October 10, 2024
Commentary

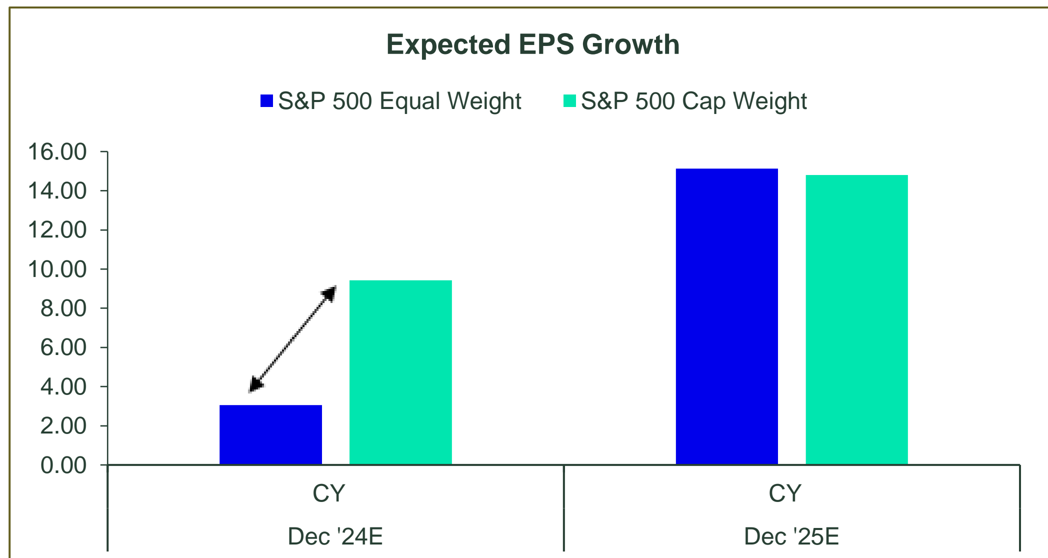
Weekly Market Update

Insight of the Week

Catch up in the S&P500 leadership!

For a while now, a narrow segment of the market, primarily driven by the tech-heavy "Mag 7" has had an outsized impact on US stock performance. These mega-cap stocks alone now represent nearly 30% of the S&P 500. Their influence has led to the cap weighted index's higher returns and valuations.

However, this dominance is starting to show signs of change. Comparing the cap weighted S&P 500 index to its equal weighted counterpart reveals a changing story in projected earnings growth between 2024 and 2025. Specifically, next year the equal weighted index is expected to catch up and have similar earnings, removing the lopsided differences. This shift could indicate a potential broadening of market leadership away from the giant large caps and toward all "the rest."



Sources: FactSet as of 10/09/2024, S&P500.

This rounding out of earnings illustrates more diversified opportunities in the market for investors. The equal weight index's profile has a value tilt and greater exposure to cyclicals and the smaller large-cap companies. Some of the non tech sectors like Health Care, Materials, and Industrials, are poised for much stronger earnings growth in 2025, each with expected growth of greater than 15%. This aligns with a potential rotation out of high valuation tech stocks. We are cautious to say this is the end of the tech run, as it will always be a pillar of the US economy. However, in 2025 we may start to see a larger opportunity set within US large caps.

Source: State Street Global Advisors, FactSet, S&P500.

