Equity Insight

July 2024

Monthly Equity Market Topics

Author

Ross Cartwright
Lead Strategist,
Investment Solutions Group

In Brief:

- Politics to the fore as elections dominate the headlines. What are investors to do?
- Growth reclaims the market narrative from inflation.
- Heuristic of the month: Recency Bias.

Politics to the fore

In recent weeks, major political events have caused uncertainty in several key economies. After the US presidential debate, former President Donald Trump is the betting favorite, but much can change before November. Here in the United Kingdom, Labour's landslide victory has ushered in a new government. However, its immediate impact seems likely to be limited, with attention shifting to how Keir Starmer will tackle significant economic challenges and stimulate growth in a post-Brexit environment.

In France, the left-wing New Popular Front coalition's surprise win in the second round defied expectations. Marine Le Pen's National Rally came third, despite success in the first round, with Macron's centrist Ensemble in second. With no clear majority, a coalition that excluded both the extreme left and right would likely be welcomed by markets, while one led by hard-left France Unbowed could negatively affect equities due to its fiscal stance. If the parties are unable to reach an agreement, President Emmanuel Macron could appoint a technocrat as Prime Minister, one who he believed could promote stability, although Macron's political standing has been severely damaged. France represents 20% of the eurozone, so it's important, and the political drama is causing uncertainty in how a new government tackles the challenges ahead and any departure from Macron's business friendly policies. C'est la vie.

What to do amid political uncertainty? We believe that altering your investment strategy based on election outcomes is unwise, as markets may respond unexpectedly. For instance, betting on clean energy and shorting fossil fuels after Joe Biden's election would have proved disastrous. We expect that the economy's overall direction will prevail, so consider remaining diversified and seek to capitalize on the opportunities that volatility provides.

Growth reclaims the market narrative from inflation

As US macro data softens and growth slows, the more economically sensitive sectors of the market have lagged, and investors seems increasingly focused on the growth outlook and more sanguine on rates and inflation. To illustrate, copper, with its tendency to be a health check on the economy, has rolled over. Other barometers of economic activity like housing, transport and small caps, have all recently underperformed.

The US and global equity markets continue to be dominated by a narrow cohort of AI-related companies. Nvidia and other semiconductor stocks lead this trend, along with utilities and industrials, which also benefit from increased power demand from AI data centers and decarbonizing.

In this environment, the big are getting bigger and the rest are being left behind, confining most market gains to a few large companies. Through the end of Q2 2024, the S&P 500 delivered a 15% return while its equal-weighted counterpart only delivered 5%. Focusing in on the second quarter, the cap-weighted index returned 4% versus -2.5% for the equal-weighted index.[1] Even within the large caps, it has been difficult to outperform the index as breadth narrowed, with only about 26% of S&P 500 large caps outperforming the index year to date,[2] while small caps are feeling the pain of higher rates and a slowing economy far more than their large cap brethren. Consequently, concentration continues to increase on the back of increasing earnings expectations for mega-cap stocks. However, beware of the flaw of averages: the S&P 500 is now heavily concentrated in a few names. To make a call on the S&P 500 index is to effectively make a call on a handful of stocks and not a call on the "market", which it no longer represents.

Morgan Stanley recently pointed out the that the spread between the market cap of the top five stocks and their net income contribution to the index is wide and continues to widen.[3] The momentum behind the AI trade has been increasing but it also getting more crowded, and the lofty valuations of these names reflect that. The question is not whether these are good and profitable companies? They typically are. But can they keep beating the earnings estimates that are reflected in their price as economic growth slows and uncertainty abounds over the ability of some of these companies to monetize AI to the extent that investors expect? Multiples can't expand forever, and while we have little doubt some are justified, these companies will need to deliver on earnings, because the higher the multiple, the lower the margin for error, and any disappointments will likely be met with aggressive mark downs.

Many large-cap tech companies have reported they intend to increase capital spending by approximately $150 billion to $200 billion for 2025. Clearly, AI compute is capital intensive and absorbs a lot of cash to fund the construction and operation of data centers to handle these new workloads. The impact on earnings will come over the next few years as they depreciate and monetize these assets.

