Equity Newsletter

4th Quarter 2024

First Trust

Overweighting the biggest stocks was the way to outperform the S&P 500 Index over the last 10 years. Hindsight is easy. What about now?

The S&P 500 Index (index) looks significantly different today than it did 10 years ago. The top 10 stocks in September 2014 comprised 18% of the index's weight (Table 1). Today, the top 10 stocks represent 36% of its weight (Table 1). While Apple Inc was the biggest stock in both periods, Microsoft Corp and Alphabet Inc were the only two other technology (tech+) stocks in the top 10 in September 2014. Today, however, there are 8 technology (tech+) names in the top 10. The technology (tech+) weighting in the index has seen a huge increase.

While the market capitalization (cap) weighted index has been the place to be these last 10 years, the question looking forward is one of risk and reward. The outperformance over the last 10 years has included a large increase in the P/E multiple of the technology sector and the entire S&P 500 Index. Today, there is also significantly more sector concentration and single stock exposure at the top of the S&P 500 Index than 10 years ago. Ten years ago, the top 10 stocks collectively had a low forward P/E multiple relative to the rest of the index while today they have the highest multiple by far (Chart 2).

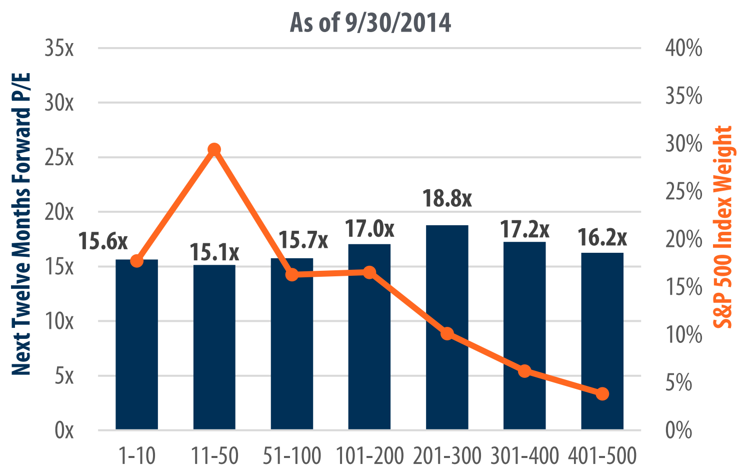
While the index is now very top heavy, we prefer to think of it as bottom light. The bottom 490 names share only 64% of the index's weight. In our view, considering the 2025 earnings growth differential between mega caps and smaller large caps in the S&P 500 Index is expected to narrow and there exists a large valuation disparity between them, the real risk may now be at the top of the index and the best opportunity across the rest of the index. **We believe the rest of the index may be ready to reward investors.**

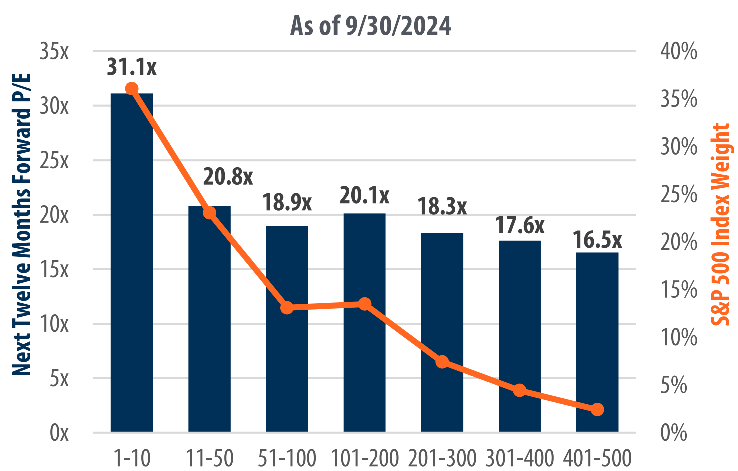
Table 1: Top 10 S&P 500 Index Holdings (%)

As of 9/30/2014	
Apple Inc	3.42
Exxon Mobil Corp	2.28
Microsoft Corp	2.18
Alphabet Inc	1.88
Johnson & Johnson	1.69
General Electric Co	1.45
Berkshire Hathaway Inc	1.43
Wells Fargo & Co	1.40
Procter & Gamble Co/The	1.30
Chevron Corp	1.29

