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NAVIGATING THE CONCENTRATED US STOCK MARKET

HIGHLIGHTS

- US equity markets have recently experienced extremely narrow breadth, with a handful of stocks contributing to the lion's share of overall gains.
- Rather than seeing this as an ominous risk signal, we believe the market's "bad breadth" reflects a rational assessment of a tug of war between tight monetary policy and AI-driven exuberance.
- History suggests that investors are well advised to stick with broadly diversified portfolios rather than chasing returns in a handful of high-flying securities.

UNDERSTANDING AND RESPONDING TO US MARKET CONCENTRATION

In a year marked by artificial intelligence exuberance and stubborn inflation, the US stock market has defied expectations, posting robust gains amid economic uncertainty. However, a closer examination reveals a market driven by a handful of tech titans, leaving many investors questioning the sustainability and implications of this rally. This phenomenon, dubbed "bad breadth," has reached extreme levels, prompting concerns about market health and future performance.[1]

THE MAGNIFICENT SEVEN AND BEYOND

The term "market breadth" refers to the number of stocks participating in a market move. In 2024, breadth has been exceptionally narrow, with the so-called "Magnificent Seven" stocks — Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla — accounting for an outsized portion of market gains (**Figure 1**).[2]

The Magnificent Seven surged 37% in the first half of the year, but the broader market struggled to keep pace (**Figure 2**). The cap-weighted S&P 500 gained 15.3%, largely buoyed by these tech titans, while the S&P Equal Weight and small cap Russell 2000 Index eked out gains of just 5.1% and 1.7%, respectively.

This concentration isn't limited to large caps. Even within the Russell 2000, a handful of names have driven the bulk of returns. The top five contributors more than accounted for the Index's modest 1.7% first-half gain, masking weakness in the broader small-cap universe (**Figure 3**).

FIGURE 1

Contributors/Detractors YTD S&P 500

Top 10 Contributors to YTD S&P 500 Return

Ticker	Company	Sector	Beginning Weight	Total Return	Contribution to Return in bps
NVDA	NVIDIA Corporation	Information Technology	3.05	149.5	458
MSFT	Microsoft Corporation	Information Technology	6.98	19.29	135
GOOGL	Alphabet Inc.	Communication	3.82	30.43	113
AMZN	Amazon.com, Inc.	Consumer Discretionary	3.45	27.2	95
META	Meta Platforms Inc Class A	Communication	1.96	42.7	88
LLY	Eli Lilly and Company	Health Care	1.16	55.8	65
AAPL	Apple Inc.	Information Technology	7.03	9.7	57
AVGO	Broadcom Inc.	Information Technology	1.22	44.9	53
BRK.B	Berkshire Hathaway Inc. Class B	Financials	1.62	14.1	25
JPM	JPMorgan Chase & Co.	Financials	1.23	20.3	25
Top 5 Contributors			**19.3**	**48.7**	**888**
Top 10 Contributors			**31.5**	**37.2**	**1113**

Bottom 10 Contributors to YTD S&P 500 Return

Ticker	Company	Sector	Beginning Weight	Total Return	Contribution to Return in bps
TSLA	Tesla, Inc.	Consumer Discretionary	1.72	-20.4	-42
INTC	Intel Corporation	Information Technology	0.53	-37.9	-21
BA	Boeing Company	Industrials	0.37	-30.2	-12
NKE	NIKE, Inc. Class B	Consumer Discretionary	0.33	-30.1	-9
MCD	McDonald's Corporation	Consumer Discretionary	0.54	-13.0	-7
ACN	Accenture Plc Class A	Information Technology	0.55	-12.9	-6
CVS	CVS Health Corporation	Health Care	0.25	-23.8	-6
LULU	lululemon athletica inc.	Consumer Discretionary	0.15	-41.6	-6
ADBE	Adobe Inc.	Information Technology	0.68	-6.9	-6
SBUX	Starbucks Corporation	Consumer Discretionary	0.27	-17.8	-5
Bottom 5 Contributors			**3.5**	**-23.9**	**-91**
Bottom 10 Contributors			**5.4**	**-20.8**	**-121**
S&P 500 Total Return			100	15.3	1529

Note: Data as of 6/30/2024.

