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MAY, 2023

The Few vs The Many

In the midst of recession fears, a banking crisis, and historically high interest rates, the S&P 500 is up 7% YTD. Meanwhile the corresponding equal weighted index of the same 500 companies is roughly flat. What is driving this intra-index divergence, is it sustainable, and where could we go from here?

By Logan Moulton, CFA

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What is the S&P 500?

The history of the most popular market index dates to its introduction in 1957 as a means to track the value of the largest 500 companies listed on the Nasdaq and New York Stock Exchange. The S&P 500, which is short for the Standard and Poor's 500, is a capitalization weighted index that, in theory, represents a gauge of the US economy. Names come and go as do their weightings in the overall index. Today, the top 10 stocks make up nearly 30% of the index while the other490 names compose the remaining 70%. This feature results in the largest companies (i.e., the largest weighted stocks in the index) generating a disproportionate contribution to the index's return.

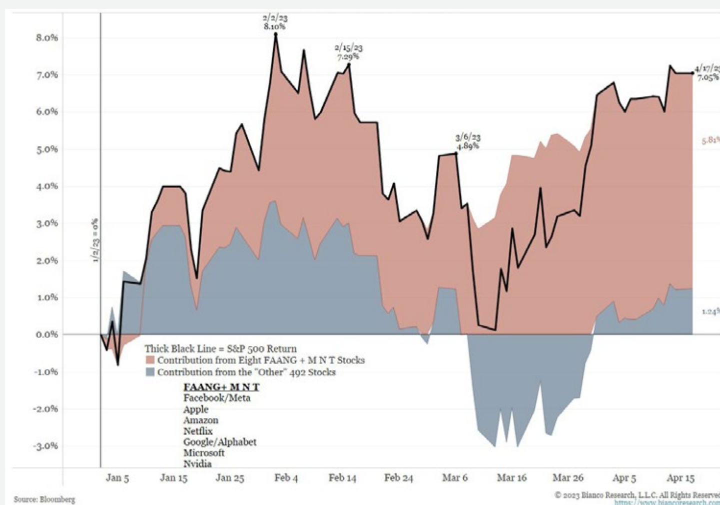
AAPL	Apple	7.5%
MSFT	Microsoft	6.7%
AMZN	Amazon	2.8%
NVDA	NVIDIA	2.1%
GOOGL	Alphabet A	1.9%
GOOGL	Alphabet C	1.7%
BRK.B	Berkshire Hathaway	1.7%
META	Meta Platforms	1.5%
UNH	United Health Group	1.3%
TSLA	Tesla	1.3%
XOM	Exxon Mobil	1.3%
		29.8%

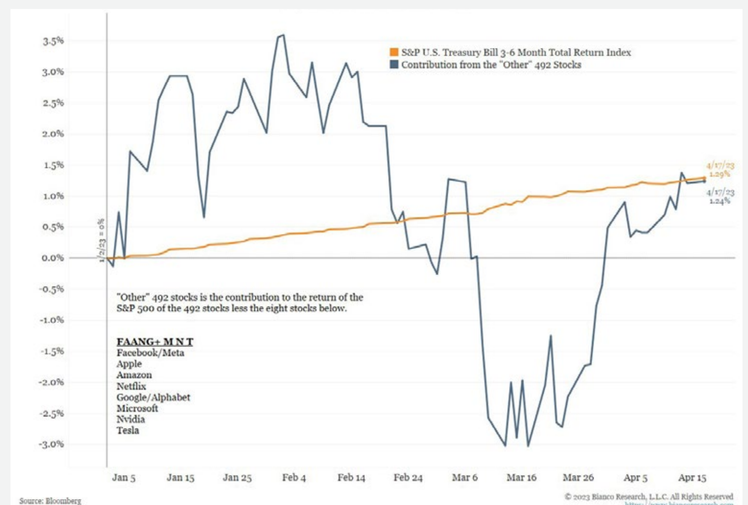
Contribution to Return

Bianco Research noted back in mid-April that over 80% of the S&P 500's year-to-date gains were derived from only eight stocks. Since then, after better-than-expected earnings reports from many of those names, that number has only gotten larger. The other 492 names collectively only contributed approximately 1% of the 7% run-up, nearly equal to the return on short dated cash equivalents.

