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The Cheapest Most Expensive Index in History

By: Justin McNichols, CFA

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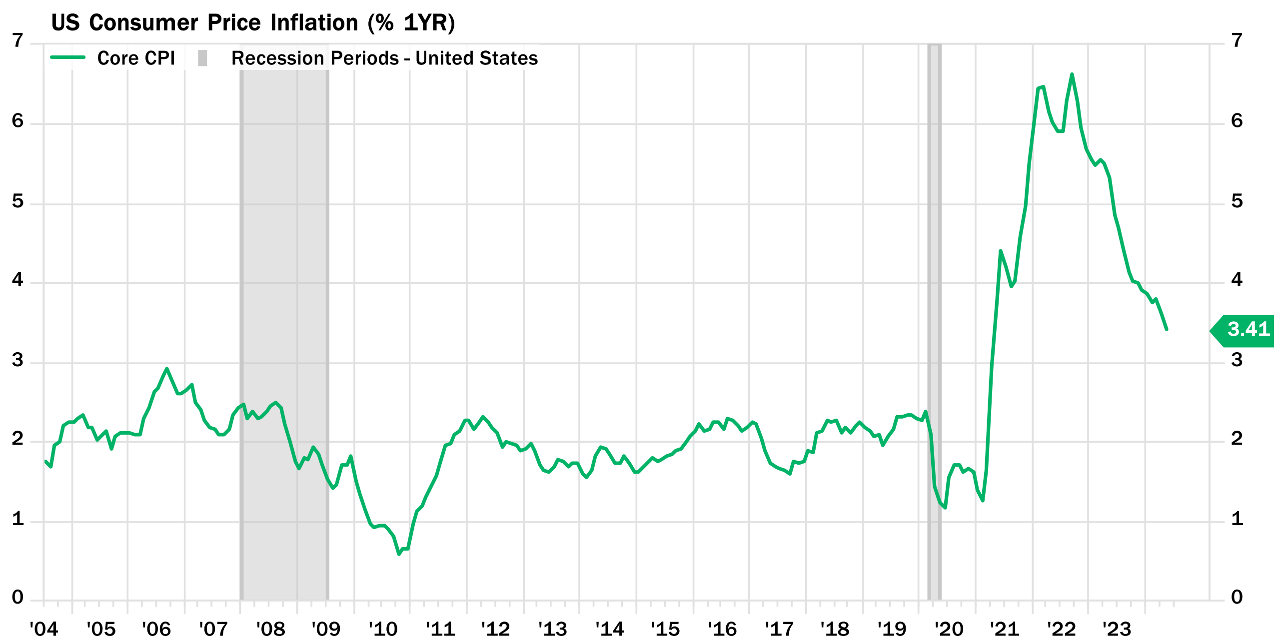
Is this arguably the cheapest most expensive U.S. equities market in history? We examine this extreme investing environment.

Entering 2024, investors were generally positive about the prospect of a solid year for U.S. stocks. After 2022's bear market which saw the S&P 500 and the Nasdaq 100 correct over 27% and 38%, respectively, 2023's rally essentially erased the 2022 bear market – leaving markets essentially flat over the two-year period. The consensus outlook was that the quickly falling core CPI and PCE during 2023 would lead the Federal Reserve to mirror its aggressive inflation fighting hiking cycle and systematically reduce short-term interest rates throughout the year. This expectation set up a meaningful broadening of the rally into more economically sensitive areas of the market.

However, due to anomalies such as beginning of year annual price increases for items like healthcare, and lagging inflation in areas like housing, the 2023 inflation decline seemed to stop as 2024 began. By the end of the first quarter, consensus expectations had shifted toward the view that inflation would be stubbornly high, and the Fed would reduce the number of interest rate cuts to potentially zero. Core CPI started 2024 at 3.91%. Although January and February fell, bringing the figure down to 3.76%, March saw a slight uptick to 3.80%, causing much of the consensus shift. Of course, once March passed, core CPI continued to fall and now stands at 3.41%. In the chart below, we show the past 20 years of core CPI. Barring a few tough comparisons over the next few months, the momentum to push core CPI back toward the mid-2% area is strong.



