Morgan Stanley

Monthly Musings

Chris Benedict, CFA
The Benedict-McLoughlin Group @ Morgan Stanley

February 11, 2025

In this Musings, I'll cover the following:

- While the long-term fundamentals continue to look promising, evidence is mounting that the mega cap tech stocks may simply be overvalued.

- Cash flow remains on sale in several areas of the global stock market.

- There may be a number of ways to take advantage of this value vs. growth discrepancy.

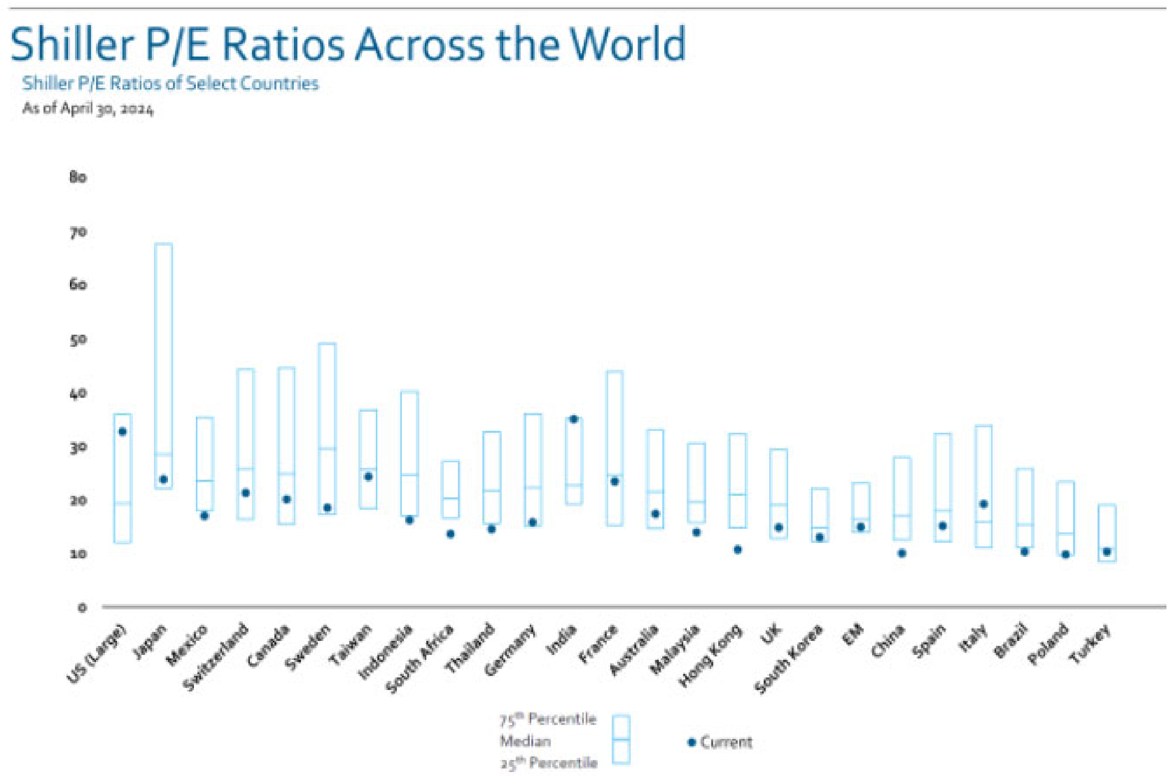
The AI theme remains the main driver of stock market returns, particularly for the mega-cap names. The S&P 500 had a strong 2024, largely driven by the biggest of the big. In fact, the 3 largest companies by market capitalization are now collectively valued at over $10 trillion (Yes, around $3.4 trillion each) as of 1/23/25.[1] As a frame of reference, here are some stats:

- The entire S&P 500 was valued at $10 trillion just over a decade ago. It took the "entire" "Magnificent 7" to add up to $10 trillion about a year ago (February 2024…then we only needed the top 3 to add up to $10 trillion starting in July 2024).[2]

- The entire Chinese economy and stock market capitalization is approximately $18 trillion and $12 trillion, respectively.[3,4] (For reference, the same numbers for the U.S. are approximately $28 trillion and $62 trillion, respectively[5]).