Sources: GW&K Investment Management, FactSet, and Standard & Poors

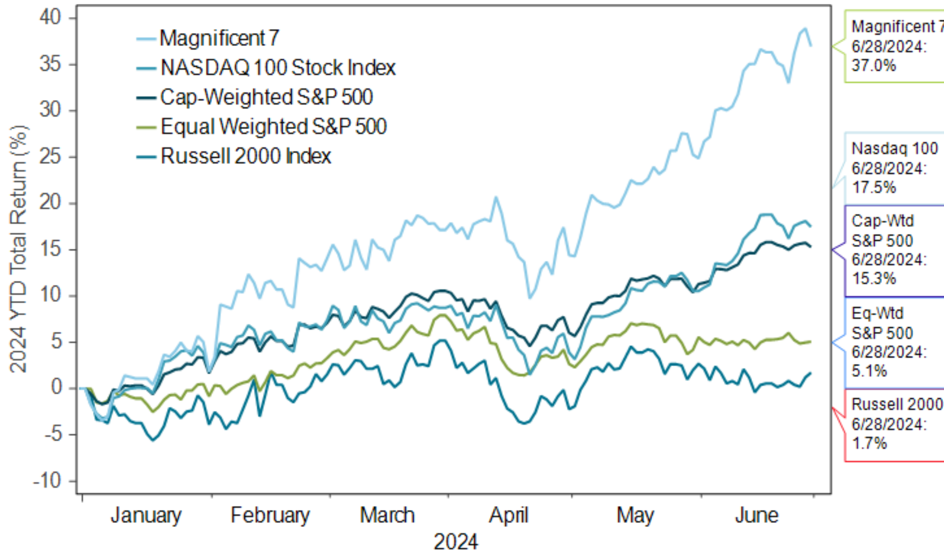
Year-to-date gains in the S&P 500 Index have been extremely concentrated, with just 10 stocks accounting for 73% of the market's 15.3% gain in the first half. Excitement over AI investment was the dominant theme.

[1] For example, economist Ed Yardeni recently noted that "Technical analysts are warning that this development increases the risks of a selloff in the market led by technology shares in general and semiconductor shares in particular — especially Nvidia." See Ed Yardeni, "Market Call: Bad Breadth Again", Yardeni Quick Takes, June 23, 2024.

[2] Among the Magnificent Seven, Tesla's performance has been a notable exception in 2024, with the stock having posted a -20.4% loss in the first half.

FIGURE 2

Bifurcated Market Led by the Magnificent 7: Year-to-Date Total Return (%)



Note: The Bloomberg Magnificent 7 Index is an equal dollar weighted equity benchmark of a fixed basket of Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.
Sources: GW&K Investment Management, Bloomberg, and Macrobond

The very narrow breadth of the US market was reflected in stellar performance from the AI-driven "Magnificent 7" stocks (ex-Tesla) versus mediocre performance for the S&P 500 Equal Weight Index and the Russell 2000 Index of small cap stocks.

FIGURE 3

Contributors/Detractors YTD Russell 2000

Top 10 Contributors to YTD Russell 2000 Return

Ticker	Company	Sector	Beginning Weight	Total Return	Contribution to Return in bps
SMCI	Super Micro Computer, Inc.	Information Technology	0.52	188.2	97
CVNA	Carvana Co. Class A	Consumer Discretionary	0.20	143.1	32
MSTR	MicroStrategy Incorporated Class A	Information Technology	0.30	118.1	29
FTAI	FTAI Aviation Ltd.	Industrials	0.18	124.5	23
INSM	Insmed Incorporated	Health Care	0.17	116.2	20
ANF	Abercrombie & Fitch Co. Class A	Consumer Discretionary	0.17	101.6	18
ELF	e.l.f. Beauty, Inc.	Consumer Staples	0.31	46.0	15
SFM	Sprouts Farmers Market, Inc.	Consumer Staples	0.19	73.9	15
FIX	Comfort Systems USA, Inc.	Industrials	0.29	48.1	14
ONTO	Onto Innovation, Inc.	Information Technology	0.30	43.6	13
Top 5 Contributors			**1.4**	**148.9**	**200**
Top 10 Contributors			**2.6**	**105.4**	**275**

