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Amundi ASSET MANAGEMENT

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Capturing the Momentum of a Narrowing Earnings Gap

INVESTMENT TALKS

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Executive summary

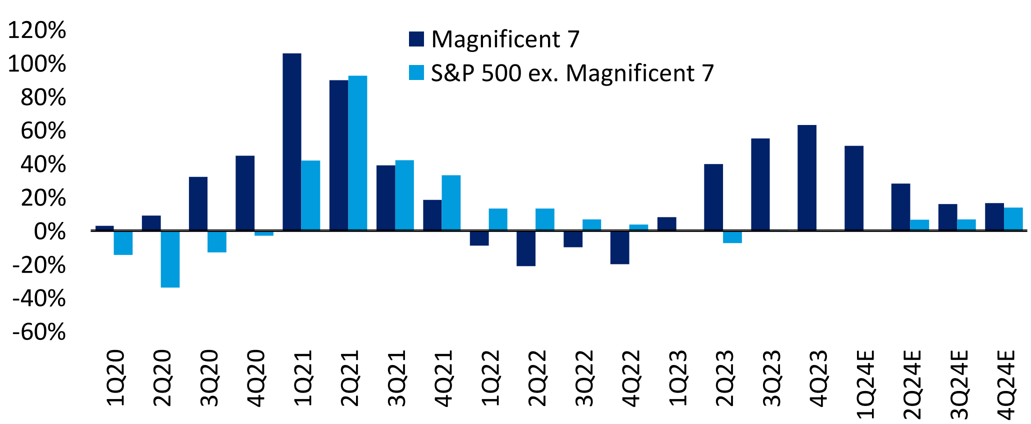
- *Top stocks including the Magnificent Seven have dominated equity returns since early 2023 as their earnings growth has far outpaced the rest of the market.*
- *We believe many stocks that have outperformed in 2023-2024 are over-owned, and expensive relative to the average stock.*
- *The concentrated, top-heavy US equity market may broaden out as the earnings growth gap between the Magnificent Seven and the rest of the market shrinks in 2024.*
- *There are meaningful structural changes happening across many industries.*
- *The market is mostly ignoring these changes, potentially presenting a range of opportunities for active investors.*

Since early 2023, a handful of the market's top stocks, including the Magnificent Seven[1], have surged in earnings and valuation, and have dominated returns. This has left equity investors with an incredibly bifurcated market. While the valuation gap between the top and average stocks is still slowly growing, 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, crowded market, sharp earnings recoveries may soon play out and structural changes may occur in many industries, creating new winning and losing stocks. Although the **m**arket is mostly ignoring the risks, we have seen signs that this market imbalance may be ready to unwind and the earnings growth that fueled it set to weaken.

Earnings growth is decelerating for the Magnificent Seven after this past year's surge.

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



Source: BofA, Factset, as of May 20 2024. BofA 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, NVDIIA, 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.

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What contributed to the Magnificent Seven's dominance?

We believe the stocks that have outperformed over the past year, including the Magnificent Seven, are over-owned and extremely expensive. Currently, the average Magnificent Seven stock has a price/equity ratio of 31x, compared to 21x for the average S&P 500 stock and 16.5x for the average stock in the S&P 500 equal-weighted index[2]. But what led to their dominance?

The Magnificent Seven were among the first to suffer in 2022, and the first to rebound

Looking back at 2022, we can see that the Magnificent Seven were among the first companies whose earnings declined, giving them a head start during the 2023 recovery and allowing them to demonstrate earnings growth when few others did. This took place against a backdrop of recession fears in an unpredictable macro environment.

