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Macro Markets Episode 75: Can U.S. Equities Sustain Their Momentum?

Michael Schwager, Equity Strategist, and Ryan Sundby, Equity Product Specialist, join Macro Markets to discuss forces driving the gains, why the rally might have room to run, and the relative value of blue chip stocks in this environment.

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Jay Diamond: Hi everybody, and welcome to Macro Markets with Guggenheim Investments, where we invite leaders from our investment team to offer their analysis of the investment landscape and the economic outlook. I'm Jay Diamond, head of thought leadership for Guggenheim Investments, and I'll be hosting today. Now, after a brief post-Liberation Day correction in April, the stock market has continued to power ahead, pushing prices multiples above historical averages. So, this momentum is persisting even as the labor market shows signs of weakening and inflation pressures are still hanging around. So is investor confidence justified? Well here to help us understand the forces driving these gains and where we might be going in this climate is Mike Schwager, managing director and equity strategist, and Ryan Sundby, who's equity product strategist here at Guggenheim. So thanks for taking the time to chat with us today, Mike and Ryan.

Mike Schwager: Thanks, Jay. It's great to be here.

Ryan Sundby: Yeah, thanks for having us on the pod today.

Jay Diamond: Well, Mike, let's start off with you. The equity markets, as I said, seem undaunted by recent uncertainty that's in the marketplace. The S&P 500 is off to a great start. Do you think that markets are becoming complacent?

Mike Schwager: Jay, I really don't. And first, if you look at the CBO volatility index, which I use as a

gauge to measure both fear and greed in the market, it currently sits right in the middle of its 12-month range. So, we're not really seeing high levels of complacency or high levels of fear for that matter. Secondly, I just want to point out that the market's performance has really started to broaden out. This is no longer just a technology story. When you look at something like the Value Line Index, which is made up of 1700 equally weighted stocks, it recently hit a new all-time high, outside the tech sector, which obviously has done very well this year. We're also seeing the industrials, utilities, and financials sectors trade at new highs in recent weeks. We have to keep in mind, the equity markets are forward looking. They tend to discount 9 to 12 months into the future. And I think the message being sent by the market is that the economy and earnings will remain in good shape in the quarters ahead. Overall, from our point of view, the macro environment remains very supportive. We have a resilient economy, solid earnings growth. The Fed is cutting rates; fiscal policy should become a tailwind in the quarters ahead; there's still $7.4 trillion of cash sitting in money market mutual funds; and corporations are on track to buy back about $1 trillion worth of stock this year. So net net, I think all of these factors are an important cocktail that should continue to drive this bull market.

Jay Diamond: You mentioned the rally is broadening. What does that actually mean and what does history tell us about this in the context of bull markets at this stage?

Mike Schwager: Right. So in terms of the broadening, as I mentioned, the value line index, which is made up of 1700 stocks, has really been doing well and lagged early in the year but it's come back, meaning it's just not, you know, a handful of stocks or a certain sector driving a performance, it's really broad now. In terms of the bull market, where are we at this stage. In studying in the last ten bull markets, we found that the current rally may still have some room to run. For example, the average duration for a bull market has been a little over five years, with average returns of about 185 percent. The current bull market, which turns three this month, is up about 88 percent, less than half of what the average bull market tends to deliver. Interestingly, of those ten bull markets, the ones that made it to their three-year anniversary, which was seven of the ten, they tended to do even better. They lasted, on average, about six and a half years and delivered average gains of about 230 percent. But Jay, as we know, the one thing that almost always kills a bull market is the recession and we just don't see that in the cards for the foreseeable future.

Jay Diamond: Great historical context, but let's turn to some of the fundamentals drivers of earnings, which of course underpin all stock performance. Let's go through some of the drivers in rapid fire style with you, if you will, one at a time. So let's start with economic growth as a driver of earnings.

Mike Schwager: Sure. You know the economy remains in fairly good shape. It posted growth of 3.9 percent in the second quarter. The Atlanta Fed's GDPNow model is signaling a similar pace of

growth for the third quarter. Now that said, the second quarter likely marked peak growth, and growth is expected to moderate in the quarters ahead. So slowing but still growing.