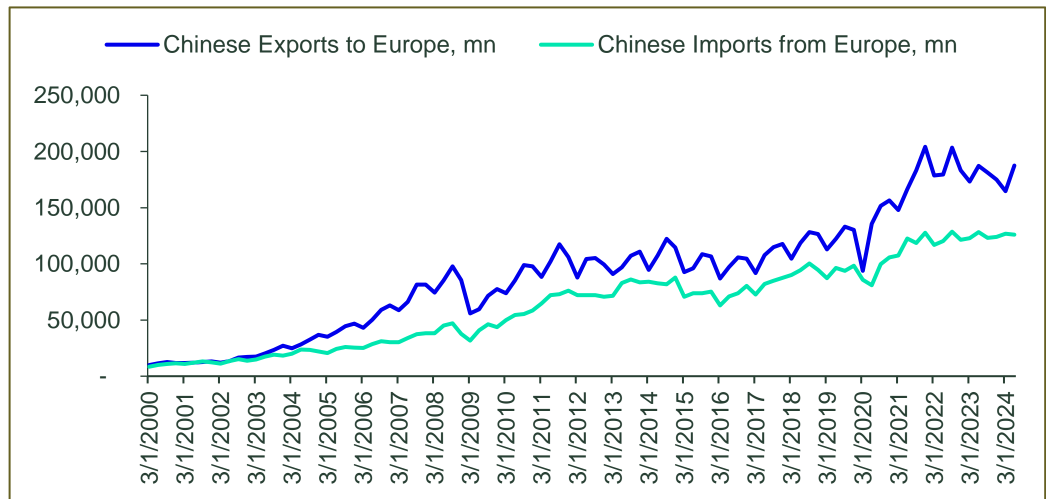
Equities

Spillover Effects: Who Else Will Benefit from China's Efforts?

Last week we explored the latest stimulus efforts in China, aimed at reinvigorating consumer spending, and supporting the real estate sector. In short: we think these policies are a step in the right direction, but will need to be improved upon for structural/long-term impact. The market has appreciated the effort, though when the NDRC failed to announce further stimulus as the market expected, China gave back some return. The MSCI China Index is up 21.7% since Sept. 24th when stimulus was announced, giving up around 10% from the higher returns of 32.1% seen on October 7th.

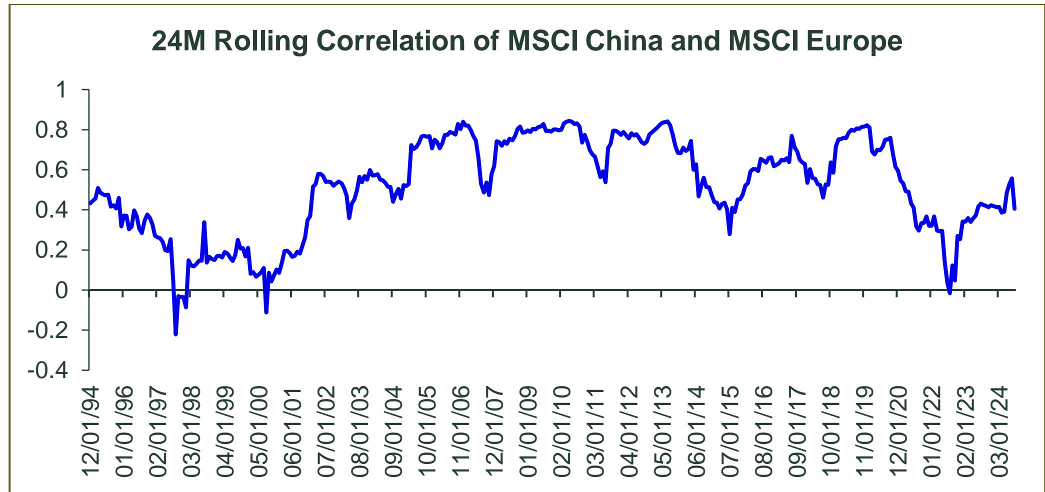
With China being the world's largest exporter, and a meaningful importer, the effects of their recovery impacts other regions, namely Europe. A few key European sectors and industries are reliant on Chinese demand. For example, these sectors include: luxury goods, industrial inputs, automobiles, and consumer goods. A healthy Chinese consumer means healthier demand for these products.

The chart below shows the trade relationship which has deepened over the last two decades. However, the more recent rate of change for both series beckons further investigating. Since the end of 2021, Chinese exports to Europe have been on a downward trajectory, and imports from Europe have been flat. The trends of protectionism and de-risking may be what's playing out here. Recently, we saw the EU increase tariffs on Chinese made electric vehicles, and in return China introduced barriers to European brandy producers.



