MARKET MINUTE
WITH McGAREL

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The S&P 500 Index just experienced its worst first six months of the year since 1970, falling 20%. The twin threats of inflation and higher interest rates have overwhelmed the market despite a low unemployment rate, cash-rich consumer balance sheets, and a significant return of demand for consumer services. While sell side analysts have not yet reduced the nearly 10% earnings growth estimates expected this year, market declines clearly indicate investors expect otherwise. Investors started the year anticipating a recession was a modest possibility and with June's decline of 8% in the S&P 500 Index, it's obvious they have moved to a recession being probable sometime in the next year.

As we look forward, it seems logical to expect an environment substantially different from the narrow megacap growth market that dominated the last decade and especially the last three years. The average fed funds rate from 2009 to the end of 2021 was less than 1%. Big growth stocks drove the performance of the S&P 500 Index, the result of not only attractive earnings but also higher multiples assigned in a "lower for longer" interest rate cycle. Looking forward, higher interest rates are expected. We can call it "higher for longer". It would be surprising to see the same narrow market leadership in a very different economic environment when the market bottoms and starts to come back.

Looking at the two recent past recessions, not including the brief recession during the Covid-19 lockdowns, we have seen a much larger number of stocks outperforming the S&P 500 Index when the market is declining and subsequently emerging from large selloffs. During the tech bubble, 1995 to 1999, we experienced very narrow leadership but once the recession started many more companies outperformed the S&P 500 Index for years thereafter. Similarly, preceding the great financial crisis, another narrowly led market formed from 2006 to 2008, followed by much wider participation in the aftermath. Looking at the last five years, 2017 through 2021, less than half the stocks within the S&P 500 Index outperformed the index each year as the top names led the market. This year through June, already we have seen a higher percentage of stocks outperforming the S&P 500 Index. [Chart 1]

Additionally, looking forward at earnings growth estimates over the next 12 months and into the future indicates more opportunity outside of mega cap stocks. The largest 50 companies in the S&P 500 Index are expected to grow slower than the other 450 companies in the index over the next 12 months and over the next two years. Additionally, the other 450 companies have cheaper valuations based on price-to-earnings estimates. Again, a very different picture than the last few years when those large stocks provided an outsized portion of the earnings growth. [Chart 2]

As we look out over the next several years, unlike the last five years, we see more opportunity away from market cap weighted indexes and prefer alternative weighting schemes such as equal weight or those based on fundamentals.

Chart 1: Percentage of S&P 500 Index Companies Outperforming the Index

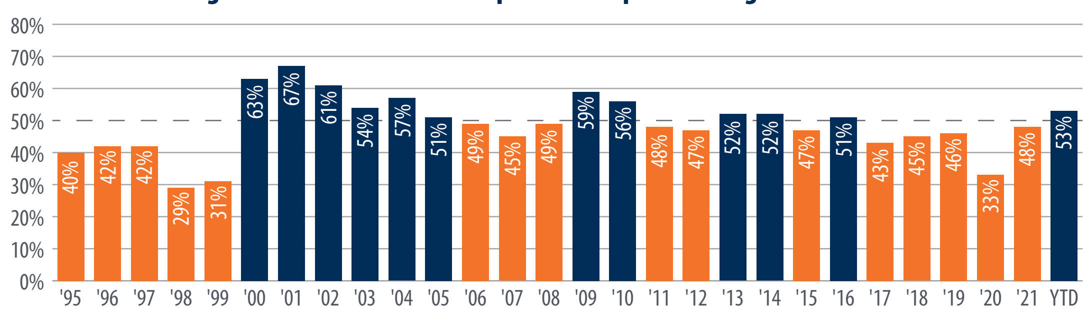
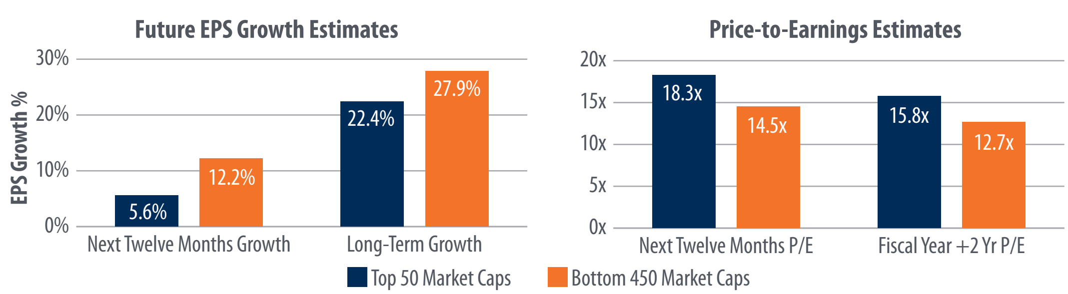


Chart 2: S&P 500 Index Top 50 vs. Bottom 450 by Market Cap



Past performance is no guarantee of future results. For illustrative purposes only.

Source: Capital IQ. As of 6/30/22.

Price-to-earnings (P/E) estimates are based on the next 12 months and fiscal year plus estimated earnings two years in the future. Forward earnings per share (EPS) growth estimates are divided by the trailing four quarters of earnings to derive future growth rates. Long-term growth is based on two-year forward estimates divided by the last four quarters of earnings. There can be no assurance that any estimates will be achieved.

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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.