VINITY

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In a Nutshell

Investors commonly look to the S&P 500 to gauge the performance of the U.S. stock market. However, diverging trends this year make the index as useful as a glass hammer. The 15.9% return for the index through the first six months is attributable to just seven of the 500 constituents. These top stocks gained 89% on average, while the remaining companies in the S&P 500 averaged just 5.6%. As a result, the index has become increasingly concentrated and is subject to the influence of just a handful of companies. It is easy to get swept up in the excitement of making money, but it is important to remember this is a two-way street. And the ride down can be much quicker and more aggressive than the ride up. While the economy has shown resilience, there are still reasons to be wary. Excess savings accumulated during the pandemic are dwindling, and indicators such as real retail sales and industrial production are moving in the wrong direction. Despite this, the job market remains strong, with the unemployment rate among the lowest on record, and real income growth finally started to tick up this year. However, it is worth noting this is quite the juxtaposition as consumers are increasingly relying on credit cards, and saving rates are well below average. Inflation is still taking a toll, as incomes are not growing fast enough to offset the impact of higher prices. With the S&P 500 currently trading at 19.5 times the next twelve months' earnings, valuations are again at rich levels. But this time, stocks have competition from bonds with short-term Treasuries yielding more than 5%, offering a noteworthy alternative to overpriced stocks. Historically, a P/E ratio above 20 for the S&P 500 results in low single-digit annualized returns over the next ten years. Investors did not care how much they paid for stocks for most of the past decade as the alternative was earning nothing in bonds due to the prolonged low-interest rate policy. However, rolling the dice on high-valuation stocks is not a risk we find compelling, especially when short-term Treasuries are giving them a run for their money. We will continue to favor stocks trading at lower valuations and fixed-income securities priced at yields not seen in more than fifteen years. Now is the time to reduce risk, not to be a hero. The gains can evaporate much quicker than they came in when trying to swing for the fences. Instead, we prefer to hit singles and doubles and compound those runs over time to generate long-term wealth.

And Then There Were Seven

It is remarkable how much influence just seven stocks can have on the market. Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla, collectively known as the "magnificent seven," are the only stocks investors seem to care about despite the thousands of publicly traded companies in the United States. The magnificent seven made up 20% of the S&P 500 at the beginning of the year, and that number grew to nearly 28% by the end of the first half. The group is responsible for a whopping 77% of the S&P 500's return through the first six months of the year, contributing 12.2% of the index's 15.9% return. This year, the average return among the seven stocks is 89%, while the remaining stocks in the S&P 500 averaged just 5.6%. As a result, these companies are becoming a larger part of many broad market indices. However, it is important to note that a company's market cap, which determines its

weight in indexes like the S&P 500, does not always reflect its revenue or earnings. A company's market cap is equal to its share price multiplied by the shares outstanding. As investors bid up the share price, its market cap increases, regardless of a commensurate increase in profitability. In fact, the magnificent seven's weight in the S&P 500 is almost 28%, despite their operating earnings contribution only being 15.4%. While these companies are among the most profitable, they are overrepresented relative to their earnings contribution.

As prudent investment managers, we cannot allocate nearly 30% of assets to seven stocks that are rapidly moving higher because they may have a product or service that may benefit from artificial intelligence, which they may be able to monetize at some point in the future. The ARK Innovation ETF, run by Cathie Wood, serves as a cautionary tale about concentration risk. Wood is known for her bombastic personality and for making bold bets on speculative stocks. By the end of 2020, her ETF's outsized returns garnered attention, and she became a favorite among the Reddit meme-stock community. From January 2020 to the peak in February 2021, the ETF produced a 217.9% total return, led by a 10% wager on Tesla, among other concentrated bets. However, her concentrated approach comes with significant risks, and in early 2021 she decided to double down, disregarding any risk management techniques. Essentially, she used all the proceeds from her lottery ticket to buy even more lottery tickets. From the February 2021 peak to the low in December 2022, her fund lost 80.9%. Even an investment at the beginning of January 2020, before the huge gain, would be underwater by almost 10% at the end of June 2023. Breaking even from the 80.9% peak to trough decline requires a 424% gain, which emphasizes the importance of risk management and downside protection, as it becomes increasingly difficult to recover from a loss as the magnitude of the loss increases. Although an extreme example, the principle is important; when a handful of names drive all the action, it can operate as a two-way street. It is crucial to avoid putting all your eggs in one basket, as relying on just a few stocks can be a risky move.

