MARKET MINUTE
WITH McGAREL

Dave McGarel, CFA, CPA
Chief Investment Officer

July 2023

The first six months of 2023 saw the reemergence of the growth trade, and with it the reversal of much of the damage in Technology Plus (Tech+) stocks that paced the 18% market selloff in 2022.

The outperformance of Tech+ and with it the long duration growth trade started in January with a rebound trade from last year's disaster along with expectations that China reopening its economy would spur faster worldwide GDP growth. Tech+ rallied in March as a shelter from the banking crisis, then moved higher on the market pricing in rate cuts this year, and also rocketed higher when NVIDIA announced a massive increase in future revenue estimates in late May. Today, the banks appear more stable, or at least less threatening to the economy, especially after the stress test, China's reopening was a dud, the Federal Reserve is almost certainly not cutting rates this year, and evidence of widespread, near term tangible benefits of AI aside from NVIDIA are generally lacking, in our view. In essence, we believe the market is embracing a small group of high performing companies and betting that little can stop them even when the thesis for the outperformance doesn't materialize.

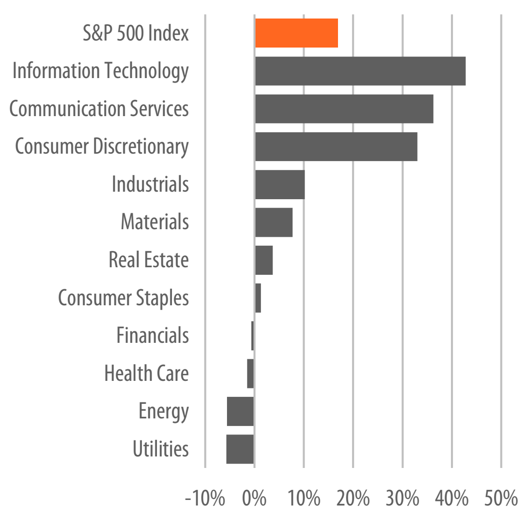
In last month's *Market Minute*, we discussed that the year-to-date (YTD) return through May 31, 2023 of the S&P 500 Index was incredibly narrow. Specifically, just 7 Tech+ stocks accounted for all of the return of the S&P 500 Index to that point. Additionally, only the three big growth sectors (Information Technology, Consumer Discretionary, and Communication Services) had positive YTD returns through the end of May.

In June, the market climbed another 7% but broadened out and was actually led by cyclical sectors, not Tech+. As per chart 1, there are now seven sectors with positive YTD returns. In our view, the market is much more likely to broaden further at the sector level than to revert back to the narrow Tech+ trade of the first five months. Regardless of market direction, up or down, in the second half of the year, we believe positioning in stocks 11-500 will produce better returns than the largest stocks in the S&P 500 Index.

When we look at chart 2, our conviction grows that the opportunity resides with the rest of the market narrowing the valuation gap and outperforming the top 10 stocks over the next six months. To further cast how concentrated the S&P 500 Index is currently, chart 2 shows that 31.5% of the S&P 500 Index weight sits in just 10 stocks. After the 7 tech+ companies (Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla and Meta), Berkshire Hathaway, UnitedHealth and Exxon Mobil are the next 3 biggest. Those 3 companies only make up 13% of the top 10's weight, however, so despite much cheaper forward multiples for those 3 companies, the top 10 still trade at 30x the next four quarters' estimated earnings. If we look at stocks 11-50, (the 11th biggest stock is Johnson & Johnson ($430 billion equity market cap) and the 50th is Nike (still a $169 billion company), there is a multiple significantly cheaper than the top 10 names. And, then every basket of stocks smaller than that trades at a declining multiple with the exception of stocks 101-200, which are marginally above the prior group.

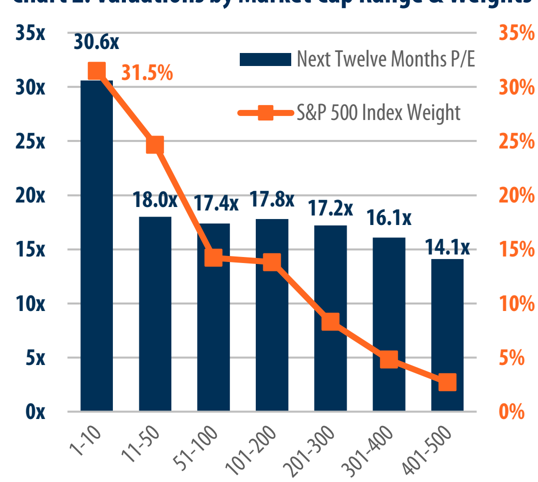
The decision to pay much higher multiples for the very largest stocks versus the rest of the large cap market index speaks to looking backward instead of forward, in our opinion. Additionally, the disparity in valuation is disconnected from the fundamentals in the large cap index, in our view. History tells us that, at some point, fundamentals will take over and investors will be better served by putting fewer dollars in the 10 largest stocks and more in the rest of the big companies in the S&P 500 Index.

Chart 1: S&P 500 Economic Sectors Total Return



Source: Bloomberg. Data from 12/30/22 - 6/30/23.

Chart 2: Valuations by Market Cap Range & Weights



Source: Capital IQ. Data as of 6/30/23. Estimates are based on the next four quarters earnings per share.

Past performance is no guarantee of future results.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

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 Multiple** is a valuation ratio that reflects a company's value on the basis of an estimated financial metric. **Forward estimates** are divided by the trailing four quarters of earnings to derive future growth rates. There can be no assurance that any estimates will be achieved. **Cyclicals** are defined as the energy, materials, industrials and consumer discretionary sectors ex internet & direct marketing. **Technology Plus (Tech+)** is a combination of the technology sector, interactive home entertainment, interactive media & services, internet & direct marketing, Tesla Inc., and Netflix Inc.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.