Source: Macrobond, GAC. Data as of 6/30/2024.

Are China and Europe becoming less entangled? Equity market returns have historically shown to be quite positively correlated. However, during COVID and beyond, we saw a deterioration of this correlation as China became more unique, dealing with extended lockdowns and a delayed recovery. The correlation has since normalized, but it is still sitting below highs of 0.8.



Source: FactSet, MSCI. Data as of 9/30/2024.

Stimulus plans seem to have sparked renewed optimism for the PRC, which in turn could be good news for Europe. However theories that these measures aren't enough has begun translating through to markets. In the end, if Europe and China's relationship is indeed unraveling, stimulus may not matter much at all.

Source: State Street Global Advisors, FactSet, MSCI, Macrobond, GAC.

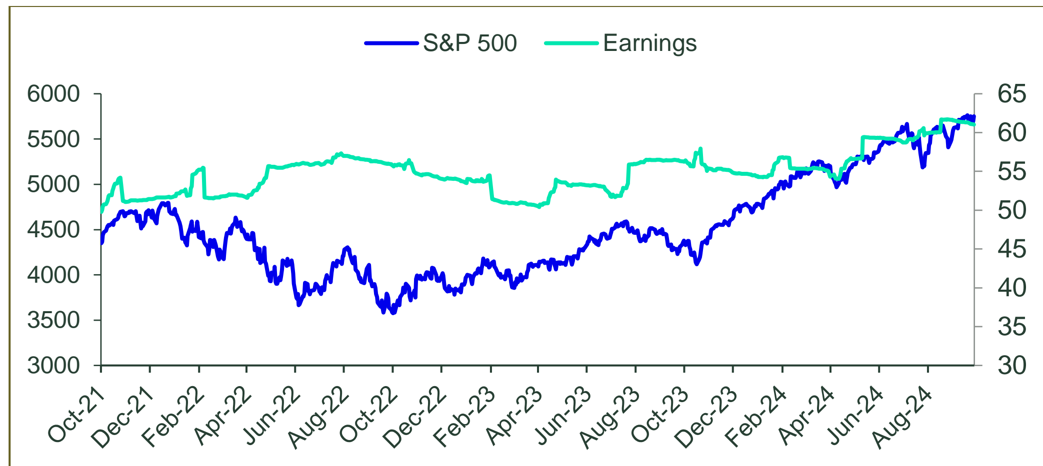
Fixed Income

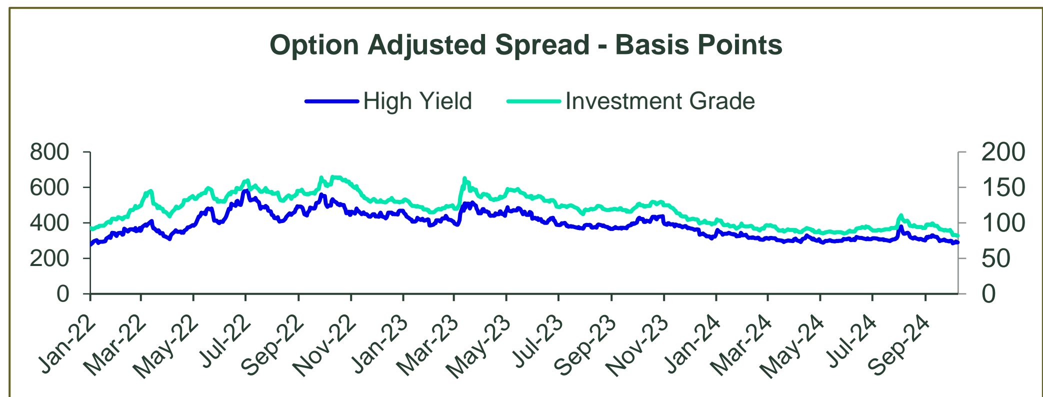
Risk Assets Exposed to Hard Landing

Last week, the September nonfarm payroll surprised to the upside and markets became convinced that the U.S. economy would escape a recession. Although a soft landing remains our base case, we implore investors to exercise caution.