Jay Diamond: Okay. Next corporate tax rates.

Mike Schwager: We saw the passage of the One Big Beautiful Bill act during the summer months that left the corporate tax rate at 21 percent. But also, the bill increases the small business tax deduction and it allows for 100 percent immediate expenses for new investments in factories and production facilities.

Jay Diamond: Okay, we've seen a lot of news and a lot of dollars being spent on AI, flesh that out for us.

Mike Schwager: Yeah, you're right. I mean, AI is all the craze right now and it still appears we're in the early innings. I mean the adoption rate by corporations has been steadily growing. Two years ago, the adoption rate was about 5 percent. Today, it's more than double to right around 12 percent. The impact is expected to be very widespread. A few examples here: pharmaceutical companies are using it in their drug development process, financial services firms are using it for risk management and back office operations and in the manufacturing sector, AI is being used to optimize supply chains. So again, widespread utilization that over time should help increase productivity.

Jay Diamond: Okay. The change in the monetary policy stance of the Fed.

Mike Schwager: Yeah. We think the Fed is likely to cut rates by 25 basis points at the end of this month and deliver an additional 25 basis point cut at the December meeting. We are also penciling in two more rate cuts next year, and that would ultimately bring the fed funds rate down to a range of 3 to 3.25 percent.

Jay Diamond: Great. So where the rubber meets the road, Mike of course, is not just price but valuations. And the S&P 500 is currently trading about 23 times forward earnings, which is higher than its 30-year average. So how do you think about valuations at this point?

Mike Schwager: Well Jay, to be honest I mean current valuation levels really don't bother me. And I'll explain why. So admittedly you know 22-23 times for 12-month earnings. The market's valuation does look a bit rich at least relative to its long-term average. But from my point of view, valuation should never be viewed as a catalyst as it can stay elevated for long periods of time, especially if the economy and earnings remain healthy, which we believe both are. Now, there was a recent study done looking at the widely followed Shiller Cape valuation ratio and the markets forward returns over the next 12 months. The correlation between the two was just 0.06. So you

know, little predictive power between the market's current valuation levels and the stock market's performance. But I do need to add that same study found that when you look at current valuation and how the market performs over the next ten years, that correlation jumps to 0.58. So, the point here is that higher valuations today often lead to lower foward returns over the next decade. Another point on current valuation levels relative to the long-term average, you have to look at the current structure of the S&P 500 today versus what it was 25 to 30 years ago. Again, we have a long-term average of about 17 times. But for the first half of those 30 years, we had slower growing asset intensive industries like energy, utilities, industrials and materials. They made up about 50 percent of the market's capitalization, whereas faster growing asset light companies like technology, telecom and health care, for that 15 year window, they only represent on average about 20 percent. Now when we fast forward to today, the script has basically flipped with higher growing asset light companies representing over 50 percent of the market capitalization, while slower growing asset heavy industries have fallen to about 17 percent. So because of this, I do feel a valuation multiple greater than the long term average is currently warranted.

Jay Diamond: So it begs the question, of course, Mike, is there still room for further upside in stock prices?

Mike Schwager: I think there's definitely upside, but as we look forward we do expect little if any multiple expansion from current levels. And we do think earnings growth will be the primary driver of stock returns. Interestingly, that's actually been the case since the start of this decade. On average, the market has delivered an annualized total return of 14.4 percent. That's from the beginning of 2000 through mid-2025. Of that 14.4 percent, earnings growth accounting for nine percentage points of that return, while multiple expansion accounting for 3.9 percentage points. The remaining 1.5 percent came from dividends.

Jay Diamond: Interesting. Now, Ryan, let me turn to you for the next couple of questions. So with the economic outlook where it is and valuations a little bit rich now, where are you finding value in the equity markets right now?

