fathom
Independent Thinking

US equities and the power of the few

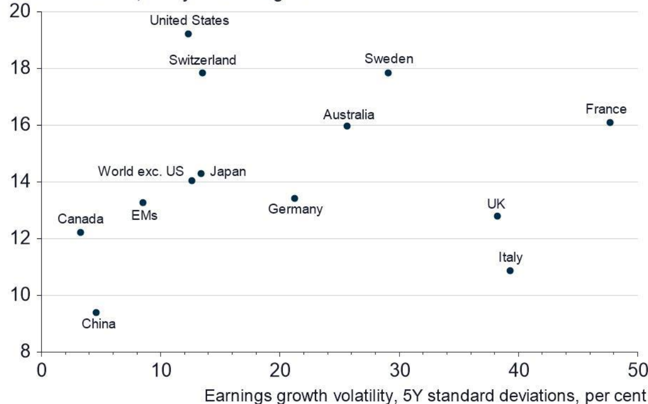
3 October 2023

Dimos Andronoudis

As wage inflation in the US continues to sink back to levels commensurate with a 2% inflation target, Fathom's *Global Outlook, Autumn 2023* singles out America as the major economy most likely to avoid a recession – indeed, in our central case it does just that. But does the US equity market reflect that outperformance? In short, it does; with rich valuations of US stocks reflecting this. As the chart below shows, the US market commanded the highest earnings multiple (forward price-earnings ratio) among major markets in the last calendar quarter, and that was not just down to positive sentiment. On the contrary, it mainly reflected the fact that even after a bad year, when rising costs were threatening profit margins, US corporate earnings remained high — because businesses succeeded in either passing on costs to consumers or tapping more and better-placed markets. When the volatility of US corporate earnings remains low even after such a challenging year, most investors would perceive the risk of throwing money into US equities as low.

Forward P/E ratio and earnings growth volatility

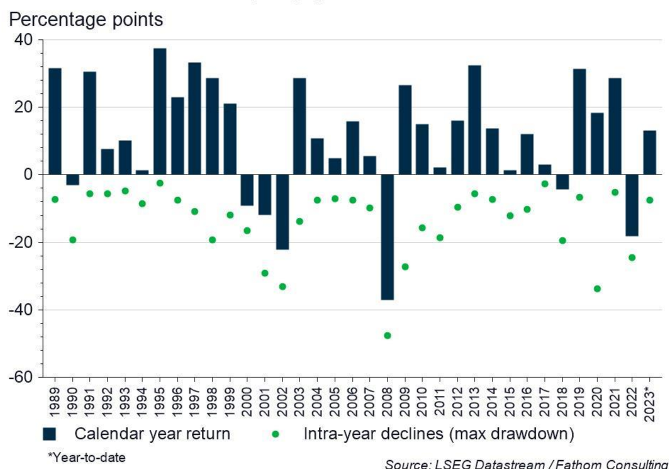
Forward P/E ratio, five-year averages



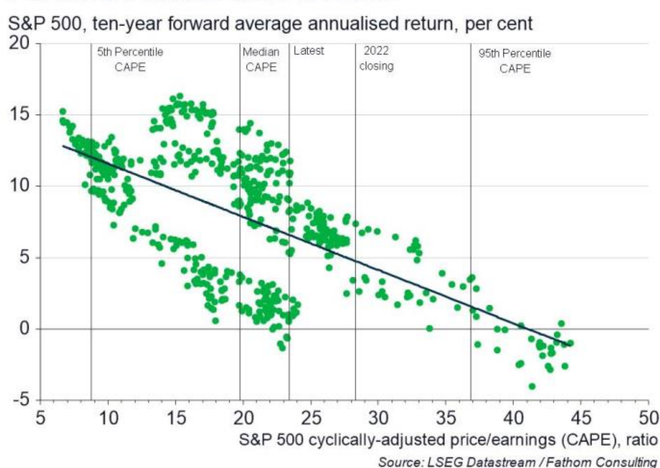
Source: LSEG Datastream / Fathom Consulting

Resilient corporate fundamentals have helped US equity prices to recover after the worst annual performance since the global financial crisis (GFC). Interestingly, the relatively large 2023 drawdown indicates that the recovery did not occur at the start of 2023 but actually materialised later. Such resilience was therefore not taken for granted but, as Fathom's chief economist Andrew Brigden outlined in a Recession Watch note in February, it had to be seen to prove itself — much like the rest of the economy.

