

The March Outlook

Market Stance

MIDDLE EAST TENSIONS

What is really relevant?

Commentary

- The main link between Middle East tensions and global financial markets is the oil price: even extended political tensions would have only limited market impact if the oil price were to correct materially
- Immediate oil supply concerns have caused a significant price spike
- Non-oil financial markets appear to be pricing only a limited period of stress
- The outcome remains uncertain

Upshot

- Saranac has closed out some equity hedges in multi-asset portfolios, and would buy into a more severe market correction

THE GLOBAL ECONOMY

Impact of higher energy prices

Commentary

- Prior to the rise in oil prices, global growth was moderately firm, with inflation trending towards central bank targets
- A short period of elevated oil prices could allow the restitution of this environment
- Economic risks would become more significant if higher oil prices persist into the second half of the year

Upshot

- We are reluctant to make major portfolio changes for now, given the uncertain outlook. The diversification in Saranac multi-asset portfolios has been helpful since the crisis broke

SUMMARY OF ASSET CLASS MOVES SINCE THE CRISIS BROKE

There have been different adjustments across financial markets to the Middle East shock

Commentary

- Oil prices are up around 50%
- In fixed income markets, there has been an aggressive re-pricing at short maturities, forcing 10-year yields ~0.25% higher
- Global equities are down ~3%, and are back to flat for the year
- The Vix index has risen sharply, but remains well below levels associated with significant market stresses

Upshot

- The major shock to energy prices has not been matched by similar responses in other asset classes, where price moves have been material but not disorderly

EQUITY MARKET CONCENTRATION AND VALUATION RISKS

Concentration and valuation risks are intertwined (see main article)

Commentary

- The ten largest companies now account for around 25% of global equity market value
- However, these megacap firms have underperformed the global equity index for over a year
- An important theme in this period has been a rotation away from US megacap stocks to other sectors and regions, supporting a further rise in global equities

Upshot

- Concentration risk remains elevated, but gains in global equity markets have become less dependent on the US

 The Long Read

Navigating concentration and valuation risk in global equity markets

SNAPSHOT

Global equity markets are often interpreted through a single lens - currently Middle East tensions or recently US megacap concentration - but recent performance shows a more complex set of drivers.

While index concentration remains elevated, US megacap stocks have underperformed for over a year, with stronger global returns coming from sectors such as materials, industrials outside the US.

Market performance has become increasingly differentiated, particularly within IT, where AI beneficiaries (e.g., semiconductors) outperform while software valuations have fallen.

Investors are showing greater discrimination between business models likely to gain or lose from AI adoption.

High-level concentration and valuation metrics hide significant rotation and divergence, reinforcing the importance of diversification and business-model strength in equity allocation.

1. Concentration in global equity indexes from high returns and valuations in US megacap stocks

Prices in global equity markets are likely for a period to be dominated by events in the Middle East. However, important as these are, there is a danger that they are taken to be the only relevant influence on these markets. Monocausal explanations rarely do justice to the complexity of themes typically in play. Indeed, developments in equity markets in the last year or so provide eloquent testimony for the relevance of a plurality of influences, despite much commentary focusing on a single major theme, that of a high level of equity market concentration associated with extended US valuations.

Much focus in this respect has been on the performance US megacap stocks, with the 'Magnificent 7' (M7) often used as a convenient shorthand for the more general theme associated with US technology-related stocks in general. A widespread concern has been that outperformance from this group has dominated both global and US equity returns in recent years, while also pushing their valuations to unsustainable levels. These stocks now comprise a significant proportion of key equity indexes in terms of market capitalization and hence contribution to overall returns.

High valuations, so the argument goes, imply a greater risk of an equity price decline at some stage. Once a significant price correction in these stocks occurs, their high weights in key indexes will drag down returns from equities more generally. If the main source of returns for equity investors in recent years goes into reverse, a significant market correction seems hard to avoid. These stocks therefore represent a unique source of fragility in the structure of global equity markets, making it an unattractive environment for equity investments more generally.

