Taking Stock

RBC Wealth Management

November 20, 2023 | Portfolio Advisory Group – U.S. Equities

The home stretch: How the market arrived at this point ahead of year-end

This unique installment of the "Taking Stock" series visually highlights the forces impacting market performance in 2023 ahead of year-end, particularly given the strength in equity markets that's not necessarily being felt inside of all investor portfolios, unless overweights to these narrow pockets of leadership in mega-cap tech exist.

Specifically, the S&P 500 Index has climbed more than 15% year to date (YTD) with only three sectors delivering outperformance, while the Nasdaq Composite Index has doubled the broader index's return. The performance of both indexes has been fueled by the so-called "Magnificent 7" (Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla) delivering a company-average return of more than 90% this year. Specifically, underperformance has been felt most acutely in dividend stocks and the Dividend Aristocrats.

Going forward, dividend stocks and the Dividend Aristocrats look timely to us on a valuation-oriented basis, given their material underperformance in recent quarters.

This year's performance has occurred in the context of the fastest Federal Reserve rate hiking cycle on record, with 10-year Treasury rates hitting 5% in October, a level not seen since 2007. Rates have since backed off that level as October data showed that inflation, as measured by Consumer Price Indexes (CPIs), slowed more than expected by the consensus, providing a tailwind currently for equity markets.

Going forward, investors will be closely monitoring inflation data in juxtaposition with interest rates and the Federal Reserve, while also keeping an eye on the bigger picture—the economy. In the near term, inflation and interest rate developments may prove constructive for markets as they could indicate a greater probability of a soft landing. As such, we believe the remainder of 2023 will provide an opportunity for portfolios to position toward quality-based companies, which frequently pay a growing dividend, ahead of an easing inflationary environment and a to be determined 2024 outcome where macroeconomic risks still exist.

2023 performance has seen a wide dispersion of outcomes, with only three sectors outperforming the S&P 500, and the Nasdaq more than doubling the S&P 500's return.

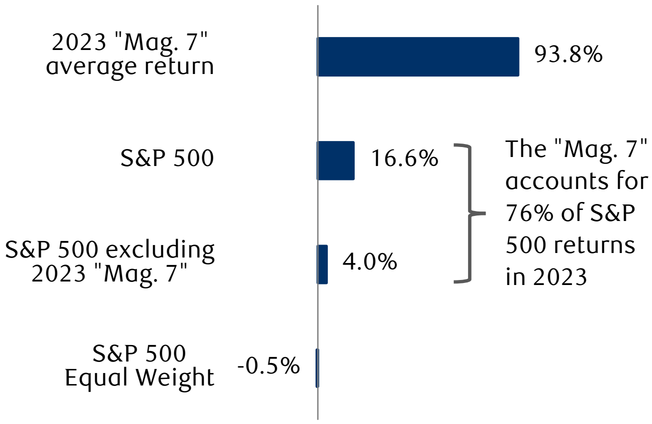
Equity market performance, year to date

Index	Price return YTD	% off 52-week high	Sector yield
Information Technology	47.0%	-0.4%	0.8%
Communication Services	45.5%	-1.0%	0.8%
Consumer Discretionary	27.4%	-7.6%	0.9%
Industrials	4.2%	-7.6%	1.7%
Materials	-0.6%	-9.8%	2.1%
Financials	-1.2%	-8.4%	2.0%
Energy	-5.1%	-11.4%	3.6%
Consumer Staples	-6.5%	-9.9%	2.7%
Health Care	-7.3%	-9.7%	1.7%
Real Estate	-7.3%	-18.0%	3.9%
Utilities	-14.7%	-16.7%	3.5%
Nasdaq Composite Index	31.8%	-4.5%	0.6%
S&P 500	15.0%	-4.2%	1.5%
Dow Jones Industrial Average	3.4%	-3.9%	2.0%

Source - RBC Wealth Management, FactSet; data through 11/10/23

Priced (in USD) as of 11/10/23 market close, ET (unless otherwise stated). Produced: Nov. 20, 2023 15:29 ET; Disseminated: Nov. 20, 2023 15:45 ET.

