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US equity opportunities beyond the Magnificent Seven

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Key takeaways

- High earnings expectations combined with a slowing economy may make the stock market prone to disappointments in 2024.
- The "dot-com" period, which featured similar index concentration and falling interest rates, offers clues to trends this year.
- We see attractive potential in areas that would allow investors to diversify their US equity portfolios beyond the Magnificent Seven.
- The fundamental characteristics across the largest companies, imply superior earnings power than in the past, with valuations more attractive for those outside the Magnificent Seven.
- Smaller companies exhibit particular characteristics that make them more attractive in today's environment.

The outlook for US equities in 2024 has a rare complicating factor—the high concentration at the top of the S&P 500 Index, where the largest seven stocks represent more than 25% of the index by market capitalization. Lifted by investor enthusiasm for the potential of generative artificial intelligence (AI), these "Magnificent Seven" stocks led performance in a market otherwise weighed down by concerns about recession and tighter financial conditions as the Federal Reserve (Fed) worked to bring down inflation.

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To gain insight on what this concentration might mean, we consider a period with similarities to today—the end of the dot-com era in 2000 and 2001. At that time, optimism for the growth potential of the internet resulted in a similar concentration at the top of the S&P 500. Gross domestic product (GDP) growth was beginning to decelerate, and the Fed was preparing to reduce interest rates. At Franklin Templeton Institute, we expect similar conditions in 2024, with the global economy likely to slow and central banks likely to cut rates. We believe market leadership might shift to areas of undervalued earnings power outside the Magnificent Seven, including both megacaps as well as small caps that offer sustainable earnings quality.

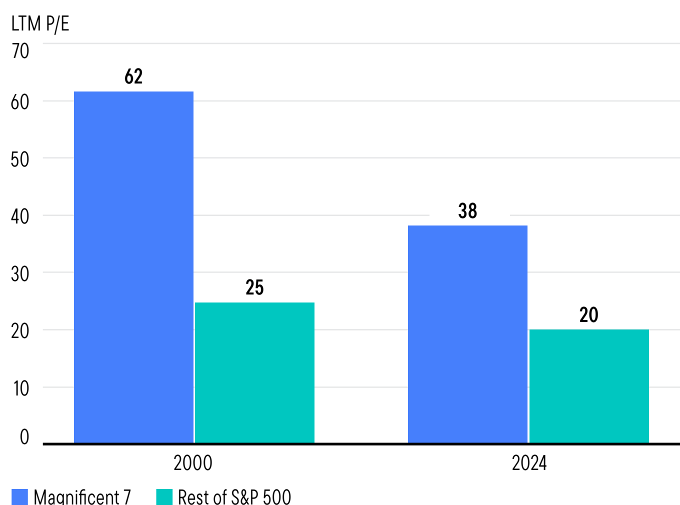
Unwinding index concentration, 2001 and 2024

At the end of 2023, the Magnificent Seven stocks represented more than 25% of the market capitalization of the S&P 500. At the end of the dot-com bubble in 2000, index concentration also reached a multi-year peak. In both cases, the price-to-earnings ratio (P/E) of the top seven stocks far exceeded the average P/E of the overall index.

Exhibit 1: The Index Became More Concentrated as the Magnificent Seven Stocks Outperformed

S&P 500 Index Concentration
Sum of Top Seven Constituents' Weights
Period from January 1990 until December 2023

Magnificent Seven vs. Rest of S&P 500
Last 12-months Price to Earnings



Sources: Bloomberg, FactSet. Analysis by Franklin Templeton Institute. The largest seven stocks in March of 2000 were Microsoft, Cisco Systems, General Electric, Intel, Exxon Mobil, Walmart Inc., and Oracle Corporation. The Magnificent Seven stocks in January of 2024 were Microsoft, Apple, NVIDIA, Amazon, Alphabet Inc., Meta Platforms Inc. Class A, and Tesla. Last 12-Month (LTM) P/E multiples are market-cap weighted.

Along with index concentration, both the S&P 500 and the Nasdaq indexes set a series of records before peaking in the first quarter of 2001. Market leadership then rotated to favor small caps while a slowing economy prompted the Fed to begin cutting rates. At the end of 2023, small caps began to close the gap with the Magnificent Seven but fell behind again in the first weeks of 2024. The first rate cut of this cycle may be months from now, but the decline in recession risk removes a potential headwind for the asset class.

Megacap earnings may stand out

We base our market 2024 outlook on our Global Investment Management Survey, which reflects the input of over 300 portfolio managers across Franklin Templeton.[1] The survey view is that GDP growth will slow from the 2023 pace while remaining positive. We also believe corporate earnings will grow at a pace of 6%, which is below the industry consensus of closer to 10%. While we are less optimistic, we still view positive earnings growth within a slowing economy to be supportive for equity portfolios. Also, selective opportunities can arise from small advantages. In addition to the lower interest burdens we highlighted for small caps, we believe it is important to seek out sustainable earnings quality among large caps.

