



MORNING BRIEFING

September 15, 2020

The Magnificent Five Now & Then

Check out the accompanying [chart collection](#).

(1) Our new Topical Study on P/E x E. (2) Explaining and making the case for forward earnings. (3) Practical applications. (4) The Mag-5 since 1993. (5) Today's Mag-5 are the FAAMG stocks. (6) Are today's Mag-5 mega because of Trump or despite him? (7) One more time with more details: Mag-5's impact on three investment styles. (8) Are today's Mag-5 mega because of ETFs?

Strategy I: S&P 500 Primer. Joe and I often receive requests to explain why we prefer to use forward earnings in our work. That led us to write our latest Topical Study, [S&P 500 Earnings, Valuation & the Pandemic: A Primer for Investors](#). We intend to publish it as another book in my series on "Predicting the Markets," available on my [Amazon homepage](#). We would welcome any comments before we go to press with our latest study. Here is a brief description of our forthcoming book:

"In this unique primer, Edward Yardeni and Joseph Abbott, two of the world's most experienced and widely followed investment strategists, provide investors with a practical understanding of the forces that drive the stock market. This study focuses on the S&P 500 stock price index, examining how it is determined by the earnings of the 500 companies that are included in the index and the valuation of those earnings by the stock market. Notwithstanding occasional bear markets, the S&P 500 has been a great investment over the years—so much so that 'S&P' could stand for 'Success & Profit.'

"The first chapter in this study covers the various measures of earnings for the S&P 500 and why we favor forward earnings among them. The second chapter discusses various models of valuation, again focusing on the S&P 500. The final chapter uses the resulting analytical framework to review how it has worked in good times and bad, focusing on the Great Financial Crisis and the Great Virus Crisis.

"The market discounts analysts' consensus estimates for revenues and earnings this year and next year on a time-weighted basis. Calculating weekly forward revenues and forward earnings

from analysts' estimates can provide very timely insights into the performance of the global economy as well as the underlying trends in quarterly revenues and earnings.

"While this framework provides a disciplined approach to analyzing the macroeconomic fundamentals that are driving earnings, the valuation of those earnings by investors will continue to be much more subjective than objective. Nevertheless, there are fundamental factors that influence valuation multiples. Some, like inflation and interest rates, will always be important in assessing the valuation question. Other factors may be relatively new and worthy of careful analysis."

Strategy II: US vs. Them. Yesterday, Joe and I reviewed the impact of the Magnificent Five ("Mag-5" for short) stocks on the three major investment styles: LargeCap-vs-SMidCap, Growth-vs-Value, and Stay-Home-vs-Go-Global. Today, we would like to continue our analysis. Currently, the Mag-5 are the FAAMG stocks (Facebook, Apple, Amazon, Microsoft, and Google). By market-cap size on Friday, the acronym would be "AAMGF": Apple (\$1.9 trillion), Amazon (\$1.6 trillion), Microsoft (\$1.5 trillion), Google (\$1.0 trillion), and Facebook (\$0.8 trillion).

On Friday, the Mag-5 accounted for 24.7% of the market capitalization of the S&P 500, down from a record high of 27.2% on September 2, when the S&P 500 hit its latest record high ([Fig. 1](#)). The FAAMGs' collective market-cap share well exceeds the peak 18.5% share of the Mag-5 during the week of March 24, 2000. Back then, the Mag-5 were the MCGIX stocks (Microsoft, Cisco, GE, Intel, and Exxon).

Joe created the Mag-5 market-cap series, which starts in 1993 ([Fig. 2](#)). We can use it to assess the extent to which the Mag-5 have outperformed and underperformed various US stock market indexes as well as foreign ones. Consider the following:

(1) *LargeCap vs SMidCap*. The Mag-5 collectively have outperformed the S&P 500 since the start of 2017. A case can be made that their outperformance since then has been attributable to President Donald Trump moving into the White House at the same time. We are inclined to see that as a coincidence. While Trump has championed reducing regulations on business in general, he often has said that the big-cap Internet companies should face more, not less, regulation. He has been particularly troubled by their dominance of social media.

In any event, the market cap of the Mag-5 is up 193.8% since the start of 2017 through Friday's close, while the S&P 500 stock price index is up 43.4% with them and 22.8% without them ([Fig. 3](#)). Since the start of 2017, the Mag-5 also have handily outpaced the Nasdaq (which includes all five of them), the S&P 400 MidCaps, and the S&P 600 SmallCaps ([Fig. 4](#) and [Fig. 5](#)).

Here is the performance derby of the Mag-5 and the major US stock price indexes since the start of 2017 through Friday's close: FAAMG (193.8%), Nasdaq (101.6), S&P 500 (43.4), S&P 500 ex-FAAMG (22.8), S&P 400 (11.7), S&P 600 (2.9), and S&P 500 Equal-Weighted (25.9).

