Low correlation in terms of market returns among companies seems to suggest that it behooves investors to be more selective going forward. The all-around rally that started last November seems largely gone. (UBS)

Within the S&P 500, there's more than meets the eye

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CIO's base case of a soft landing in the US economy this year has for the most part become the consensus. Unsurprisingly, this has been coupled with the dissipation of bearish investor sentiment, which has partly helped fuel the ongoing market rally.

That said, the equity market's outperformance year-to-date has exceeded even CIO's most optimistic expectations. CIO's current S&P 500 targets for June and December stand at 5,100 and 5,200, respectively, implying a modest upside from current levels.

Considering that, at the time of writing, the S&P is already above 5,100, CIO's base case covers the possibility of equity markets tapering down a bit in the near term. This is not to mean that there is no upside left in the equities tank; CIO thinks there is. Yet, the seemingly low correlation in terms of market returns among companies seems to suggest that it behooves investors to be more selective going forward. The all-around rally that started last November seems largely gone.

What does this "low correlation" thing mean, exactly?
Rather than all equities within the S&P 500 showing a similar trend, CIO has started to notice that a large portion of the companies that make up the index are now showing mixed behavior. For example, the S&P 500 has rallied roughly 24% since last October's low; over that period, nearly 90% of the companies that made up the index gained in value. Year-to-date, however, the stock price of only 61% of the firms in the S&P 500 has increased.

CIO's Head of Asset Allocation, Jason Draho, recently underlined that "low correlations are a corollary of high return dispersion, and for the S&P 500 it's about as low as it's been in many years." In fact, the three-month implied correlation index[1], a measurement of correlation in the market, is now at its lowest level in nearly two decades.

In more digestible terms

While the overall figure of the S&P 500 has been increasing, the parts that make it whole are now moving, more than before, in opposite directions. If this behavior were to remain, CIO thinks there's reason to believe the S&P 500 could remain range-bound, and that investors seeking to outperform the market will need to be selective in their allocations.

In this context, CIO maintains a neutral preference for US equities and highlights that there may be better opportunities to add to equity positions. From a sector standpoint, CIO is most preferred on healthcare, industrials, and information technology, and least preferred on real estate and utilities.

For more on this, see "Rain or shine," 4 March 2024
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[1] As per CBOE, the implied correlation index is a financial benchmark that provides instantaneous market estimates of expected correlation using implied volatilities of the S&P 500 and the top 50 stocks within the index. Note that implied correlation is a gauge of herd behavior.