The market will likely be prone to earnings disappointments in 2024 and is likely to prize companies with the ability to generate sustainable earnings growth. We see some of the best opportunities one level removed from the Magnificent Seven, in the other megacaps that make up the top 20. Companies in this group are likely to see steady improvement in earnings per share. They are extending their recovery after the challenges of the COVID pandemic (Exhibit 2). While the average earnings growth across the Magnificent Seven is expected to be 24% in 2024, the next 13 companies are expected to grow earnings by 15%; both rates are well above the forecast for the broad market.[2]

Exhibit 2: The Largest 20 US Companies are Likely to Continue Earnings Uptrend

Top 20 S&P 500 Constituents, Earnings-per-Share Growth for 2022 and Estimates for 2023–2025

As of February 8, 2024

			EPS Growth			
Ticker	Company	Sector	2022	2023E	2024E	2025E
AAPL	Apple Inc.	Information Technology	(2%)	9%	4%	7%
BRK.A	Berkshire Hathaway Inc.	Financials	15%	22%	4%	8%
JPM	JPMorgan Chase & Co.	Financials	(21%)	34%	(1%)	1%
XOM	Exxon Mobil Corporation	Energy	161%	(32%)	(9%)	13%
HD	The Home Depot, Inc.	Consumer Discretionary	7%	(10%)	4%	7%
JNJ	Johnson & Johnson	Health Care	4%	(2%)	8%	3%
LLY	Eli Lilly and Company	Health Care	(3%)	(20%)	98%	45%
PG	The Procter & Gamble Company	Consumer Staples	1%	12%	5%	8%
UNH	UnitedHealth Group Incorporated	Health Care	17%	13%	11%	13%
WMT	Walmart Inc.	Consumer Staples	(3%)	3%	10%	9%
MSFT	Microsoft Corporation	Information Technology	3%	21%	10%	17%
COST	Costco Wholesale Corporation	Consumer Staples	14%	9%	9%	12%
AMZN	Amazon.com, Inc.	Consumer Discretionary	N/A	N/A	41%	30%
NVDA	NVIDIA Corporation	Information Technology	(25%)	268%	66%	18%
MA	Mastercard Incorporated	Financials	27%	15%	18%	16%
GOOGL	Alphabet Inc.	Communication Services	(19%)	27%	16%	16%
META	Meta Platforms, Inc.	Communication Services	(38%)	73%	33%	14%
V	Visa Inc.	Financials	25%	14%	14%	13%
AVGO	Broadcom Inc.	Information Technology	33%	6%	19%	16%
TSLA	Tesla, Inc.	Consumer Discretionary	80%	(23%)	1%	35%
Average/ Magnificent 7			**(0%)**	**62%**	**24%**	**20%**
Average/ The Other 13			**21%**	**5%**	**15%**	**13%**

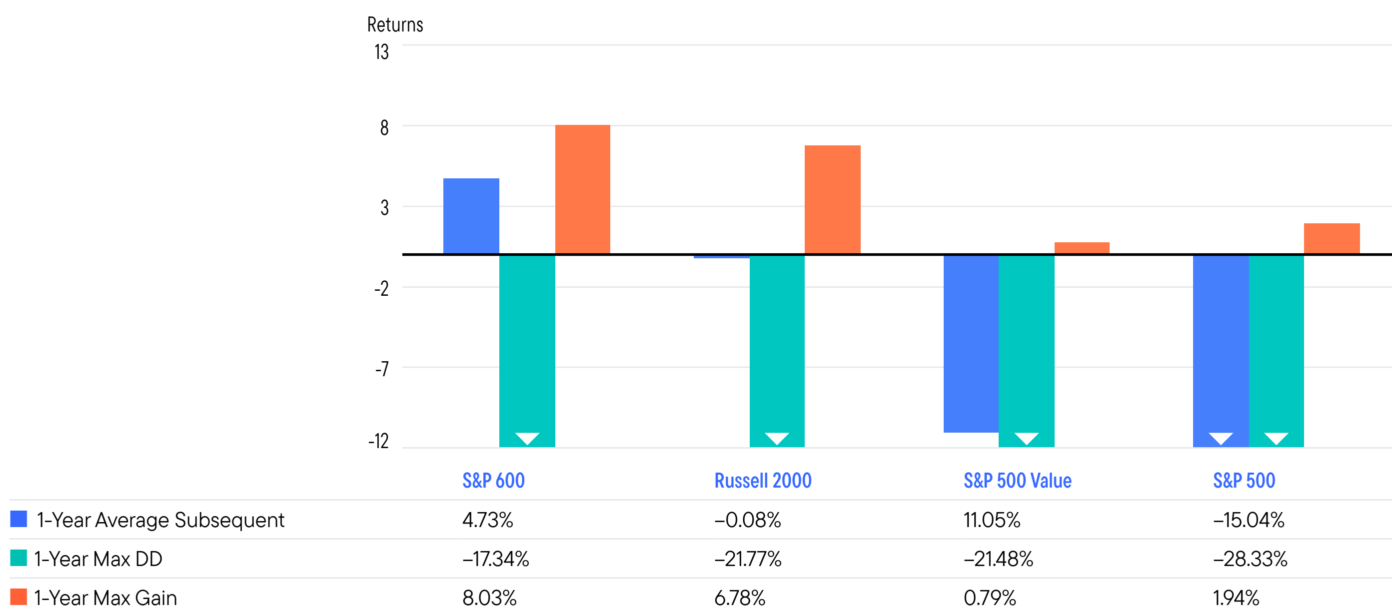
Source: S&P Global, median analyst estimates as of February 8, 2024. There is no assurance that any estimate, forecast or projection will be realized.

