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The "Magnificent Seven" Ride Again
But Can They Save the Market?

For mid-20th century film aficionados, the "Magnificent Seven" is a must-see Western. Its plot line is elegantly simple and emotionally satisfying. Based on the 1954 film, "Seven Samurai", by the great Japanese director, Akira Kurosawa, the plot line of the 1960 version pits a group of humble villagers against a band of evil bullies whose purpose in life is to steal and oppress. The villagers seek protection and rescue from an outlander band of gunslingers led by Yul Brynner and Steve McQueen. In the end, the eclectic cadre of white knights defeat the bad guys. The people are saved. Good triumphs over evil. All ends happily.

This classic storyline was echoed in last year's stock market action as equity investors sought their own "magnificent seven" to help them triumph over the investment losses they suffered in the previous year.

But unlike the gunfighters who helped the poor villagers in the movie, these "magnificent seven" were no strangers to investors. In fact, they were stocks with household names that included Apple, Amazon, Meta, Google, Microsoft, Nvidia, and Tesla. Many investors saw them as sure bets at a time of otherwise lackluster prospects for most stocks.

Together, these seven technology names made up almost 30% of the S&P 500 by market capitalization. Yet, they accounted for roughly 66% of the S&P's 24% rise in 2023. The remaining 493 stocks contributed the rest.

The spark that ignited the rally in the magnificent seven was the buzz among investors that the Fed would finally start cutting interest rates in 2024 after nearly two years of rate hikes. Interest rates are a key component of stock market valuations. High or rising interest rates often dampen borrowing by corporations and constrain growth, potentially lowering profits. Technology stocks are particularly sensitive to interest rate changes, up or down, since much of their growth depends on debt. The prospect of lower interest rates in 2024 suggested to many investors that a new bull market would be in the offing for the major stock market indicators, and that it would be led by the technology sector's "magnificent seven".

For investors broadly, speculating about future events is nothing new. It is, in fact, what the stock market is based on and why it is considered a leading economic indicator. Investors often anticipate important events months in advance in order to stay ahead of the curve. Thus, the speculation in 2023 about interest rate cuts in 2024 was not out of the ordinary in its timing.

Yet, successful long-term investing involves more than speculative thinking or hopeful guessing. Among a host of other things, it requires a credible rationale that is rooted in tangible facts and trends, as well as sound investment strategies.

It remains to be seen if bullish investors are indeed correct in their early projections of interest rate cuts and new bull markets in 2024, or if their enthusiasm is too much, too soon.

"We lower the odds."

Our preference is for a more measured and patient approach. We know that successful investing does not require us to buy at the absolute low of the market or to sell at its absolute high, but that profits can be made at many points in-between. This is true even after greater clarity emerges on important stock market drivers such as interest rates.

One of the key objectives of sound investing is to stay in the game for a long time. Stock market history shows that in longer holding periods profits are more likely than losses. That means that we, as investors, have to be mindful of what works and what does not work - we have to properly gauge the odds. As Steve McQueen's character in "The Magnificent Seven" said to those companions of his who were worried that the odds of victory were against them, "We lower the odds". In other words, one of the goals in any strategic endeavor, including investing, is to lower the odds of losing, thereby increasing the odds of winning.

With that in mind, relying on seven stocks to boost investment returns cannot be viewed as a prudent strategy for the long-term. That approach does not lower the odds of losing, but actually increases them over time. As a reminder, the magnificent seven stocks were less than magnificent in 2022 as they lost -40% of their collective value during the stock market's correction that year. That year, the S&P 500 declined -18%, and the NASDAQ Composite dropped by -33%. Meta (Facebook) was the biggest loser in the "magnificent" bunch, falling by -65%. Concentration into a small number of stocks increases the odds of a big portfolio loss if the factors that propelled these stocks higher in the first place reverse and become unfavorable.

No matter how impressive the magnificent seven stocks may be on their fundamental merits, they should be treated like all other stocks. They should be used sparingly and should be seen as investments to be included in a well-diversified portfolio with the understanding that they are just as susceptible to corrections and bear markets as any other stock. They may be magnificent, but like the four gunfighters in the movie who never made it back, they are not bulletproof!

Why We Don't Share the Market's Enthusiasm, Just Yet

As a long-only shop focused mostly on equities, we add value to our clients' portfolios when the markets and our stock selections go up. We don't relish the prospect of a declining stock market,

or root for one to materialize. We understand that the markets move up and down in broad multi-year cycles, and that a down market is just as normal as an up market. To the extent possible we attempt to anticipate both up and down markets and to adjust asset allocations accordingly in order to keep our clients on course.