Bottom 10 Contributors to YTD Russell 2000 Return

Ticker	Company	Sector	Beginning Weight	Total Return	Contribution to Return in bps
ALTM	Arcadium Lithium Plc	Materials	0.00	-50.7	-14
CYTK	Cytokinetics, Incorporated	Health Care	0.31	-35.1	-11
PACB	Pacific Biosciences of California, Inc.	Health Care	0.10	-86.0	-9
QLYS	Qualys, Inc.	Information Technology	0.29	-27.3	-8
ACAD	ACADIA Pharmaceuticals Inc.	Health Care	0.15	-48.1	-7
FRSH	Freshworks, Inc. Class A	Information Technology	0.15	-46.0	-7
BBIO	BridgeBio Pharma, Inc.	Health Care	0.18	-37.3	-7
STNE	StoneCo Ltd. Class A	Financials	0.21	-33.5	-7
VLY	Valley National Bancorp	Financials	0.18	-33.8	-6
COUR	Coursera Inc	Consumer Discretionary	0.10	-63.0	-6
Bottom 5 Contributors			**0.8**	**-40.7**	**-49**
Bottom 10 Contributors			**1.7**	**-40.4**	**-83**
Russell 2000 Total Return			100	1.7	170

Note: Data as of 6/30/2024.
Sources: GW&K Investment Management, FactSet, and FTSE

Year-to-date gains in the Russell 2000 Index of small-cap stocks have also been driven by a handful of names. The top five contributors more than accounted for the index's 1.7% first-half gain.

DECODING THE DIVIDE: AI EXUBERANCE MEETS MONETARY TIGHTENING

Rather than viewing this narrow breadth as an ominous portent, it's crucial to understand it as a reflection of the current economic landscape. Two powerful forces are at play: the transformative potential of artificial intelligence and the constraining effect of tight monetary policy.

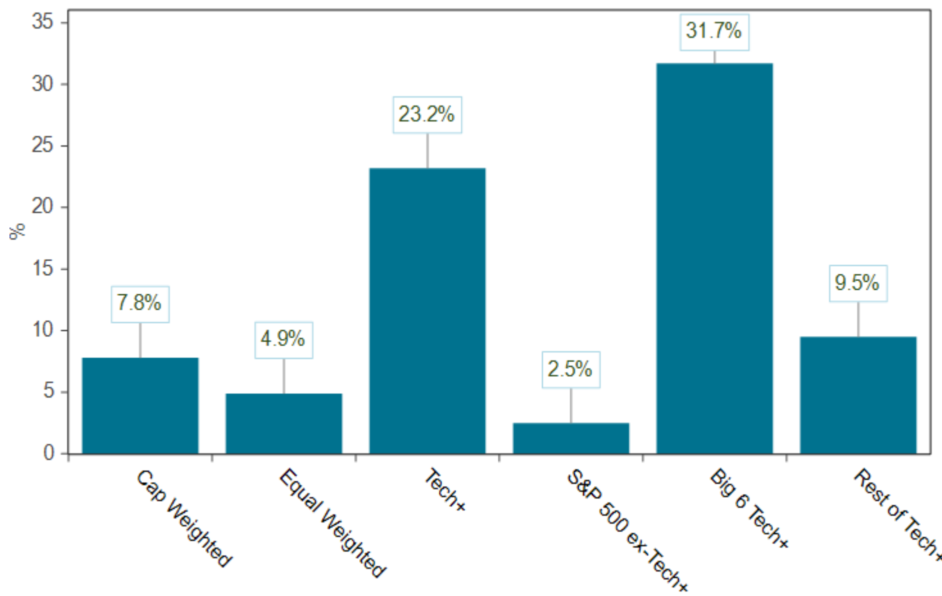
The earnings data tells a compelling story. Tech stocks, especially the largest names, have posted strong double-digit earnings gains (**Figure 4**). This contrasts sharply with the low single-digit growth seen in the S&P 500, excluding technology. Furthermore, earnings revisions have strongly favored the largest tech names, while the rest of the market has seen negative revisions (**Figure 5**).

