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SUMMARY

- We believe there is little evidence that narrow breadth kills a bull market.
- Market breadth has been broadening in June, in our view.
- Valuations are above average, but we do not believe they are near bubble levels.

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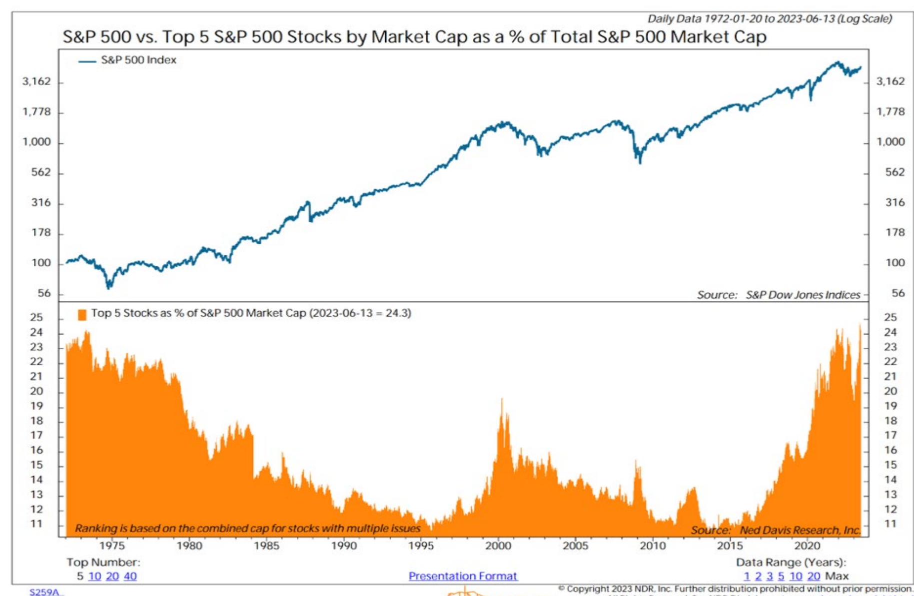
'Narrow' Markets are Not a Bad Omen for Stocks

Dispelling Three Widely Held Perceptions About the Current Stock Rally

This year, the US stock market has climbed the proverbial 'wall of worry', confounding the bears fixated on high inflation, the March banking crisis, and the debt ceiling. As these concerns have receded, the current fear *du jour* is now the 'narrow breadth' of 2023's S&P 500 rally, with just a few high-flying mega-capitalization tech companies responsible for most of the index's gains.

The S&P 500 is up over 13% year-to-date (YTD) through June 14. An 'equal-weighted' version of the S&P 500 – the same stocks, but with each of the 500 weighted equally - is up less than 4% over the same time period. The weightings of the top five largest stocks in the 'cap-weighted' S&P 500 - Apple, Microsoft, Amazon, Alphabet and Nvidia - make up over 24% of the entire index as of June 13…a five-decade high, according to Ned Davis Research (NDR) (see chart below).

Is this narrow breadth a reason to be bearish on the S&P 500? In defiance of some market perceptions, we don't think so. Below we provide some historical reasoning for challenging these perceptions.



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Perception #1: "Narrow Leadership is Bad for Future Market Returns"

Reality: We were unable to find historical proof that a 'narrow market' is consistently a bad omen for stocks.

We agree that narrow breadth in bull markets tend not to persist over time. However, narrow markets don't only resolve themselves to the downside, with the high-fliers collapsing as in 1973's 'Nifty 50' bear market, or the bursting of the late 1990's 'Tech bubble' in 2000. At least as often the reverse happens, whereby the rest of the market strengthens and catches up to

the early leaders, broadening out breadth and adding another leg to the stock rally. Examples of this include 1980, when the US was coming out of recession, and more recently in 2020, as it became clear the economy was in the process of recovering from the pandemic. These are both periods where the S&P 500 went meaningfully higher over the next year.