Magnificent 7 leadership has led to an extremely narrow market in 2023



Note: Magnificent 7 includes Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla

Source - RBC Wealth Management, FactSet; data through 11/10/23

Dividend stock underperformance in 2023 has been acute

S&P 500 year-to-date returns by dividend yield levels

	Yield = 0%	Yield < 1%	Yield < 2%	Yield < 3%	Yield > 3%
Average	9.5%	20.4%	6.4%	-2.4%	-13.9%
Best performer	165.7%	218.7%	63.0%	41.7%	43.6%
Worst performer	-75.0%	-46.0%	-60.8%	-53.0%	-58.0%
Percent of companies with returns greater than 0%	57.6%	79.0%	60.6%	41.0%	12.5%
Number of S&P 500 companies	99	62	104	83	152

Source - RBC Wealth Management, FactSet; data through 11/10/23

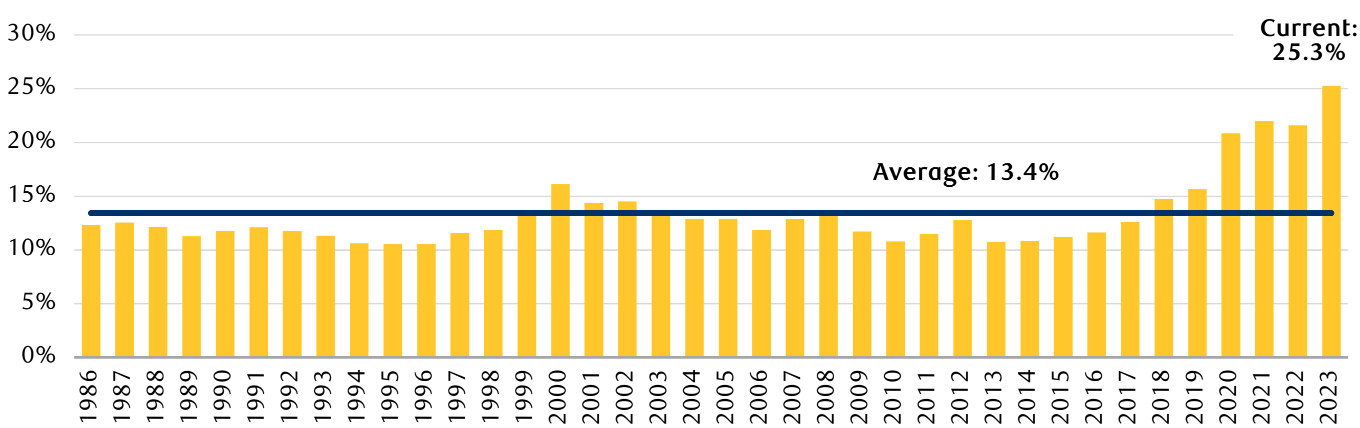
The so-called "Magnificent 7" has delivered an average return approaching 100% thus far this year, meaning these seven stocks have accounted for more than three-fourths of the S&P 500's return. Excluding these stocks, the S&P 500 would only be up 4% this year, and the equal-weighted version of the index is actually lower on the year (see top left chart).

The five largest publicly traded U.S. equities constitute more than one-fourth of the S&P 500, a level not seen in at least the last 37 years. On average, the five largest stocks in any given year represent 13% of the S&P 500. Today's concentration is nearly double that level (see bottom chart).

The dividend factor has been dramatically out of favor in 2023 as rates have moved higher. Specifically, stocks that pay a dividend of less than 1% or not at all have climbed 13% on average in 2023. Those with a yield greater than 3% have flipped the script and have posted an average decline (price-return) of 14% (see top right chart).

Five largest publicly listed U.S. companies as a percentage of S&P 500 market cap