As of 9/30/2024	
Apple Inc	7.27
Microsoft Corp	6.57
NVIDIA Corp	6.13
Alphabet Inc	3.64
Amazon.com Inc	3.57
Meta Platforms Inc	2.57
Berkshire Hathaway Inc	1.73
Broadcom Inc	1.65
Tesla Inc	1.49
Eli Lilly & Co	1.44

Chart 2: S&P 500 Index Valuations by Market Cap Range and Weights





Source: Capital IQ. Estimates are based on the next four quarters. 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. See definitions on page 3.

Past performance is no guarantee of future results.

Sector Views

Communication Services

- Digital advertising spending is robust, and stands to benefit from election cycle tailwinds.
- Internet and streaming firms are investing in Artificial Intelligence (AI) to increase monetization and improve efficiency.
- Risk of increasing regulation.
- Focus on quality within sector.

Consumer Discretionary

- Low unemployment and strong wages are positives for consumption, but declining job openings and a falling quit rate are early indications that the demand for workers may be slowing.
- Cumulative impact of inflation in recent years remains painful for consumers, especially on the lower end of income distribution.
- Dwindling excess savings, the impact of past monetary tightening, and still elevated interest rates are key risks to sector.
- Increasing e-commerce penetration, automation of warehouses are secular positives to profitability.
- Valuation not particularly attractive, in our view.

Consumer Staples

- Defensive sector but offers what we see as relatively meager growth.
- Consumer staples retailers and grocers face risk of reduced pricing power as inflation slows.

Energy

- We are less positive towards energy than earlier this year, as the potential for a slowing U.S. economy presents risk to future oil market demand and energy equities.
- That said, sector currently provides strong free cash flow generation as exploration & production companies have maintained capital expenditure (capex) discipline.
- For now, OPEC oil production cuts currently remain in place, but Saudi Arabia and others could potentially reverse some production curtailments in upcoming months. Additional production from Libya, Guyana, and the U.S. present risk of excess supply.
- Geopolitical tail risks to oil supply are escalating due to tensions in Middle East between Israel and Iran.

Financials

- Loan growth is mixed, as tightening lending standards and higher interest rates have resulted in less commercial lending and tepid real estate borrowing. Consumers have increased credit card utilization, but growth in slowing. Loan growth may begin to reaccelerate as the Federal Reserve cuts rates.
- Net interest margin (NIM) on loans have been gradually compressing as deposit rates have increased; NIM may improve in upcoming quarters if the yield curve steepens, or compress further if loan demand falters.
- Credit quality is slowly deteriorating but remains reasonable. That said, any significant rise in unemployment would increase delinquencies.
- Investment banking growth has been inconsistent.
- While current valuation levels are attractive, any economic slowdown would likely impact loan growth and credit quality.

Healthcare

- Provides opportunity to invest in growth that is less correlated to business cycle
- Healthcare providers and services industry benefiting from strong utilization and growth in elective procedures and office visits. Additionally, cost headwinds from contract healthcare workers may moderate over time.

Healthcare (continued)

- Managed Care is suffering from weaker than expected Medicare advantage reimbursement and the costs of drugs such as GLP-1s.
- Biotechnology stands to benefit from secular innovation, and potentially increasing merger activity as cash rich Big Pharma is motivated to replenish their pipelines, additionally, falling interest rates may ease tight funding environment for smaller biotechnology firms.
- Life science tools industry may benefit from progress made towards normalization of excess inventories.
- Valuation is attractive in the sector, in our opinion.

Industrials

- Demand for capex is a secular driver that may benefit sector, as firms are motivated to reshore supply chains and increase productivity in tight labor market.
- Sector stands to benefit from fiscal spending on infrastructure as well as national defense.
- ISM Manufacturing PMI index continues to indicate cyclical weakness in industrial activity.
- Weak international macroeconomic growth may impact industrial exports.
- Defense industry names may benefit from increasing geopolitical risk.
- We believe valuation in sector is reasonable.

