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CIO thinks risk to the economic outlook have increased, and tighter financial conditions are likely to weigh on activity. (ddp)

Not the time to chase growth

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The S&P 500 ended the first quarter with a robust gain of 7.5%, including dividends, despite the turmoil in the banking sector last month.

More specifically, nearly all the market gains were thanks to mega-cap growth stocks—Microsoft, Apple, Alphabet, Nvidia, Meta, Amazon, and Tesla. Without these names, the S&P 500 was only up 1.4%.

The divergence can also be seen when one compares the performance of the equal-weighted S&P 500 versus the normal, market-cap weighted version of the index. In the first quarter, the equal-weighted index only rose 2.9%, trailing the market-cap weighted index by 460 basis points.

However, we maintain our cautious stance on growth stocks, which we rate as least preferred in our global strategy.

A new bull market is unlikely on the horizon. History suggests a spread of the current magnitude between the equal-weighted and market-cap weighted indexes typically only happens in the later stages of a bull market. Importantly, this is not the hallmark of the start of a new bull market. In fact, quite the opposite. The equal-weighted index usually outperforms in the early stages of a bull market.

Growth stocks are expensive. As a result of the very strong outperformance of mega-cap growth stocks, the Russell 1000 Growth index is expensive once again. Its forward P/E is nearly 70% higher than the Russell 1000 Value P/E, or about twice the long-term average. If the US economy has a soft landing, the cyclical parts of the value index would likely have strong relative gains. And if the economy has a harder landing, those with the highest relative valuations versus history would likely be most vulnerable.

The latest US economic data point to elevated recession risks. The Institute for Supply Management's (ISM) manufacturing purchasing managers' index (PMI) fell to 46.3 in March from 47.7 in February, the lowest reading since May 2020 and the index's fifth straight month in contraction territory (below 50). New orders and employment weakened, while price pressures also abated. We think risks to the economic outlook have increased, and tighter financial conditions are likely to weigh on activity. In this environment, the valuations of some defensive sectors are more attractive than growth stocks.

We therefore recommend diversifying beyond the US and growth in our global equity strategy, favoring emerging markets including China, and defensive sectors such as consumer staples and utilities. We also see select opportunities in Europe, including the German market and consumer stocks. Structured investments and capital-preservation strategies could be another way to attain exposure in a more defensive way.

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