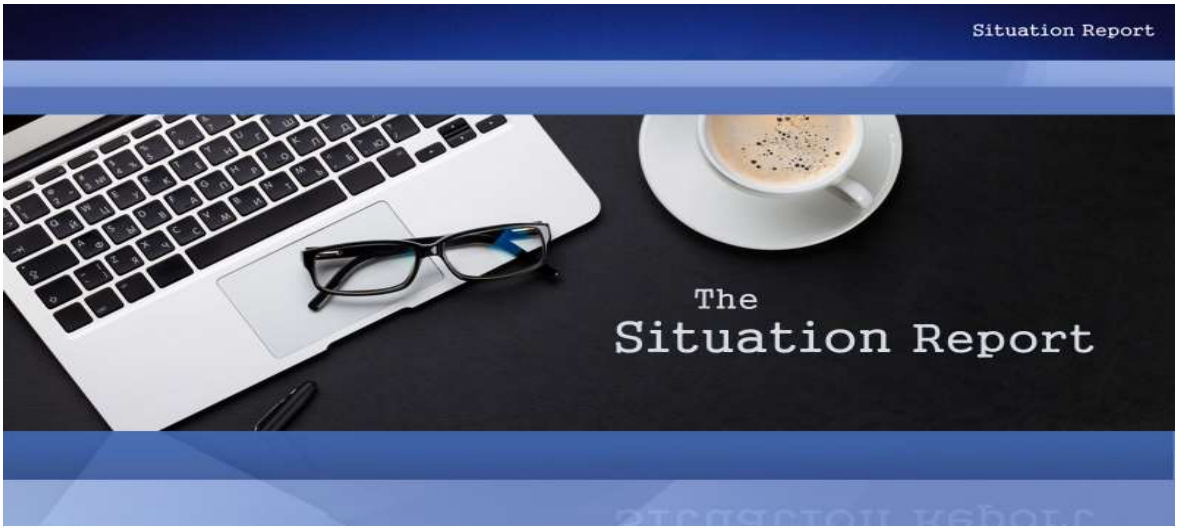


Record Concentration of Market Capital in 5 Largest Stocks

Figure 1.

Apple, Amazon, Google, Microsoft, Facebook = 22% of S&P 500
Investors are stoked. They are frantically buying up the "hot" Big Five stocks: Apple, Amazon, Alphabet/Google, Microsoft, and Facebook regardless of price. The pace is reminiscent of the "melt up" leading to the popping of the Tech Bubble in early 2000.

With much of the country in lockdown, the lion's share of consumer sales was captured by just a handful of companies. So, investors concluded: Why not just buy the stocks of these companies? -It sounds reasonable, but market history says, LOOK OUT!

Throughout history, whenever there have been similar "*Can't Lose"* bets in the financial markets, things did not end well.