This bifurcation in earnings performance helps explain the valuation gap evident in the data (**Figure 6**). The Magnificent Seven Index trades at a forward P/E of 32.7, almost double that of the S&P 500 Equal Weight Index at 17.6. While this premium may raise eyebrows, it reflects the market's assessment of these companies' growth prospects in an AI-driven future.

Simultaneously, the Federal Reserve's aggressive tightening cycle has created headwinds for many sectors, particularly those sensitive to interest rates. This monetary policy environment has clearly enhanced the appeal of cash-rich tech giants, capable of self-funding their growth initiatives.

FIGURE 4

Diverging Fundamentals: Q2 2024 S&P 500 EPS Growth

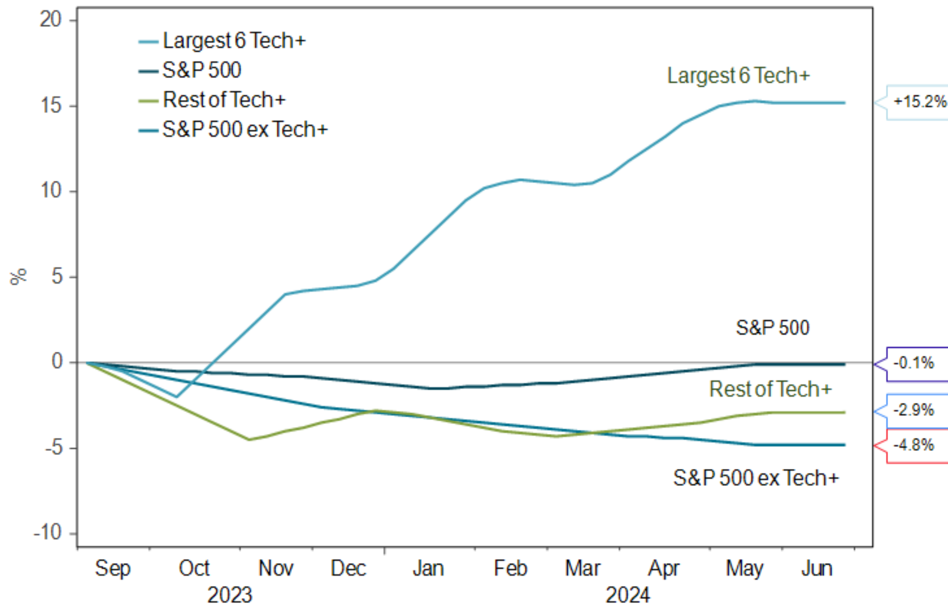


Sources: UBS, Standard & Poors, FactSet, and Refinitiv

Earnings trends have clearly favored tech stocks, especially the largest names, with strong double-digit earnings gains contrasting to low single-digit earnings growth for the S&P 500, excluding technology.