As of the end of May, about 20% of the constituents of the S&P 500 were outperforming the index itself on a rolling basis over the prior three months. In the last 50 years, there are only nine other time periods where this percentage has been below 30%. In six of these nine instances, the S&P 500 was actually higher 3 and 6 months later, according to NDR Research.

In studying thousands of historical outcomes going back to 1927 using a broad all-cap US stock index, our opinion is that neither the probability nor the magnitude of positive 3-month forward stock returns were significantly impaired during periods when the number of stocks declining outpaced those advancing (another measure of breadth). This challenges the view that narrow breadth is consistently bad for stocks.

Perception #2: "Current Market Breadth is Poor"

Reality: Across a broad set of indices, advancers are now starting to outnumber decliners and the majority of stocks are now trading above their moving averages, suggesting to us market leadership is broadening.

RiverFront's investment team monitors a variety of market breadth indicators across different indices, some of which serve as inputs into our historical modelling that helps inform our tactical asset allocation decisions. One of them is the number of index stocks making new 52-week highs versus new lows (New Highs vs New Lows); another input tracks the percentage of stocks in an index that are trading above their longer-term moving averages. A mosaic view into these metrics suggests to us that breadth is actually improving in June, not worsening.

For instance, New York Stock Exchange (NYSE) stocks making new 52-week highs are now outpacing ones making 52-week lows for much of the last few months, suggesting high and rising breadth. In addition, 61.8% of S&P 500 companies, 70.5% of NDR small-cap, and 72.3% of Nasdaq 100 stocks are trading above their 50-day moving averages as of June 14. This suggests to us that under the surface, breadth is actually broadening in June, dispelling the perception that the market rally is only being driven by a small handful of stocks.

Perception #3: "With the Tech Stock Mania, the S&P 500 is now in a Market Bubble"

Reality: S&P 500 valuations are trading higher than historical averages, but nowhere near 'Tech Bubble' levels.

Despite the recent tech-led rally, the S&P 500 does not appear dramatically overvalued to us, trading at roughly 18x 12-month forward earnings estimates. While 18x is at the upper end of valuations during non-recessionary periods and a bit higher than the long-term average of roughly 16.5x, it is not anywhere near the 24x number seen at the height of the 'Tech Bubble' period from 1998-2000 (chart right, shaded region), before tech stocks spectacularly flamed out. In fact, today's valuation levels were visited multiple times prior to COVID.

Source: Refinitiv Datastream, RiverFront. Data monthly as of June 14, 2023. Chart right shown for illustrative purposes.

Conclusion: Breadth Itself not a Reason to be Bearish; Markets Sending us Increasingly Positive Message"

With the S&P 500 having definitively broken out above its 'decision box' range of 3800-4200 laid out in prior weeklies, we are modestly bullish and thus slightly overweight equities in our portfolios. While we prefer select mega-cap technology stocks as a theme, we also recognize the growing opportunity in equities outside that universe as market breadth broadens. Some other preferred portfolio themes include dividend sustainability, reflation plays in energy and materials, and moving down in size, both broadly and specifically in industrials in our longer-horizon portfolios.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Ned Davis Research (NDR) is a global provider of independent investment research, solutions and tools. Founded in 1980, NDR helps clients around the world make objective investment decisions.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

The Nifty Fifty was a group of 50 large-cap stocks on the New York Stock Exchange that were most favored by institutional investors in the 1960s and 1970s. Investment in these top 50 stocks—similar to blue-chip stocks of today—is said to have propelled the American economy to its bull market of the 1970s. Companies in this group were usually characterized by consistent earnings growth and high P/E ratios.

Tech bubble refers to a pronounced and unsustainable market rise attributed to increased speculation in technology stocks. Rapid share price growth and high valuations based on standard metrics, such as price/earnings ratio or price/sales, normally characterize a tech bubble.

Mega cap is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion.

The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks. These non-financial sectors include retail, biotechnology, industrial, technology, health care, and others.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

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