While FactSet has consensus growth for the S&P 500 at 11% for 2024, what is evident is that the growth rate for the mega-cap tech earnings is slowing after a stellar year and the rest of the market is recovering after a poor 2023. In short, the gap in earnings growth rates between the Mag 7 and the rest is closing. According to ASR, earnings growth as reported by IBES for the Mag 7 is expected to fall from 54% over the past 12 months to 27% for the next 12 months, while earnings growth for the rest of the market is seen accelerating from 3% to 9%. If correct, improving earnings breadth should support improved price breadth.

Recency bias

Investment choices are often distorted by your beliefs and experiences. The more recent and dramatic the experience, the more likely you are to be influenced by and attach outsized importance to it. Beware of recency bias. As our global investment strategist Rob Almedia eloquently points out, the environment has materially changed. You may be disappointed if you keep following the same strategy and expect the same outcome when many of the conditions that supported that outcome have changed.

Endnotes

[1] Bloomberg as at 28 June 2024.

[2] Piper Sandler.

[3] Morgan Stanley - US Equity Strategy July 5, 2024, Strategy Data Pack – July 2024.

Equity Insight

July 2024

"Standard & Poor's®" and S&P "S&P®" are registered trademarks of Standard & Poor's Financial Services LLC ("S&P") and Dow Jones is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones") and have been licensed for use by S&P Dow Jones Indices LLC and sublicensed for certain purposes by MFS. The S&P 500® is a product of S&P Dow Jones Indices LLC, and has been licensed for use by MFS. MFS' Products are not sponsored, endorsed, sold or promoted by S&P Dow Jones Indices LLC, Dow Jones, S&P, or their respective affiliates, and neither S&P Dow Jones Indices LLC, Dow Jones, S&P, their respective affiliates make any representation regarding the advisability of investing in such products.

The views expressed herein are those of the MFS Investment Solutions Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as the Advisor's investment advice, as securities recommendations, or as an indication of trading intent on behalf of MFS.

GLOBAL DISCLOSURE

Unless otherwise indicated, logos and product and service names are trademarks of MFS® and its affiliates and may be registered in certain countries.