 The Long Read

2. The historic parallel: the ‘nifty fifty’ in the 1970s

There have been examples from the past in which concentrated markets proved challenging for equity investors. In the early-1970s, for example, the so-called ‘nifty-fifty’ generated material outperformance relative to the broader market, trading ultimately on very high valuations up to their peak in 1972, at which point they accounted for a significant proportion of market capitalisation. Multiples of prices to earnings for the group on average were very high, around 40x-50x earnings. As these multiples contracted once the economic environment deteriorated in the face of higher inflation and interest rates, the nifty-fifty group underperformed the market, depressing overall returns for equity investors. A decade was required for this group to reattain the previous peak in nominal terms, and a further decade to recapture the loss in after allowing for inflation.

3. Megacap stocks have been underperforming for over a year

Some components of this argument are unambiguous. In particular, equity market indexes have become demonstrably more concentrated. The weight of the top ten stocks by market capitalization in the MSCI world index, which includes the M7, was 7% ten years ago, 20% five years ago, and is 24% at present – albeit down slightly from the peak of 26% in 2025.

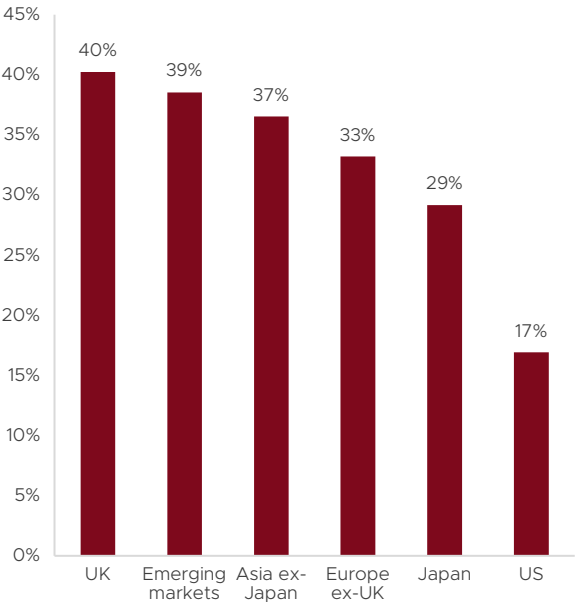
However, other aspects of the argument are more contentious. Most notably, the US megacap group has not been the dominant source of equity market returns for over a year. True, absolute returns have been positive and significant, with the M7 delivering a 17% return from the start of 2025. However, this has been eclipsed by much stronger returns elsewhere in the global equity universe.

This is evidenced in charts 1-4 below. Since end-2024, the US has delivered the lowest absolute returns of all the major regional blocks, and IT

has been a relatively poor performer compared to more ‘traditional’ parts of the global market, such as materials and industrials. In addition, the M7 constituents are seen as archetypal ‘growth’ stocks, but growth stocks have underperformed value stocks for much of this period.

CHART 1

Regional Equity Returns Since 2024 (US\$)