- Using a 13% discount rate, $800 billion of free cash that would grow 5% per year in perpetuity (i.e., a reasonable terminal growth rate) would give a $10 trillion current valuation. The 3 largest companies have generated $253 of free cash flow over the last 12 months…pretty darn good…but, not even close to what their valuations are implying.[6] The #'s just don't pencil out, in my opinion.

Due to the significant outperformance and resulting valuations, these mega caps dominate the weighting of the S&P 500 and make the entire S&P 500 look overvalued both on an absolute and relative basis, in my opinion (see graph below).



Source: Morgan Stanley ChartBook (See disclosures below)

Additionally, starting from such elevated valuations, investors should hope for a pretty clear glidepath for the expected forward growth. However, there are a number of potentially troublesome issues that could cause a hiccup or two. Competition would certainly be one of these potential issues. Venture capitalists like to use a metric called TAM ([How to Calculate Total Addressable Market (TAM)]) when sizing up a potential investment…I would say the TAMC (total addressable market cap) also looks pretty enticing…$10 trillion for the top 3! The recent news out of China where a company claimed they basically matched the performance of the U.S. leading Large Language Model for a fraction of the development cost should make investors sit up and take notice. There will likely be others as well.

But, even if no real competition does materialize, it's still a bit of a conundrum for investors whereas, if these companies were to actually continue to grow at the rates implied by current valuations, wouldn't there be anti-trust concerns? We're already seeing action being taken in Europe against the top technology companies. If AI really is going to be as pervasive in our lives as some experts predict, do we really want all of the power controlled by a small handful of companies? There is precedent with the "trust busting" of the late 1800's and early 1900's.

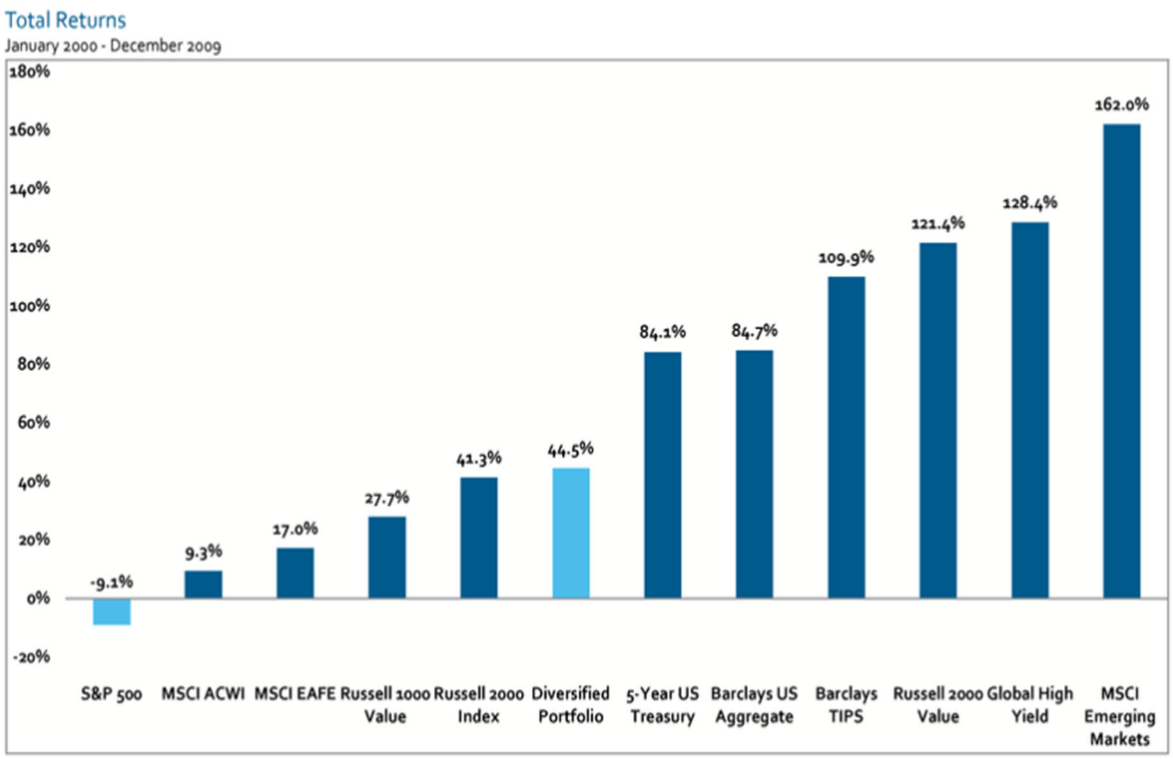
The history of the market is littered with great growth companies where the fundamentals continue to be relatively good but, just not good enough to maintain lofty valuations…and then their stock price languishes for years. It's happened to a leading mobile chip company, a large athletic shoe/sportswear company, the largest coffee house company in the world, etcetera, etcetera. In fact, that leading mobile chip company had a great run in the late 1990s hitting high after high until sentiment shifted and it stopped making new highs. The good news is that it ultimately made a new high…the bad news is that it took 20 years for it to happen.