Ryan Sundby: Yeah. As Mike mentioned, while we are seeing nice strength across a broader range of stocks as the market continues to hit new highs this year, when valuations get stretched or uncertainty starts to rise, our preference really tends to focus back on owning the highest quality large cap names, which are often referred to as blue chips in the investment world. Why is that? Well, I think there are a couple of compelling reasons, really. First, these are household names with products and services that are integrated into the fabric of everyday life, think mega-cap companies with strong balance sheets, stable earnings and a track record of weathering the ups and downs of market cycles. Blue chips also tend to be market leaders in the respective industries with durable competitive advantages or moats in place. That [have] commitment to innovation and are often stewarded by great leadership teams. This results in a unique combination of brands,

reach, and operating platforms that are nearly impossible to replicate. Because of that, this also typically means blue chip companies show above average revenue growth and profit margins over time. So I guess with that foundation in place, I think it is important to translate this over to the perspective of an equity investor. Let me introduce some data here to help our conversation, because the market dominance that is afforded to blue chip firms, total return performance over the past decade for the Russell Top 200, which we often use as a proxy for the blue chip universe here at Guggenheim, easily outperforms the broader market when you look back over the past decade, delivering compound annual total return growth of nearly 16 percent per year. And importantly, blue chip stocks have been able to deliver this outstanding performance on the back of some pretty attractive attributes. For instance, when we look at total return against the backdrop of volatility, you can see the Russell Top 200 has delivered strong returns while maintaining a lower standard deviation versus that broader market gauge, like the Russell 3000. Blue chip companies have also been able to leverage their leadership position and economies of scale to consistently deliver higher profitability, whether you want to look at metrics like EBITDA margins or return on equity when compared to the broader market. And then finally, blue chip companies, they tend to operate with a greater degree of financial security and flexibility, which we measure as favorable cash balances as a percentage of total assets or net debt to EBITDA ratios. So I think the important takeaway from all this, at least to me, is that the greater the static combination of higher returns and lower risk, along with greater levels of financial flexibility, provides somewhat of an asymmetric return when it comes to blue chips. More specific, when you look at the broader market, blue chip stocks actually perform better in both up and down market capture ratios when you look back over the last 5- or 10-year periods. So as an investor, you really getting higher upside invested in blue chip stocks during the up markets, but lose last and down markets over the past decade when compared to the broader market.

Jay Diamond: Thank you for that, Ryan. You briefly touched on this, but can you give us some examples of what you mean by blue chip stocks?

Ryan Sundby: Yeah, as I just mentioned, I really do think having some exposure to a blue chip strategy really is relevant to almost every investor, given the attractive up and down market capture ratios I referenced. And I think that's becoming particularly more important here as blue chip companies become more focused on growth, whether that be through investments in innovation, research and development or capital spending on things like AI, both on an absolute basis, but also on a relative one as well. So look, without going through a specific list of holdings here, I will say that there are a lot of different types of blue chip companies out there, which I think, quite frankly, is part of the beauty of not having a firm and fast definition of what makes a quote unquote blue chip. Rather, it's something you just kind of know and feel when you see it within certain parameters of course. If you look, some are growth focused, others tend to be more value oriented. Some are large global platforms, while others are built around a single product or service. Some are relatively new, while others have been around for more than a century. So

really, you know, an example of a blue chip stock can be broader than you might think at first blush, but I will say there are always common threads in place that you tend to notice in the corporate fabric of these companies, which I think ties back to some of those characteristics I've mentioned before. So commonly, the way these attributes are expressed can vary from company to company or across different sectors. For instance, I can think of a blue chip consumer packaged goods company that we view as an excellent brand builder. If you look at their current portfolio, they currently own more than 30 brands that exceed $1 billion in sales on their own, a threshold most companies would love to surpass by themselves. Impressively, about half of these brands are created internally by the company, while another 12 are grown past the billion dollar mark after they were acquired, and then the remaining brands were added through a large scale acquisition. You can see by staying true to this ethos of the brand builder, this company has been able to create shareholder value in a number of different ways, and really importantly in doing so, this has allowed the company to build dominant market share positions, not just in its core category, but adjacent segments as well. And then from there, it's been able to leverage its global reach, infrastructure and economies of scale to consistently drive profits and cash flow higher, further reinforcing its position as a blue chip leader. Hopefully, that gives you a little bit of a feel for what a blue chip might look like. Without getting into too many specifics here.

Jay Diamond: Now, Mike, Ryan has just made a very strong case for blue chips. But what other investing themes, are you looking at right now?