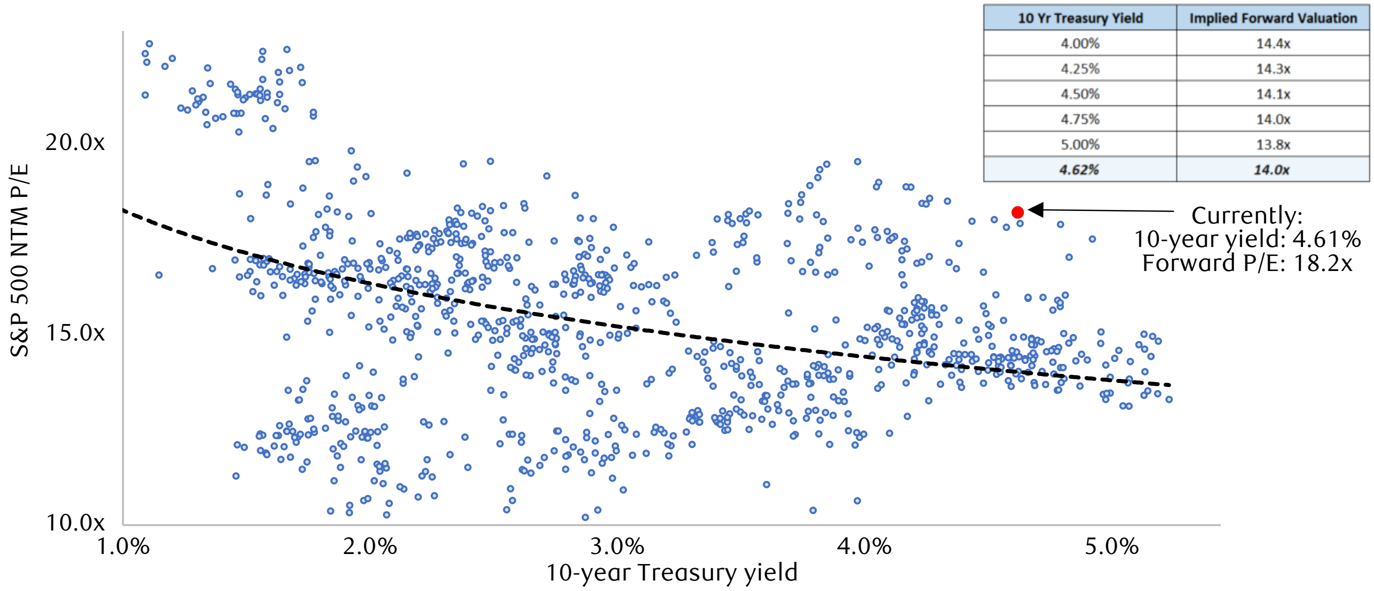
2023's top five companies include Apple, Microsoft, Amazon, NVIDIA, and Alphabet



Source - RBC Wealth Management, FactSet; data through 11/14/23

When viewed in relation to Treasury yields, equity markets look expensive in 2023. Going forward, it's hard for us to imagine equity market valuations expanding from current levels ...

Market valuations are at historically elevated levels in relation to Treasury yields



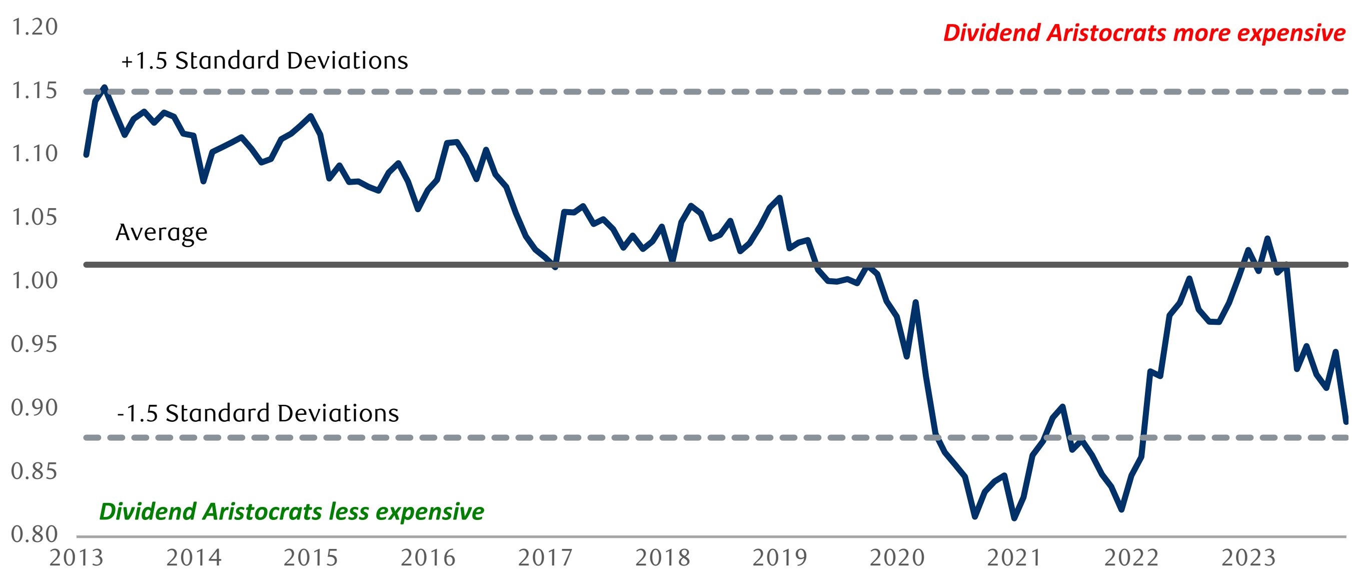
10 Yr Treasury Yield	Implied Forward Valuation
4.00%	14.4x
4.25%	14.3x
4.50%	14.1x
4.75%	14.0x
5.00%	13.8x
4.62%	*14.0x*