Information Technology

- Key innovations such as AI and process automation offer substantial secular growth opportunities.
- We expect IT corporate spending to remain relatively stable for now, but a recession would negatively impact IT budgets. Additionally, we believe technology stocks are still too expensive relative to value stocks.
- Prefer quality within the sector, particularly firms with strong corporate balance sheets and reasonable valuation.
- Lower rates may improve access to risk capital for cloud software firms, while implementation of AI features within industry may improve value-added to clients.
- Key semiconductor (semi) end markets such as AI, high bandwidth memory, and vehicle electrification stand to benefit from secular tailwinds. Valuation is a risk for some well-known semis currently benefiting from investor enthusiasm towards AI, although earnings have been robust. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- On a cyclical basis, international economic weakness, especially weak Chinese construction, remains a key negative. Meanwhile, any emerging slowdown in U.S. economic growth would weigh on the sector as well.
- Incremental demand from clean energy grid infrastructure and electric vehicle transition is a secular positive.
- Materials sector stands to benefit over time from policies and investment designed to reshore supply chains amid geopolitical tensions.

Utilities

- Defensive, dividend paying nature is more attractive in times of macroeconomic uncertainty.
- Utilities are sensitive to interest rate movements, a potential positive if rates continue to decline.
- Data center power consumption is a source of secular growth in electricity demand.

Real Estate Investment Trusts (REITs)

- Higher yielding sector and has been sensitive to rising interest rates, stands to benefit if rates continue to decline.
- Data center REITs may provide strong secular opportunity, but any IT spending slowdown would impact the industry.

International Views

DEVELOPED MARKETS

Europe

- Inexpensive valuation in comparison to US stocks, but no clear near-term catalyst.
- Economic growth remains sluggish, but positive. Uneven industrial activity and soft exports are key areas of weakness.
- European Central Bank continued easing policy in September as inflation has moderated, and the central bank turns its focus to stimulating growth.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports, but we remain cautious towards Chinese growth.
- Geopolitical risk from increased influence of populism on national politics within Eurozone, and Russia's war on Ukraine.

United Kingdom

- Manufacturing PMI surveys point to modest improvement in industrial activity.
- The Bank of England has begun to gradually ease interest rate policy, with a 25 basis point cut in July.
- Fiscal policy less supportive in 2024.
- Inexpensive valuation in comparison to U.S. stocks.

Japan

- Robust wage growth improving domestic demand prospects, driving inflation and corporate pricing power.
- Rising wages and core inflation has led the Bank of Japan to embark on a monetary tightening cycle, potentially lifting the Yen.
- New Japanese Prime Minister Ishiba may be more hawkish on fiscal policy, creating some uncertainty.
- Japan stands to benefit from "friend-shoring" and increased secular demand for advanced technology exports such as automation equipment.
- Structurally low return on equities, although some corporate governance reforms have been implemented by the Tokyo Stock Exchange .
- Challenging demographics limit long-run potential economic growth.

Australia

- Commodity exporter which stands to benefit from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- Energy and metals exporter which stands to benefit from higher oil prices and commodity inflation and would suffer from a U.S. recession.

EMERGING MARKETS

Emerging Asia

- Chinese policymakers have recently announced more forceful monetary stimulus measures, and signaled that fiscal policy stimulus may be increased, as well. That said, Chinese economic growth remains underwhelming, as the beleaguered Chinese property market continues to weigh on fixed asset investment, while unemployment has begun to rise.
- Rising geopolitical tensions between U.S. and China present risk to supply chains for key technologies and materials, and complicate U.S. firms' decisions to invest in China.
- India is experiencing robust economic growth, driven by strong consumption trends and infrastructure investment; valuation remains a risk.

Latin America

- Mexican economy stands to benefit from exports to U.S., but would be negatively impacted by US recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Populist election results impact sentiment towards the region, as fiscal discipline may be called into question. Mexico is recent example.
- Brazil and Latin America overall are sensitive to demand for commodity exports, and commodity price inflation.
- Federal Reserve policy easing affords Latin American central banks more monetary policy flexibility.

Definitions

The **S&P 500 Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. **Forward Price-to-Earnings (P/E)** is the price of a stock divided by estimated forward earnings. **Technology Plus (Tech+)** is a combination of the technology sector; the interactive home entertainment and interactive media & services industries; Amazon.com Inc., Tesla Inc., and Netflix Inc.

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