Distributed by: **U.S. –** MFS Institutional Advisors, Inc. ("MFSI"), MFS Investment Management and MFS Fund Distributors, Inc., Member SIPC; **Latin America –** MFS International Ltd.; **Canada –** MFS Investment Management Canada Limited. **Note to UK and Switzerland readers:** Issued in the UK and Switzerland by MFS International (U.K.) Limited ("MIL UK"), a private limited company registered in England and Wales with the company number 03062718, and authorised and regulated in the conduct of investment business by the UK Financial Conduct Authority. MIL UK, an indirect subsidiary of MFS®, has its registered office at One Carter Lane, London, EC4V 5ER. **Note to Europe (ex UK and Switzerland) readers:** Issued in Europe by MFS Investment Management (Lux) S.à r.l. (MFS Lux) – authorized under Luxembourg law as a management company for Funds domiciled in Luxembourg and which both provide products and investment services to institutional investors and is registered office is at S.a r.l. 4 Rue Albert Borschette, Luxembourg L-1246. Tel: 352 2826 12800. This material shall not be circulated or distributed to any person other than to professional investors (as permitted by local regulations) and should not be relied upon or distributed to persons where such reliance or distribution would be contrary to local regulation; **Singapore –** MFS International Singapore Pte. Ltd. (CRN 201228809M); **Australia/New Zealand -** MFS International Australia Pty Ltd ("MFS Australia") (ABN 68 607 579 537) holds an Australian financial services licence number 485343. MFS Australia is regulated by the Australian Securities and Investments Commission.; **Hong Kong -** MFS International (Hong Kong) Limited ("MIL HK"), a private limited company licensed and regulated by the Hong Kong Securities and Futures Commission (the "SFC"). MIL HK is approved to engage in dealing in securities and asset management regulated activities and may provide certain investment services to "professional investors" as defined in the Securities and Futures Ordinance ("SFO").; **For Professional Investors in China –** MFS Financial Management Consulting (Shanghai) Co., Ltd. 2801-12, 28th Floor, 100 Century Avenue, Shanghai World Financial Center, Shanghai Pilot Free Trade Zone, 200120, China, a Chinese limited liability company registered to provide financial management consulting services.; **Japan -** MFS Investment Management K.K., is registered as a Financial Instruments Business Operator, Kanto Local Finance Bureau (FIBO) No.312, a member of the Investment Trust Association, Japan and the Japan Investment Advisers Association. As fees to be borne by investors vary depending upon circumstances such as products, services, investment period and market conditions, the total amount nor the calculation methods cannot be disclosed in advance. All investments involve risks, including market fluctuation and investors may lose the principal amount invested. Investors should obtain and read the prospectus and/or document set forth in Article 37-3 of Financial Instruments and Exchange Act carefully before making the investments ; **Bahrain -** This document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally. The Central Bank of Bahrain assumes no responsibility for the accuracy and completeness of the statements and information contained in this document and expressly disclaims any liability whatsoever for any loss howsoever arising from reliance upon the whole or any part of the contents of this document. The Board of Directors and the management of the issuer accepts responsibility for the information contained in this document. To the best of the knowledge and belief of the board of directors and the management, who have all taken all reasonable care to ensure that such is the case, the information contained in this document is in accordance with the facts and does not omit anything likely to affect the reliability of such information.; **Kuwait -** This document is not for general circulation to the public in Kuwait. The information has not been licensed for offering in Kuwait by the Kuwait Capital Markets Authority or any other relevant Kuwaiti government agency. No private or public offering of the information is being made in Kuwait, and no agreement relating to the information will be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the information in Kuwait.; **Oman -** For Residents of the Sultanate of Oman: The information contained in this document does not constitute a public offer of securities in the Sultanate of Oman as contemplated by the Commercial Companies Law of Oman (Royal Decree 4/74) or the Capital Market Law of Oman (Royal Decree 80/98). This information is being circulated on a limited basis only to corporate entities that fall within the description of sophisticated investors (Article 139 of the Executive Regulations of the Capital Market Law). The recipient acknowledges that they are a sophisticated investor who has experience in business and financial matters and is capable of evaluating the merits and risks on an investment.; **South Africa -** This document has not been approved by the Financial Services Board and neither MFS International (U.K.) Limited nor its funds are registered for public sale in South Africa.; **UAE -** This document, and the information contained herein, does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The information is only being offered to a limited number of exempt investors in the UAE who fall under one of the following categories of non-natural Qualified Investors: (1) an investor which is able to manage its investments on its own, namely: (a) the federal government, local governments, government entities and authorities or companies wholly-owned by any such entities; (b) international entities and organisations; or (c) a person licensed to carry out a commercial activity in the UAE, provided that investment is one of the objects of such person; or (2) an investor who is represented by an investment manager licensed by the SCA, (each a "non-natural Qualified Investor"). The information and data have not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority, the Dubai Financial Services Authority, the Financial Services Regulatory Authority or any other relevant licensing authorities or governmental agencies in the UAE (the "Authorities"). The Authorities assume no liability for any investment that the named addressee makes as a non-natural Qualified Investor diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document you should consult an authorised financial adviser.; **Saudi Arabia -** This document may not be distributed in the Kingdom except to such persons as are permitted under the Investment Funds Regulations issued by the Capital Market Authority. The Capital Market Authority does not make any representation as to the accuracy or completeness of this document, and expressly disclaims any liability whatsoever for any loss arising from, or incurred in reliance upon, any part of this document. Prospective purchasers of the securities offered hereby should conduct their own due diligence on the accuracy of the information relating to the securities. If you do not understand the contents of this document, you should consult an authorised financial adviser.; **Qatar -** This material/fund is only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such material/fund. The material does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). The fund has not been and will not be registered with the Qatar Central Bank or under any laws of the State of Qatar. No transaction will be concluded in your jurisdiction and any inquiries regarding the material/fund should be made to your contact outside Qatar.