Cetera® Investment Management
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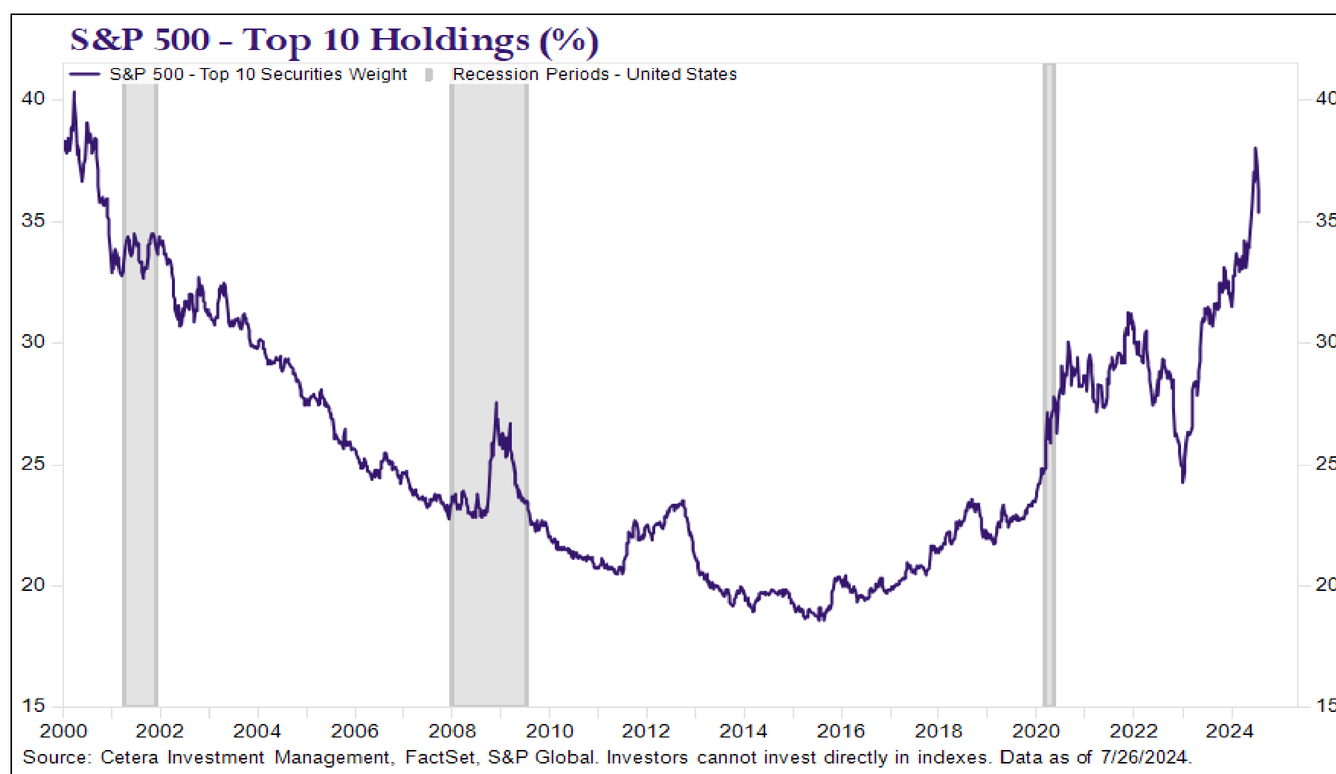
Commentary

Risks: Expectations, Valuations and Concentration

- High valuations, high expectations, and high concentration have increased market risks.
- The S&P 500 is down about 6% from recent highs and a correction is possible.
- We expect more volatility, but do not expect a bear market. Stay diversified in times like this.

U.S. equities have rallied all year on high expectations and excitement around technology, specifically artificial intelligence (AI). This has pushed stock market valuations well above historical averages. The largest discrepancies can be seen in Large cap growth stocks, where the average 20-year trailing P/E is around 22.5, and recently, this P/E was close to 40. This was mostly driven by optimism around extremely large companies collectively known as the Magnificent Seven (Mag-7). The Mag-7 are part of the ten largest companies in the S&P 500, which made up an astonishing 38% of the index recently, the highest we have seen since the dot-com bubble (see table 1). With such a huge weight in indices, anything derailing this AI optimism would likely lead to a market pullback and a possible correction.



Source: Cetera Investment Management, FactSet, S&P Global. Investors cannot invest directly in indexes. Data as of 7/26/2024.

We are deep in earnings season, and a few of the primary market leaders have released less than spectacular earnings reports, and even worse have offered disappointing future earnings guidance.

Furthermore, we have seen weak economic data, which coincides with the weak earnings guidance. This past week we saw a key manufacturing report fall to an eight-month low, combined with multiple employment readings suggesting a quickly weakening labor market. With the Federal Reserve (Fed) not cutting interest rates this week, market sentiment has increased that the Fed may be behind the curve and has underestimated the lag effect of high interest rates on the economy. Investors optimistic about rate cuts are now questioning if they need to be more pessimistic around the reason for the rate cuts (slower economic growth, which causes slower inflation growth).

With the combination of high valuations, weaker than expected earnings and below consensus economic reports, U.S. equities have fallen about 6% from their recent peaks. With sentiment so negative right now, a market correction, where stocks fall 10% or more from their peak, is a concern. However, market corrections are a normal part of investing and occur about once per year. Keep in mind that the S&P 500 had a correction from July to October last year. We do not expect a possible market correction to worsen into a so-called bear market, when stocks fall 20% from their peaks, for multiple reasons.

- First, despite the weaker economic data, the economy is still on solid footing and has a ways to go before we enter a recession. Generally, for a bear market, an economic recession is needed. Economic data has weakened, such as the labor market, however, an unemployment rate of 4.3% is still respectable.

- Second, corporate earnings, the key driver of stock prices, still look strong. For example, earnings for the S&P 500 are expected to rise a robust 11% for 2024 according to Factset

- Third, with inflation close to their long-term targets and economic growth slowing, we expect the Fed to cut rates this year. Lower rates tend to be a boon to U.S. stocks as borrowing costs decline. Recently, financial markets had expected the Fed to cut just 1 or 2 times in 2024. Now this expectation has risen to 3 or4 times.

- Lastly, similar to what occurred at the end of last year's correction, there is a significant amount of money and savings ready to be deployed if stocks and valuations fall. Today, about $24 trillion of money market assets and bank deposits are on the sidelines waiting for better market valuations. With the U.S. stock market capitalization at about $50 trillion, any market pullback will likely see some of this $24 trillion enter the market and provide some support to equities. Not to mention, if the Fed cuts rates investors in money market assets will see their interest rates fall, perhaps incentivizing them to move their money elsewhere.

More volatility is likely if the economy continues to weaken, and the Mag-7 continue to disappoint in their outlooks. Diversification can help mitigate this volatility. If volatility escalates, we think it could be short-lived as the Fed is likely going to cut rates soon and the labor market is still strong, despite some weakening. Corrections and pullbacks are a normal part of investing. Your financial professional can help you stay focused on your personal financial goals. As always, please contact your financial professional with any questions about tailoring your portfolio to your personal situation.

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Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The **S&P 500** is an index of roughly 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of large cap universe.

The **Russell 1000** index is a stock market index that tracks the top 1,000 stocks by market capitalization in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index.

The **Russell 1000 Growth** index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The **Russell 1000 Value** index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.

The **Russell 2000** index is comprised of 2000 small-capitalization companies. It is made up of the bottom two-thirds in company size of the Russell 3000 index.