STRATOS
INVESTMENT MANAGEMENT

THE MAG SEVEN AND THE MARKETS

COMMENTS ON Q2 2024, OUTLOOK FOR THE SECOND HALF AND AN EARLY LOOK AT 2025

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The Mag Seven became the Mag 5 and it seems like equity markets are hanging on all things AI (Artificial Intelligence). We have also been hearings comparisons between the current market and the dot com bubble at the end of the last century. Unfortunately, even though the Mag Seven became the Mag Five, the top seven stocks now represent nearly a third of the total market capitalization of the S&P 500. (The S&P 500 is a market capitalization weighted index, where each company's weighting is determined by its size relative to the index.)

Are we witnessing another bubble ala the dot com era? One thing about my having started in the investment business on Black Monday 1987, is that we do have some perspective into those kinds of markets.

In our minds, the most obvious comparison is between NVIDIA, which gained nearly 4300% in a recent five-year period, and Cisco Systems which gained approximately 4500% in the five years leading to its peak in 2000. While both companies are/were dominant technology hardware firms, the earnings profile is different. At its peak, Cisco had a PE of 131X forward earnings estimates in March 2000, whereas NVIDIA trades at approximately 40X expected earnings. Is NVIDIA's value extended? In our view, certainly, but not nearly as bad as the extreme valuations of the dot com era.

Performance Comparisons

While trying to compare the performance of the S&P 500 to S&P 500 Equal Weight Index, we used FactSet to plot performance comparisons (on a price basis) over the last five years. What we saw was that the two indices tracked each other fairly closely until March of 2023, when the S&P 500 started to distance itself from the Equal Weight Index, with that divergence seeming to accelerate in February of this year.

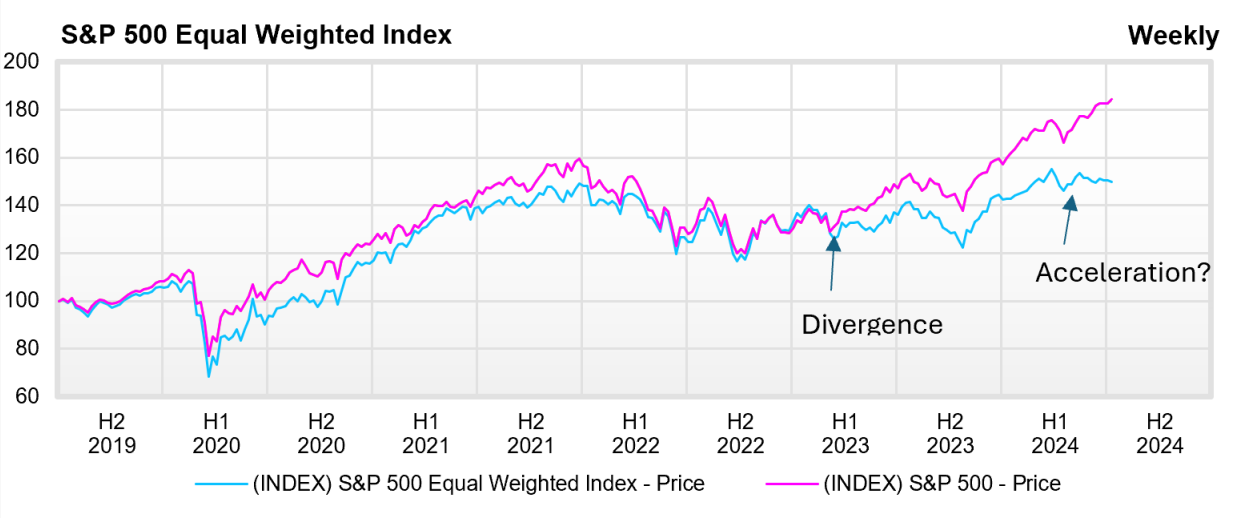

Figure 1 - Source: FactSet

Comparing that to the dot-com era, we see from the chart below, that the divergence seemed to happen much earlier, with acceleration appearing to occur during the second half of 1999, with the performance acceleration coinciding with a singular event – Y2K.

