



A Franklin Templeton Company

AOR Update: The Average Stock Advantage

3 February 2025

Key Takeaways

- ▶ The emergence of a lower-cost AI model from DeepSeek and ongoing tariff gyrations have shaken U.S. equity market leadership, with investors facing the prospect of a more durable inflection if these potential catalysts evolve into “show me” moments.
- ▶ Since 1989, when the S&P 500's top 10 has accounted for over 24% of the benchmark — as it does now — the equal-weight S&P 500 has outperformed its cap-weighted counterpart 96% of the time over the next five years.
- ▶ We expect investors will embrace cheaper areas of the market like value, small and mid caps, i.e., the average stock, in the coming year as earnings delivery broadens. A healthy U.S. economy should remain supportive of this shift.

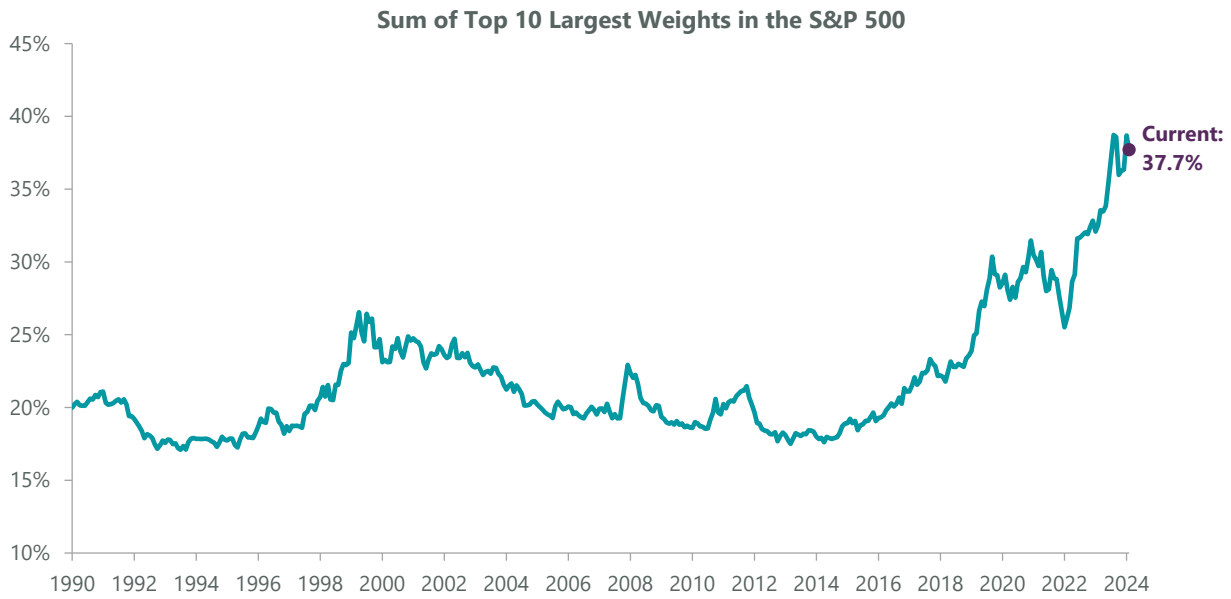
Approaching a “Show Me” Moment?

A market leadership tug-of-war has been taking place over the past several quarters between mega cap growth and the rest of the U.S. equity universe. Leadership has proven fickle with many twists and turns, such as the latest news about DeepSeek's AI model, which has cast doubt on the magnitude of the AI investment cycle and the cost to train AI models. Whether or not DeepSeek's models represent a true breakthrough that will shift the demand for semiconductors, data centre capacity, and power generation will not be known for some time. What is clear, however, is that equity investors are once again faced with the prospect of an inflection in market leadership.

Often the catalysts for a sustained shift are unknowable until after the fact, as new information surfaces that substantially alters the investment landscape. Unfavourable news can create headwinds to even the most bulletproof companies, where lofty embedded expectations can prove vulnerable to investors reassessing the path of future earnings. As seen with the recent DeepSeek-led shakeup, high-flying leaders can suffer sharp declines when investors decide to book profits. With the biggest companies in the S&P 500 Index trading at a substantial premium to the rest of the index and market concentration near record levels (Exhibit 1), there is little room for disappointment at present.

