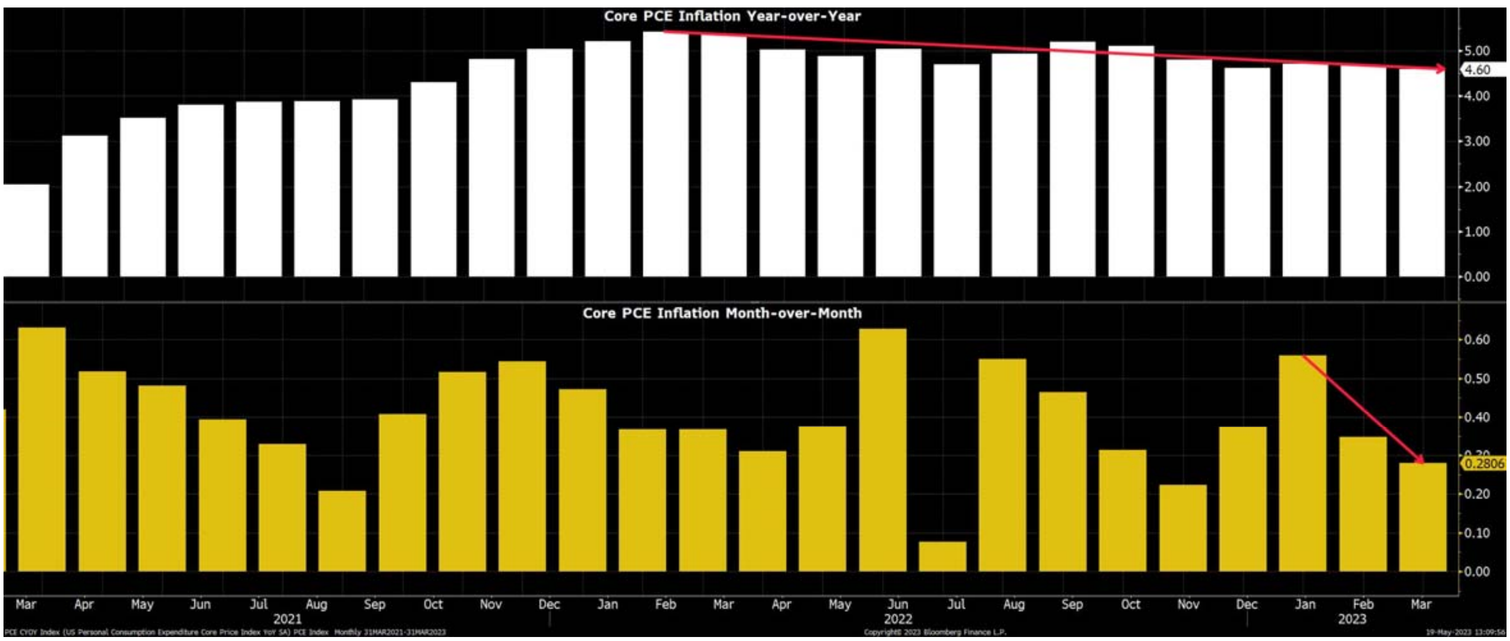
The main U.S. large-cap equity benchmark index is the S&P 500 Index. On a total return basis, since falling 18.11% in 2022, it has rallied 7.71% year-to-date as of May 16th. Similarly, the S&P 500 Equal Weighted Total Return Index and the Russell 2000 Total Return Index are down 0.12% and 0.89% respectively. The S&P 500 Index is a market cap weighted index, which means that companies with a greater market value will have a larger weighting in the index. The S&P 500 Equal Weighted Index, on the other hand, has the same constituents as the S&P 500, but each company has the same fixed weight. Finally, the Russell 2000 consists of 2000 smaller-sized companies and is also market cap weighted.

Most of the rally this year in the S&P 500 can be attributed to a handful of mega-sized companies (greater than $200B market value). Apple, Microsoft, Amazon, Google, and Tesla are up over 30% as of May 16th. Nvidia and Meta are each up close to 100%. The larger size of these companies gives them more weight and return contribution in the S&P 500 Index. More empirically, these names make up about 26% of the S&P 500 Index's total market cap but have contributed 7.82% to the Index's 7.71% overall return. This may be in part due to the fact that in times of distress, investors deviate towards these well known mega-cap stocks. Looking on a broader basis, however, we can see that the S&P 500 Equal Weighted Index and the Russell 2000 Index are relatively flat this year, implying that the smaller and lower market value companies have not done as well.

Bulls may cite a number of reasons why the strength in the market will persist. One of the Federal Reserve's (FED) primary inflation gauges is the core personal consumption expenditures (PCE) price index. This is defined as PCE prices but excludes the volatile food and energy prices. We can see that the rate of inflation is slowing both on a year-over-year (top panel) and on month-over-month (bottom panel) basis as shown in the chart below. Inflation is still measuring above the Fed's 2% target, but recent trends demonstrate that inflation continues to slow and may warrant a pause in further rate increases. Another reason may be that earnings for the first quarter of 2023 were not as bad as expected. For the 92% of companies that have reported, 78% of the S&P 500 companies have beaten the earnings per share (EPS) expectations and 75% have beaten revenue expectations, as per FactSet. Finally, the labor market still appears to be strong with the unemployment rate for the month of April registering at 3.4%, matching a 53-year low hit in January.

Bears, on the other hand, may cite a number of reasons why the market strength may not persist. One reason may be valuation. A very elementary tool investors use to consider market valuation is to simply look at the index price level in relation to the total expected earnings over the next 12-months for all the companies that comprise the index. Currently, the S&P 500 trades at a multiple of earnings of 17.99x with the 10-year average being 17.31x. With inflation still above the Fed's target and with rapid rate hikes not yet impacting credit, multiples may need to contract as headwinds arise later into the year or in 2024. Finally, real GDP growth has been slowing since Q3 2022's reading of 3.2% quarter-over-quarter annualized. For the first quarter in 2023, we have decelerated to 1.1% with further expectations of deceleration for the rest of 2023, based on current estimates.

We believe that in the midst of all the uncertainty, it is favorable to have a slight defensive posture in relation to asset class and sector allocations. This would entail allocations to intermediate and long-term government and corporate bonds as well as defensive equity sectors such as healthcare, consumer staples and utilities. The slowing growth and inflation data and expectations contribute to our view.



Source: Bloomberg