I'll be the first to admit that valuation (cheap or expensive) rarely acts a catalyst for things to turn. This current trend may, in fact, last a while longer. As John Maynard Keynes once famously said…"markets can stay irrational longer than you can stay solvent". But, although it has worked in recent quarters, simply betting that someone else will pay more for your stock in the future (i.e., The Greater Fool Theory) is not a medium or long-term investment thesis. The good news is that the opportunity in good old fashioned fundamental investing outside of the U.S. mega caps looks very promising, in my opinion.

Time to Get Greedy on Mis-priced Cash Flow? Some Potential Solutions…

So, how do investors take advantage of this potential opportunity? There are a number of ways to do it including old fashioned stock picking, ETFs, actively managed Separately Managed Accounts (SMA's) and hedge funds (where appropriate). I am biased but, I believe active management can "add value" in the world of value investing. And, for those are worried about what the next few years may bring for the S&P 500 given what I outlined above, other segments of the market can do well even in the face of potentially lackluster S&P 500 returns like we experienced in the decade following the dot-com peak (see graph below).

Another benefit of including value stocks in your portfolio is the diversification it may provide for certain investors. Different securities, sectors and asset classes act differently from each other which means they are typically not correlated (i.e., a correlation of less than 1 on a scale of -1 to +1). This lack of correlation is a key component for overall portfolio construction and risk reduction, as measured by standard deviation.[7] So, selectively adding value exposure might potentially both improve your returns and reduce overall portfolio risk.



Source: Morgan Stanley ChartBook (See disclosures below)

***See My Previous Investment Commentaries here*:**
https://advisor.morganstanley.com/benedict-mcloughlin-group

***Tactical Allocation Strategies in my Global Growth and Global High-Income Model Portfolios:**

Overweight	Underweight
Global Value Equities, Long/Short Equity Strategies, Quality Dividend Paying Global Equities, Emerging Market Consumer Equities, Total Return Strategies, Shorter-term Corporate Bonds	High P/E technology/growth stocks, Mid and Long-Term Fixed Income

* These weightings do not consider each client's unique profile, preferences and/or constraints and therefore may not be applicable to you.

* The Global Growth strategy is designed to achieve growth via investments in global equities. The Global High Income strategy is designed to achieve above average income via investments in bonds, ETFs, closed end funds and dividend paying equities.

The Benedict-McLoughlin Group always strives to use sound judgment…at every decision point.

We bring experience, credentials, and tenacity which we expect to continue to enable us to help achieve our clients' goals over time.