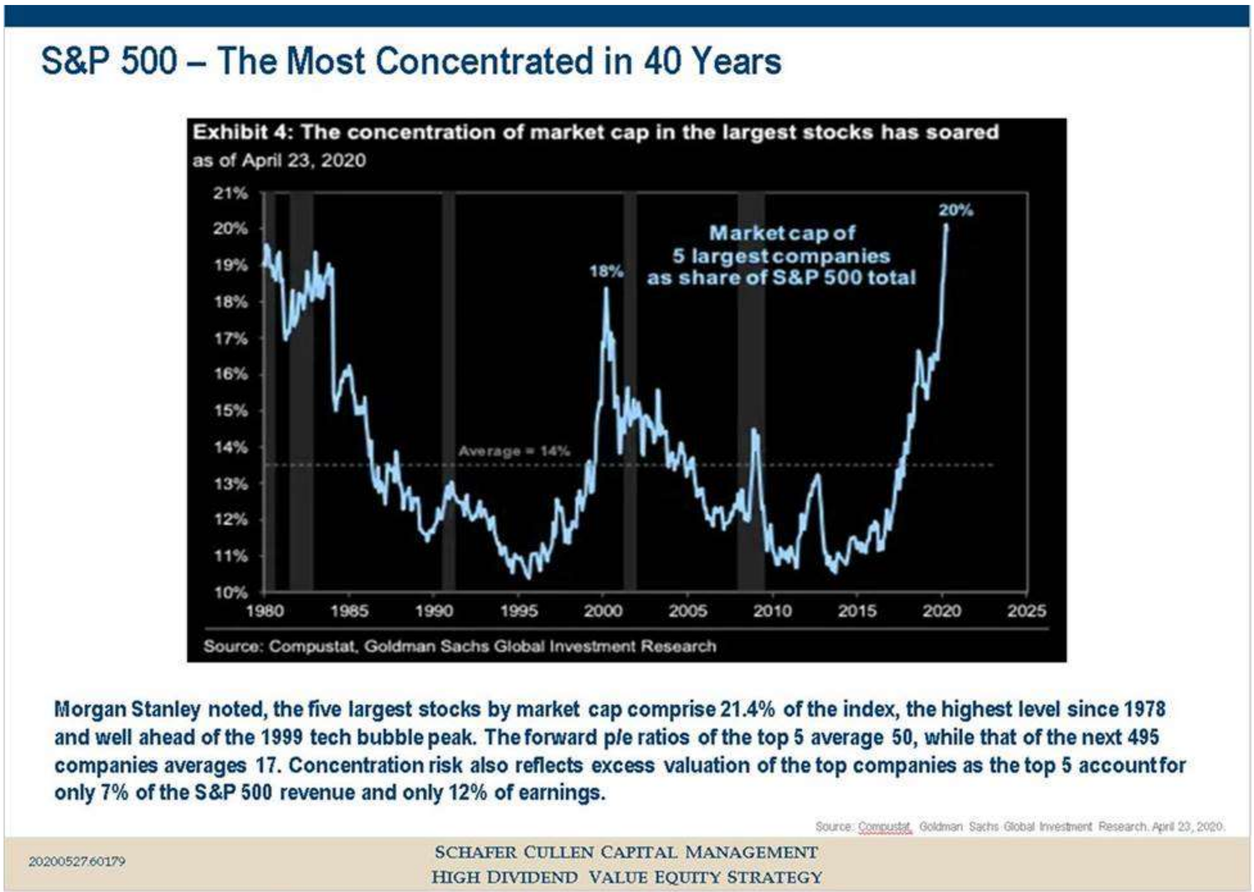


Figure 2. Source: Shafer Cullen Capital Management

After a long market advance, history shows that speculation builds and money tends to flow into fewer and fewer stocks, a concentration that coincides with major market tops.

Morgan Stanley reports that the five largest stocks by market capitalization (market cap) account for 21.4% of the S&P 500 index. That is the highest level since 1978 and well ahead of the 1999 tech bubble peak when the top five stocks at that time accounted for 18%. (See Figure 2. above).

Here's an interesting look at the S&P 500 for the month of June.

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

Souce: Ycharts

Figure 3. The chart compares the fundamentals for the 500 stocks in the S&P 500 Index

At the beginning of July, the Top 50 S&P stocks were showing positive year to date returns. 450 others were not. What is most reveling on the chart (above) is the *price to earnings,* (P/E) and *price to sales* (P/S) ratios.

<u>Ordinarily the P/E ratio of the SP 500 is around **16.**</u> In other words, the average price of a stock in the S&P is, on average, about 16-times earnings. Today, the P/E ratio of the 500 S&P stocks is high at about **23**, and the P/E of the Top 10 stocks is about **31**.

Also, <u>the price to sales ratio</u> of the Top 10 S&P stocks at **6.2** is about 2 ½ times the average price to sales of the S&P 500 at **2.4**. So, here is the kicker: The Top Five stocks account for only 7% of the S&P 500 revenue, and only 12% of sales earnings. Yet, look at the price to earnings ratios:

50
The average forward P/E Ratios the Top Five stocks

17
The average forward P/E Ratios of the next 495 stocks

Today, the S&P 500 index hinges on a very small group of stocks. That is not a healthy market situation.

