

## It's Still Narrow at the Top

July 2023

Letter No. 120

The highlights from the month of June:

\* The Federal Reserve (Fed) left interest rates unchanged, but rather than hinting they will remain that way, they instead committed to two more increases in 2023

\*The major indexes, the Dow Jones Industrial Average, the S&P 500, and the NASDAQ 100 were up in June approximately 3.0%, 4.8%, and 5.1% respectively, largely on the backs of the same seven of the largest companies (the “Magnificent Seven”)

\* Artificial Intelligence (AI) has become a staple phrase of the financial lexicon (see last month’s letter #119, “Artificial Intelligence or Artificial Stupidity?”), continuing to drive the current “glamour” growth stocks higher

As we begin a new month (and a new quarter), it will be interesting to see the price reactions to corporate earnings, forecasts, and business prospects as the quarterly reports start to come out in earnest starting the second full week of July. As is always the case, there are a lot of moving parts, but the most dominant force in the U.S. stock market in 2023 has been the strength of a narrow handful of the largest companies, and they continue to be the main driver of performance for the major stock indexes. In my May letter (#118, “Gold Glitters!”), I dedicated a few paragraphs illustrating just how potent these few extremely large companies have been in their importance to the leading indexes. Here we are, two months later, and it has only gotten more concentrated at the top. From a Barrons.com article of June 22 (*“The S&P 500 Gains are Deceptive, A Look at the Numbers”*):

***“....megacap tech has attributed almost 12% of the total gain to the S&P 500 this year (ed., which was up by 14.9% total as of June 20). By excluding those***

*seven stocks (which were named earlier in the article), the index would be up about 3% year-to-date, making it a truly average year.”*

This very narrow leadership at the top may well be distorting the average investor’s view of the underlying health (or weakness, depending upon your view) of the total market. This is making 2023 perhaps more challenging from an asset-allocation perspective than many of the more recent years of the past. I have read articles from authors who I have a very high regard for that effectively view the current conditions as a sort of “trap door.” That is, the “breadth” of the market is so poor (given the huge disparity between those top seven leadership stocks and nearly everything else) that it’s a real possibility we may be sitting on a potential downturn (if those seven or so stocks should falter). However, on the other end of the spectrum, there are others of whom I also respect who believe the perfect set-up exists where all the rest of the stocks could start to catch up, leading to a potential rally in the second half of this year. As the summer months go by we will have the answer as to whether one or the other of those two extreme opinions are the more accurate, or if the end result is somewhere in between.

It would be wonderful to know the answer to the obvious question, “Which is it?” This is what creates the mystery of the markets. It is also imperative that each investor has to decide for themselves how much risk exposure they should have that makes them most comfortable given the current set up. Those who choose to greatly reduce their equity risk can now earn mid-single digit returns with the short-term fixed income holdings (unlike the past where the return was near zero). If your investment timeline is still a long one, then more equity risk exposure might still make sense if your future required annualized return estimates has you needing more than what a typical 5-year or 10-year bond can deliver in the current environment, particularly if you can continue to add new capital on a regular basis, allowing for long-term dollar-cost averaging.

**And then there is this:**

There are two graphics below. The first (Fig.1) is an illustration, created by Jean-Paul Rodrigue of Hofstra University, that depicts what has classically been considered the changes of investor sentiment as we traverse a “typical” full

market cycle (defined as the completion of both the bull cycle and the subsequent bear cycle). The second graphic (Fig. 2) is a 10-year chart of the NASDAQ 100, the leading index wherein the aforementioned “megacap tech” stocks are the most influential. Notice a nearly uncanny similarity between the movement of the NASDAQ 100 and Rodrigue’s conceptual depiction for the first two-thirds of his graphic. Of course, no one knows what the future holds, but we do have history as a guide. Take a look:

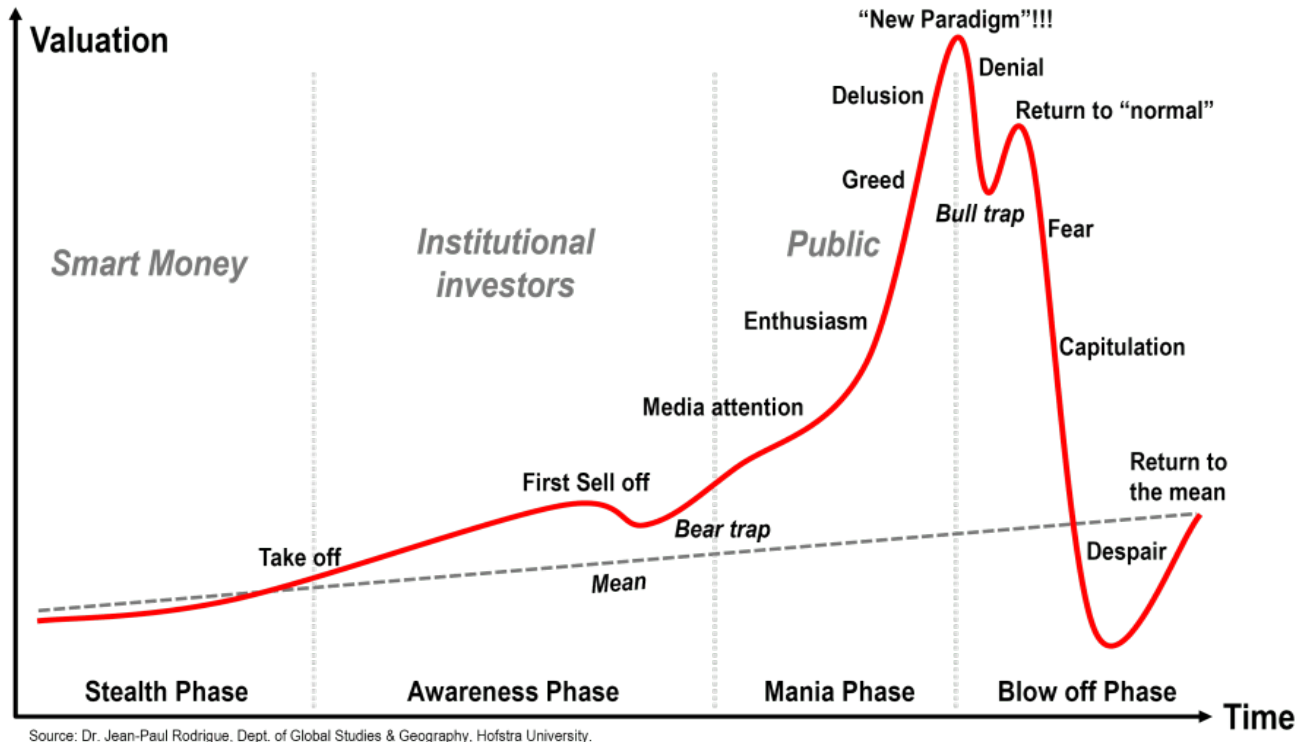
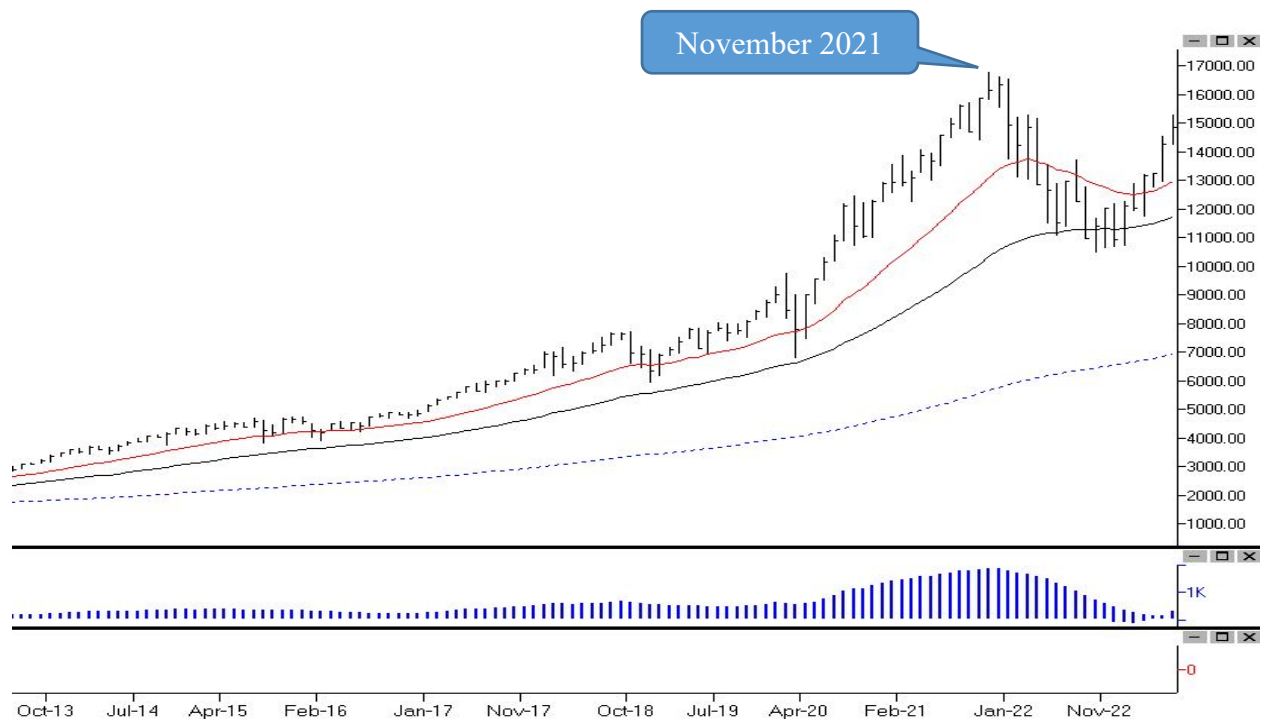


