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# 2023 Outlook Theme #2: Rising Rates Create a Headwind for Equity Valuation

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Rising interest rates have become a headwind for Equity valuations.

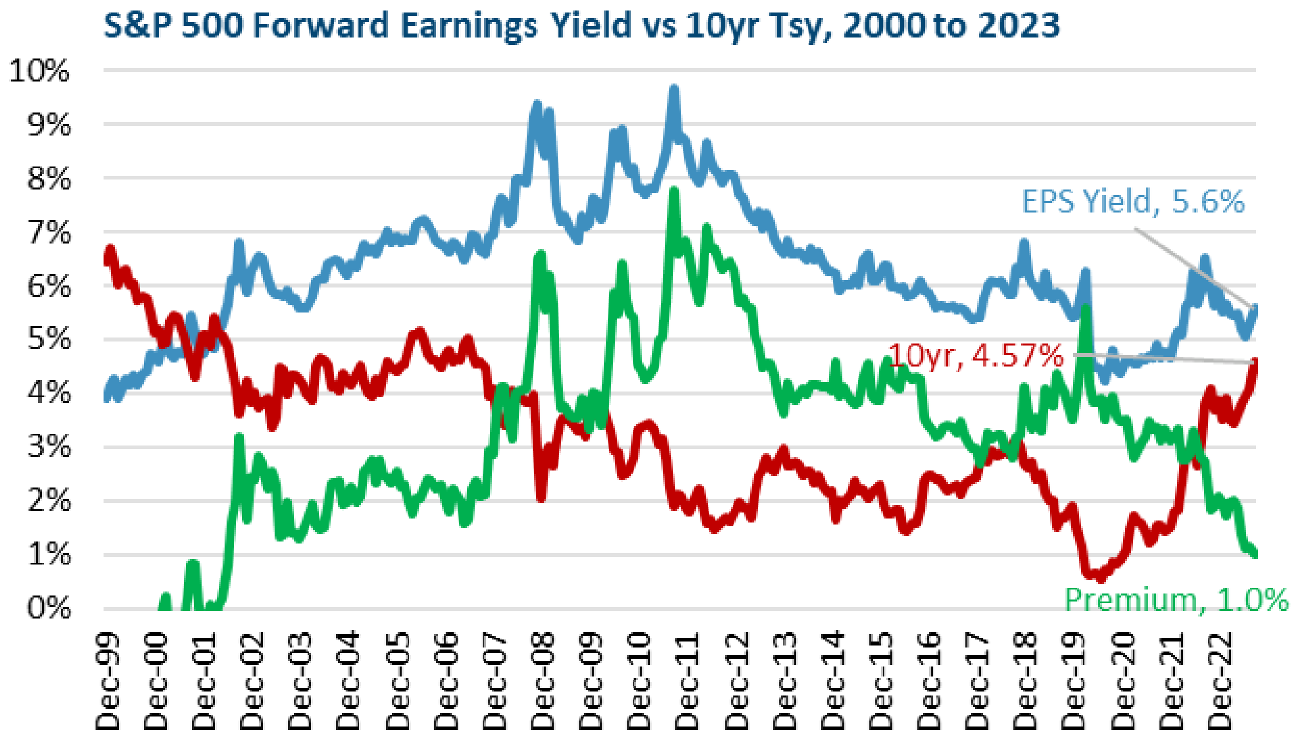


Chart 1

Chart 1 shows the earnings yield on the S&P 500, the yield on the 10yr Treasury, and the difference between the two, known as the Equity Premium. A higher Equity Premium means stock investors are getting more compensation relative to bonds. While the earnings yield has risen since the end of 2021, the catch is that, with the 10yr yield rising as well, the excess return offered by equities has declined to about 1%. From 2002 to 2007, prior to the Fed's QE interventions, a 1-3% Equity Premium was common. This suggests the Equity Premium today is manageable, although it could be pressured by further rate increases. Day to day stock market sensitivity to interest rate moves has risen as the Equity Premium has pushed closer to 1%.

2023 has seen an equity market recovery after a challenging 2022, at least when looking at the S&P 500's 13% ytd return. Beyond the S&P 500, returns are not as robust.

