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In a Nutshell

The performance divergence within the S&P 500 is troublesome. The average return among the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) is 82.7%, compared to the average return among the remaining 493 stocks of just -0.2% through the end of the third quarter. In short, investors with a diversified portfolio were penalized this year. Yes, those taking a prudent approach to portfolio construction were lucky to eke out positive results through the first nine months of the year. The head-scratching performance of the Magnificent Seven has resulted in those names representing a growing portion of the index. Historically, as concentration peaks in the S&P 500, a sharp reversal ensues in the coming years. The experience so far this year feels like the encore to the S&P 500's dominance over the past fifteen years. However, just because the S&P 500 got you here does not mean it will get you there. Keep in mind fifteen years ago, we were in the middle of the worst financial disaster since the Great Depression. The S&P 500 went on to fall 57% from its peak to the low in March 2009, paving the way for a generational buying opportunity, second only to the Great Depression in terms of the magnitude of the peak-to-trough decline. The environment today is markedly different, with the S&P 500 near all-time highs, so assuming the experience over the past fifteen years will continue is foolhardy. Starting valuation is a crucial indicator for long-term performance, and the 19 forward P/E ratio at the end of September does not compare favorably to the forward P/E ratio of 13 in September 2008. The significance of the relationship between starting P/E ratios and the subsequent annualized ten-year total return portends underwhelming future results for the S&P 500. The very accommodative interest rate environment also contributed to the S&P 500's tremendous run over the past fifteen years. Over this time, the Fed Funds rate averaged less than 1%, and the yield on the 10-year Treasury Note averaged 2.4%. The environment left little incentive to invest in bonds priced with unprecedentedly low yields. Today, the Fed Funds rate is 5.25%, and the 10-year Treasury note yields 4.6%, much different than the environment that propelled us here. And with investment-grade corporate bond yields at 6.2%, they represent a compelling alternative to overpriced stocks. At this juncture, it would be wise for investors to ratchet down their expectations for US large-cap stocks moving forward. Thankfully, the S&P 500 is not the only game in town, and we are most excited about the prospects for emerging market equities. Not only do they represent an attractive entry point following more than a decade of lackluster results, but structural tailwinds like favorable demographics, growth of the middle class, and a head start on reining in inflation compared to developed market economies should propel the asset class in the years ahead. As tempting as it may be to chase the performance of US large caps, this is rarely a wise decision, especially given the attractive alternatives we have today, unlike the past fifteen years.

Mirage

Contrary to popular belief, this year has been quite challenging. The headline performance number reported for the S&P 500 over the first nine months of 11.7% omits the rest of the story. The

performance represents just seven of the 500 stocks in the index. Stripping out the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), the index is up just 0.8%. The S&P 500 is becoming concentrated among a few names, and this dynamic typically does not portend a positive outlook for the broad index after reaching a peak in concentration. Historically, the equal-weight version of the S&P 500 outperforms the market cap-weighted version in the years ahead. During two prior peaks in concentration, March 2000 and November 2008, the equal weight index outperformed the market cap-weighted index over the subsequent two years by 35% on average.

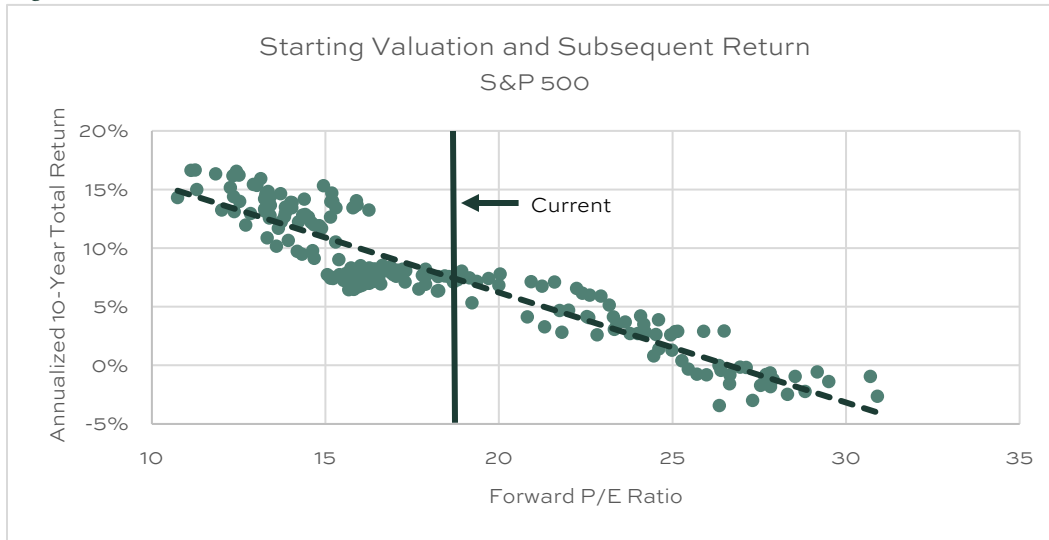
Investing in the S&P 500 proved profitable over the past fifteen years. However, just because the S&P 500 got you here does not mean it will get you there. The circumstances today are vastly different from what they were fifteen years ago, in September 2008, during the worst financial disaster since the Great Depression. By the end of September 2008, the S&P 500 had dropped by 25% from its peak, eventually falling 57% by the low in March 2009. Needless to say, the dust settled, and this marked a generational buying opportunity. Investors who put money to work in the S&P 500 between 1/1/2009 and 9/30/2013 enjoyed an average annualized ten-year total return of 13.8%, compared to the long-run annualized total return closer to 10% for the S&P 500. We can trace this successful run for the S&P 500 to two factors: starting valuations and interest rates.