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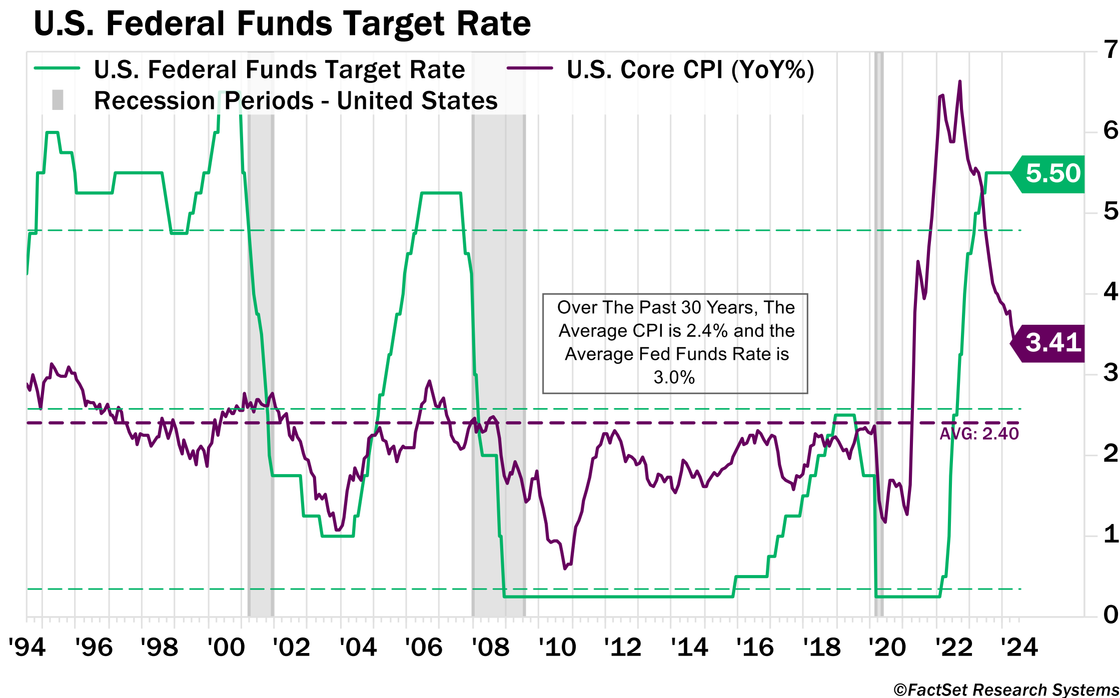
A moderately slow growing economy, coupled with a decent but slowing labor and wage picture, caused the Fed to delay reducing the Fed Funds rate from an extremely high (and dangerous) level. In fact, today is the first time in at least 30 years that inflation has fallen dramatically without the Fed reducing the Fed Funds rate. For the past 30+ years, on average the Fed Funds rate has been about 50-60 basis points above the average core CPI. Today the difference is 209 basis points, indicating the Fed Funds rate is 150 basis points too high (and/or the Fed is SIX 25 basis points cuts behind the cycle). The following chart depicts this unique situation.



The resulting effect on the stock market in 2024 has not been terribly shocking. Each day that passes with interest rates too high is another day that companies in numerous sectors feel a deeper fundamental slowdown. When consumer and business activity slows due to high borrowing rates, many sectors from consumer discretionary to industrials to financials to materials feel the slowdown.

As investors shift away from these sectors, fearing the Fed will "never reduce rates," those same investors searched for investments and themes that are less affected by the stubborn Federal Reserve. Once the Artificial Intelligence theme began to amplify, with use cases and addressable market estimates growing exponentially, investors had found their investing theme. Additionally, with so few companies growing earnings over the short-term, investors have stuffed their portfolios into only a handful of companies. The following chart points to the high level of earnings growth derived from only 5 companies in the S&P 500 during the first quarter. As you can see, the estimated earnings growth between the 5 and the remaining 495 is set to converge throughout the rest of 2024.