After years of recession fears, investors are now pricing in a high probability of a soft landing which has led to a soar in valuations. The S&P 500 increased by 21% and earnings grew by 12% YTD. This rosy picture poses a risk as any shock or signs of a hard landing could cause valuation to plummet, making risk assets a lot more riskier.

Within fixed income we see the same story. Valuations remain rich as investors price out chances of a hard landing. Within both investment grade and high yield, bond spreads have rallied to three-year lows, a clear sign that investors within credit remain bullish, and continue to price out risks of a hard landing.





Source: Bloomberg as of October 9, 2024.

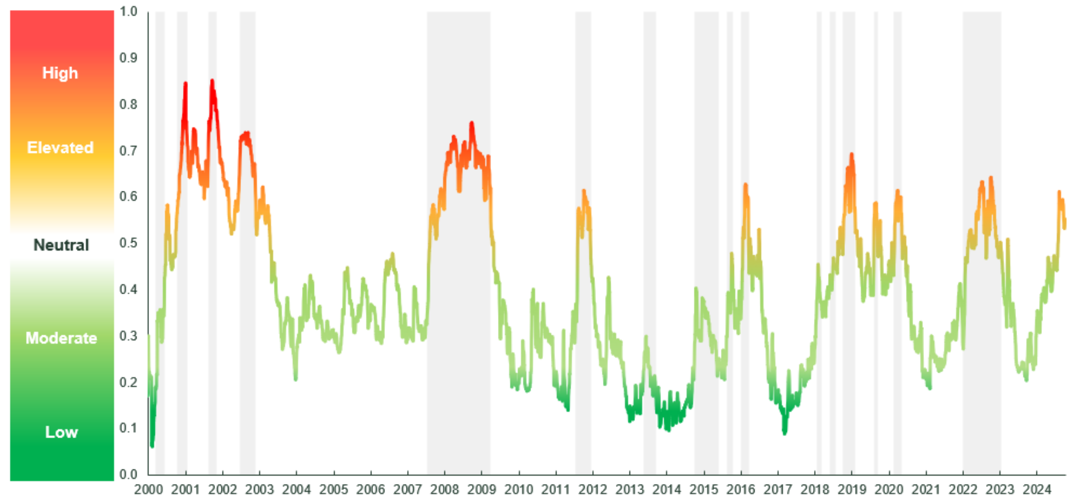
High budget deficits, wanning fiscal stimulus, geopolitical risks, and the upcoming U.S. elections could upend the soft-landing narrative. Inflation risks have subsided but not completed abated, and unexpected strength in the labor market and/or the economy could reaccelerate inflation. Given their rich valuations, risk assets are not adequately pricing in these risks and are exposed to shocks.

Recession is not our base case, but we do believe the risks remain elevated, and as such investors should exercise caution. Based on our views, we favor duration, and given rich valuations we remain neutral to spread sectors.

Source: State Street Global Advisors, Bloomberg.

Market Regime Indicator

The Market Regime Indicator (MRI) represents a proprietary multi-asset class model designed to characterize risk appetites within the capital markets.



Source: State Street Global Advisors, Investment Solutions Group (ISG). As of October 2, 2024. The data displayed is not indicative of the past or future performance of any SSGA product. The above data represents a back-test of the MRI model, which means that those results were achieved by means of the retroactive application of the model which was developed with the benefit of hindsight. Data displayed beyond this date is not backtested, but is still generated by the model referenced. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of four risk regimes: Low Risk, Moderate, Normal, Elevated and High Risk..

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*Pensions & Investments Research Center, as of 12/31/23.
†This figure is presented as of June 30, 2024 and includes ETF AUM of $1,393.92 billion USD of which approximately $69.35 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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