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In the Markets Now

Can a falling market be a good thing?

We believe in the old saying: a picture is worth a thousand words. Here, we aim to recap recent market action and provide some perspective to investors.

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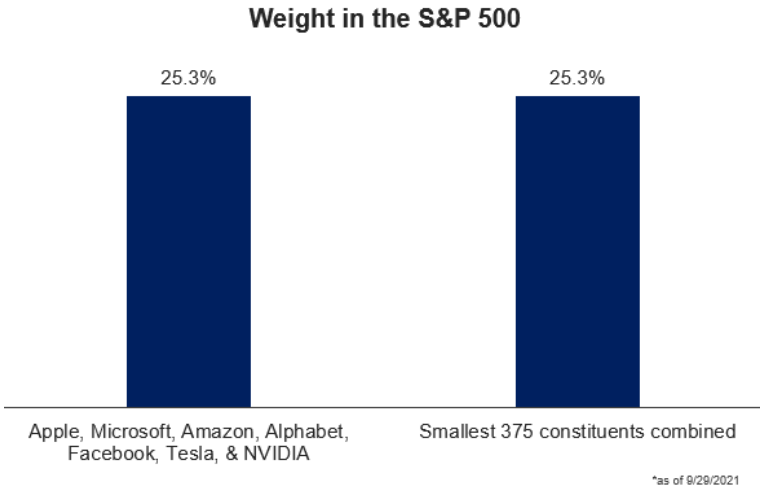
COULD S&P 500 WEAKNESS BE SIGNALING STRONGER ECONOMIC GROWTH?

We've written before about how, though painful to endure, the occasional market selloff can be healthy. As we said in this article, "Irrational investor optimism leads to speculation, overextension and bubbles that ultimately pop. **The occasional correction can let the air out of any bubbles before they grow too taut and help flush some of the shorter-term speculation out of the market…near-term pain for long-term gain."**

But there are other reasons that market weakness can be healthy, or at least telling a different story than headlines might imply. The S&P 500 is a cap-weighted index, meaning that the largest companies in the US by market cap (share price x shares outstanding) get the biggest weights. Over the last decade, this has resulted in an ever-growing concentration in 5-10 big technology (or tech-adjacent) companies. These firms have been outstanding performers, and so the S&P 500 has soared.

But these companies are not necessarily reflective of the broader economy. In fact, you could argue that their stocks' success comes partially from the fact that economic growth has been so middling. These companies were fast growers at a time when the broader economy was anything but—the 2010s saw one of the slowest and weakest recoveries from a recession in the last century. Meanwhile, sectors more closely link ed to the near-term performance of the economy (Financials, Energy, Industrials) underperformed handily. And to make this divergence even more stark, many of those same technology outperformers were the big pandemic winners, as lockdowns meant more time (and money) for Facebook and Amazon, less for cruises and cocktails.



So with this large concentration in just a few big names, it goes without saying that their performance can dictate the performance of the broader index. **Currently, the seven largest companies in the S&P 500 (all Tech, I might add) represent the same weight as the smallest 375.**

Which brings us back to the main point: if the S&P 500 is falling because the higher-weighted (more defensive) tech names are selling off in favor of more economically-sensitive (but lower-weighted) cyclical sectors, that can represent a positive sign for the economy overall—even if the headline index finishes down. The outperformance of cyclical and value stocks might indicate a strengthening economic growth outlook, a lifting of political and/or geopolitical uncertainties, or both.

So while a selloff never feels good, it often pays to look under the surface to get the bigger picture. At the very least, understanding the nature of concentration in cap-weighted indexes can help us better understand what is moving markets and why—a key tool in any investor's toolbox. Reach out to your Baird Advisor today with any market questions you may have.

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