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PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

# U.S. Equities: Back to the Future?

June 2023

- U.S. large-cap growth stocks have delivered exceptional returns year-to-date with a handful of mega-cap tech stocks accounting for nearly 90% of the U.S. market's gains.
- We view this runup as an overextrapolation of a modest improvement in fundamentals that does not warrant such price action.
- As such, we see this speculative excess as an opportunity to deploy capital into more attractively valued equities both within, and especially outside, the U.S.

For many investors, the past three months might conjure up a sense of déjà vu. In a pattern reminiscent of the COVID era, U.S. tech-oriented large-cap growth stock multiples have exploded. On the back of their strength, U.S. equities have overtaken other developed and emerging markets in terms of year-to-date performance. (Figure 1)

In this brief note, we offer our take on salient themes that have driven equity market performance in 2023 as well as on the outlook going forward. While the U.S. large-cap growth runup has a basis in economics and fundamentals, we provide evidence that valuations have become stretched. Based on that view, we believe that U.S. large-cap growth has again become expensive and, by extension, that other markets and market segments look relatively attractive.

## A Narrow Rally

Through the first five months of the year, U.S. equities have risen nearly 10%. They have recently pulled ahead of other developed markets (DM) and are well in front of emerging markets (EM) too, which are roughly flat on the year. Large-cap growth stocks have led the way; the MSCI USA Large Cap Growth Index has climbed more than 27%, much of that during a steady advance since mid-March.

As has been chronicled in the financial media, however, the runup has been quite narrowly based. Just seven large-cap tech companies, which we might refer to as the MANAMANs,[1] have accounted for almost 90% of the MSCI USA Index's gain.[2] Moreover, MSCI's Small Cap U.S. growth benchmark has underperformed its large-cap cousin by a remarkable 21% YTD.

### Figure 1: 2023 Year-to-Date Performance—Select MSCI Equity Indexes

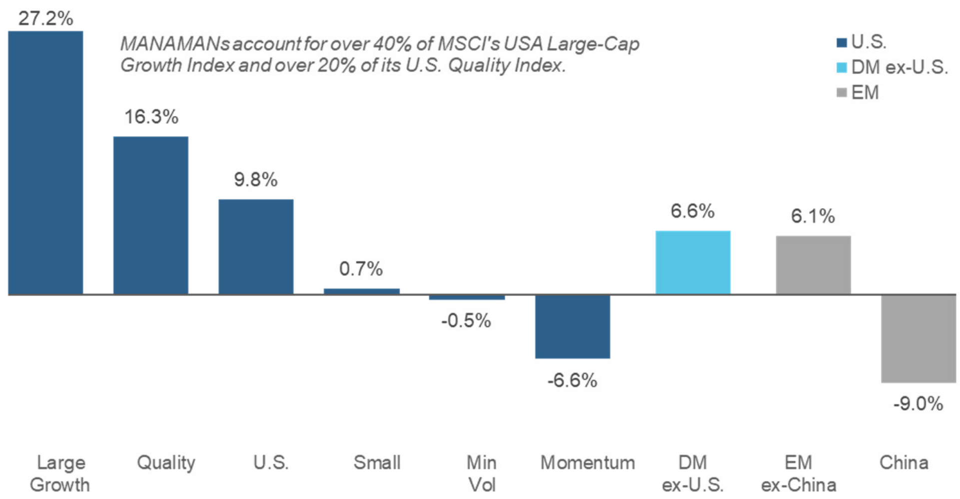


*Chart shows cumulative Gross Total Return in USD through 05/31/2023 of MSCI indexes. Source: Acadian based on data from MSCI. MSCI data copyright MSCI 2023. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. It is not possible to invest in any index. Past performance is not indicative of future results. Every investment program has the opportunity for loss as well as profit. This is an educational exhibit. For illustrative purposes only.*

[1] Microsoft, Apple, Netflix, Alphabet, Meta, Amazon, and Nvidia. References to these and any other specific companies in this write-up should not be construed as recommendations to buy or sell any securities.

[2] 8.8% of 9.8% through May 31, 2023.

For investors, a key question is whether this narrow tech-led U.S. growth rally will persist or might even herald a resumption of explosive multiple expansion characteristic of the COVID era.

## Drivers of the Runup

Undoubtedly, substantive fundamental and economic drivers have contributed to this runup. The dark blue trace in Figure 2 shows that earnings estimates for the MANAMANs stabilized in early 2023 and have risen since, increasing 5% in May alone. This reflected a combination of factors, including some reduction in concern about a Fed-led contraction as inflation started to cool. It has also reflected a ChatGPT-inspired focus on advancements in AI and hopes for its commercialization. Several of the MANAMANs are viewed as direct beneficiaries of these technologies because they produce inputs required to apply them in scale, especially the chip-designer NVIDIA, or have made substantial early investments in AI itself, such as Microsoft, Apple, and Alphabet.