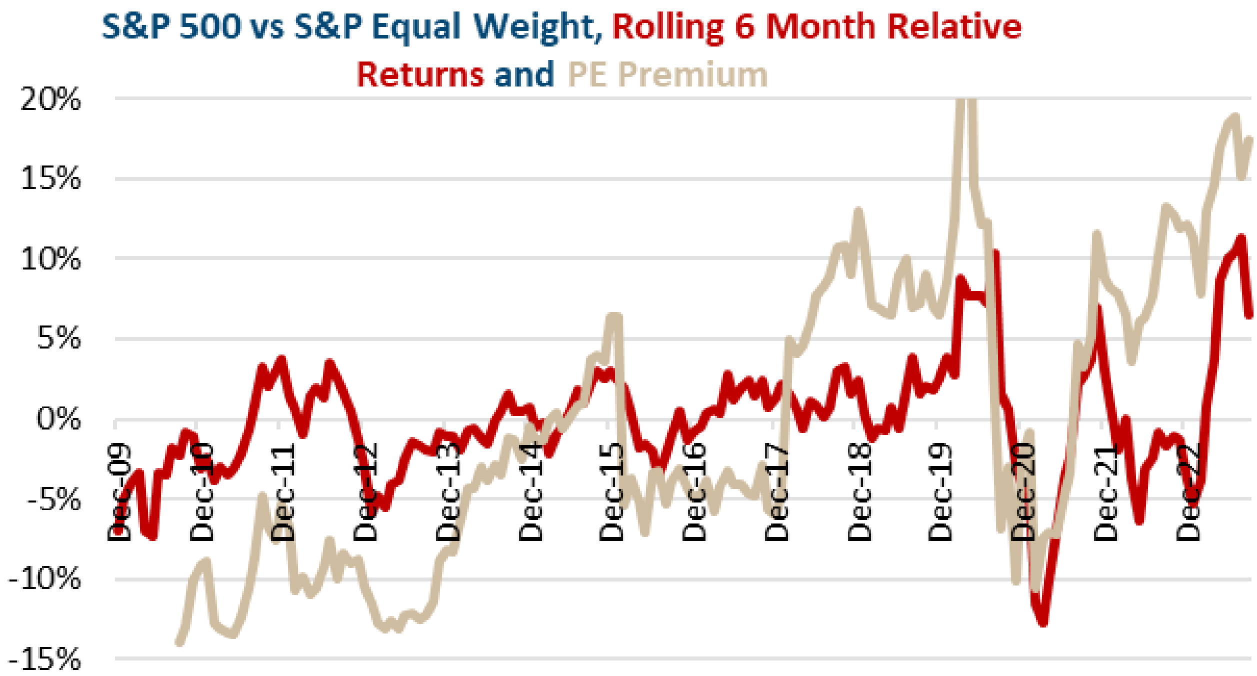


Chart 2

A major theme for 2023 is that S&P 500 returns have become highly concentrated in just a few large stocks, which is evident by comparing the S&P 500 (which is capitalization weighted) to the Equal Weight S&P 500 (with the same members, but each has an equal 0.2% contribution). Looking at rolling 6 month returns in the chart to the left, the gap had reached 10% on 6/30/23, for only the third time since 1992. During Q3, this reversed a bit, and the gap has fallen to 6%. On top of the relative performance difference, the PE multiple on the cap weighted S&P 500 over the equal weighted index is over 15% (21.8 v 18.5). As the chart shows, not only is this an extreme level, but prior instances of premium PEs have coincided with relative outperformance, and have preceded mean reverting periods where the equal weight makes up ground on the cap weighted index.

These two issues (earnings premium and market concentration) are combined when looking at the "Magnificent 7" (Mag 7) stocks, the top 7 stocks by market capitalization in the S&P 500 (Apple, Microsoft, Alphabet, Tesla, Nvidia, Amazon, Meta). Not only is this a highly concentrated group, accounting for over 25% of the market cap, but it is a highly correlated group, as all 7 are tied into technology, specifically with potential for AI (artificial intelligence).

Both the performance and valuation gap are more extreme for the Mag 7 versus the "S&P 493" than the market cap versus equal weight gap discussed earlier in this section.

Regarding performance, for the year through 9/29/23, while the S&P 500 is up 13% overall, the Mag 7 are up over 50%, while the "493" are up just 5%.

| | Mkt Cap | Weight | Ytd Return | Fwd PE | EPS Yield |
|---|---|---|---|---|---|
| S&P 500 | $37,341 | 100% | 13.1% | 17.9 | 5.6% |
| "Mag 7" | $10,404 | 28% | 53.0% | 34.7 | 2.9% |
| S&P "493" | $26,937 | 72% | 5.3% | 15.3 | 6.5% |

Table 1

Looking at valuation, as the table above shows, the Mag 7 PE is 34.7, versus 15.3 for the "493". Going back to the earnings premium, compared to the 10yr yield of 4.6%, the S&P 500 has a below average 1.0% premium. But the Mag 7 is NEGATIVE 1.7%. while the 493's premium is nearly double the S&P 500, at 1.9%.

Cumulatively, this is a way of saying that while the S&P 500 is higher, and with the rise in the 10yr yield, its valuation warrants some caution, both the higher price and valuation issues are highly concentrated, and thus the remainder of the market is more favorable.

The notable investor risk is the temptation to chase the market leaders and ignore the parts of the market, and diversification in general, that are beneficial. *Rising Rates Create a Headwind for Equity Valuation*, but diversification can remain a key to mitigating that risk even as, thus far in 2023, diversification might have left investors disappointed.

market performance of 21 emerging markets. The MSCI All Country World Index is a free float adjusted market capitalization index designed to measure the performance of large and mid and cap stocks in 23 developed markets and 24 emerging markets. With over 2,800 constituents it represents over 85% of the global equity market.

-The Barlcays Aggregate Index represents the total return performance (price change and income) of the US bond market, including Government, Agency, Mortgage and Corporate debt.

-The BofA Merrill Lynch Investment Grade and High Yield Indices are compiled by Bank of America / Merrill Lynch from the TRACE bond pricing service and intended to represent the total return performance (price change and income) of investment grade and high yield bonds.

-The S&P/LSTA U.S. Leveraged Loan 100 is designed to reflect the largest facilities in the leveraged loan market. It mirrors the market-weighted performance of the largest institutional leveraged loans based upon market weightings, spreads and interest payments.

-The S&P Municipal Bond Index is a broad, comprehensive, market value-weighted index. The S&P Municipal Bond Index constituents undergo a monthly review and rebalancing, in order to ensure that the Index remains current, while avoiding excessive turnover. The Index is rules based, although the Index Committee reserves the right to exercise discretion, when necessary.

-The BofA Merrill Lynch US Emerging Markets External Sovereign Index tracks the performance of US dollar emerging markets sovereign debt publicly issued in the US and eurobond markets.

-The HFRI Fund of Funds index is compiled by the Hedge Funds Research Institute and is intended to represent the total return performance of the entire hedge fund universe.