First Trust

Market Minute

With McGarel

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By almost any account, the S&P 500 Index year-to-date performance has been incredibly narrow and concentrated. Just seven companies account for the entire 10% return. The other 493 companies combined are delivering a slightly negative return. Stunning.

The mega-cap stocks at the very top of the S&P 500 Index (Apple, Microsoft, Amazon, Google, and Tesla) that led the 18% decline in 2022 are back in a market leadership position and are accounting for the majority of the market's 10% gain in the first five months of 2023. Those five companies lost almost 4 trillion dollars of equity market capitalization last year. They were the five biggest losers on that metric last year. Yet, they have increased in value by nearly 2.5 trillion dollars this year. Today, they are five of the seven biggest winners in market cap gained. NVIDIA and Meta are the other two.

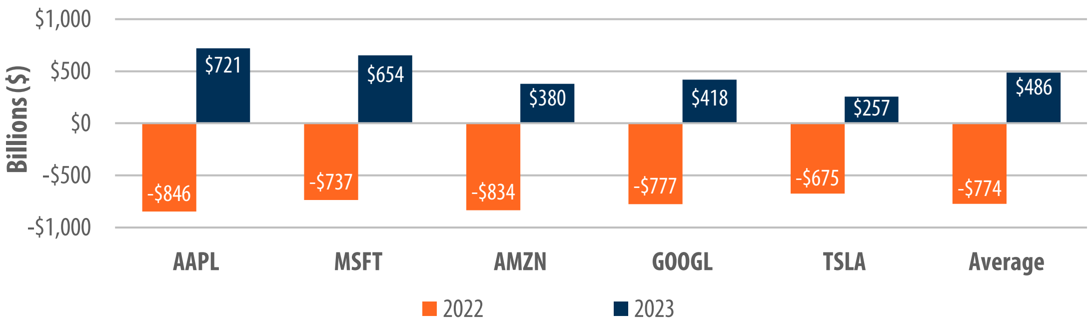
Why are these companies soaring when the rest of the market is flat and potentially starting to price in a recession? Most importantly, will it continue? First, let's consider the reason those stocks fell so hard last year. On average, they declined 42% in 2022. They had high valuations (61x forward earnings) at the beginning of 2022 and the Fed was raising interest rates to slow the economy. Pretty simple. Lower interest rates for longer was out and that meant valuations had to reflect slower growth. The entire market needed to acknowledge a lower equity risk premium in a higher cost of capital environment. The S&P 500 Index forward P/E multiple declined from 25x to 19x in 2022 while the top five ended 2022 at 29x.

Our problem with the path forward for these companies is we don't know what changed, yet they now trade at 42x forward earnings. Meanwhile the rest of the market has only gone from 19x to 22x forward earnings (driven entirely by those top five names). Interest rates are even higher today than when those stocks fell last year. We disagree that the Fed is anywhere close to cutting interest rates in any meaningful way. Additionally, earnings expectations are virtually unchanged since the beginning of 2023 for all five of these companies.

Absent an inflection upward in earnings forecasts for these stalwarts, the valuation of this group is hard to justify by the fundamentals. Further, the valuation spread between these mega-cap tech winners and the rest of the market has widened to unsustainable levels, in our opinion. We are wary of this concentrated trade to start the year and see much better opportunities in companies with modest growth and much better valuations.

Past performance is no guarantee of future results.

Market cap gained/lost



Source: S&P CapitalIQ. Data as of 5/31/2023.

Forward P/E	12/31/2021	12/31/2022	5/31/2023
AAPL	31.2x	21.0x	28.1x
MSFT	35.9x	24.3x	31.2x
AMZN	84.8x	60.2x	71.3x
GOOGL	26.6x	17.9x	22.0x
TSLA	125.6x	23.7x	56.2x
Average	60.8x	29.4x	41.8x
S&P 500 Index	25.3x	18.8x	21.6x

Source: S&P CapitalIQ. Data as of 5/31/2023.

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Forward Price-to-Earnings (P/E) is the price of a stock divided by estimated forward earnings. Forward Earnings of S&P 500 Index is the next-twelve months consensus estimate.