But aspects of sentiment have played a role as well. Large-cap growth stocks benefited from a flight to quality during March, as investors sought the most reliable producers of fundamental earnings growth amid concerns that financial instability originating with regional U.S. banks might weigh on the economy. In fact, Figure 3 shows that the Fama-French U.S. large-cap growth portfolio dramatically outperformed all other market segments during March.

## Speculation and Growth Valuations

But in this runup we also see signs of renewed speculation that is vulnerable to reversion. Tech stocks, and particularly AI-related ones, are behaving much like "work from home" stocks did in 2020. Returning to Figure 2, the light blue trace shows that price increases have far outstripped the rise in earnings expectations, suggesting that investors are capitalizing expectations of even higher future growth. In fact, collective MANAMAN market values are within 15% of their 2021 peak. Moreover, Figure 4 documents that forward-earnings multiples of the MANAMANs have expanded dramatically during 2023, and much more so than major equity indexes. The MANAMAN premium versus the U.S. index is essentially at highs last seen in August 2020. At a time when discount rates are substantially higher than their 2020 lows, long-term earnings growth rates would have to rise sharply to justify MANAMANs' current multiples.

Given this evidence, we view U.S. large-growth stocks, and the benchmarks in which they have significant weight, as vulnerable to retracement relative to the broader market and non-U.S. equities. In fact, as Figure 4 shows, U.S. equities currently trade at a significant premium, on the order of 50%, relative to other markets.[3] This is not a call that the U.S. will falter as an engine of technological innovation, with respect to AI or more broadly, or that the U.S. market is due for a major drawdown. Rather, it is a view about *relative* attractiveness on the basis of valuations. This is also not to say that all AI-related companies are overvalued. The present context is one in which we would expect markets to have trouble understanding and evaluating the complex web of relationships that companies have with these new technologies.[4] Indeed, for some stocks, the market may not appreciate the potential for fundamental growth, and for others, sentiment may become so strong as to warrant a forecast of further gains in the short-term.

### Figure 2: MANAMAN Earnings Expectations and Market Capitalizations

Normalized versus December 31, 2015

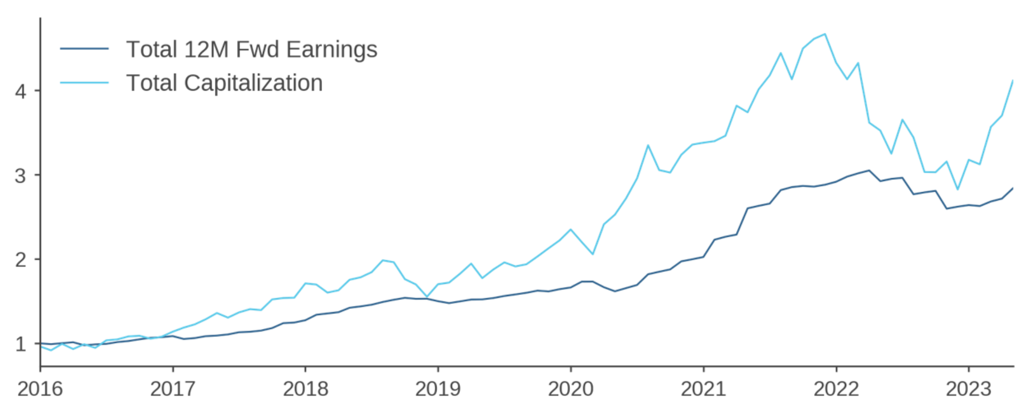


*Chart shows total IBES 12-month-forward earnings expectations and total market capitalization for Microsoft, Apple, Netflix, Alphabet, Meta, Amazon, and Nvidia. Source Acadian. This is an educational exhibit. For illustrative purposes only.*

[3] For more details, see Opportunities Beyond U.S. Shores, Acadian, 2023.

[4] Perhaps indicative of the challenges facing investors in parsing corporate rhetoric around the use of AI, FactSet noted that more companies used the term "AI" in Q1 2023 earnings calls than at any point over the prior decade.