FIGURE 5

Diverging Revisions: Path of 2024 S&P 500 EPS Revisions

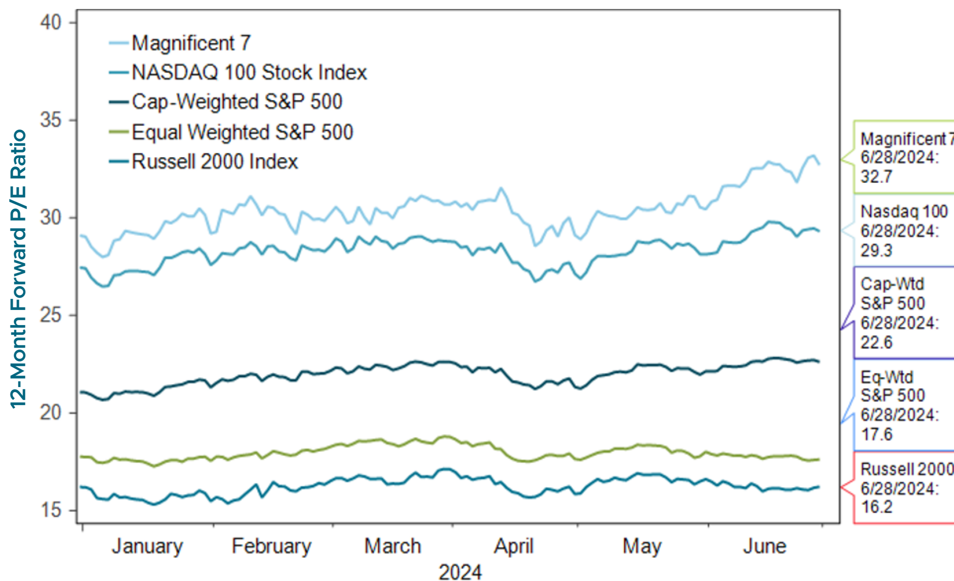


Sources: UBS, Standard & Poors, FactSet, and Refinitiv

Earnings revisions trends this year have also clearly favored the largest tech names compared to negative revisions trends for the rest of tech or the S&P 500, excluding tech.

FIGURE 6

Bifurcated Stock Valuations: Adjusted Positive Price/ Estimated Earnings Across US Indexes



Note: Based on blended 12-month forward estimated earnings for companies with positive earnings.
Sources: GW&K Investment Management, Bloomberg, and Macrobond

Narrow market breadth has also left the small cap and S&P 500 Equal Weight indexes trading at large discounts to tech-heavy indexes like the Magnificent 7, Nasdaq 100, or the S&P 500 cap-weighted indexes.

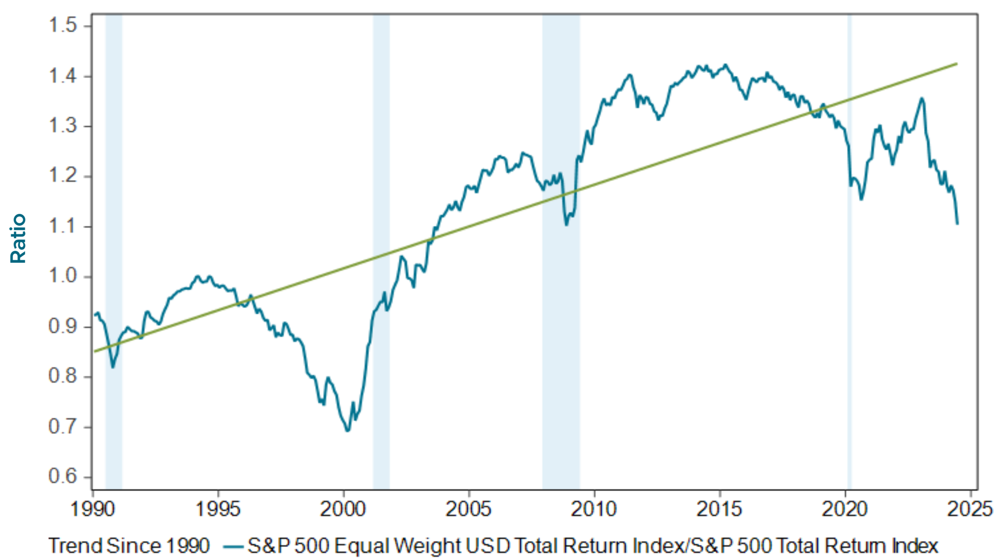
HISTORICAL PERSPECTIVE AND FUTURE IMPLICATIONS

While the current market concentration is extreme, it's not unprecedented. History shows that the ratio of the S&P 500 Equal Weight Index to the cap-weighted S&P 500 Index has fluctuated over time, with periods of both outperformance and underperformance for the average stock (**Figure 7**).