Now let's do the same comparison since the start of the bull market on March 9, 2009 through Friday's close: MAG-5 (647.7%), Nasdaq (755.5), S&P 500 (393.8), S&P 400 (358.4), S&P 600 (374.1), and S&P 500 Equal-Weighted (325.5) ([Fig. 6](#)).

(2) *Growth vs Value*. Since 2017, the Mag-5 clearly have outperformed the S&P 500 Value index and also have outperformed the S&P 500 Growth index, which includes them all ([Fig. 7](#)). Here is the performance derby since 2017 through Friday's close: FAAMG (193.8%), S&P 500 Growth (88.0), and S&P 500 Value (12.0) ([Fig. 8](#)).

(3) *Stay Home vs Go Global*. During most of the bull market since 2009, Joe and I have been recommending a Stay Home (SH) versus a Go Global (GG) investment strategy. We remain in the SH camp, but we have to acknowledge that the success of that approach, especially since 2017, has had a lot to do with the outperformance of the Mag-8 on a global basis. We've been monitoring the SH/GG relative performance using the ratio of the US MSCI stock price index divided by the All Country World ex-US MSCI stock price index in both dollars and local currencies ([Fig. 9](#)). It's been no contest.

Here's the performance derby for the major MSCI stock price indexes since March 9, 2009 through Friday's close in dollars and in local currencies: US (398.9%), EMU (98.2, 111.7), Japan (112.0, 127.7), UK (50.7, 62.2), and Emerging Markets (125.0, 149.1) ([Fig. 10](#)). (See our chart publication [S&P 500 Sectors & MSCI Indexes During Bull Markets](#).)

Here's the comparable performance derby since 2017 through Friday's close in dollars and in local currencies: US (51.2%), EMU (14.8, 2.4), Japan (19.2, 8.5), UK (-15.5, -18.3), and Emerging Markets (26.6, 31.0). Over this same period, the market cap of the Mag-5 is up

193.8%, while that of the S&P 500 ex-Mag-5 is up 22.8%. In other words, Mag-5 has accounted for much of the outperformance of Stay Home since 2017.

(4) *ETFs*. It's widely recognized that the Mag-5 are widely over-owned. After all, they account for a quarter of the market cap of one of the most widely owned portfolios of stocks in the world, namely the S&P 500. It's the most "crowded trade" in history. It's widely believed that contributing to this development in recent years has been the proliferation of exchange-traded funds (ETFs). The largest ones tend to track the S&P 500. For example, [SPDR S&P 500](#) has \$295.7 billion under management. [Vanguard S&P 500 ETF](#) currently has total assets of \$560.0 billion. The top five holdings of all such funds are obviously the Mag-5.

According to the Investment Company Institute, "broad-based" total domestic equity ETFs had assets of \$2.2 trillion during July ([Fig. 11](#)). Even if they all together had 25% of their assets in the FAAMGs, they would only account for \$550 billion, or 8% of the current \$6.8 trillion market cap of the FAAMGs. This suggests that the remaining \$6.2 trillion must be held in portfolios mostly managed by individual and institutional investors. This belies the widely held notion that the Mag-5 have flourished mostly as a result of passive investments by ETFs.

CALENDARS

US: **Tues:** Headline & Manufacturing Industrial Production 1.0%/0.8%, Capacity Utilization Rate 71.5%, Empire State Manufacturing Index 5.95, Import & Export Prices 0.5%/0.4%, API Crude Oil Inventories. **Wed:** Retail Sales Total & Ex Autos 1.0%/0.9%, Business Inventories 0.1% NAHB Housing Market Index 78, MBA Mortgage Applications, EIA Crude Oil Inventories, Fed Interest Rate Decision. (DailyFX estimates)

Global: **Tues:** Eurozone ZEW Economic Sentiment Index, Germany ZEW Economic Sentiment Index 69.8, UK Employment Change & Unemployment Rate -120k/4.1%, France CPI 0.2% y/y, Italy CPI -0.5% y/y. **Wed:** Eurozone Balance of Trade, UK Headline & Core CPI 0.1%/0.6% y/y, Canada CPI 0.1% m/m/0.4% y/y, Australia Employment Change & Unemployment Rate -50k/7.7%, BOJ Rate Decision -0.1%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week. LargeCap's forward earnings has risen for 17 straight weeks, MidCap's is up in 14 of the past 15 weeks, and SmallCap's posted its 14th gain of the past 17 weeks.