Note: S&P 500 price-to-earnings ratio using consensus next-twelve-months earnings per share (EPS)

Source - RBC Wealth Management, FactSet; data through 11/10/23

... however, pockets of the market look attractive on a valuation basis. The Dividend Aristocrats Index is trading near record-low valuations relative to the S&P 500, a setup we generally like for dividend stocks heading into 2024 ...

Dividend Aristocrats Index looks attractive relative to the S&P 500



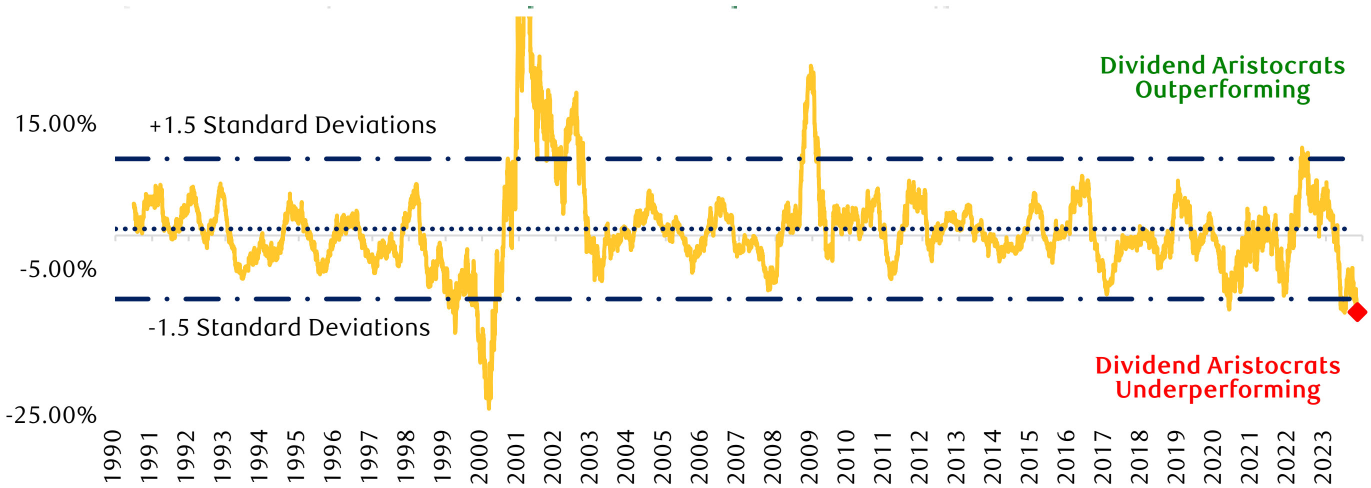
Note: Dividend Aristocrats price-to-earnings ratio relative to the S&P 500, using consensus next-twelve-months EPS

Source - RBC Wealth Management, FactSet; monthly data through 10/31/23

... and when looking at the Dividend Aristocrats' relative performance against the S&P 500 over the last six months, it's plain to see that underperformance is at the lows that have traditionally held and reversed trend. The one caveat being the run-up to the tech bubble in 2000 when Dividend Aristocrats' underperformance deteriorated beyond current levels.