FAANG + MNT Stocks' Impact on S&P 500

Top 8 Stocks Contribution to Total Return





The reason? These megacap giants have benefited significantly during the recent market stress as allocating funds to their stock is perceived to be a flight to safety. Their cash rich balance sheets and lower leverage are added benefits to their monstrous size. Investors have shunned the opposite attributes, favoring higher capitalization companies in lieu of the smaller companies.

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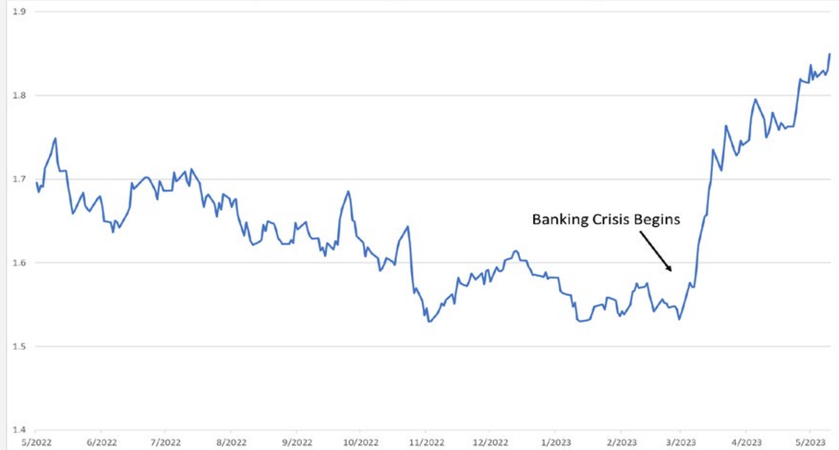
These megacap names are by no means bad businesses, but the recent concentration and narrowing breadth overall in equities is concerning for market forecasters. Historically, markets that rely on a few names to carry index returns can be riskier markets. Riskier, in the sense that an investment is not as diversified as they might expect as a dollar purchased of the index is increasingly going to purchase more and more of these large names.

Top 50 Market Cap Names vs Small Caps



Investigating the equal weighted S&P500 index, which can provide a better sense of the "average stock", we see a downward trend and lower lows painting a gloomier technical picture. Compare this to the concentrated S&P500, where a more bullish pattern can be perceived. Index investing, and by that we mean investing in the S&P500, has been rewarding investors so far in 2023. However, to extrapolate this trend by suggesting the broader underlying market is showing strength could be dangerous. In essence, the enhanced performance of the largest companies, and therefore the largest index weightings, has masked the weaker performance of the overall market and could lead investors believe stocks have been resilient universally.

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Where do we go from here?

Since May of last year stocks have been confined to a distinct trading range, with key resistance at around 4,200 on the index level. As the macroeconomic backdrop and the overall tightened credit conditions from Fed policy and the recent banking crisis play out, we need to observe more resilience from the "average stock" to develop a bullish outlook from a technical perspective. Without help from the foot soldiers of this market, it will be difficult for the index to make a sustainable push higher. Lastly, the general's outsized effect on the market's push higher, could be the impetus for a strong move lower if they swing the other way.

As always, we will continue to monitor key trading levels as economic data flows in. The overall picture, however, remains cloudy. Consumer strength has buttressed spending, especially in the service sector while companies are increasingly lowering guidance due to expected margin pressure. Inflation is in a disinflationary trend, but the ultimate level of stabilization is uncertain. In recent weeks, we have begun to observe a distinct transition from "bad news is good news" to "bad news is bad news" on the economic front. The Fed has maneuvered between a rock and a hard place given the need for cool inflation while simultaneously balancing banking stress risks by keeping interest rates elevated. All of the noise will eventually be reflected in market pricing. Where that pricing ultimately cements itself, lower or higher, remains a matter of intense debate.

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2700 Via Fortuna #100, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com

5555 Glenridge Connector, Suite 200 Atlanta, GA 30432 • (470) 552-5902 • www.WaterlooCap.com/IWS

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