LargeCap's forward earnings is now up 10.5% from its lowest level since August 2017; MidCap's has risen 19.0% from its lowest level since May 2015; and SmallCap's is up 28.6% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November until mid-February, before tumbling due to the COVID-19 economic shutdown. LargeCap's forward earnings is now 12.9% below its record high at the end of January. MidCap's and SmallCap's are 20.9% and 29.6% below their October 2018 highs. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings improved to -12.2% y/y from -12.4%. That's up from mid-May's -19.3%, which was the lowest since October 2009, and down from 23.2% in September 2018, which was the highest since January 2011. The yearly rate of change in MidCap's forward earnings rose w/w to -19.2% y/y from -20.2% y/y, and is up from a record low of -32.7% at the end of May; that compares to a TCJA-boosted 24.1% in September 2018 (the highest since April 2011). SmallCap's rate rose w/w to -21.1% y/y from -22.7% y/y and is up from a record low of -41.5% in early June. SmallCap's prior record low in its y/y percent change occurred during July 2009 and compares to the TCJA-boosted eight-year high of 35.3% in October 2018. Analysts' y/y earnings growth forecasts for 2020 are down substantially since early March but have been relatively stable since late May. Here are the latest consensus earnings growth rates for 2020 and 2021: LargeCap (-20.2%, 27.9%), MidCap (-32.6, 49.3), and SmallCap (-52.6, 107.6).

S&P 500/400/600 Valuation ([link](#)): Valuations dropped across the board last week and slipped further below their recent cyclical and record highs. LargeCap's forward P/E fell to an 11-week low of 21.4 from 22.1 a week earlier and a 19-year high of 22.7 the week before that. That's up from 13.3 in mid-March, which was the lowest since March 2013. MidCap's was down 0.6pts w/w to a 17-week low of 18.8, which is down 4.1pts from its record high of 22.9 in early June. SmallCap's fell 1.1pts w/w to a 19-week low of 19.9 and is down 6.8pts from its record high of 26.7 in early June. That compares to MidCap's 10.7 and SmallCap's 11.1 in mid-March, which were their lowest readings since March 2009. LargeCap's forward P/E in mid-February—before COVID-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, where it mostly has been since August 2018. It was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a fourth week and for the first time since May. SmallCap's P/E had

been mostly below from May 2019 to May 2020 after being solidly above since 2003. During mid-March, SmallCap's P/E was briefly below MidCap's for the first time since July 2008.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Analysts are adjusting their estimates slightly higher for Q3 as the quarter begins to wind down. During the Q2 earnings season, which came in substantially better than expected, they adjusted their future forecasts higher instead of lower as is the norm. In the latest week, the S&P 500's Q2 blended EPS estimate/actual rose 2 cents w/w to \$28.11. That \$28.11 estimate represents a decline of 32.0% y/y on a frozen actual basis and -30.2% y/y on a pro forma basis. For Q3, the estimate rose 4 cents w/w to \$32.49, which represents an earnings decline of 22.9%, or 22.3% on a pro forma basis. That compares to a 12.8% decline in Q1-2020, a 3.1% gain in Q4-2019, a 0.3% decline in Q3-2019, and y/y gains of 3.2% in Q2-2019, 1.6% in Q1-2019, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). The last time earnings fell markedly y/y was during the four quarters through Q2-2016. Just three of the sectors have recorded positive y/y earnings growth during Q2: Health Care, Tech, and Utilities. That's a big improvement from Q1 when all 11 sectors posted a y/y decline in earnings. Looking ahead to Q3, six of the 11 sectors are expected to post less worse growth on a q/q basis, reflecting the reopening of the US economy. Energy is expected to report a second straight quarterly loss during Q3. Here are the S&P 500 sectors' latest Q3-2020 earnings growth rates versus their Q2-2020 growth rates: Information Technology (-1.4% in Q3-2020 versus 5.4% in Q2-2020), Health Care (-2.4, 6.8), Utilities (-3.5, 6.4), Consumer Staples (-6.7, -5.2), Real Estate (-14.3, -15.1), Materials (-19.5, -28.6), Communication Services (-20.7, -16.7), Financials (-23.3, -45.6), Consumer Discretionary (-39.3, -64.9), Industrials (-65.0, -82.5), and Energy (-107.0, -168.5).

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production ([link](#)): The bounce back from the COVID-19 lockdown was still going strong in July, building on May's record-breaking advance. Output climbed 4.1% in July and 28.0% over the three months ending July to within 7.3% of its pre-pandemic level; production had plummeted 27.5% during the two months through April. Here's a look at how the main industrial groups fared during the three months through July, and where they stand in relation to February levels: consumer durable goods (+94.5% & -4.4%), capital goods (+51.9 & -7.8), intermediate goods (+22.6 & -9.7), consumer nondurable goods (+13.1 & -3.7), and energy (+7.2 & -2.5). Here's the same exercise for the top four Eurozone economies: Italy (+64.4% & -5.3%), France (+41.4 & -7.2), Spain (+43.1 & -3.4), and Germany (+24.1 & -11.7).

Looking ahead, according to August's IHS Markit M-PMI, the recovery in the Eurozone's manufacturing sector continued during August. Output and new orders both rose at markedly faster rates, with the M-PMI above 50.0 for the second month; August's reading of 51.7 was little changed from July's 51.8, which was up from June's 47.7; it was at a low of 33.4 in April.

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