Note, however, that the long-term trend has been for the S&P 500 Equal Weight Index to outperform the cap-weighted index. Presumably that reflects the fact that a typical company, or smaller companies in general, have an easier time growing their earnings than the giants who already dominate their industries. Indeed, Warren Buffett has popularized the concept that size is the enemy of outperformance.[3]

FIGURE 7

Ratio of S&P 500 Equal Weight Total Return Index to the Cap-Weighted S&P 500 Total Return Index



Note: Shaded areas denote NBER recession periods.
Sources:GW&K Investment Management, Bloomberg, S&P, and Macrobond

Historically, the S&P 500 Equal Weight Index has tended to outperform the S&P 500 cap-weighted Index. But recently there has been an extreme deviation from that long-term trend.

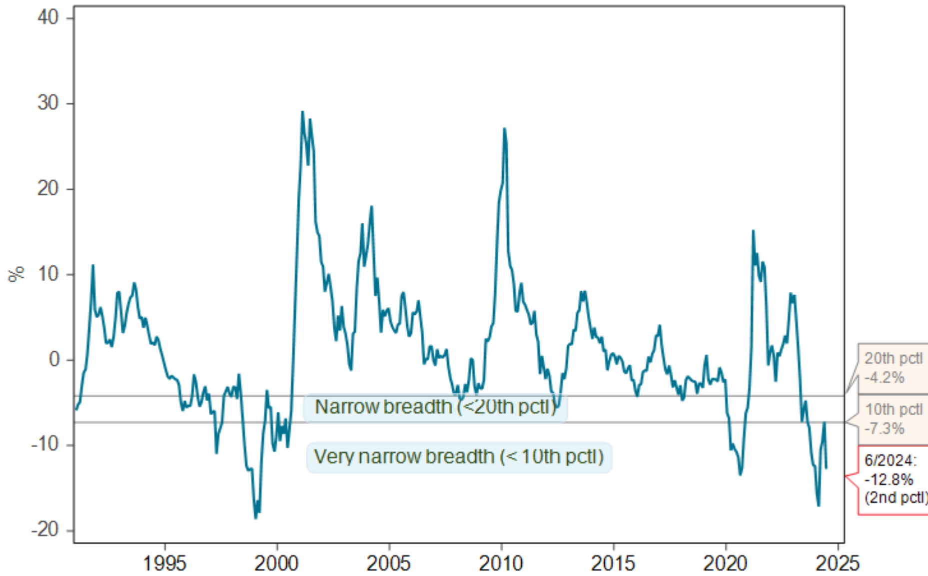
That said, the magnitude of the current market divergence is striking. Viewed in year-on-year terms, the one-year performance gap between the S&P 500 Equal Weight Index and its cap-weighted counterpart has reached nearly 13%, a reading in the second percentile since 1990 (**Figure 8**). This level of concentration has historically been unsustainable.

Interestingly, periods of narrow breadth have often been followed by notable small-cap outperformance over subsequent 1-, 3-, and 5-year periods (**Figure 9**). This historical pattern may offer a glimmer of hope for patient investors in overlooked market segments.

[3] Warren Buffet, Letter to Berkshire Hathaway Shareholders (1996).

FIGURE 8

One-Year Total Return Performance Gap: S&P 500 Equal Weight Index vs Cap-Weighted Index



Sources: GW&K Investment Management and Macrobond

Over the past year, the S&P 500 Equal Weight Index has underperformed the S&P 500 cap-weighted Index by nearly 13%. That is a second percentile reading since 1990, reflecting very narrow market breadth.

FIGURE 9

Narrow Breadth Tends to Precede Small Cap Outperformance

January 1990 to June 2024

	Average Russell 2000 vs S&P 500 Relative Performance*		
	Next Year	Next 3 Years	Next 5 years
Narrow Breadth (< 20th pctl)*	3.8%	1.7%	3.9%
Very Narrow Breadth (< 10th pctl)*	7.0%	4.1%	7.7%
All Periods	0.1%	-0.1%	-0.2%

	Median Russell 2000 vs S&P 500 Relative Performance*		
	Next Year	Next 3 Years	Next 5 years
Narrow Breadth (< 20th pctl)*	3.8%	2.1%	3.5%
Very Narrow Breadth (< 10th pctl)*	7.5%	5.5%	8.5%
All Periods	0.3%	-0.1%	0.0%