Mike Schwager: We talked about AI earlier. It's been all the rage, especially with the companies that produce the equipment to make AI work, semiconductors in particular. You know, Jay, what's been interesting to me has been watching some of the second derivative plays. You know, creating artificial intelligence requires vast amount of energy. And as a result, this has been a boon for typical sleepy industries like utilities and power generation. And as a result of all this, we are actually seeing the emergence of the nuclear power industry. Another thing we're watching is deregulation in the financial services area, particularly the banks. The current administration has begun to loosen regulations around the banking sector, which in turn could result in higher levels of profitability. We also think we could see a wave of consolidation in the sector that's actually already started, but we do think this is likely to continue for the foreseeable future.

Jay Diamond: Terrific. Now, Mike, there are lots of different ways people can get exposure to equities. What should an individual think about when considering investing in stocks?

Mike Schwager: Yeah, I mean picking individual stocks, it's a very, very difficult task. You really need to do your homework. Not only do you need to choose the right stock, but you also have to have good timing when it comes to making buy and sell decisions. Complicating things, these decisions are often clouded by emotions. Nobody likes to lose money or admit they made a bad call, so people tend to hold to bad investments, convinced that at some point they will come back

and, you know, a lot of times they just don't. Now, I think for individual investors, a better way to get equity exposure is through packaged products, things like mutual funds, exchange traded funds or unit investment trusts. These underlying investments are selected by investment professionals. The buy and sell decisions within the portfolio are also made by the same professionals. And most of these products bring diversification benefits to the table. You know, why buy an individual stock when you can own the whole sector, or the whole market for that matter? And I think investment legend John Bogle summed it up pretty nicely. He said, "why look for the needle in the haystack when you can buy the whole haystack?"

Jay Diamond: Well, listen, this has been terrific. Mike and Ryan, really appreciate your time on a very busy day. But before we let you go, do you have any final thoughts you would like to leave with our audience? And, Mike, why don't we start with you?

Mike Schwager: Investing in the equity markets is a marathon. It's not a sprint. Over the long term equity markets have done very well. In fact, equities are unique asset class in the sense that the longer you hold them, the higher your odds of generating a positive return. And really, no other asset class can say that. Now, in any given year, you have about a 75 percent chance of a positive return, on a five-year basis, those odds jump to 90 percent, and over ten years there's about 94 percent. So very favorable odds. And that really underscores that it's time in the market that matters versus timing the market. Now when we look back over the past 90 plus years, the markets have produced an average annualized total return of just over 10 percent. Now, in this long window of time, we've had recessions, we've had bear markets, bull markets, geopolitical events, and both Democratic and Republican leadership. And while there were certainly potholes and speed bumps along the way, the path of least resistance over time has always been higher. Now, the takeaway here is that these events, while unnerving at the time, they tend to be temporary and markets ultimately are a reflection of developments in the real economy, including things like demographic trends, interest rates, and ultimately a corporation's ability to generate bottom line growth. There's an old trader's rule of thumb that says when both the economy and earnings are growing, which is the case today, then the probability of a major market meltdown is low. Now, with that in mind, trees don't grow to the sky and there will be corrections and setbacks along the way, but over the long term, equity markets have rewarded patient investors.

Jay Diamond: Very wise words. Thank you, Mike. Ryan, any last thoughts for our listeners?

Ryan Sundby: I do feel like Mike always does a great job here, providing perspective around what makes equity markets so attractive to us over the long run and why we're so passionate about them here at Guggenheim. So please don't hesitate to reach out if you want to learn more, as we would love to connect.

Jay Diamond: Thank you guys again so much for your time. I really appreciate it. I hope you'll visit

again with us soon. And thanks to all of you who have joined us for our podcast. If you like what you are hearing, please rate us five stars. That's how people find us online. And if you have any questions for Mike, Ryan, or any of our other podcast guests, please send them to MacroMarkets@GuggenheimInvestments.com, and we will do our best to answer them in a future episode or offline. Now I'm Jay Diamond. We look forward to gathering again for the next episode of Macro Markets with Guggenheim Investments. In the meantime, for more of our thought leadership, including our weekly viewpoint, which focuses on the equity market, visit GuggenheimInvestments.com/perspectives. So long.

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