At the end of September 2008, the S&P 500 had a forward P/E ratio of 13, an attractive entry point for investors. At the same time, the Fed Funds rate was 2% before dropping to zero in December 2008, where it remained until December 2015. The Fed Funds rate averaged less than 1% over the past fifteen years, and the average yield on the 10-year Treasury Note was 2.4%. This low-interest rate environment further bolstered stocks as there was little incentive to invest in bonds priced with unprecedentedly low yields. However, the present circumstances are different. The Fed Funds rate is 5.25%, and the 10-year Treasury Note yields 4.6%, a stark contrast to the environment that propelled us here. The S&P 500 currently trades at a 19-forward P/E ratio, a far cry from the forward P/E ratio of 13 in September 2008. Compared to investing in the S&P 500 at the low in March 2009, when the index was trading at a level lower than any time since 1997, investing in the S&P 500 today near all-time highs and trading at a rich multiple does not carry the same allure. The market's current valuation should be a cause for concern for all investors as the predictability of starting P/E ratios on future outcomes is significant. Based on current valuations, it is highly likely that the S&P 500 will deliver below-average returns over the next decade. Therefore, investors need to reset their expectations and focus more on where we are going, not where we have been.

Understanding the relationship between starting valuations and future results is noteworthy as the correlation between the two variables is meaningful. Correlation measures the strength of the relationship between two variables, with values ranging from -1 to +1. A correlation of -1 indicates a perfect negative relationship between the two variables, meaning they move in opposite directions. A correlation of +1 indicates a perfect positive relationship, meaning the two variables move together in the same direction. A correlation of zero means the two variables have no relationship.

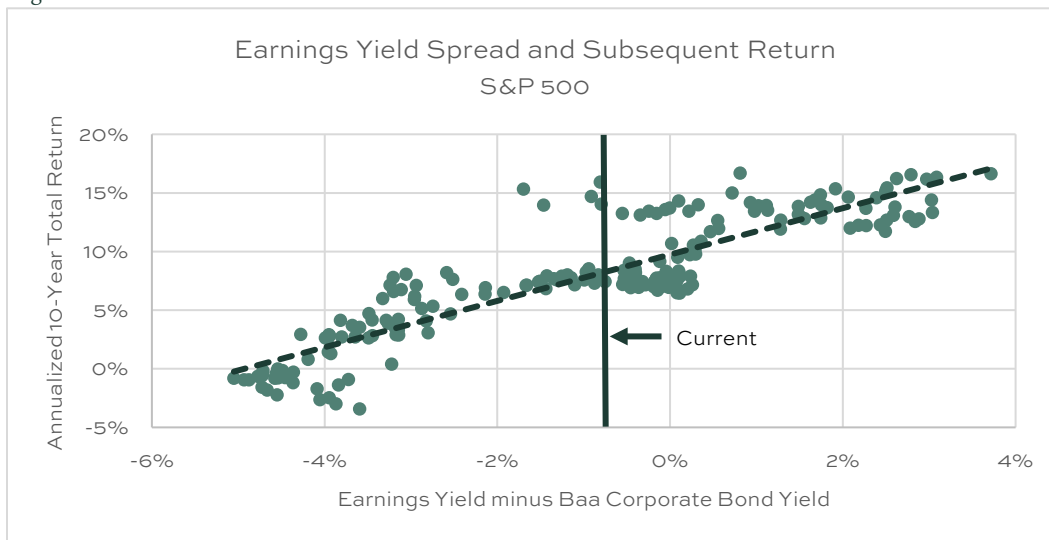
The correlation between the starting P/E ratio and the subsequent annualized ten-year total return for the S&P 500 is -0.93. So, the two variables move almost perfectly in opposite directions. When the P/E ratio falls, the annualized ten-year total return increases, and vice versa.

Figure 1.



