Zacks
INVESTMENT MANAGEMENT

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Mitch on the Markets

Portfolio Manager Investing Insights

Are Dispersion and Concentration in the Stock Market Too High?

U.S. large cap stocks, as measured by the S&P 500, delivered a solid performance in the first half of 2024. In January, the index eclipsed an all-time high, and in the five months that followed, it reached 31 more. Volatility has also been relatively subdued. In the first six months, there was only one instance when the index rose or fell by more than 2% (it went up).[1]

But it hasn't been a story of a rising tide smoothly lifting all boats.

In fact, looking under the hood at individual stock returns reveals quite the opposite. As I write, approximately 40% of stocks in the S&P 500 are at least 10% below their all-time highs, with dozens of stocks still in negative territory for the year.

Many readers likely have a general understanding of how this is happening—a handful of mega-cap technology companies are making an outsized impact, and the effect is bolstering overall returns. Indeed, in the first half of 2024, just four of the "Magnificent Seven" stocks contributed over half of the S&P 500's total return.

The picture we're left with is one with historic levels of dispersion and concentration in the S&P 500. And that has some investors worried that year-to-date gains are unhealthy, unbalanced, and susceptible to a quick reversal.

High Dispersion

The term 'dispersion' in equity markets refers to a lack of correlated movement among stocks, which is what we've seen at near historic levels within the S&P 500 this year. Dispersion rose in the aftermath of the pandemic, as technology stocks soared while many other categories of stocks—particularly value names—lagged. Dispersion fell in 2022 with rising interest rates and the bear market, but it has risen again recently driven by the Magnificent Seven and surging earnings growth tied to Artificial Intelligence.

ABOUT MITCH ZACKS

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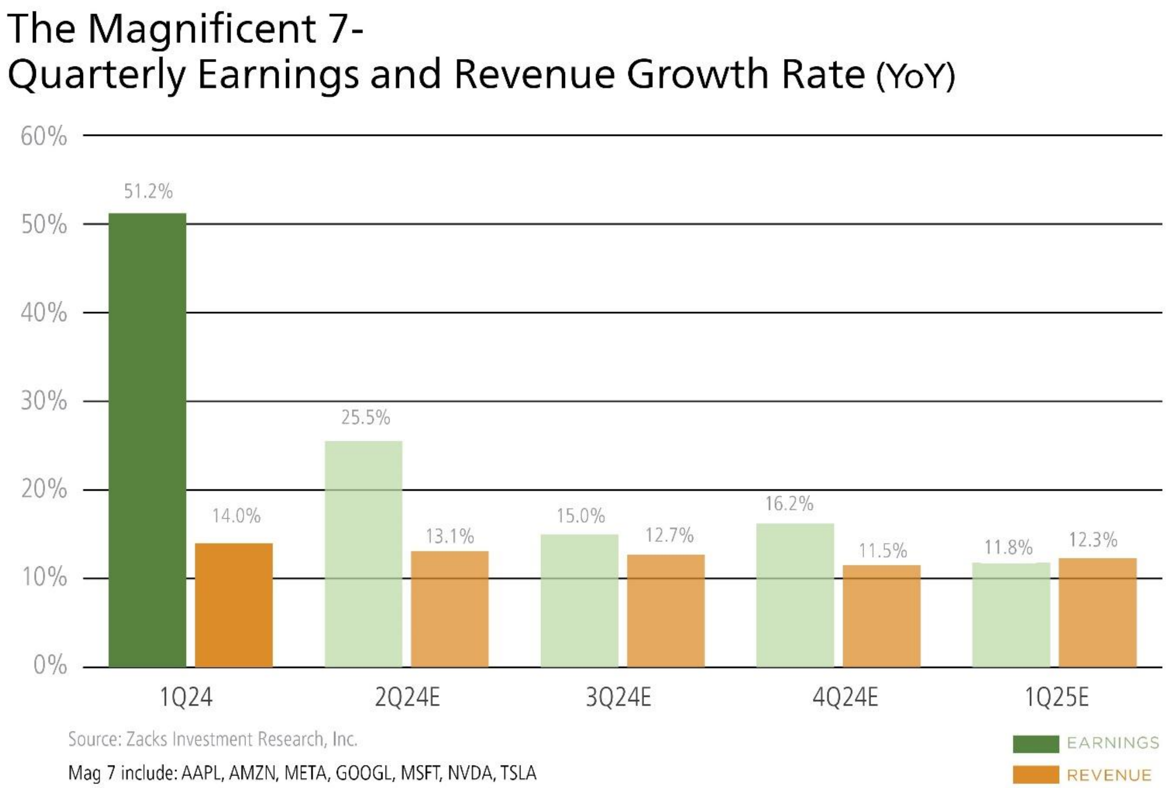
Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

As seen in the chart below, the rise of the Magnificent 7 has not been pure speculation—earnings growth has been powerful over the past several quarters and should continue apace in 2024.