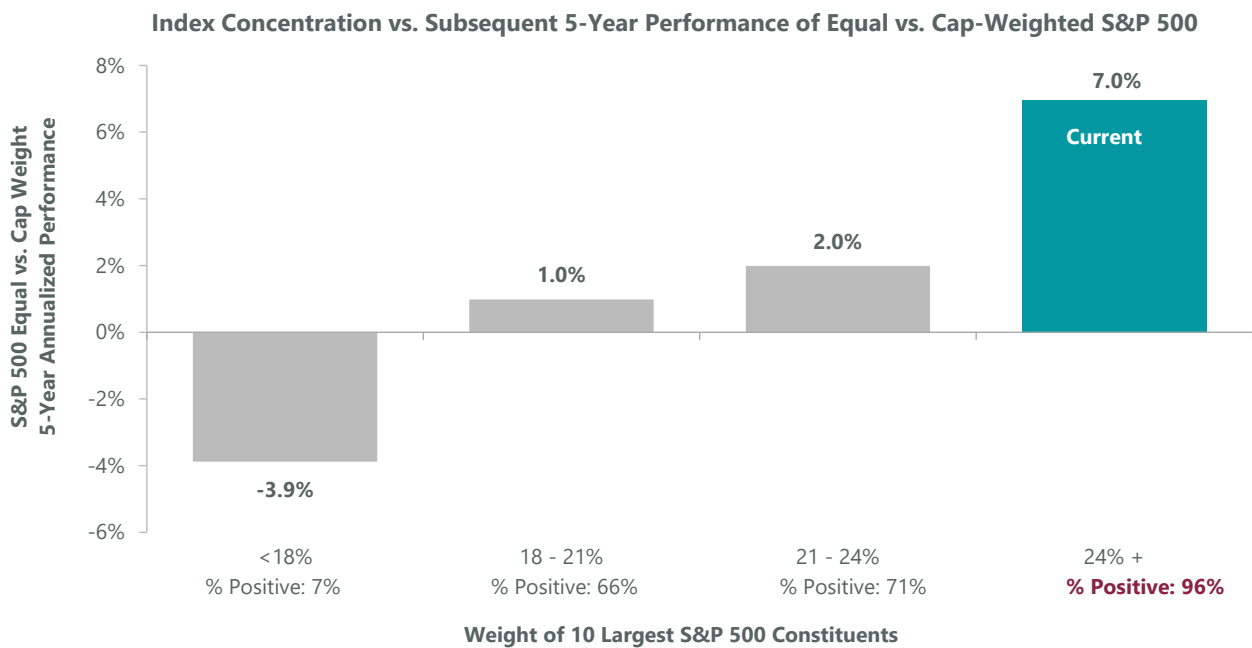
If history is a guide, some of today's perceived winners will in fact deliver on their promise and become key players in tomorrow's landscape, while others will fall by the wayside. This presents an opportunity for active managers relative to passive benchmarks, which cannot sidestep this potential mean reversion. In fact, when the top 10 weights in the S&P 500 have accounted for over 24% of the benchmark, the equal-weight S&P 500 has outperformed its cap-weighted counterpart by an average of 7.0% (annualised) over the next five years since 1989, with positive relative returns occurring 96% of the time. At present, the 10 largest weights in the benchmark account for 37.7%, which is well in excess of this critical threshold (Exhibit 2).

Exhibit 1: Trouble Concentrating?



Data as of 31 January 2025. Sources: S&P, FactSet, and Bloomberg.

Exhibit 2: Concentration Leads to Broadening: The Sequel



Data shown is from December 1989 – January 2025. Monthly constituent level market cap data. Data as of 31 December 2024. Source: FactSet.

While some catalysts for a rotation can appear seemingly out of nowhere, others are well understood but ignored by investors until price action encourages broad repositioning against the underlying trend. Often a “show me” moment can create the sense of urgency to embrace new leadership. Over the past several years, a narrow group of stocks has driven the majority of the benchmarks earnings growth, but sell-side consensus expectations suggest that 2025 will see broader earnings delivery, which [should help support the typical stock](#).

While investors will typically pay a premium for earnings growth when it is scarce, the opposite also tends to occur when earnings growth is more abundant. Put differently, we anticipate that investors will embrace cheaper areas of the market like value, small and mid caps, i.e., the average stock, in the coming year as earnings delivery broadens. Although this dynamic is highly anticipated and reflected in consensus estimates, we believe it is not fully priced into share prices after being deferred repeatedly in recent quarters. As a result, fulfillment could help investors move toward the “show me” moment for relative outperformance.

For 2025, the outlook for the U.S. economy remains healthy as many of the foundational elements of [U.S. economic exceptionalism remain intact](#). This strength continues to be reflected in the ClearBridge Recession Risk Dashboard, which shows an overall green expansionary signal with negligible recession risks on the horizon. The dashboard experienced two positive indicator changes this month with both ISM New Orders and Money Supply improving to green, bringing the total number of green indicators to nine.