To expand this methodology to include the current interest rate environment, we can use the earnings yield spread to understand whether stocks are overvalued or undervalued relative to bonds. The earnings yield is the inverse of the P/E ratio, calculated by dividing a stock's earnings per share by its price per share, so the lower the P/E ratio, the higher the earnings yield, while the opposite also holds. We can compare the earnings yield to the yield on corporate bonds to determine if investors are compensated adequately for the risk of a stock investment versus a bond investment. Bondholders are senior to stockholders, so in the event of bankruptcy, bondholders may recover a portion of their original investment while stockholders are left holding an empty bag. As such, a rational investor will expect a higher return for a stock investment, so a positive earnings yield spread indicates stocks are undervalued relative to bonds. The earnings yield spread is meaningful because of its strong relationship to future returns, similar to starting P/E ratios. The correlation between the earnings yield spread and the subsequent annualized ten-year total return is 0.89. This means the higher the spread, the higher the return over the next ten years.

Figure 2.



Considering the starting P/E ratio and earnings yield spread together, we can explain how we got here and where we are going. At the end of September 2008, the forward P/E ratio for the S&P 500 was 13, and the earnings yield spread was 0.6%. From September 2008 to the end of 2019, valuations slowly increased, and during that period, the earnings yield spread averaged 1.2%. Although stocks were becoming expensive, they were still relatively cheap compared to bonds because of the Fed's lower-for-longer interest rate policy. The earnings yield spread also explains why investors have overlooked stock valuations for the past three years. For instance, at the end of 2020, when the S&P 500 had a 24-forward P/E ratio, investors could point to the positive earnings yield spread of 1% as a reason why stocks were not overvalued. A forward P/E ratio of 24 indicates stocks are more than two standard deviations overvalued. However, with the Fed Funds rate at zero, stocks still looked attractive relative to bonds as measured by the positive earnings yield spread, creating quite a quagmire for investors. The situation is directly a result of the Fed's ultra-easy monetary policy featuring unprecedentedly low interest rates. At the end of 2020, the 10-year Treasury Note yield was less than 1%, and corporate bonds yielded just over 3%, so rolling the dice on stocks did not seem so bad. However, cheap money is now a thing of the past, and bonds are a meaningful contender to stocks for the first time in fifteen years.

At the end of September, the S&P 500 forward P/E ratio was a lofty 18.8, which equates to a 5.3% earnings yield, while the yield on investment-grade corporate bonds was 6.2%. A negative 0.8% earnings yield spread indicates that US large cap stocks are expensive relative to bonds, and the 18.8 forward P/E ratio implies US large caps are overvalued as an asset class. With both indicators at levels associated with below-average long-term results, now is the time to position for the future, not the past. Over the long run, US large caps have experienced periods above the long-run average, like the past ten years, and periods below the long-run average, most likely the next ten years. Most important is setting reasonable expectations as the market transitions to the next wave of leadership. The good news is that, contrary to popular belief, the S&P 500 is not the only game in town. The global opportunity set is quite attractive sans US large-cap stocks. At the top of our list is emerging market equities.

More than a decade of sub-par results from emerging markets has produced an attractive entry point for the asset class. Emerging markets are trading at a one standard deviation discount relative to US large caps, and as previously discussed, starting valuation is the best indicator for long-term performance. Supporting the attractive entry point are structural tailwinds for the asset class in the years ahead. Emerging markets countries' populations are younger and growing and expected to contribute nearly one billion people to the worldwide growth of the middle class by 2030. In addition, many emerging markets' central banks are ahead of their developed markets counterparts in abating inflation, with several countries already cutting rates. And real GDP growth is expected to surpass the US in 2024. The outlook for emerging markets is bright, and we believe the current entry point represents a meaningful long-run opportunity.

Today, the S&P 500 is on a different planet compared to the generational buying opportunity at the depths of the Financial Crisis. Keep in mind that an investor in the S&P 500 from 3/9/1999 to 3/9/2009 would have lost 37.2%, including reinvested dividends. With stock prices underwater after ten years, it is no wonder it was so easy to make money in the years ahead; there was no place to go but up. Chasing past performance is tempting but rarely wise. The circumstances today are materially different, and unlike the past fifteen years, we have very compelling alternatives to US large caps today.

Figure 1. Annualized 10-year total returns, on a rolling monthly basis, beginning in February 1997. The forward P/E ratio represents the price at the start of the period divided by the next twelve months' earnings per share estimates. **Figure 2.** Annualized 10-year total returns, on a rolling monthly basis, beginning in February 1997. The earnings yield spread represents the earnings yield (next twelve months' earnings per share estimate at the start of the period divided by the price) less the Moody's Seasoned Baa Corporate Bond Yield.

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Past performance is not indicative of future results. Indexes are unmanaged and you cannot invest directly in the index.

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, MFS, WisdomTree, YCharts.

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