Fig. 1: Depiction of a full market cycle by Dr. Jean-Paul Rodrigue, Hofstra University



**Fig. 2:** 10-year Chart of the NASDAQ100, June 2014 to present (Source: Refinitiv)

Two notes of interest for the Rodrigue graphic: 1. Take note of the phrases in the mid and lower areas of the graphic, as the phrase “Smart Money” sits above “Stealth Phase,” “Institutional Investors” sits above “Awareness Phase,” and “Public” sits above “Mania Phase.” It has been well-documented from history that the general public arrives late (and large!) at the terminal phases of any asset bubble, and in my opinion this has occurred once again, driven in part by the seemingly void of interest-bearing alternatives. Then 2. At the uppermost part of the graphic you’ll see “New Paradigm” followed by “Denial” and “Return to ‘Normal’”. I also believe that this part of the full market cycle correlates extremely well with investor attitudes and psychology that drive the NASDAQ 100 stocks. For the record, an all-time high water mark was notched in November 2021, followed by a meaningful dip and subsequent recovery that is still below the prior high. Interesting set-up.

If the similarities between Rodrigue’s depiction and the real-world, real-time trajectory of the NASDAQ 100 continue, that would suggest that the scary sell-off from that November 2021 all-time high and the first low in mid-October 2022 (a 33% total decline) might correlate with the “Denial” phase in the upper graphic. Then, the recovery from there to now may also correlate to what is

depicted as “Bull Trap” and “Return to ‘Normal’”. Does it feel like we are returning to normal to you? The “trap door” analogy that I mentioned on Page 1 would be correlated with Rodrigue’s depiction on the far right, the “Fear” phase which is then followed by the “Capitulation” phase. I must emphasize again that the future is unknown, but the depiction as illustrated by Rodrigue has historical merit.

At this stage, here in July, we are at what could be a critical market junction. If the major stock market averages can continue upward to take out new all-time highs and the talk of an explosive summer rally actually comes to pass, those who can tolerate higher risk (while seeking higher returns) might have to hold their noses on the valuation levels and simply join in. If we fail to get to new highs, if the forecast for higher second half earnings are called into question, or if the Fed carries out more rate hikes, the potential for caution and further market deterioration may be the more likely outcome. For the record, it is my view that the “Magnificent Seven” stocks mentioned above are being treated as the “New Paradigm” by too many within the speculating community, but are actually going through a highly speculative “blow off” phase, the most terminal of phases following near-vertical pathways of price action. Again, that is my opinion.

My strategy remains unchanged from the past several months despite the relatively flat returns generated for most of us so far (year-to-date). Let me state for the record that I tend to lean into value investments more than growth. If given the opportunity to buy a high-flying growth stock at what are historically “off the charts” valuations, even if momentum, future growth of earnings forecasts, and rabid price speculation are all working to drive the stock to newer and higher highs, versus an out-of-favor, unloved, unwanted quality company with fairly predictable cash flows, an attractive (high) dividend, low financial ratios (price/earnings, price/revenues, etc.), and exceptional turn-around or restructuring or cyclically beneficial potential, I will take the latter all day long. That is my investment style. It should also be mentioned here that I am actually seeing more and more potential for my type of stocks out there, despite what appears to be a total lack of interest from the rest of the investing crowds.

Certainly the runaway stocks are fun, but sometimes the higher they go the harder they fall. Stocks that grow to the sky are fun until they get so over-bought that they ultimately collapse of their own weight (or height!). Some would argue (logically) that it is better to have some of both kinds, high growth and value-oriented stocks, and I would whole-heartedly embrace that if we were at a bottom phase of the overall markets. Look at the depiction in Fig. 1 again and look for where you see the word “Despair” on the far right. This is the point in time of the major market cycle where I would gladly come in and buy the beaten down growth”stocks hand-over-fist. I’ve lived through many “full market” cycles in many different kinds of assets in my lifetime. I can say with full confidence that the day of “despair” will arrive soon enough where we are back below the mean, and when it does, I believe we will need to have liquidity, firepower, and the willingness to take the unpopular side.

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Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees.

The Standard & Poor’s 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The NASDAQ-100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies. The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market.