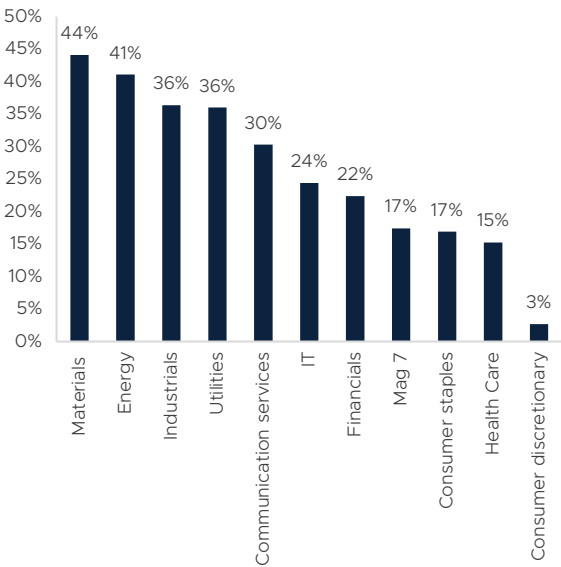
Source: Saranac / Bloomberg

The main theme in equity markets in this period has not, therefore, been a weak global equity market undermined by poor returns from the M7. The more important element has been a significant rotation within equity markets away from the previous US-dominated return structure to a broader-based picture. This has facilitated additional gains in equity markets, even while US megacap stocks were relatively poor performers. This rotation has been driven in part by a broader profits recovery in the sectors which have delivered the stronger returns in the past year and more.

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CHART 2

Global Sector Returns Since 2024 (US\$)



²Source: Saranac / Bloomberg

The sources of these returns has varied. In the UK, for example, banks benefited from a steeper yield curve (long-term rates were higher than short-term rates, generating higher margins), and the sector's return from end-2024 at one stage was over 80%. In addition, firmer commodities prices have assisted returns in the materials sector. Concentration risk did not therefore prevent a further leg to the market rally, and thus risk has been diluted, if only modestly, by outperformance outside the megacap group even while equity markets have continued to deliver positive returns. Global equities have proved to be more than a one-trick pony.

4. Dispersion between 'winners' and 'losers' from the AI investment boom challenges high-level market generalisations

A legitimate push-back to this interpretation would be that the past year has been only the first act in a

multi-act play. Concentration risk remains elevated, and some have argued that the decisive test for equities will come should a wider range of the business models of US megacap companies are called into question.

Interestingly, however, to some extent this has already been a feature of market pricing over the past year and more. Terms such as 'the Magnificent 7' and 'IT firms' are useful summary expressions, but what lies behind them has become much more complex. Significant divergence in performance has become increasingly apparent not just within the M7, but also within the much larger IT sector more generally. An important contemporary theme has been the much greater discrimination between the perceived beneficiaries of the deployment of artificial intelligence, and the higher capital spending associated with it, and the potential losers.

CHART 3

Relative Performance of Growth over Value



³Source: Saranac / Bloomberg

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Within IT, semiconductor producers have in general been perceived as best positioned to benefit from AI, with a somewhat less positive environment priced for IT hardware, and more particularly software, where the average price of firms within the sector has declined by some 25% in recent months (chart 4). Software companies entered 2025 with the most extended valuations within the IT sector. However, these companies have been challenged on concerns that AI could commoditise some software functions, and as corporates have for the moment prioritized spending on microchips, datacentre hardware and cloud infrastructure over software.

CHART 4

Performance by sub-sector in global IT



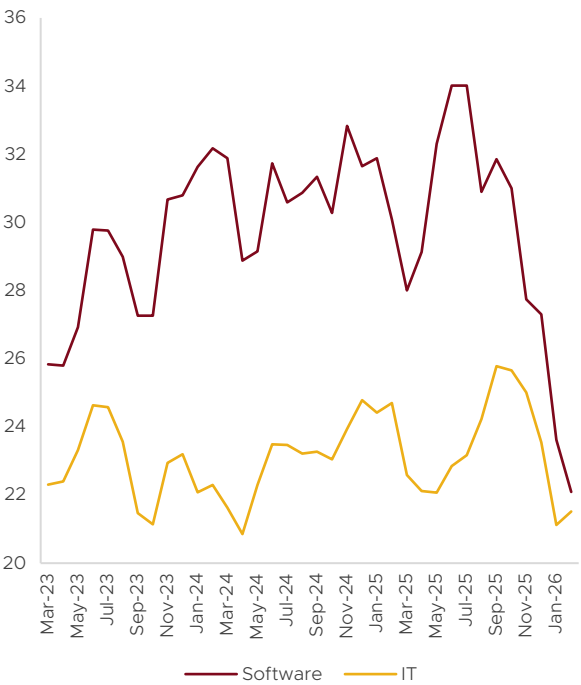
⁴Source: Saranac / Bloomberg

As a result, the sector has been repriced as a mature growth sector, not as a hyper-growth sector. In absolute terms, earnings growth in software has remained robust, but below previous expectations -

hence the de-rating of the multiple of prices to earnings (chart 5). In contrast, the share prices of the beneficiaries of AI have been supported by stronger earnings trends.