### Figure 3: March 2023 Performance—Select U.S. Equity Style Groups

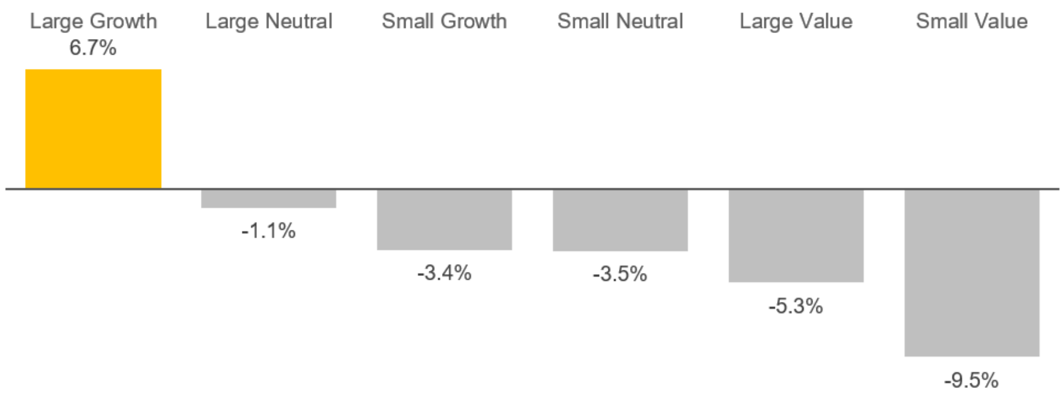


*Chart shows March 2023 returns calculated from U.S. monthly factor returns as found in the "6 Portfolios Formed on Size and Book-to-Market (2 x 3)" file at Kenneth R. French data library. Copyright 2023 Kenneth R. French. All Rights Reserved. Hypothetical returns do not represent investment returns generated by actual trading, an actual portfolio, or an investible strategy and are not indicative of future results. Every investment program has the opportunity for loss as well as profit. This is an educational exhibit. For illustrative purposes only.*

### Figure 4: Price to Forward Earnings Ratios—MANAMANs vs Select MSCI Equity Indexes

12M Forward P/E (Percent Change) as of May 31, 2023

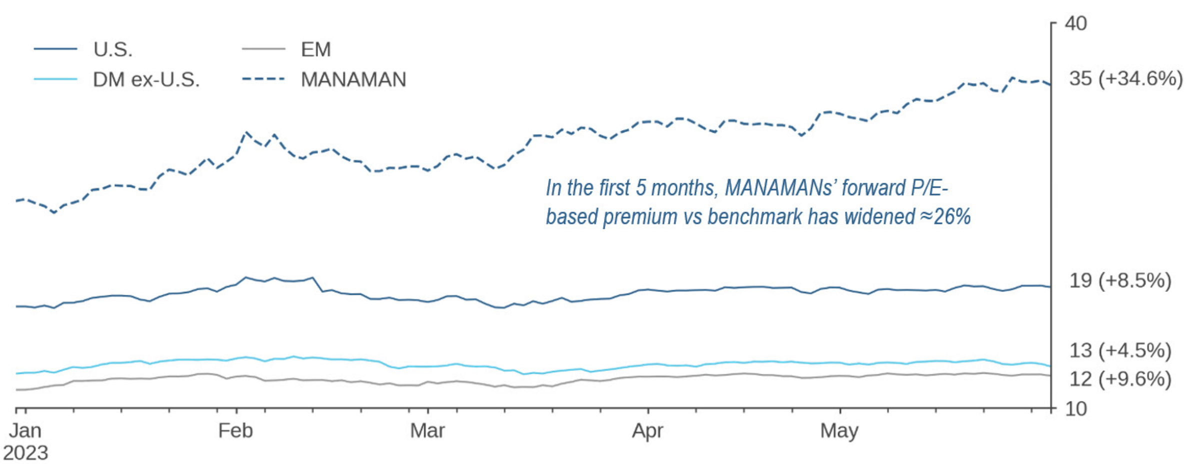


*Chart shows the 12M forward P/E of the MSCI USA Index, MSCI World ex-U.S. Index, MSCI EM Index and the MANAMANs. Source: Acadian based on data from Bloomberg, IBES, and MSCI. MSCI data copyright MSCI 2023. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI. This is an educational exhibit. For illustrative purposes only.*

## Conclusion

In our 2020 work on diversification, we cautioned investors against chasing strong performance of U.S. large-cap growth stocks.[5] Their protracted run of dominance ended abruptly in 2022. As we consider the environment today, we would see this speculative excess as an impetus to seek out more attractively valued areas of the equity markets both within the U.S. and, particularly, elsewhere.

[5] See Re-examining Diversification: 20/20 Perspective, Acadian, 2020.

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