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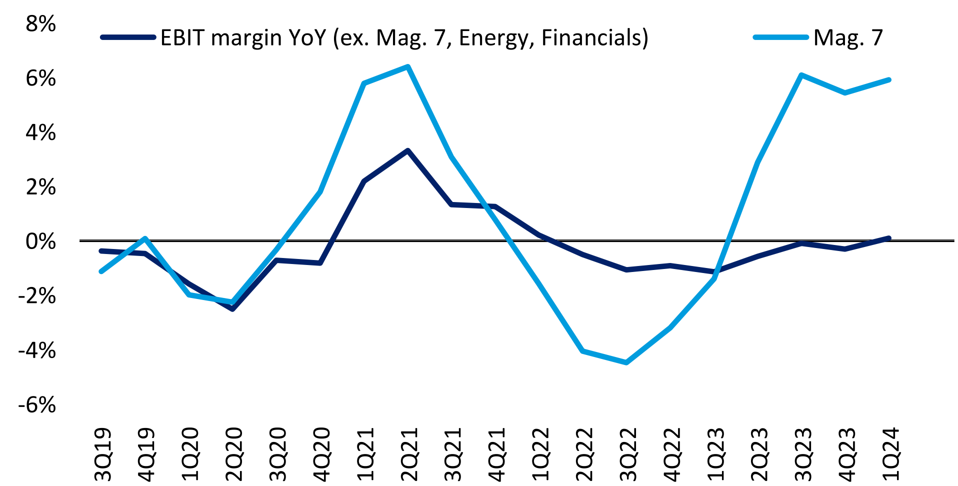
Lingering effects of COVID-19

Although it represents less than 20% of the overall US economy, manufacturing and goods production represents an outsized 50% of the S&P 500. Since 2023, many manufacturing companies have been managing through post-COVID-19 distortions such as supply chain and inventory issues, dampening production, lowering the valuations of many of these stocks, and contributing to an earnings recession for them. Their outsized representation in the S&P 500 in turn led to lower overall index performance. Looking ahead, these companies have already cut expenses to manage normalized margins and have drawn down inventories, which means these stocks could be poised to move ahead.

In contrast, several Magnificent Seven companies were able to cut costs last year, sometimes aggressively, in order to pull back their overgrown COVID-19 expense bases. While it has contributed to their success, this optimization is now mostly already priced into the market. Partially as a result, earnings growth is decelerating for the Magnificent Seven after this past year's surge.

Exhibit 2: The Magnificent Seven stocks recouped their margin loss by cutting costs



Source: BofA, Factset Alpha Testing, as of May 20 2024. EBIT: Earnings before interest and taxes. 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.

[2] Source: Amundi US, Bloomberg, as of Apr 30 2024. 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.

Shifting market momentum is opening doors for other sectors

As the Magnificent Seven momentum begins to slow, we believe other parts of the market are demonstrating real promise.

Cyclical companies

As the market undergoes a transition, momentum is shifting to new leaders. We are optimistic about cyclicals, whose prices fluctuate with the economy's macroeconomic conditions. Examples include analog semi-conductor and chemical companies, which have already taken the sales/earnings/inventory pain initiated by excess post-COVID-19 demand. We expect them to recover within the next couple of quarters, and believe their promise of recovery and normalization is not yet priced in. Looking ahead to the end of 2024, we foresee other areas joining this group, such as industrial automation companies.

There are also many cyclicals for which we expect the next 10 years to be much different than what they were in the last 20 years because of structural shifts and second-derivative impacts in many sectors as a result of technology and geopolitics. Moreover, we are seeing a number of factors lessening the irrational competition that was an outcome of the zero to near-zero interest rate environment. These include more rational competition, an enhanced focus on capital allocation and shareholder returns, and a higher cost of capital. In many cases, the market still values some areas to have the same cyclical amplitude as during prior cycles. Examples are materials sub-sectors such as aggregates and copper, as well as energy and segments within financials.

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.

Banks

As we move beyond the banking sector's deposit and balance sheet challenges of March 2023, we expect net interest margins to stabilize, investment banking activity to improve, and the concern around regulatory overreach to fade. All of these changes could potentially lead to 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, has caused the market to undervalue the largest US banks that continue to demonstrate a relative stability through macroeconomic challenges since the end of the Global Financial Crisis.

Defensives

Some defensive stocks, which generally provide consistent dividends and earnings regardless of overall market performance, are increasingly interesting. These include utilities, which is the best performing sector year-to-date[3] after a poor performance in 2023; and certain staples. Additionally, there are companies in many other sectors with defensive-like characteristics that are interesting right now.

Technology

Technological shifts are also having an outsized impact on the market and present 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 new developments, including the push for artificial intelligence, we believe an understanding of potentially shifting competitive advantages as a result of this generational revolution in technology will make careful stock selection vital. But to be clear, in many industries, we expect it 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.

Conclusion

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. 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 over the next year, and beyond. With so much uncertainty and variability across industries and companies, it is essential today to manage portfolios actively as we find opportunities across markets and industries.

[3] Source: Bloomberg as of May 15, 2024.

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.