Many narratives about high dispersion make it seem as though the remaining 493 S&P 500 stocks are in the doldrums, but that's not quite right. About 60% of the stocks in the index are 10% higher than their low points in 2024, and the other half of the S&P 500's year-to-date gains have been driven by the broad swath of non-Magnificent Seven companies in the index that have posted solid performance for the year.

But earnings are the main reason I do not get overly worried about high year-to-date dispersion in the S&P 500. According to Zacks Investment Research, S&P 500 earnings excluding Technology are poised to grow 6% for the full year 2024, and it appears possible that the 'remaining 493 stocks' in the index could deliver stronger earnings growth than the Magnificent Seven by the fourth quarter—thereby closing the earnings gap and bolstering the case to own a broad set of equities outside this narrow group, in my view.

High Concentration

Over the past 50+ years, the composition of the S&P 500 has changed substantially. In the 1970s, for instance, Industrials and Materials had significant weightings, making up over 25% of the index. Today, those two sectors combined are only about 10.6% of the index.

Fast forward to the present day, and Information Technology companies make up 32.4% of the S&P 500 (as of June 30), with the share rising to 41.7% when including Communications Services. Financials have also become bigger, now comprising 12.4% of the index. In the 1970s, Technology and Financials combined to make up about 13% of the S&P 500. Today, they make up more than half of the index.

Technology's high concentration has also impacted dividends. Technology companies are generally growth stocks, and growth stocks tend to hoard cash or invest in future growth—versus returning cash to shareholders in the form of dividends. Given this insight, the S&P 500's dividend yield has done what investors might expect—it's gone from over 4% in the 1970s to an average of 1.45% in the 2020s.

BOTTOM LINE FOR INVESTORS

So, what does this all mean for investors?

I think it strengthens the case for owning a broadly diversified portfolio of equities and rebalancing regularly to ensure your exposure to sectors and individual companies remains within the desired range. This is already part of our investment discipline at Zacks Investment Management. Remember, too, that in a diversified portfolio you will almost always see variance—some strong performers, and some weak ones. The outliers tend to neutralize each other's impact on portfolio returns over long stretches of time, leaving the middle-of-the-road stocks doing the heavy lifting.

[1] Wall Street Journal. June 28, 2024. https://www.nytimes.com/2024/06/28/business/stocks-dispersion-trade.html

Weekly Market Update

Important Market News We Think Worth Considering

Zacks INVESTMENT MANAGEMENT

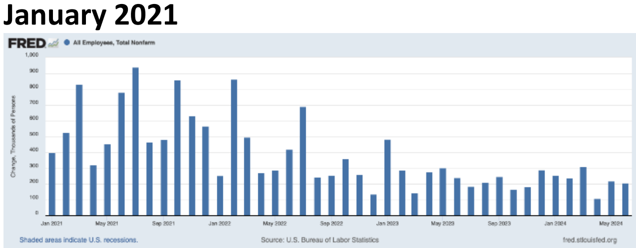
STEADY INVESTOR WEEK

- **U.S. unemployment rate crosses 4%**
- **Fed Chairman Jerome Powell testifies before Congress**
- **What to watch during the next earnings season**

The U.S. Unemployment Rate Crosses 4% for the First Time Since 2021

At first glance, the Labor Department's jobs report released last Friday looked like great news—the U.S. economy added 206,000 new jobs, slightly beating expectations.[1]

Total Nonfarm Payrolls, Monthly Change Since January 2021



Source: Federal Reserve Bank of St. Louis[2]

But the main takeaway from this report was actually that the jobs market was decisively cooling. The unemployment rate rose to 4.1%, marking the first-time unemployment higher than 4% since 2021. The Labor Department also revised job gains in April and May lower, by a combined 111,000 jobs. And average hourly earnings rose 3.9% year-over-year in June, the smallest increase since 2021. These data points don't exactly paint a picture of the labor market collapsing. But it does indicate a 'leveling off' within the labor market, which investors largely viewed in a positive light. The reason is that a cooling jobs market—as opposed to a jobs market that's too hot—gives the Fed some breathing room when it comes to setting monetary policy. The Fed is increasingly aware of the risk that keeping rates too high for too long could lead to more job losses over time, which at this stage would not be a desirable outcome. If inflation continues to trend lower in the coming months, further cooling in the jobs market would be viewed as a strong rationale for cutting rates in the fall—perhaps at the September meeting.