Dividend Aristocrats Index underperformance at post-tech bubble extremes

Dividend Aristocrats rolling 6-month return relative to the S&P 500

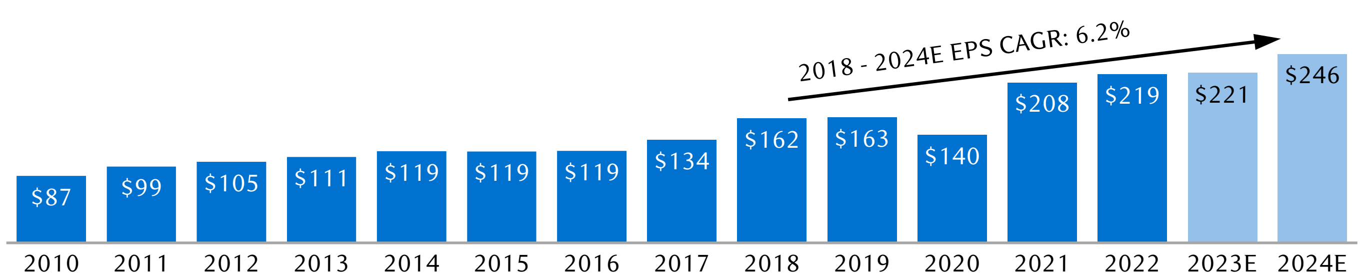


Source - RBC Wealth Management, FactSet; data through 10/31/23

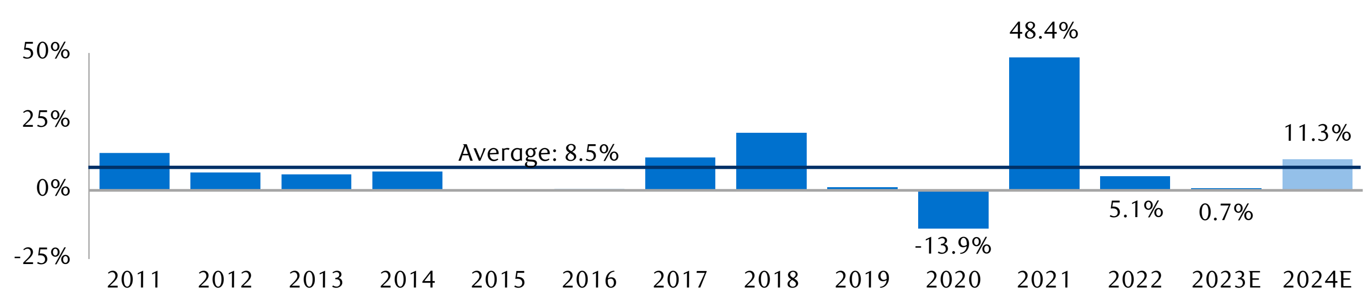
S&P 500 earnings, while volatile in the last five years, have only grown at an annualized rate of 6.2% from 2018 through the forecast 2024 level. The 2019 pause came on the heels of the Trump-era tax cuts, while the 2022–2023 pause came on the heels of the global pandemic and the related digestion required after nearly 50% growth in 2021.

Since 2011, earnings have grown 8.5% annually, on average. However, volatility in the growth rate has clearly materialized in recent years.