Continued

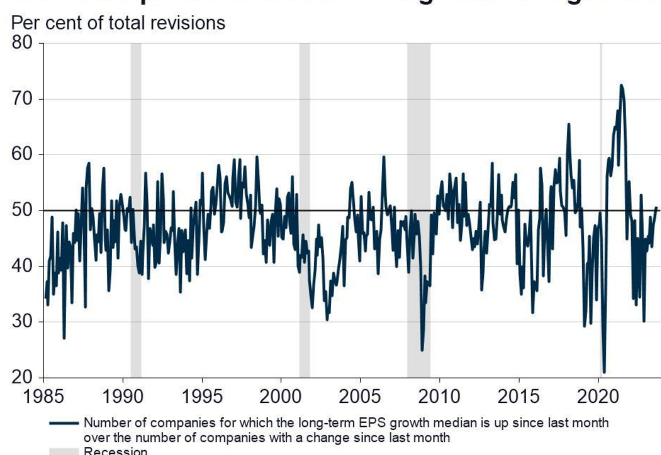


Rotations in corporate valuations can be tracked via earnings momentum — changes in forecasted future earnings — as well as by the rates at which these earnings are discounted. The end of 2023 Q1 saw a turning point, as indications multiplied that the hiking cycle — then a year old — had curbed neither consumption nor employment, while inflation remained on a downward trajectory. At that point, analysts started upgrading their earnings forecasts while, later still, discount rates indicated a slight fall. The indicative valuations based on these earnings forecasts, now discounted at lower rates, set the tone for an improving US equity market performance for 2023. This improving performance seems set to continue if the relationship between the cyclically-adjusted price-to-earning (CAPE) ratio and future returns is to be trusted. By indicating cheaper cyclically-adjusted earnings when lower, CAPE points to further price appreciation in the next decade, on average. However, the devil is in the detail and, statistically, relations based on averages do not always materialise. Indeed, there are some points of note in the second chart below. In particular, we can see when lower CAPE was not followed by higher equity returns



Continued

Are there any weak links in the 2023 performance? Professional analysts upgraded the long-term earnings forecasts of approximately half of the largest and most robust US companies, but what is happening to the rest of corporate America? The truth is that a more comprehensive US sample is unlikely to have the same high proportion of positive future earnings views – forecasts there would have to be more timid, as companies are far smaller.