We also know that having a "perma-bull" mindset, as some advisors have, can lead us and our clients into unpleasant situations, especially as the market winds its way from long-term peaks to long-term troughs. As Steve McQueen's character observed about the cockeyed optimism of a man who fell off a ten-story building, "…as he was falling, people on each floor kept hearing him say, 'So far, so good' ". This kind of naive thinking is at odds with objective, unbiased investing, and goes against the certain knowledge that even "magnificent" stocks are subject to the laws of gravity, and that markets go down as well as up.

Unlike the consensus sentiment, we are currently less enthusiastic and more cautious about the sustainability of the market's 2023 year-end rally. We assume that for a significant part of 2024 stock market returns will be less ebullient than many now assume, and that investors who are focusing on the benefits of potential interest rate declines in the year ahead, may be ignoring other important factors that could drag stocks lower, or sideways.

For example, in the U.S. almost 70% of the economy is driven by consumer spending. At the moment, consumers are becoming increasingly tapped out as their pandemic-related stimulus checks from the federal government have been spent. The use of credit cards is now on the rise, with the average credit card balance standing at over $6,300 according to credit reporting company Experian. That represents about 8.4% of the average household's 2023 annual income of $75,143. By comparison, in 2021 when consumers were flush with pandemic cash, the credit card balance figure was $5,200, or 6.8% of that year's median household income of $76,330. Rising consumer debt places caps on future consumer spending, which is largely what corporate earnings and rising stock prices rely on.

Globally, we see the weakening economies of Europe and China as further drags on U.S. economic and corporate growth. China is experiencing disinflation, where prices are falling due to a lack of sufficient demand. Europe in turn is being hobbled by declining exports to China, Europe's biggest trading partner. The companies that make up the S&P 500 Index produce roughly 40% of their sales in foreign markets, so there is no avoiding the negative impact that a slowdown overseas will have on S&P 500 earnings.

With slowing economies in the major regions of the world, the U.S. Treasury yield curve continues to be inverted as safety-minded bond investors from around the world flock to long-dated U.S. treasury securities. That effectively sends long yields lower and short yields higher, thereby inverting the treasury yield curve. The inverted yield curve is a reliable signal that an economic slowdown in the U.S. is a distinct possibility.

At the same time, the U.S. stock market remains expensive by almost any measure and is therefore susceptible to a slowdown in economic activity. The chart below shows the ratio of Total Stock market Capitalization to GDP for the United States (Source: gurufocus.com). It highlights the reality that the stock market has a value that is currently almost 75% above the value of the country's

total economic output. That's a sign of frothiness in the stock market and is a headwind to stock market returns in the future.

Despite these facts, retail investors continue to expect positive returns from their stock holdings in 2024. According to the American Association of Individual Investors, "Bullish sentiment, expectations that stock prices will rise over the next six months, increased 4.0 percentage points to 51.3%. Optimism is now unusually high, at its highest level since July 20, 2023 (51.4%). Bullish sentiment is above its historical average of 37.5% for the sixth consecutive week and the seventh time in 10 weeks". (www.aaii.com, 12/14/2023). Individual investors may be right in their positive assessment of investment returns in 2024, but from an historical point of view, highly bullish sentiment tends to be associated with declining, rather than rising, stock markets in the future.

Avoid "Jumping in a Mess of Cactus"

Investing always involves some level of uncertainty and risk, so the current uncertain and speculative environment is nothing new. It is par for the course.

However, as investors, we have a choice between following the crowd as it looks for short-term gains, or taking a more measured approach, with the goal of preserving assets and positioning portfolios for growth over the long term.

In the current speculative environment, we prefer to increase the odds in favor of secular value creation for our clients by waiting for greater clarity on the direction of interest rates. At the same time, we continue to keep an eye on other important factors that can affect investment returns, such as the economy. This is an active strategy that aims to position portfolios to be less volatile than the overall market while still being able to benefit on the upside from a potential cut in interest rates. This means that we are always on the lookout for opportunities to purchase attractive stocks and fixed income securities, or to maintain appropriate levels of cash.

To us, no matter how important the magnificent seven companies may be for their technological innovations, chasing a few super-charged stocks and hoping they will lead the broader market higher seems unwise. It reminds us of a comment by Yul Brynner's character in the 1960 movie. He said, "It's like a fellow I once knew in El Paso. One day, he just took all his clothes off and jumped in a mess of cactus. I asked him why? He said, 'It seemed to be a good idea at the time.' "

Wise perspective for any investor.

All the best for 2024.

V. Henry Astarjian

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