S&P 500 consensus EPS



S&P 500 consensus EPS, y/y percent change

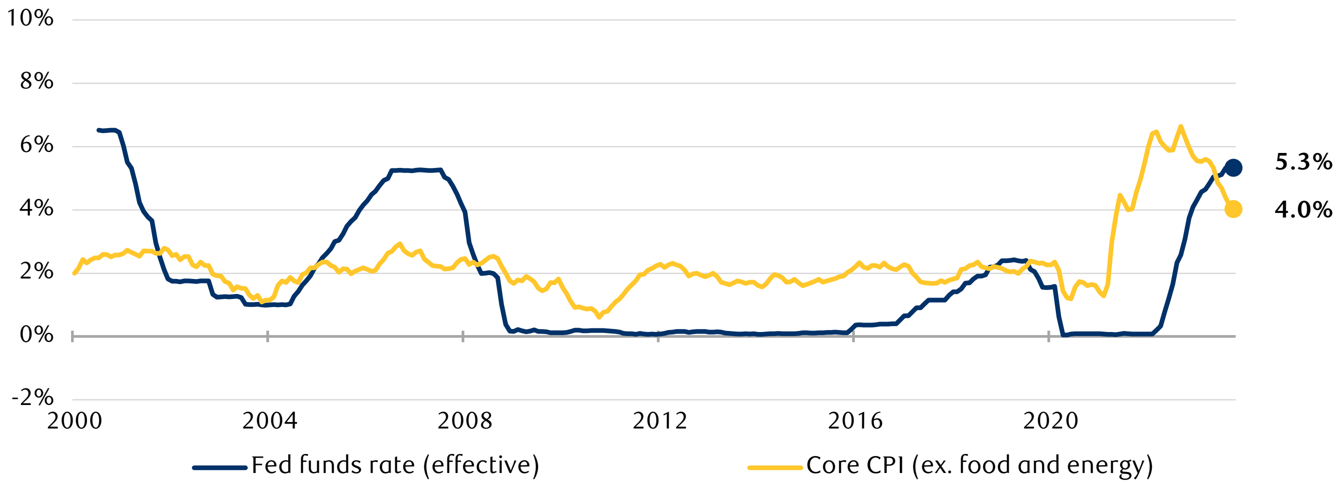


Source - RBC Wealth Management, FactSet; data through 11/10/23

The effective fed funds rate has only recently exceeded the level of inflation, as measured by the Core Consumer Price Index (excluding food and energy prices). This means monetary policy has only recently become restrictive. Nonetheless, it is now restrictive with interest rates in excess of inflation. Additionally, inflation is trending lower, faster than consensus expectations. This has been one of the tailwinds to equity market performance in recent days.

Fed funds rate recently exceeded core inflation level

Effective fed funds rate & U.S. Core Consumer Price Index y/y

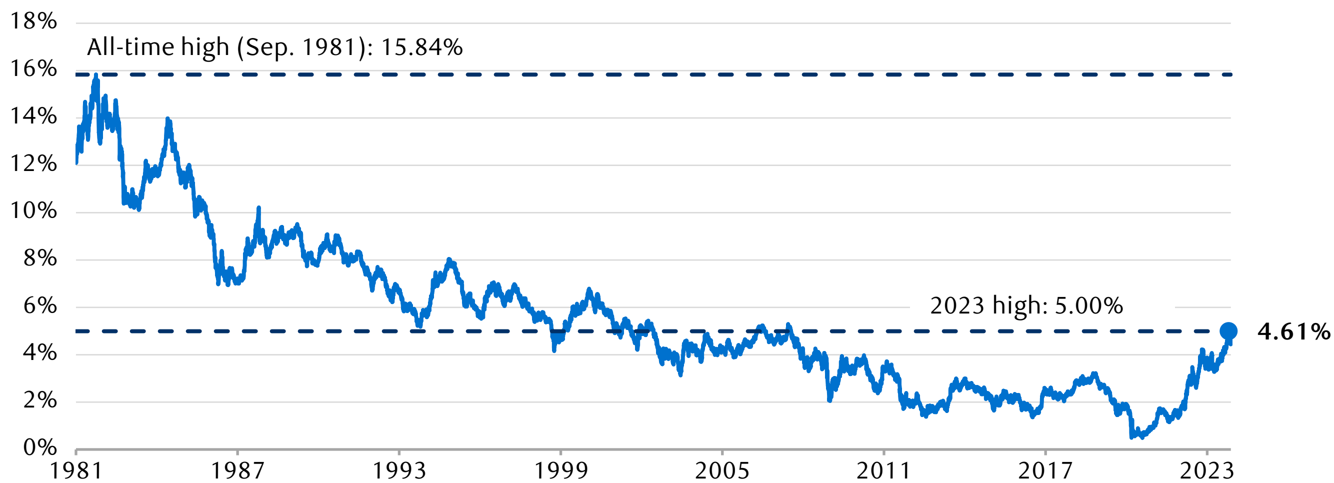


Source - RBC Wealth Management, FactSet; data through 10/31/23

As the 10-year Treasury rate has risen in 2023, it's important to step back and put that level into context. Certainly, it's risen quickly, and expecting equities to perform as they have in 2023 while rates move higher like they have was well beyond the beginning-of-year consensus expectation, and reasonably so. But here we are, and rates, while higher, remain well below levels seen in the past.

After hitting 5% for the first time since 2007, 10-year yields have moderated with inflation developments and ongoing Fed commentary

U.S. 10-year Treasury rate



Source - RBC Wealth Management, FactSet; data through 11/10/23

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