While these megacaps stand out, we believe they are indicative of more widespread opportunities to find sustainable earnings quality across large caps in multiple sectors. Active managers may have an advantage in identifying and selecting these idiosyncratic opportunities. Our Institute survey highlights the key factors likely to distinguish sustainable growers: They will have the ability to generate high free cash flow yield and return on equity. Firms that can churn out cash will be able to choose whether to make capital investments or reward shareholders with dividends. Note that we distinguish stocks that can grow dividends, which is a sign of financial strength, from stocks with a high current dividend yield, a group which typically includes cyclical or over-leveraged companies that may find the current period of slowing economic growth and higher borrowing costs more challenging.

Exhibit 3: One-Year Performance Following the First Rate Cut in 2001

Performance of S&P 600 Index, Russell 2000 Index and S&P 500 Index

January 3, 2001–January 3, 2002



	S&P 600	Russell 2000	S&P 500 Value	S&P 500
1-Year Average Subsequent	4.73%	–0.08%	11.05%	–15.04%
1-Year Max DD	–17.34%	–21.77%	–21.48%	–28.33%
1-Year Max Gain	8.03%	6.78%	0.79%	1.94%

Sources: S&P Dow Jones Indices, FTSE Russell. The S&P SmallCap 600® Index (S&P 600) is a market-capitalization-weighted index and measures performance of the small-cap segment of the US equity market. The Russell 2000® Index is a market-capitalization-weighted index and measures the performance of the approximately 2,000 smallest companies in the Russell 3000® Index. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

Aside from the parallel to the dot-com era, we also believe valuations and interest-rate sensitivity add to the case supporting this opportunity.

- Small caps continue to offer lower valuations, with the P/E ratio of the Russell 2000 at 14×, compared with 20× for the S&P 500.[3]
- Small caps carry more debt than large caps and may see a greater benefit if the Fed makes multiple interest rate cuts this year as expected. Companies in the Russell 2000 Index have a net-debt-to-EBITDA ratio of 3.2, compared with an average of 1.6 for S&P 500 companies.[4]
- Small caps tend to carry more adjustable-rate debt, and the burden of interest payments on operating earnings could fall as the Fed cuts rates. Only 55% of Russell 2000 companies have fixed-rate debt, which compares with 91% of S&P 500 firms.[5]

Focus on quality

We favor a selective approach this year, looking for pockets of opportunity with a focus on quality. While this outlook may seem tempered, recall that it was not long ago that recession loomed and could have seriously undermined earnings. Instead, we see the likelihood that equity portfolios will benefit from continuing economic and earnings growth, falling inflation and lower interest rates. Small caps appear poised to benefit from macro tailwinds, while megacaps outside the Magnificent Seven may outperform as the market pays closer attention to valuation and earnings quality.

Endnotes

1. The Franklin Templeton Investment Management Survey produces an aggregate view by taking the average of answers provided by more than 300 portfolio managers across Franklin Templeton investment groups and Specialist Investment Managers, including equity, private equity, fixed income, private debt, real estate, digital assets, hedge funds and secondary private markets.
2. There is no assurance that any estimate, forecast or projection will be realized.
3. Source: Bloomberg, based on price-to-forward-12 months earnings before extraordinary items.
4. Source: FactSet. EBITDA is a measure of a company's profitability and represents earnings before interest, taxes, depreciation, and amortization.
5. Source: FactSet.

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