If all of this sounds familiar, it is because it is very similar to the situation we reported to you in our January issue when the Big Five accounted for just 17% of the S&P 500 Market cap. This was just before the S&P 500 peaked in February and fell off over 35%.

We also mentioned that a healthy rally is one with broad participation. As the old market axiom goes: "a rising tide floats all boats." This market is leaving too many boats stranded. It is dependent on less than 2% of the S&P 500 member stocks for most of its growth.

A recent *Barron's* article pointed out that the concentration in the NASDAQ index is even more extreme. At the beginning of July, its ten largest issues, led by the FANG stocks - **F**acebook, **A**mazon, **N**etflix and **G**oogle (Alphabet)- were up +$900 billion this year, while the other 2600 or so stocks in the index were down -$300 billion.

Figure 4. Source: Michael Gayed Lag-Lead Report July 10, 2020

The divergence between the Nasdaq (blue) and the S&P 500 index (orange) is shocking and reminiscent of the tech bubble of the late 90s.

It's easy to see that the price of the Nasdaq market index has gone parabolic. In the 25 years of its existence, the Nasdaq 100 and the SP 500 ratio has only been this divergent one other time--1999.

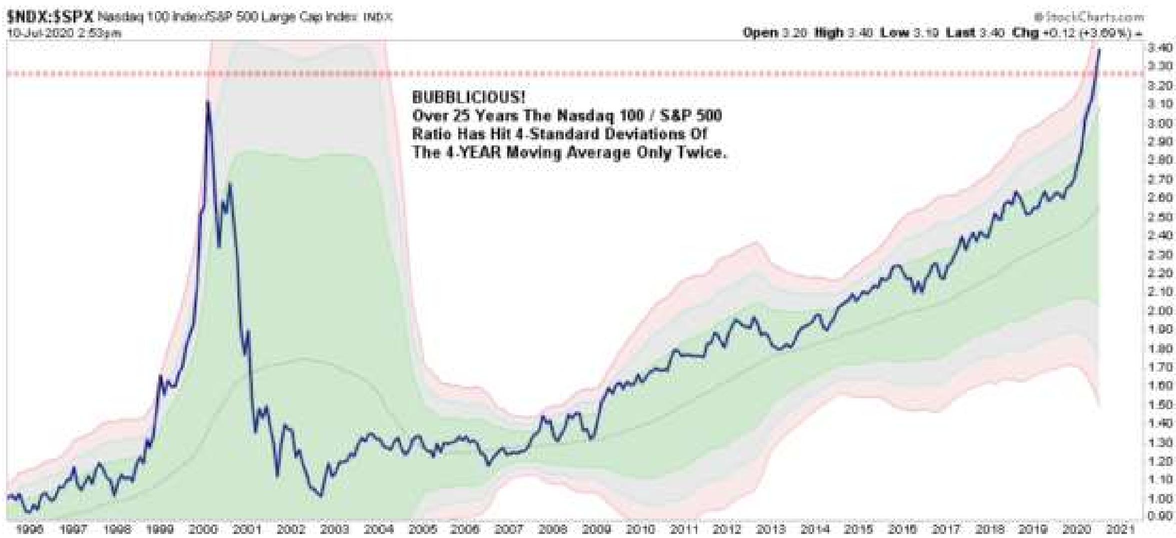


Figure 5. Experience tells us that whenever a market index goes parabolic, LOOK OUT.

Figure 6.

Here is a chart of Amazon on July 7. Is this a sustainable trajectory?

The near-vertical price acceleration in stocks, like this one, has been a historical hallmark of late-stage market cycle advances, also known as a "melt-up" phase. Amazon’s P/E ratio is **152** according to Seeking Alpha. There are no fundamentals that will support paying such a high price. There is always a right time to buy more stock. This is clearly not it.

