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Amundi
ASSET MANAGEMENT

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Looking Beyond a Top-Heavy Market: Four Areas for the Future

INVESTMENT TALKS

Craig STERLING
Head of Equity Research, US
Director of Core Equity
Portfolio Manager

We believe the stocks that have outperformed over the past year, including the Magnificent Seven, are over-owned and extremely expensive.

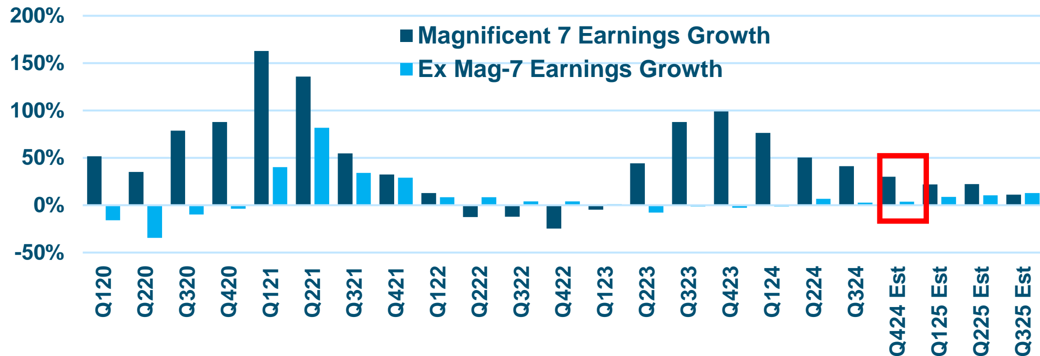
Executive summary

- *Over the past two years, we saw a small portion of the US equities markets, including the Magnificent Seven[1], dominate returns of the major US equity indices.*
- *This dominance is beginning to equalize as earnings growth from the top stocks slows and the rest of the market accelerates, a process we expect to continue into 2025.*
- *Meaningful structural changes are occurring across many industries, presenting active investors a range of potential opportunities across several key areas. Impacts from the recent US presidential election could also catalyze these shifts.*

Over the past 18 months, a handful of the market's top stocks, including the Magnificent Seven[1], have surged in earnings and valuation, dominating returns. Currently, the average Magnificent Seven stock has a price/equity ratio of 45x, compared to 26x for the average S&P 500 stock and 19.3x for the average stock in the S&P 500 equal-weighted index[2]. We believe the fundamentals behind the top stocks do not support such a large differential, and the market concentration in those stocks could be poised for a reversal.

Underneath the surface of this concentrated market, sharp earnings recoveries may soon play out and structural and cyclical changes may create new winning and losing stocks. Although the market is mostly ignoring the valuation risks, we have seen signs that this market imbalance may be ready to unwind. Notably, a higher-than-average amount of S&P 500 returns is explained by company-specific factors rather than macro factors, and valuation dispersion is also high. For active managers, the key is not just to identify pockets of value, but paths to future value through revenue and earnings growth.

Exhibit 1: Magnificent Seven earnings may soon decelerate, while the earnings of the other 493 S&P 500 stocks are expected to improve



Source: Bloomberg, as of Nov 13, 2024. Bloomberg consensus forecasts. Indices are unmanaged and their returns assume reinvestment of dividends and do not reflect any fees or expenses. It is not possible to invest directly in an index. Securities listed are not meant to represent any current or future holding of an Amundi US portfolio, and should not be considered recommendations to buy or sell any security.

[1] The Magnificent Seven stocks include: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVDIA, and Tesla. Securities listed are not meant to represent any current or future holding of an Amundi US portfolio, and should not be considered recommendations to buy or sell any security.

[2] Source: Amundi US, Bloomberg, as of Nov 12 2024.

Four areas for the future: Shifting market momentum is opening doors for other sectors

As the momentum of the market's top stocks begins to slow, we believe other parts of the market are demonstrating real promise and momentum is shifting to new leaders.

Cyclical and manufacturing companies

We are cautiously optimistic about market segments of cyclicals, whose prices fluctuate with the economy's macroeconomic conditions. We are particularly positive about cyclicals for which the next 10 years could present a large shift from the last 20 years, causing the market to overlook their renewed potential. This shift could be due either to structural changes such as reshoring, second-derivative impacts from technology and geopolitics, or a focus on capital allocation. We are also seeing a number of factors lessening the irrational competition that was an outcome of the zero to near-zero interest rate environment, including an enhanced focus on capital allocation and shareholder returns as well as a higher cost of capital. In many cases, the market still assumes some areas will have the same cyclical amplitude as prior cycles. Examples include sub-segments of materials sectors such as aggregates and copper, as well as energy.