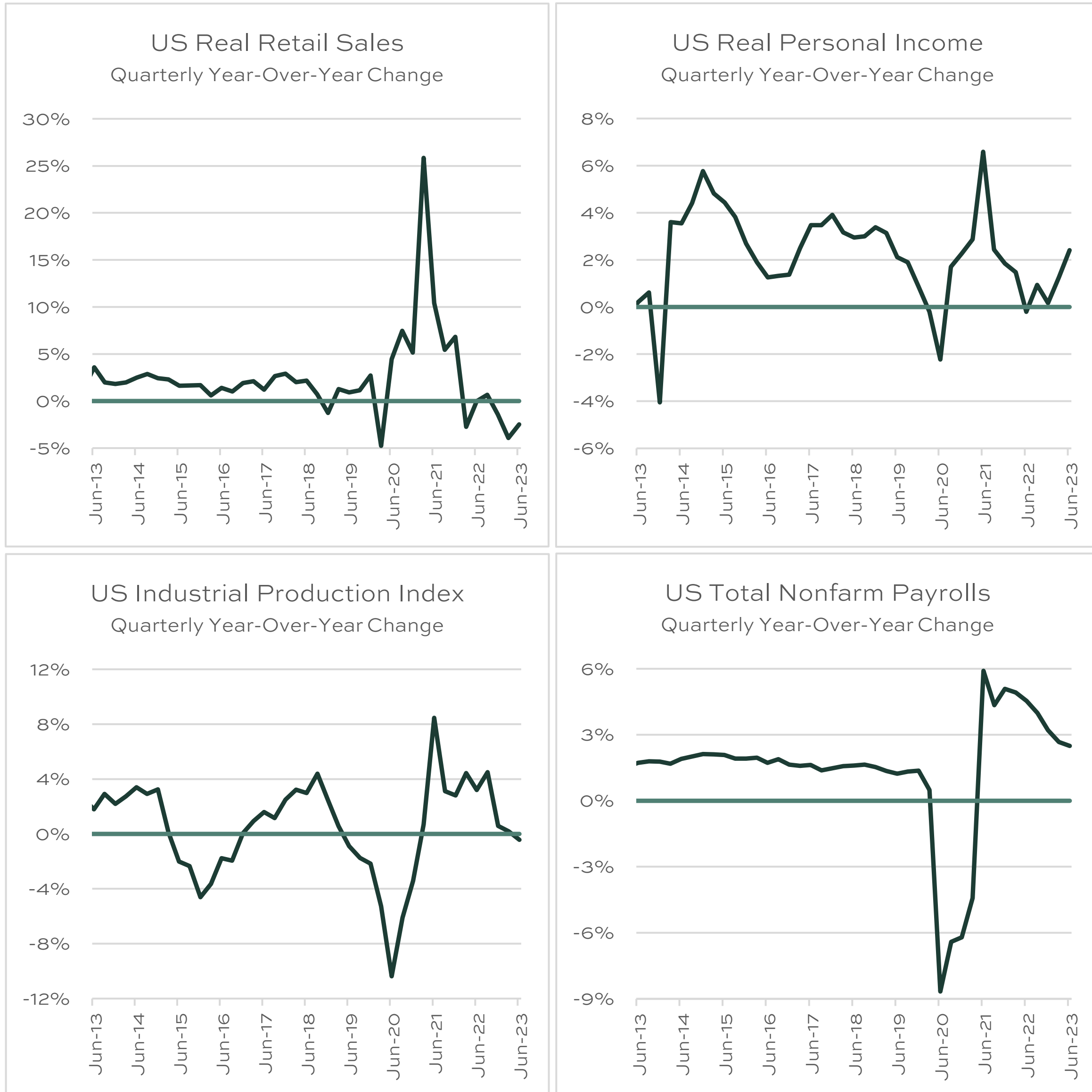
Recession or Not, Here It Comes

The economy has proven to be more resilient than anticipated thus far. Consumers have weathered higher prices thanks to a war chest of savings stockpiled in 2020 and 2021. A peak of $2.1 trillion in excess savings, accumulated through August 2021, the amount saved above the pre-pandemic trend, is down to $400 billion through the end of June. Those savings will run dry in about five months at the current pace. The unique dynamic of narrowly avoiding an economic crisis and pivoting on a dime to a period of spectacular excess and prosperity has made forecasting quite arduous. Cracks in the foundation alongside technical indicators have been flashing warning signs for more than twelve months, all while the economy keeps chugging along unscathed. While we are not totally in the clear, the chance we might be able to avoid a recession is at least greater than zero.

Whether or not we meet the criteria for a technical recession, the economy is still cooling, which remains our chief concern. Real retail sales and industrial production have been trending downward for over a year. Additionally, real personal income has only started trending upward this year, and even then, it's only been averaging 1.5% annually since the end of 2019. This is well below the pre-pandemic trend of 2.4%. On the jobs front, nonfarm payrolls have been strong up to this point. Since reclaiming all the jobs lost during the pandemic by July 2022, employers have added an average of 293,000 jobs

