Cetera® Investment Management

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Commentary

Investors Start to Question High Valuations

- Large tech companies are dragging down indexes this morning.
- Investors have largely ignored valuation concerns, but questions are starting to arise.
- With high valuations, diversification is even more prudent.

U.S. markets sold off today on news that a Chinese artificial intelligence company, DeepSeek, has built an Artificial Intelligence (AI) model that is competitive with American rivals, but at a fraction of the cost. American companies have been spending billions of dollars on capital expenditures in a race to build AI models. DeepSeek uses less advanced computer chips and focuses on a different process that involves smaller models. The news has driven chipmaker and AI stocks lower. These stocks have lofty valuations and make up much of the indexes that they are included.

We have been warning about high valuations. Valuations have been frothy and just continued to climb with little volatility in markets. Because the S&P 500 weights companies in the index by size, the biggest companies make up a higher percentage of the index. As the biggest companies' stock prices continued to soar, they became an even bigger part of the index. The top 10 stocks, which include the infamous Magnificent Seven stocks, became nearly 40% of the index. We haven't seen these concentration levels since the dot-com bubble.

While valuations in these stocks do appear high, that doesn't mean we are in another dot-com type bubble. Investors have been bidding AI and related AI stocks higher for a long time. Valuations didn't seem to matter, as the prospects for growth were also high. Valuations can remain elevated for long periods of time, but eventually either earnings must grow at an outsized pace and catch up with the price of the stocks or the price of the stocks falls to match the earnings.

Investors are finally questioning if high valuations are healthy for markets. Markets can get dislocated from fundamentals, as enthusiasm for one sector grows. It is prudent for investors to be skeptical of high growth targets. Good companies can still be expensive. While DeepSeek is gaining attention, it is still questionable if it can compete with American AI companies in the long run. It is hard for Chinese companies to buy the most advanced chips due to U.S. export controls. According to the *Wall Street Journal*, DeepSeek trained its models using stockpiled American graphics-processing units (GPUs), which is not a viable long-term solution. It may have also acquired American chips in a breach of U.S. export rules. Regardless, the company does appear to be making AI models that are effective at a fraction of the cost that American companies are spending to create these models.

We are due for a correction, or a 10% pull back from the peak, which typically occurs about once a year. The S&P 500 hasn't seen a correction since October 2023. If we do experience a correction, that would be normal. It would also likely be driven by the stocks that make up much of the index that are selling off today. The equally weighted S&P 500 (not weighted by company size) is outperforming the S&P 500 by roughly 1.50% today.

Valuations outside of the top ten stocks in the S&P 500 are much more reasonable. Indexes outside of large cap are better diversified and less concentrated. While diversifying away from the top ten stocks in the S&P 500 has hurt portfolio performance over the past couple of years, we think it is prudent to be well diversified to mitigate risk. Bonds are also doing well today as bond yields are falling. This should also help smaller companies which could benefit more from lower borrowing costs.

It is important to stay focused on your own long-term financial goals and avoid getting caught up in the market enthusiasm or trying to call the next bear market. As always, please consult your financial professional for guidance during these times.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

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