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And Then There Was One

Stock Market Breadth Narrows Further

A few years ago, a friend of mine who was a new investor at the time asked me which stock I would own if I could own only one stock "forever". His goal was to extract the single name from my list of favorite companies that I felt most enthusiastic about.

I answered that picking only one stock and sticking with it "forever" wasn't such a great idea. No matter how well a company's business may be doing today, no one can predict its long-term prospects with complete certainty. Besides, a one stock portfolio would almost surely suffer huge swings in price over time and would be a source of angst for him.

Today, I find myself observing my friend's mindset among investors generally. The attraction of owning one single stock that holds the promise of unimaginable wealth is completely understandable. It is simple and efficient. A one stock portfolio means less work, fewer decisions, fewer buys and sells, and far fewer things to monitor. It's the ultimate auto-pilot investment - set it, forget it, and wait for the big payday.

So when one stock, like Nvidia, comes along and is universally lauded as *the* single best growth company of the present and the future, it is natural that investors would flock to it or would assume that it should be their biggest holding, if not their only holding. In 2023, the "Magnificent Seven" were all the rage, but are now almost passé as a group. Investors seem to have moved on, employing a much simpler one-stock strategy instead. After all, why bother with seven stocks when only one will do?

As a result, the stock market's breadth has narrowed further in recent months. A narrow market is one in which only a few stocks lift the market higher. Narrow breadth in a bull market is often seen as a harbinger of market weakness, possibly even of a full-blown correction or bear market.

We've Been Here Before

Yet, this fixation on one single stock is not a new phenomenon. We have seen this scenario many times before.

Looking back a few years to another time of rapid technological innovation, the 1990s, we can find parallels from the Internet revolution that are both relevant and instructive to today's situation.

The '90s saw one of the strongest stock markets in U.S. history with the S&P 500 rising over 300%. Much of that rise was fueled by the technology sector.

Looking back on that period, if I asked you to name one of the 10 best performing stocks of the decade, what would you guess? Microsoft? Apple? Nvidia? McDonald's? No. It was none of these. Cisco Systems (CSCO), the company that designs and manufactures internet routers, was one of the top performers of that decade. The Internet was a growth industry at that time and routers were a key component of the system.

From the start of the '90s to its end, Cisco's stock rose by a staggering 1,339 times! A $1000 investment into this stock at its initial public offering in February 1990 would have mushroomed to $1,339,000 by December 1999. Understandably, Cisco was the darling of the investment world for years, and it shared unqualified and enthusiastic support from both Wall Street and retail investors alike.

At its peak, Cisco's share price traded at more than 200 times the company's earnings, and 38 times its sales. To put that into perspective, the S&P 500 Index historically trades at an average 15 times earnings and 1.6 times sales. And while some Wall Street pros were expressing hesitation at the stock's stratospheric valuation, some others seemed to err, not on the side of caution as the stock went up, but on the side of FOMO, the fear of missing out. They argued that if the stock is going up and investors are willing to pay the hefty premiums, there's no reason to stop them. As they say in New Orleans, "laissez les bons temps rouler!"

Hence, Cisco's stratospheric valuations didn't deter eager investors who believed that the company's prospects were stellar for many years into the future, perhaps even forever.

By the end of the decade, however, the stock had run its course and during the next two years it declined by as much as 90% from its high with the bursting of the Internet Bubble in 2000. Since then, it has never regained its former high. An investment in this stock at its all-time peak in March 2000 would still be underwater by more than 38% today. That's 24 years of losses for anyone who bought near the highs and then held on in the belief that the company's prospects were unquestionably great, in perpetuity.

Another high performing and popular stock of the 1990s was a company that you may never have heard of, Viavi Solutions (VIAV), formerly JDSU, or JDS Uniphase. This company makes testing and monitoring equipment for internet networks. Over the decade of the '90s, its stock skyrocketed by 304 times, meaning that a $1000 investment here would have ballooned to $304,000 by the end of the decade. Like Cisco, Viavi finally hit its all-time peak in March 2000 and then proceeded to fall in lockstep with the bear market of the next two years. This stock too has never regained its March 2000 highs, and today trades 99% lower.

What is the moral of the story here? It is certainly *not* that investors should avoid high growth stocks or that they should forego the most popular names simply because they are popular. Indeed,

there can be a place for high-flying stocks in well-thought-out, well-diversified, and well-monitored portfolios, but only when those stocks are purchased in reasonable quantities and at reasonable valuations. A more haphazard approach that's based on FOMO rather than sound investment principles, risks poor portfolio performance, or even a loss of capital.

In the end, investing is a long-term endeavor that requires more than one home run by one single super-stock.

Nvidia and the Fed - Today's Market Drivers

At the start of 2024, Wall Street expected the Fed to cut interest rates by up to six times this year. You may recall from my January 2024 letter that I was skeptical of that expectation, knowing that inflation in key areas such as services, food, and housing would be hard to tame. I concluded that reducing inflation would probably necessitate higher rates for some time.

More than six months on, the Fed still has not cut interest rates. Street analysts have tempered their earlier expectations and are now looking for only one or two cuts by the end of this year. Their insistence on the need for rate cuts is based on the fact that the general level of inflation has already eased substantially over the past two years. They argue that inflation is close enough to the Fed's 2% target to justify cuts that would stave off an economic recession and keep the stock market moving higher. That may be the case, but inflation has not been eliminated across the board. It remains especially pronounced in the services sector which is a vast area that accounts for more than 65% of the U.S. economy.

Since interest rates are a key input into the valuation of both individual stocks and the overall stock market, what the Fed does has a direct bearing on the value of our investments. This is almost universally understood.

But what may be less appreciated is the effect that Nvidia can have on the valuation of the whole stock market at this time, and hence on almost every portfolio in existence. Because of its massive size in the marketplace, this company's influence on the whole equity market cannot be overstated or ignored. It is truly substantial.

During the first half of this year, Nvidia contributed more than a third of the S&P 500's 15.1% rise. By comparison, the S&P 500 Equal Weighted Index, which puts Nvidia on an equal footing with the index's 499 other components, rose by a more modest 4.1%.

Due to its unprecedented size, Nvidia will also play a vital role in guiding Wall Street analysts as they make their predictions for the S&P 500 Index's year-end price targets and earnings per share estimates.

According to FactSet, the company that tracks earnings data for the S&P 500 Index, "Nvidia is…the largest contributor to earnings growth for the entire S&P 500. If this company were excluded, the blended earnings growth rate for the index would fall to 3.3% from 6.0%" (FactSet Insights 05/24/2024).

Can there be any greater proof that today's stock market is extremely narrow? It feels perilously perched on the apex of a fulcrum, ready to tip much lower at the slightest imbalance. If just one mega-cap company, Nvidia, misses its earnings target due to high interest rates or company-specific glitches, the entire stock market could sell off. That's something that serious investors should consider.

Let's get back to my old friend again. When I told him the risks of owning just one super-stock, which potentially included high volatility and a loss of capital, his response was that I should not worry. He would follow the company closely and would sell the stock when it hit its peak. I don't know if he would have been able to achieve that ambitious goal, but you have to admire his rookie confidence.

Today's stock market reminds me of my old friend - a novice investor who is willing to risk everything for one spectacular payout no matter what the cost may be. Yet, if history is any guide, a high-flying stock will continue to fly high, until it doesn't anymore.

At times like this, caution is surely a virtue.

V. Henry Astarjian

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