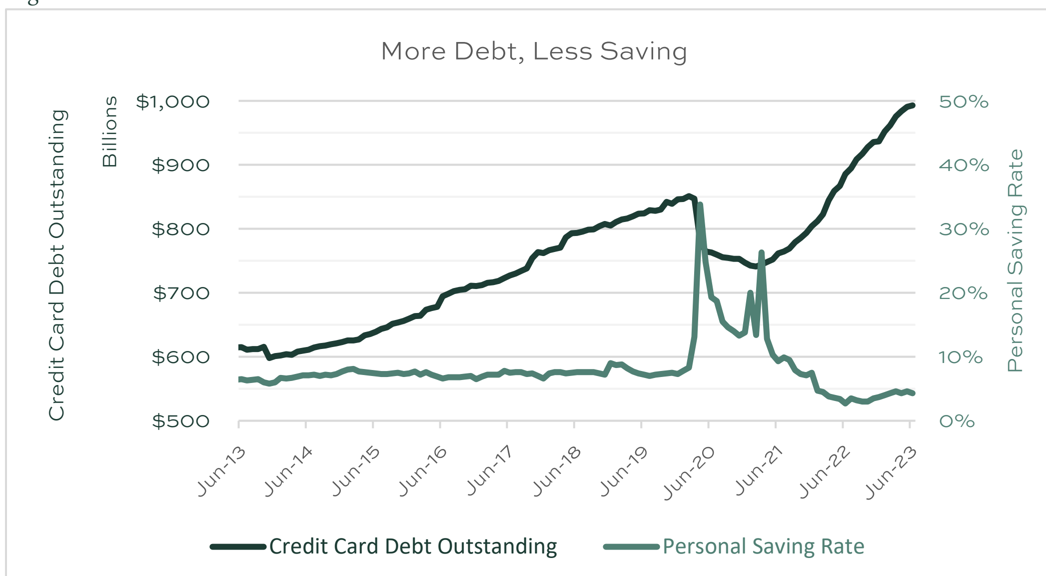
each month, well above the pre-pandemic trend of 200,000. While some of the strength is starting to wane, the jobs component remains a bright spot.

Figure 1.



It is perplexing to balance the current job market strength and recent income growth with consumers' increasing reliance on credit cards and well below-average saving rates. Unfortunately, prices remain high in many categories, making it difficult for some to make ends meet. Mortgage payments are among the most egregious, now double the June 2019 level, representing 28% of the median family income compared to the historical average of 15%. The government and central bank-supplied economic growth enhancers, such as stimulus and a prolonged easy monetary policy, sustained consumers longer than expected. But we fear this may only delay an economic slowdown rather than avoiding one altogether.

Figure 2.



Yield Ahead, Bonds Coming Through

The S&P 500 is trading at 19.5 times the next twelve months' earnings, an almost 20% premium to the historical average of 16.5. Considering economic activity and consumer spending are moderating, it is necessary to consider how much you are willing to pay for stocks. The S&P 500 finished the second quarter at 4,450; however, using the 16.5 price multiple and the consensus forward earnings of $228 per share, the imputed fair value is 3,750. The earnings estimate assumes 12% growth over the following twelve months, although if earnings growth is flat, the S&P 500 fair value is closer to 3,400.

As I have discussed in greater detail in past quarterly letters[1], the relationship between starting valuation and subsequent ten-year annualized return is too statistically significant to ignore. Historically, a forward P/E ratio below 15 is associated with double-digit annualized returns over the next ten years, while a P/E ratio above 20 has seen low single-digit annualized returns over the succeeding ten years more often than not.

Investors use the P/E ratio to determine how much they are paying for a stock per $1 of earnings generated. As the multiple increases, the investor pays more for the same $1 in earnings. While this framework provides a simple comparison among stocks, it provides limited insight when compared to other asset classes. A better way to look at valuations across asset classes is to calculate an earnings yield, which expresses earnings as a percentage of the current stock price. The earnings yield is the inverse of the P/E ratio, calculated by dividing the earnings per share by the stock's price (EPS / Price = Earnings Yield). For example, a company trading at a 10 P/E has an earnings yield of 10% ($1 / $10 = 10%), while a stock with a 20 P/E has a 5% earnings yield ($1 / $20 = 5%). However, the dilemma is that an investor can currently buy a 1-year Treasury Bill yielding over 5%, and if held to maturity, is guaranteed sans the U.S. government defaulting on its obligations. Conversely, nothing for a stock is

[1] Waiting for the Other Shoe to Drop – Q3 2022, and Forewarning, Reality Lies Ahead – Q1 2023.

guaranteed, and the potential return is subject to numerous assumptions and may exhibit meaningful volatility. With the current yield on short-term Treasuries besting the earnings yield for high P/E stocks, a rational investor has little to contemplate when deciding where to allocate assets.

With valuations stretched and the path forward for the economy uncertain, we will continue to prioritize stocks with lower valuations and fixed-income securities priced at yields not seen in fifteen years. The risk/reward calculation is not favorable following the 16% price gain for the S&P 500 over the first six months, while earnings estimates for 2023 and 2024 have fallen 4% and 2.5%, respectively. The current rally, driven by the fear of missing out, is based on the hope more people will come off the sidelines and bid up stocks. Hope is not an investment strategy, and chasing an overheated market is certainly not something we can defend. Now is the time to reduce risk, not attempt to hit a home run. History continuously reminds us that as easy as the gains may come, they can evaporate much quicker. While swinging for the fences may result in a quick windfall, it is not sustainable. Instead, we strive to hit singles and doubles and compound the runs over time to generate wealth. After such a strong start this year, now is not the time to be greedy and risk it all. To paraphrase Billy Beane in *Moneyball*: you hired us to get on first, not get thrown out at second.

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Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization.

Sources: J.P. Morgan Asset Management, S&P Dow Jones Indices, WisdomTree, YCharts.

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