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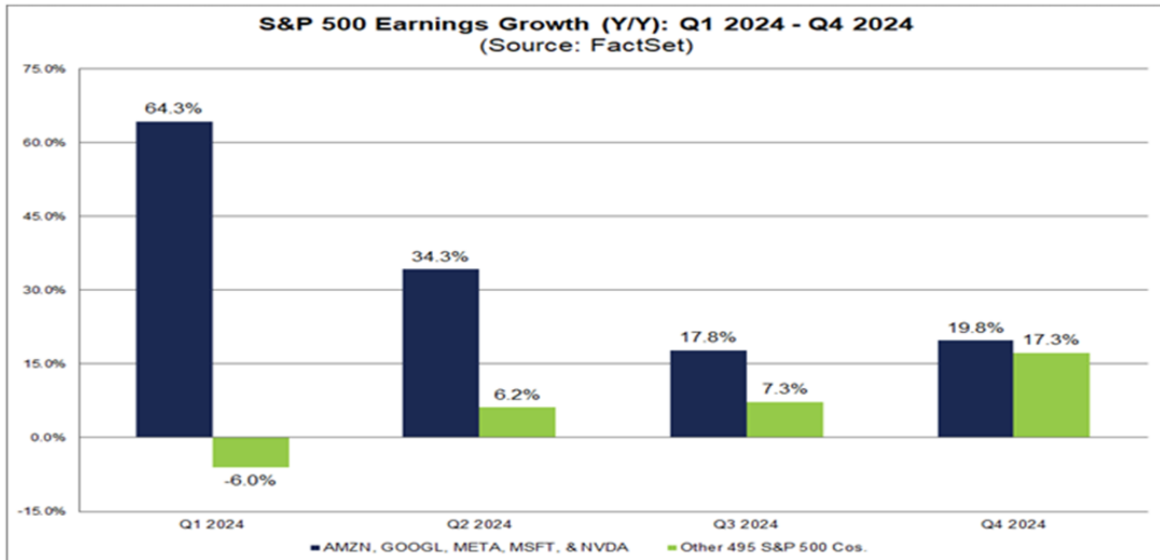
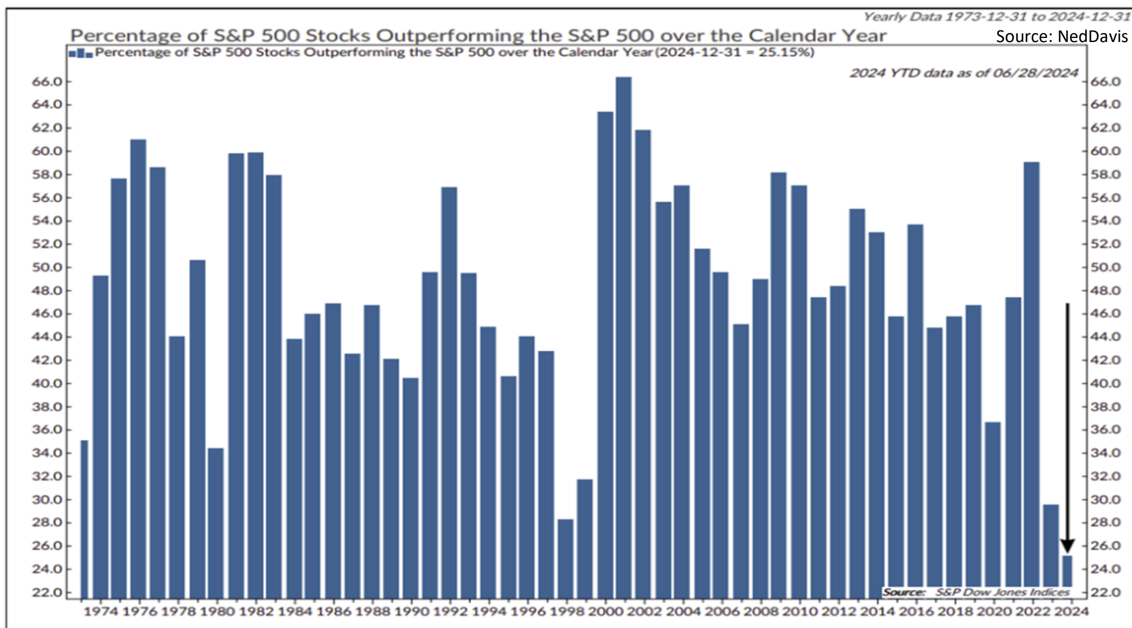


The result of this phenomenon of high popularity in only a few large companies is domestic equities as an asset class has now posted numerous record-breaking extremes. First, and arguably most importantly, the 2024 performance of <u>four</u> of the 500 companies in the S&P 500 represent nearly 60% of the total return in the first six months. The four companies are Nvidia (~35% of the index return), Microsoft (~10%), Alphabet (~10%), and Amazon (~7%). Without delving too deeply into any of these companies, it is interesting to note that Nvidia's four largest customers (by far) are Microsoft, Amazon, Google, and Meta, which are estimated to comprise over 50% of Nvidia's revenue. So, the four companies that equate to 60% of the S&P 500's return are majorly intertwined. How extreme is this S&P 500 return concentration? It's essentially the highest in modern history – over 50 years. As seen in the bar chart below, over the past 50 years, there has never been a year when fewer individual companies in the S&P 500 outperformed the overall index. Presently only 25% of companies are outperforming the index.