	Hit Rate: Russell 2000 vs S&P 500 Outperformance		
	Next Year	Next 3 Years	Next 5 years
Narrow Breadth (< 20th pctl)*	64%	63%	78%
Very Narrow Breadth (< 10th pctl)*	71%	67%	100%
All Periods	50%	48%	47%

Note: (1) Annualized percentage differentials; and (2) breadth based on 12-month trailing performance gap between the S&P 500 Equal Weight and cap-weighted Indexes. (3) Figures reflect price return.
Sources: GW&K Investment Management, Bloomberg, S&P, FTSE, and Macrobond

Since 1990, periods of narrow market breadth have tended to be followed by small cap outperformance over subsequent 1-, 3-, and 5-year periods.

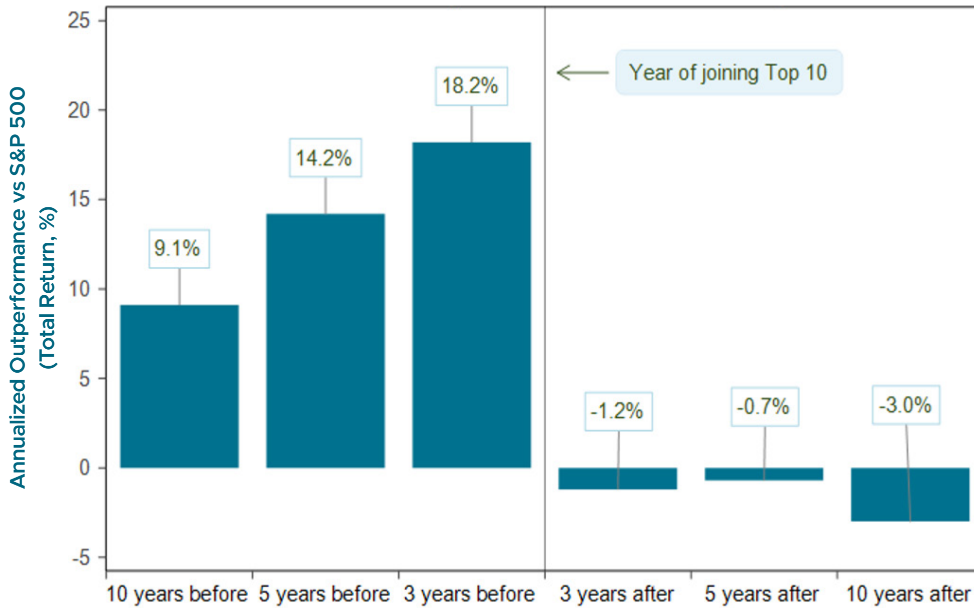
THE CASE FOR DIVERSIFICATION

Given these dynamics, it might be tempting to concentrate portfolios in the handful of stocks driving market returns. But history offers a sobering reminder: the best time to buy exciting companies has historically been before they reached the top 10 in market cap (**Figure 10**). Once they achieved this status, stellar returns became much harder to sustain.

This insight, coupled with the cyclical nature of market leadership, makes a compelling case for maintaining broadly diversified portfolios. While it's important to have exposure to potential AI beneficiaries, it's equally crucial not to neglect other sectors and market segments that may be poised for a rebound.

FIGURE 10

Average Annualized Outperformance of Companies Before and After the First Year They Became One of the 10 Largest in the US*



*Note: Based on year-end annual data from 1991 to 2023.
Sources: GW&K Investment Management, Bloomberg, FactSet, and Macrobond

Historically, the best time to buy exciting companies was *before* they reached the top 10 in market cap. Once they reached this category, stellar returns were hard to come by.

CONCLUSION

The narrow breadth characterizing today's market is neither an unambiguous buy signal for laggards nor a clear sell signal for leaders. Instead, it reflects a rational, if perhaps overzealous, response to a complex economic environment where technological disruption collides with monetary tightening.

For investors, the key is to resist the siren call of chasing returns in a handful of high-flying stocks. History suggests that market leadership is transient, and today's laggards may well become tomorrow's leaders. By maintaining a diversified portfolio, investors can position themselves to benefit from potential breadth expansion while managing the risks inherent in an increasingly concentrated market.

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