Overall, we maintain a company-specific approach to finding opportunities within industries, as meaningful structural and technological changes are happening in nearly every corner of the economy.

Manufacturing and goods production are other examples. Although it is less than 20% of the overall US economy, manufacturing represents an outsized 50% of the S&P 500. Since 2023, many manufacturing companies have been managing through post-COVID-19 distortions such as uneven demand and supply chain and inventory issues. In many cases, these challenges dampened production, lowered valuations, and contributed to earnings recessions. Today, these companies have already cut expenses to manage margins and have drawn down inventories, potentially positioning them to move ahead as volumes recover. Promising examples include industrial automation, analog semiconductor, and transport & logistics companies.

Banks

As we move beyond the banking sector's deposit and balance sheet challenges of March 2023, we expect net interest margins to improve as the yield curve normalizes, investment banking activity improves, and the concern around regulatory overreach fades as a result of the US presidential election. All of these changes, could potentially lead to loan growth and impressive capital returns for the banking sector. We also believe the 2023 collapse of banks with flawed business models, such as Silicon Valley Bank, Signature Bank, and First Republic Bank, had caused the market to undervalue the largest US banks, which have continued to demonstrate relative stability, even through macroeconomic challenges. Moreover, it is important to compare bank valuations to pre-Great Financial Crisis levels, when interest rates were not distorted by zero- to near-zero levels and unprecendented central bank balance sheet deployment.

Technology

Technological shifts are presenting potential opportunities for stock-specific active management. Some companies in every industry have been ahead of the curve on investing in technology, while others have fallen behind. As a result of this generational revolution in technology, including the push for artificial intelligence, we believe active managers must develop a thorough understanding of shifting competitive advantages and translate this to careful stock selection. In many industries, we expect these developments to enable the companies that are already competitively advantaged to sustain their lead, assuming they have already been investing in the cloud, data, digitization, and machine learning/ artificial intelligence.

Health care

The health care sector has been the worst performing market sector year-to-date, meaningfully underperforming other traditional defensive sectors like utilities and staples. The post-COVID-19 regime introduced historically high levels of cyclicality and earnings volatility that are historically unusual for health care. The sector continues to innovate, and unlike other sectors, is generally not excessively priced. Thus, we expect potentially high earnings growth over the next year. At the time of this writing, there are new potential risks from the new leadership of both the US Health and Human Services department and Centers for Medicare & Medicaid Services. Seemingly, the biggest risks are priced into valuations, but more than ever, active management will be critical to success in this complex sector.

Conclusion

We maintain a company-specific approach to finding opportunities within industries, as meaningful structural and technological changes are happening in nearly every corner of the economy. While some management teams and companies have demonstrated an impressive ability to manage through uncertainty and economic volatility, others have not. Separating the potential winners from the rest of the market will be key to portfolio success through the rest of 2024 and beyond. With so much uncertainty and variability across industries and companies, active management remains essential as we find opportunities across markets and industries.

Index and Term Definitions

- Average price/equity ratio (estimated): The current price of a stock divided by the estimated one-year projection of its earnings per share.
- Beta: A measure of the contribution of an individual asset to the risk of the market portfolio.
- Compound annual growth rate: The mean annual growth rate of an investment over a specified period of time longer than one year.
- Cyclical stocks: Stocks whose performance moves in sync with trends in the economy, often because they make or sell items and services that are in demand when the economy is doing well.
- Defensive stocks: Stocks that generally provides consistent dividends and stable earnings regardless of the state of the overall stock market.
- Earnings before interest and taxes (EBIT): A common measure of profitability.
- Global Financial Crisis: The period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.
- Magnificent Seven: Reference a group of seven high-performing and influential stocks in the technology sector. Stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVDIIA, and Tesla.
- Megacap stock: A designation for the largest companies in the investment universe as measured by market capitalization; a common measure is those with a market capitalization above $200 billion.
- The Russell 1000® Growth Index: measures the performance of the large-capitalization growth sector of the US equity market. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

Important information

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