Regards,
Chris

Christopher N. Benedict, CFA, CEPA
Senior Portfolio Manager/Financial Advisor
Alternative Investments Director

The Benedict-McLoughlin Group – *"Institutional Caliber Portfolio Management, Customized to Your Personal Situation"*

Morgan Stanley Wealth Management
10960 Wilshire Boulevard, Ste 2000 | Los Angeles, CA 90024
310-443-0556 | 800-648-3833 | (F) 310-443-0566
chris.benedict@morganstanley.com

Sharpen your financial focus. Simplify your financial life. Learn more – watch the two minute Account Aggregation Video

Learn about our new *Goals Planning System (GPS)* – watch the two minute GPS Video

Linked in: www.linkedin.com/in/chrisbenedictcfa

WEB: http://fa.morganstanley.com/benedictmcloughlingroup/

NMLS #1278939

Notes:

1. Bloomberg Markets, 1/23/25.
2. Bloomberg Markets, 1/3/25.
3. www.asiatimes.com, 2/8/25.
4. www.ceicdata.com, 2/8/25.
5. www.siblisresearch.com, 2/8/25.
6. Bloomberg Markets, 2/4/25.
7. www.cfainstitute.org, 2/11/25.

Past performance is no guarantee of future results. Actual results may vary. Diversification does not assure a profit or protect against loss in a declining market.

Alternative investments involve complex tax structures, tax inefficient investing, and delays in distributing important tax information. Individual funds have specific risks related to their investment programs that will vary from fund to fund. Clients should consult their own tax and legal advisors as Morgan Stanley Wealth Management does not provide tax or legal advice.

Interests in alternative investment products are only made available pursuant to the terms of the applicable offering memorandum, are distributed by Morgan Stanley Smith Barney LLC and certain of its affiliates, and (1) are not FDIC-insured, (2) are not deposits or other obligations of Morgan Stanley or any of its affiliates, (3) are not guaranteed by Morgan Stanley and its affiliates, and (4) involve investment risks, including possible loss of principal. Morgan Stanley Smith Barney LLC is a registered broker-dealer, not a bank.

Actual results may vary and past performance is no guarantee of future results.

International investing may not be suitable for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

The individuals mentioned as the Portfolio Management Team are Financial Advisors with Morgan Stanley participating in the Morgan Stanley Portfolio Management program. The Portfolio Management program is an investment advisory program in which the client’s Financial Advisor invests the client’s assets on a discretionary basis in a range of securities. The Portfolio Management program is described in the applicable Morgan Stanley ADV Part 2, available at www.morganstanley.com/ADV or from your Financial Advisor.

Holdings are subject to change daily, so any securities discussed in this material may or may not be included in your account if you invest in this investment strategy. Past performance of any security is not a guarantee of future performance. There is no guarantee that this investment strategy will work under all market conditions. Do not assume that any holdings mentioned were, or will be, profitable.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be suitable for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives.

Chartbook Source: FactSet, Morgan Stanley Wealth Management GIC. (1) The cyclically adjusted P/E ratio (CAPE), also known as Shiller P/E ratio, uses a 10-year average of inflation-adjusted earnings to value the stock market. Historically, cyclically adjusted price-earnings ratios have led subsequent returns with a 10-year lag. Recent price earnings levels suggest equity returns could be better going forward than they have been over the recent past, assuming the statistical relationship holds. Standard deviation (volatility) is a measure of the dispersion of a set of data from its mean. Past performance is no guarantee of future results. Estimates of future performance are based on assumptions that may not be realized. This material is not a solicitation of any offer to buy or sell any security or other financial instrument or to participate in any trading strategy. Please refer to important information, disclosures and qualifications at the end of this material.

Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustration purposes only and do not show the performance of any specific investment. Reference to an index does not imply that the portfolio will achieve return, volatility or other results similar to the index. The composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error target, all of which are subject to change over time. For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Morgan Stanley Smith Barney LLC. Member SIPC

CRC#4234452