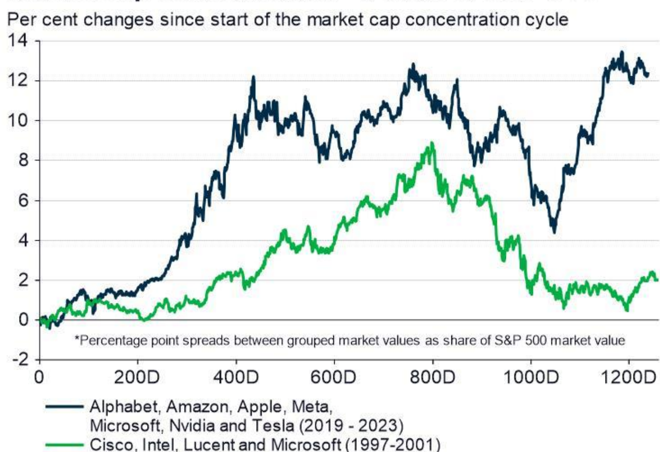
Additionally, the good performance is concentrated in a few companies, making it harder to assess the overall robustness of the 2023 US equity market. So far this year, the S&P 500 has returned around 13%, but this has been largely attributable to the proportion of the 'Magnificent Seven' — a new set of tech companies replacing the FAANG group, as artificial intelligence (AI) takes the world by storm — increasing by 7% (from 19.5% at the end of 2022 to around 27% now). We have now reached a point where the combined market capitalisation of the 'Magnificent Seven' represents around 40% of the remaining 493 stocks. A market that is so heavily dependent on the performance of so very few stocks is a fragile market indeed. It is also a market with a heightened fear of bubbles, where any negative shock is amplified. This recent, spectacular outperformance of a few is reminiscent of the 'dot.com' bubble at the turn of the millennium. Then, as now, considerable hype surrounded a handful of tech stocks that rose spectacularly within a short period. In a classic bubble, some of the stocks that saw a dramatic rise subsequently crashed out completely. We recently came perilously close to a repeat of that, as the second chart below shows. Fortunately, the launch of OpenAI's GPT-4 (at the 1084th day of the event study chart) has turbo-charged the prospects of the 'Magnificent Seven', reversing their downward trajectory and placing a distinct separation between the 'dot.com' bubble and now — at least for the time being...

Continued

'Magnificent Seven' market cap dominance

Source: LSEG Datastream / Fathom Consulting

Market cap concentration* trends in S&P 500



Source: LSEG Datastream / Fathom Consulting

Was this a tribute to the unparalleled resilience of corporate America and its versatility and innovative spirit, which positioned it to best integrate AI into a pivotal (indeed, transformational) role, thus unlocking higher trend rates of economic growth? Or was it just a fortunate coincidence that was then super-hyped by today's media? Is there something else brewing in corporate America that is potentially hidden behind the good aggregate performance? In an upcoming *In-depth* note, Fathom will examine the US corporate sector for signs of trouble. We will delve specifically into the world of financially constrained firms and how, when faced with hardship, such troubles may lead to widespread market upheaval.

Further reading

Global Outlook, Autumn 2023: fortunes diverging

Recession Watch: longer debt maturities are no panacea

Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
dimos.andronoudis @fathom-consulting.com
www.fathom-consulting.com

This newsletter is a confidential, copyright protected communication intended only for the person to whom it was originally sent. If received in error, please notify the sender and delete immediately. Its intended recipients may not make copies of this newsletter, or distribute it to third parties, without the written consent of Fathom Consulting.

Fathom Consulting is a trading name of Fathom Financial Consulting Limited, a company registered in England & Wales under the Companies Act, company number 04942817, © 2023

Regulatory Disclaimer

FFC LIMITED and all of its affiliates (henceforth FFC) do not conduct "investment research" as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor do they provide "advice about securities" as defined in the Regulation of Investment Advisors by the U.S. SEC. FFC is not regulated by the SEC or by the FCA or by any other regulatory body.

This research report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nonetheless, FFC has an internal policy that prohibits "front-running" and that is designed to minimize the risk of receiving or misusing confidential or potentially material non-public information.

The views and conclusions expressed here may be changed without notice. FFC, its partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. This report may not be copied, redistributed or reproduced in part or whole without FFC's express permission.

Information contained in this report or relied upon in its construction may previously have been disclosed under a consulting agreement with one or more clients. The prices of securities referred to in the report may rise or fall and past performance and forecasts should not be treated as a reliable indicator of future performance or results. This report is not directed to you if FFC is barred from doing business in your jurisdiction. Nor is it an offer or solicitation to buy or sell securities.

Analyst Certification

I Dimos Andronoudis, the lead analyst, certify that the views expressed herein are mine and are clear, fair and not misleading at the time of publication. They have not been influenced by any relationship, either a personal relationship of mine or a relationship of the firm, to any entity described or referred to herein nor to any client of FFC nor has any inducement been received in relation to those views.

I further certify that in the preparation and publication of this report I have at all times followed all relevant FFC compliance protocols including those reasonably seeking to prevent the receipt or misuse of material non-public information.