"We have reached the inevitable conclusion that no one is standing in the way of insanity" *--Mike Green Portfolio Mgr. Dynamic Funds*

In further researching "market bubbles," we were drawn to the work of Mark Hulbert, a frequent contributor to MarketWatch. Mark spent his early years in Manhattan, Kansas, and he has published The Hulbert Report, a publication that has rated investment newsletters for many years. Mark points out that while valuations and divergences are indeed indicators of an unhealthy market, they are not necessarily good short-term indicators of the end of a market trend.

Throughout history all market crashes have been the result of more than valuation levels. Such things as liquidity issues, government actions, monetary policy mistakes, recessions, and inflationary spikes have played a part. With the possible exception of inflation, all of these factors are in play today. You may recall that the market became overvalued in the mid-1990s, yet stock prices continued to rise for several more years. As Mark indicates: "bubbles" are a psychological phenomenon that will continue to run as long as investor greed overrides logic and restraint. It is to be expected that a new bubble will be significantly different than other bubbles.

If the stock markets go higher it will be because more money is being printed.

AFP VIA GETTY IMAGES

The factors that could stop the stock market's rise aren't stopping them.

A July 25th article by Nigam Arora in MarketWatch indicates that we could see the stock market headed toward one or more new highs before the November elections.

There seem to be no constraints on the central bankers, and another stimulus package is likely ahead fueled by more borrowing and printing. We have pointed out how markets thrive on printed money—"it doesn't pay to fight the Fed." We've seen gold reach a new all-time high due to the actions taken by the Fed, and as investors become more concerned about the market. As more money is being printed, we're seeing a debasement of our currency. So as the value of the dollar declines, we're seeing the value of gold climb higher.

Prudent investors are asking: "Is there a limit?"

Nigam Arora says that right now, none of the following factors that limit spending are in play for the following reasons:

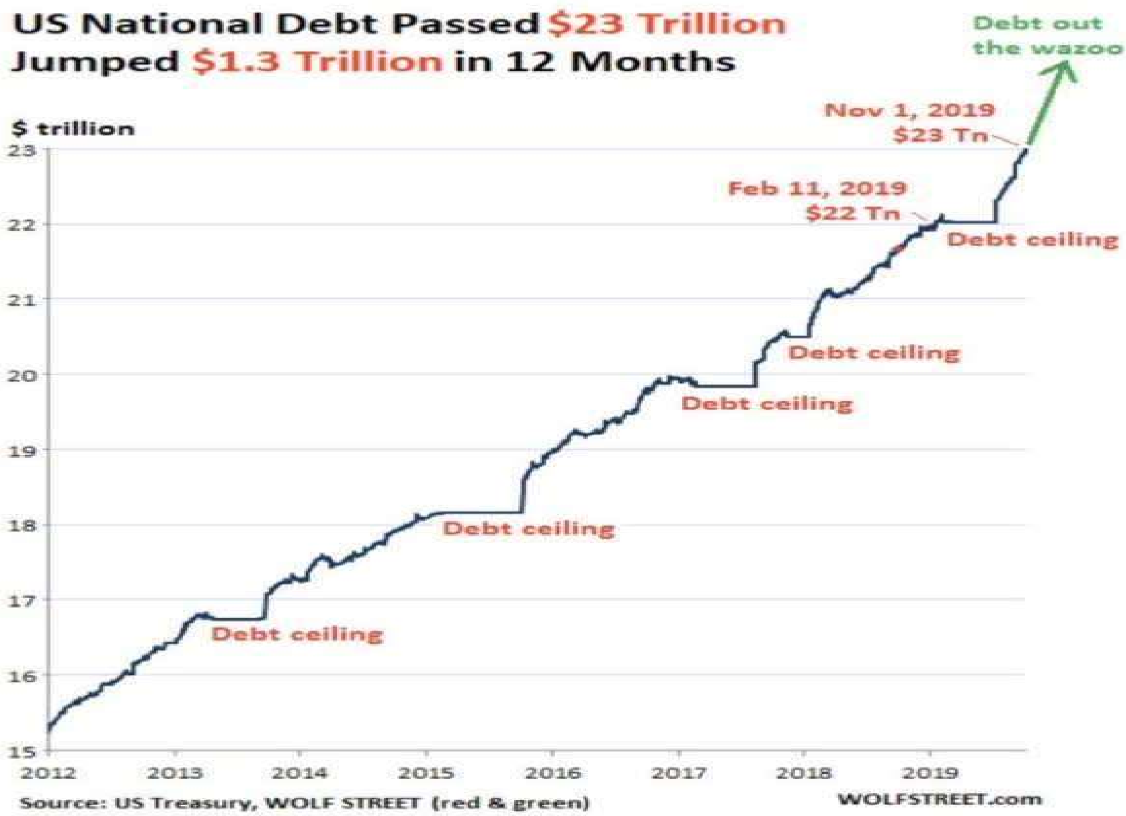
• *Inflation* is low because of the way the government calculates inflation as well as artificially low interest rates and globalization.

