DWS

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Marketing material

When things look great, be careful

In Theme #9 we look at the increasing cluster risks following Trump's election victory

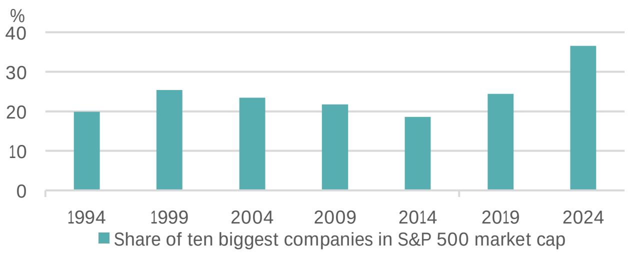
From January 20, 2025 the U.S. will be governed by Donald Trump again. And to a certain extent, the rest of the world will be co-governed by him, especially the capital markets.[1] If his first term is any guide to the future, this is likely to increase event risk for individual asset classes – for example, if another punitive sector tariff is suddenly announced by tweet. However, other risks are also looming for the markets in 2025. An escalating conflict in Taiwan that may disrupt chip supply chains. A potential end to the bond markets' patience with the U.S. debt mountain. A damp ending to the AI boom. And these are just a few of the foreseeable risks. However, it is the unexpected that may pose the greatest market risk.[2]

Investing in a broadly diversified stock index – whether the S&P 500 or the MSCI World Index – might seem to reduce the risks but there is another risk: excessive concentration in many asset classes. The ten largest stocks in the S&P 500 account for a full 37% of its market capitalization, an all-time record. Even at the height of the internet bubble in early 2000, it was less than 30%. But even then, only five of the top ten stocks were tech stocks.[3] Today, nine out of ten are.[3] This means that anyone who believes they have the entire U.S. economy covered by buying the S&P 500 index is in fact putting a third of their money in just nine companies in the same sector. That is called cluster risk. It doesn't get any better when you look at the global picture. Even though the U.S. economy only accounts for around a quarter of global GDP, roughly two-thirds of the trade in and market value of bonds and shares are attributable to the U.S. Of the ten largest listed companies, only two are not American. In 2010, seven were not American.

Of course, there are examples of high concentration elsewhere – in Germany's Dax index, the three largest companies account for almost a third of the market value. But the global dominance of the U.S. stock exchange, and its dominance by a few tech stocks, is a major concern. Goldman Sachs has even cut its average nominal return expectation for the S&P 500 over the next ten years from 7% to 3% for this reason.[4] History, too, suggests that today's top 10 will not be the top 10 in 10 years. Concentration risk may be hedged either by choosing the equally weighted S&P or by weighting other regions higher. However, this is only half the battle. If the 60% price increase[5] of the MSCI World in the last two years makes you dizzy, you may want to diversify outside equities. We currently consider this attractive because bonds are yielding a decent amount. Should the stock markets fail to achieve the growth rates they are currently pricing in, interest rates are likely to fall and bond prices to rise. If you believe government bonds do not offer enough yield, corporate bonds are another option. However, for high-yield bonds, in particular, when default rates are rising again, a broad selection of securities may help reduce the risk posed by individual holdings.[6] Those who are more concerned about a resurgence in inflation could diversify into commodities or gold.

The temptation to bet on the exact same bundle of securities that have dominated the stock markets for several years is understandably strong - especially as their run could continue if their earnings grow sufficiently and investors remain willing to pay a premium for growth stocks in a low-growth world. But a time of such dominance is precisely the moment when you may want to hedge and diversify. A price-to-earnings (P/E) ratio of almost 30 for the S&P 500 Information Technology sub-index is ambitious and does not leave room for many surprises.[7] And under President Trump surprises shouldn't be a surprise. "Under our core scenario we have a positive outlook for most asset classes in 2025. Still, to help avoid unpleasant surprises, a broadly diversified portfolio across many asset classes, investment styles and durations is a good choice", says Henning Potstada, DWS Head of Multi Asset.

The biggest firms are getting bigger



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 11/12/24

Footnotes

[1] Less due to the geopolitical supremacy of the USA than to its dominance of the global financial markets.
[2] Covid, Ukraine, China's real estate crisis, to name just the most obvious, although some market participants would no doubt claim that this or that crisis was foreseeable.
[3] Among them, of course, the so-called Magnificent 7.
[4] Goldman Sachs, Global Strategy Paper. 'Updating our long-term return forecast for US equities to incorporate the current high level of market concentration'; as of 10/18/24.
[5] The S&P 500 has more than doubled in five years, which corresponds to an annual return of 16%. Since 1994, the index has returned an average of 11% per year. Source: Bloomberg Finance L.P.; as of 11/10/24.
[6] Jim Reid Chart of the Day as of 10/21/24: "In fact on my calculations, since 2004 the default rate for European High Yield has only been higher less than 10% of the time, all of which was during the GFC and Covid."
[7] P/E ratio is based on projected 2025 earnings

Glossary

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence.

The Dax is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

The default rate refers to the proportion of borrowers who cannot service their loans.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Magnificent 7 is a name for the group of the 7 largest stocks in the S&P 500.

The MSCI World Index tracks the performance of mid- and large-cap stocks in 23 developed countries around the world.

In economics, a nominal value is not adjusted for inflation; a real value is.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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