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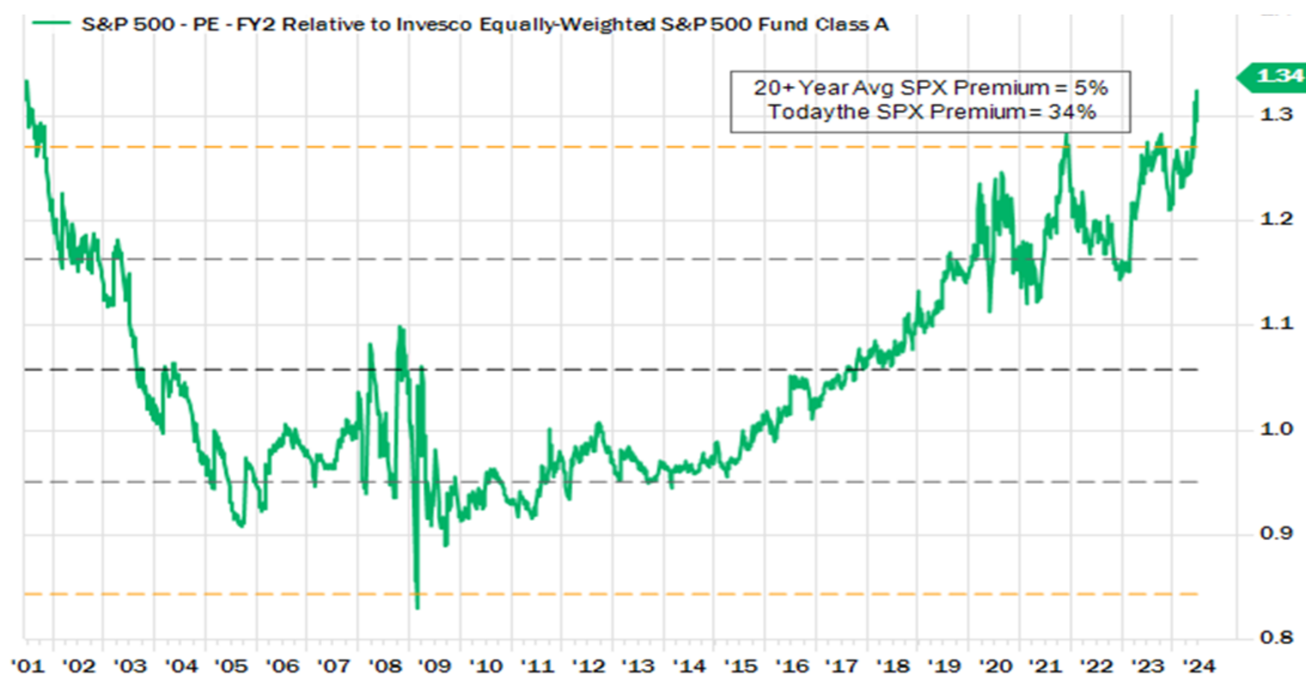
This action pushes domestic equities toward a second major extreme. When 5 of the largest companies in the world are some of the few that are outperforming, the valuation differential between the market cap (size) weighted S&P 500 and the equally-weighted S&P 500 increases. We are now at a point not seen in well over 20 years, where the valuation premium between the S&P 500 and the equally-weighted S&P 500 is 34%. Over the long-term, these two have traded toward parity on average. Statistically, a 34% premium occurs approximately 1% of the time over this lengthy time period. The last time the relative extreme was this high was as the internet bubble was popping.



Source: OPCM, FactSet

From a valuation perspective, we feel the S&P 500's high valuation is actually masking the fact that the majority of companies are at or below long-term average valuations. The table below shows while the S&P 500 trades over 21x earnings, 1.5 standard deviations above the average, if you remove the ten largest companies and the five largest defensive consumer staples companies, the remaining 485 trade at a <u>discount</u> to the long-term average.

	PRICE	P/E NEXT 12 MONTHS	WEIGHTING	10 YR AVG	10YR 1SD	10YR 2SD
S&P500 (SPX)	5537.02	21.29	100%	18.1	20.1	22.1
SPX Excluding 5 Largest		18.63	27%			
SPX Excluding 10 Largest		18.10	35%			
SPX Excluding 10 Largest & 5 Largest Consumer Staples		17.84	39%			

Source: OPCM

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What typically happens after these extremes when 1) Concentrations are high – the ten-largest companies in the S&P 500 are at a record 35%+ of the index, 2) The S&P 500 valuation is at a multi-decade premium to the equally-weighted S&P 500, 3) Very few companies are outperforming the index, and 4) The return differential between the S&P 500 and equal-weighted are at an extreme – this year +15% versus +4% equally weighted?

Although timing the shift is difficult, the last time we saw these ingredients, nearly exactly 24 years ago, the equally-weighted S&P 500 outperformed for over 7 years straight. Taking this full circle, if inflation continues its downward trajectory, and the Fed begins to reduce the Fed Funds rate, the low valuations and future easing earnings comparisons should support equal-weighted S&P 500 relative returns in the future. The probability of the average stock in the S&P 500 outperforming will increase, enabling seasoned investment teams to find incredible values.

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