• *Currency depreciation* has not been an issue only because most governments in the world are engaging in similar policies. European leaders have agreed on a recovery plan that will cost $2.1 trillion.

• *Borrowing* is obviously not an issue for anyone.

• *Interest rates* Central banks are determined to artificially keep interest rates at low levels and even negative in some parts of the world.

• *Public awakening* There are no signs of public objections to the dangers of unbridled debt. (The long-term consequences are likely unimaginable).



This chart shows progression of the Fed's balance sheet.

Before the great recession of 2008, the Fed's balance sheet stood at $0.87 trillion. Now it is headed toward $10 trillion. Altogether, the U.S. debt is now about **$26.5 trillion**.[1] When properly accounting for all the present and projected (unfunded) future liabilities of the government, total liabilities stand at about $132.68 trillion.

By some estimates, each taxpayer's share of that liability is $860,000.

[1] Click the link to check out the US Debt Clock in Real Time

The Economic Outlook

Although the earnings outlook for the overall S&P 500 is uniformly negative, investors have made a clear distinction between companies expected to end up as winners in a post–COVID-19 world, and those that will struggle. The clear winners are enterprise technology companies such as the Big Five whose infrastructure or software supports the shift to remote work environments and deliver services to customers in a low-friction manner through an internet-based interface.

The second-quarter earnings reporting season for S&P 500 companies unofficially kicks off Tuesday, July 28, when a number of banks reveal their results. Financials are expected to see a -55.3% earnings drop according to FactSet.

All 11 S&P 500 sectors are expected to suffer negative earnings growth. Information technology, which includes Apple and Microsoft, is expected to show a 9.5% earnings decline. While communications services, which includes Alphabet and Facebook, is expected to fall -30.4%. The best performer is currently estimated to be the utilities sector, whose earnings are forecast to be down -1.8%.

The outlook for sales is much better, with analyst expectations pointing to an 11.0% decline overall. Health care and utilities are the two sectors projected to see year-over-year sales growth.

All 11 S&P 500 sectors are currently projected to suffer negative third-quarter earnings growth. Meanwhile, third-quarter sales are expected to decline at a -5.5% rate according to FactSet data.

Summing the Situation Up

Consumer sentiment has started dropping from late-June 2020, and the fall is likely to intensify because unemployment claims aren’t coming down yet, and the virus continues to cause problems for the economy.

Until a vaccine or cure is developed, the COVID-19 inflicted economic pain will continue. It is likely the virus will impact our spending, saving habits, psychology, relationships, and our way of life for some time. It is uncertain how the situation will evolve, and, hence, the near-term reading of the economy is bearish. All the nice upticks in consumer spending may soon be ending.

We've been cautious throughout this artificially induced rally fed by enormous Fed stimulus, and we see an evident disconnect between the real economy and the stock market. Furthermore, we do not believe that the economy will return to "normal" any time soon.

We’ll be closely monitoring our indicators for any sign of a broadening selling base. We are risk managers who believe in a “safety first” strategy. There is no reason to hold our clients too far out on the risk curve under the current market conditions.

At ProActive Capital Management, we remain completely open to any eventuality that the market brings, and we are confident that our indicators will help us to respond appropriately to changing market conditions as they develop.

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