Fed Chairman Jerome Powell Testifies Before Congress

Federal Reserve Chairman Jerome Powell testified before Congress last week, and market-watchers were probing his comments for any hints for when rate cuts would commence in this cycle. Chairman Powell did not offer any clear signals. But he did slightly reposition the Fed's stance when it comes to how they're weighing risks in the economy. In Powell's words, "elevated inflation is not the only risk we face," adding that "we've seen that the labor market has cooled really significantly across so many measures…it's not a source of broad inflationary pressures for the economy now." This statement is important because for much of last year, the Fed was worried that a hot labor market and rising wages were contributing to sticky inflation, and a cooling labor market was essentially a stated goal. With the softer labor market data cited above, Powell conceded that allowing the jobs market to cool too much was surfacing as a key risk, stating that "we're very much aware that we have two-sided risks now." All told, Powell seemed to be positioning for a rate cut later this year, assuming inflation data in the next three months continues to show signs of improving.[3]

Earnings Season Gets Underway. Here's What to Watch

With a blink of an eye we're back in earnings season, and our colleagues at Zacks Investment Research have compiled three key factors to watch for Q2's reports. The first is that we've seen a steadily accelerating earnings growth trend. The chart below shows the year-over-year earnings and revenue growth for the second quarter relative to the preceding four periods and expectations for the following three periods[5]:

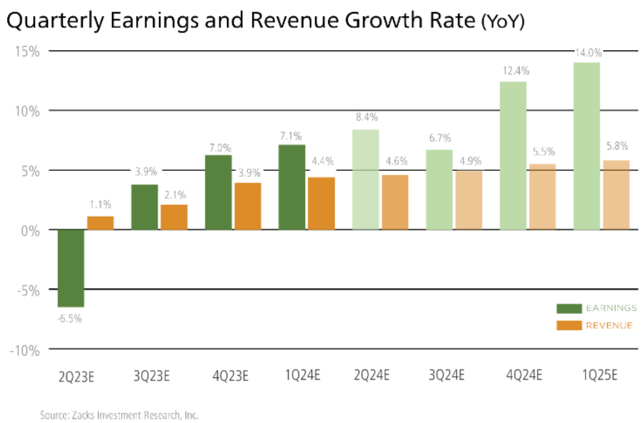


Image Source: Zacks Investment Research

The +8.4% second quarter expected earnings growth rate is the highest we've seen in almost two years. The second factor is the favorable development on the revisions front, with estimates for Q2 holding up far better than other recent periods. In the three-month period from the start of the quarter through June 30, Q2 estimates for the S&P 500 index fell the least relative to comparable periods of other recent quarters. The chart below gives us a good visual sense of this favorable revisions trend.

A final factor to watch is the outsized role Technology stocks continue to play, particularly the 'Magnificent 7 Stocks.' Total Tech sector earnings are expected to be up +15.7% from the same period last year on +9.6% higher revenues. Had it not been for the Tech sector's strong growth, Q2 earnings for the rest of the index would be up only +4.8% (vs. +8.4% otherwise). For the Mag 7 stocks, Q2 earnings are expected to be up +25.5% on +13.2% higher revenues.

[1] Wall Street Journal. July 5, 2024. https://www.wsj.com/economy/jobs/jobs-report-june-unemployment-economy-68275d9e?mod=economy_lead_pos4

[2] Fred Economic Data. July 5, 2024. https://fred.stlouisfed.org/series/PAYEMS#

[3] US News. July 9, 2024. https://www.usnews.com/news/economy/articles/2024-07-09/powell-tells-congress-inflation-is-coming-under-control-is-it-enough-to-calm-angry-voters

[4] Zacks.com. https://www.zacks.com/commentary/2297407/3-key-things-to-know-about-the-q2-earnings-season

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