Exhibit 3: ClearBridge Recession Risk Dashboard

	January 31, 2025	December 31, 2024	November 30, 2024	
Consumer	Housing Permits	↑	↑	●
	Job Sentiment	×	×	×
	Jobless Claims	↑	↑	↑
	Retail Sales	↑	↑	●
	Wage Growth	↑	↑	↑
Business Activity	Commodities	↑	↑	↑
	ISM New Orders	↑	●	×
	Profit Margins	↑	↑	↑
	Truck Shipments	●	●	●
Financial	Credit Spreads	↑	↑	↑
	Money Supply	↑	●	●
	Yield Curve	●	●	×
Overall Signal	↑	↑	↑	

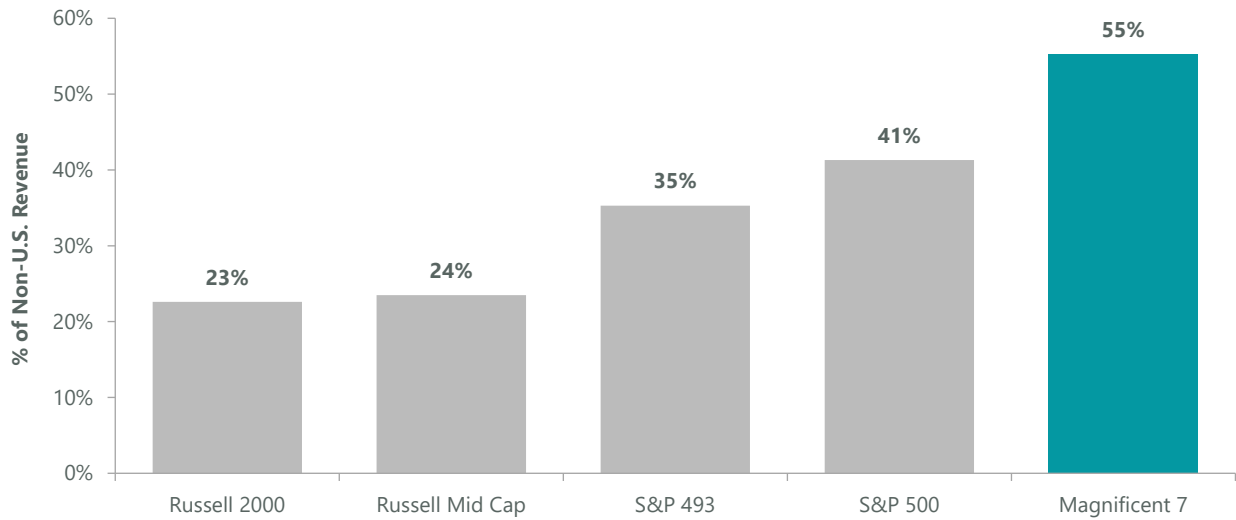
↑ Expansion ● Caution × Recession

Source: ClearBridge Investments

ISM New Orders surged in January to 55.1, the highest reading since mid-2022. However, this indicator could prove fickle in the coming months as some of the pickup in orders likely represents a pulling-forward of activity in anticipation of rising tariffs. Tariffs represent another potential catalyst for market leadership, and they may be undergoing their own “show me” moment. The prospect of rising tariffs is not unknown to investors; instead, what is unknown is when, where and on what products they will be levied.

As we have seen in recent days, these risks have not been fully discounted by equity investors. Importantly, the implementation of tariffs could prove to be another potential catalyst for a U.S. equity leadership rotation given the outsize share of sales the largest companies in the benchmark derive from overseas. Specifically, the Magnificent Seven stocks generate 55% of their revenues from outside the U.S., a substantially larger share than the rest of the benchmark at 35% or small and mid cap benchmarks, which are below 25%.

Exhibit 4: Mag7 Soft Spot?



Magnificent 7 data refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of 31 January 2025. Sources: FactSet, Russell, S&P.

With a healthy economic backdrop, corporate profits are likely to hold up and provide broad support for equities. Current conditions suggest that leadership over the next several years is likely to look different than the past several as elevated concentration is unwound. While the specific catalyst(s) will only be known in hindsight, this dynamic leads us to continue to favour the equal-weighted S&P 500 relative to the cap-weighted, value relative to growth, and small and mid caps relative to large. Portfolio diversification from both a cap and style perspective should benefit as a result.

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