CHART 5

Software Sector De-rates (PE Multiples)



⁵Source: Saranac / Bloomberg

Probing beneath the surface of high-level generalizations relating to market concentration and valuations is, therefore, helpful in interpreting recent intra-equity market developments. The trends we have identified suggest that, far from backing IT-related themes indiscriminately in the context of a broader 'bubble', investors have in fact become increasingly sensitive to the implications of AI for different business models. This is also evident in the broader market outside the IT sector. Firms in a range of sectors with business models more

 The Long Read

susceptible to automation have been subject to material price declines, while potential beneficiaries have seen a re-rating.

An interesting example in this respect has been the utilities sectors in a number of countries. These have traditionally been viewed as relatively stable companies with more limited upside potential for their earnings. However, they have benefited from the rise in energy demand associated with the ramp-up in AI spending. Unusually, they have been a global outperformer in a period in which equity market returns have been generally firm.

5. Conclusions: focus on the business models, not just the valuation

There are two conclusions from this analysis. The first is that it can be unhelpful to draw very strong investment conclusions from broad characteristics of equity markets alone. The high level of concentration in equity-market indexes has not prevented further gains being made, and a disproportionate amount of these gains have come from market segments outside the US megacap firms which account for the unusual level of concentration even in global equity indexes. The important equity market feature of the past year and more has not been a correction driven by overvalued US large cap stocks, rather a significant rotation out of megacap stocks and into other sectors. This points to the benefits of diversification in an equity portfolio, which allows aggregate returns to be harvested even while performance from some market sectors is underwhelming.

Second, a focus on concentration, and the strong performance in US IT which accounts for it, disguises the very marked differences in performance even within that sector. This is evidence against the view that an indiscriminating and irrational wave has raised all boats. On the contrary, market gains have largely been driven by new opportunities for earnings growth, and underperformance driven by earnings pressures. A further sign of discrimination is

that companies with the highest valuation are those perceived to have the most sustainable strength in corporate earnings.

The argument is not that the market is inevitably correct in these evaluations. A legitimate concern is the extent to which the boom in AI investment is sustainable and can deliver returns to those making the outlays. The experience of the 'Nifty Fifty' companies mentioned earlier is instructive in this respect. Care must be taken in drawing precise parallels with the present: the high PE multiples in this group at the 1972 peak contrast with the much lower average multiple in the IT sector of 21x at present, down from almost 30x in mid-2024. In this article, we have wrapped together valuation and concentration risk, but arguably the latter is the more important.

This contrast notwithstanding, it is relevant that the valuation correction of the 'Nifty' companies did lead to an extended period of underperformance from the group, and some firms in it are no longer household names. Nevertheless, others with stronger business models continued to deliver firm profits growth, and in the long-term delivered returns superior to the broader market.

This again points to the need for a more sophisticated view of potential risks and returns in assessing the exposure to global equities than simply high-level views on aggregate valuations and concentration levels, even if these are relevant components of a broader analysis. Robust business models matter, even in the face of changing market assessments of how to value them.

Saranac reconciles these competing influences in its equity portfolios as follows. We continue to expect equities to be the highest-returning public market asset class in the long-term, but with significantly lower returns than the double-digit outturns of the past ten years. We are mindful of concentration risk and have less than market exposure to the megacap companies, and also to the US, to ensure adequate diversification. Nevertheless, the US remains a significant component of the equity allocation.

SARANAC

PARTNERS

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