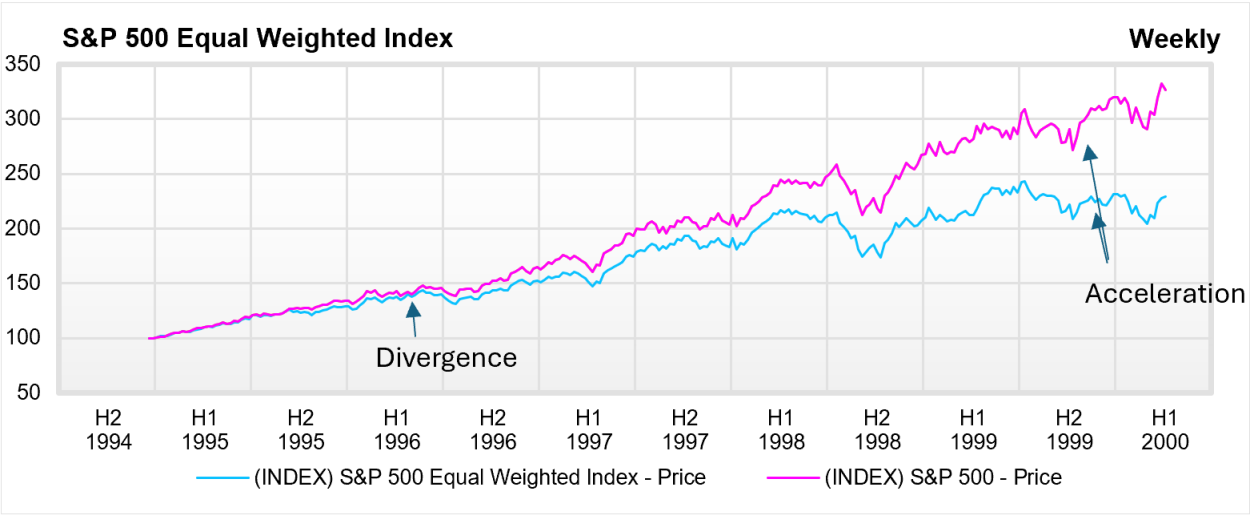

Figure 2 - Source: FactSet

Because most of the computer code written up to the late 1990s used a two-digit code to designate the year, there was concern that when the date hit 1/1/2000, that computers would assume the date to be 1900, and all computer systems would crash, lights wouldn't

come on, etc. As a result, there was a huge rush to upgrade computer equipment and re-write computer code, with the result that there was a huge influx of computer and equipment purchases made in the last couple of years of the 1990s making it look like spending growth was accelerating on a "more permanent" basis. Because we believe Wall Street likes to extrapolate current data into the future, many firms assumed that this higher level of spending would last for some time and when the Y2K upgrade spending stopped and showed up in the revenues for many of the dot-com names (and beneficiaries) the stocks re-priced downward – sometimes significantly so.

The big question, therefore, is, "Is it different this time?" We believe the answer might be, "maybe". That said, we believe that there are also some causes for concern.

Is It Different This Time?

In our view, the biggest difference between now and the dot com era is the fact that there is no single "event" like Y2K driving the AI spend. WE don't believe that AI spending should stall simply because of a specific point in time. AI spending is, indeed, in its infancy and it should have a profound impact on the way business is done for many years, if not decades, into the future. Yet the event that has, in our view, largely created the need for the efficiencies AI helps push forward has had both a long gestation period and should have a long tail. That is the aging of the Baby Boomer generation and the advent of both the Millennial Generation and Gen Z.

The Baby Boom Generation, at one time the largest generation in history, has been the driving force behind many of the economic changes over the last sixty years. In our view, Boomers were the reason behind the significant inflation experienced in the 1970s and are the reason behind the employment dislocations occurring today.

Born between the years 1946 and 1964 (or 1966 depending on the demographer), Boomers are now (on average) 69 years old. This has translated into the age 65+ age group as the fastest growing sector of the labor force according to statistics from the US Bureau of Labor Statistics. As you can see from the chart below, the 65+ cohort now makes up roughly 22% of the labor force, whereas Millennials and GenZ (represented by the Cohorts 16-24; 25-34 and 35-44 yrs.) represent 14.52%, 16.56% and 16.45% of the Labor Force respectively.

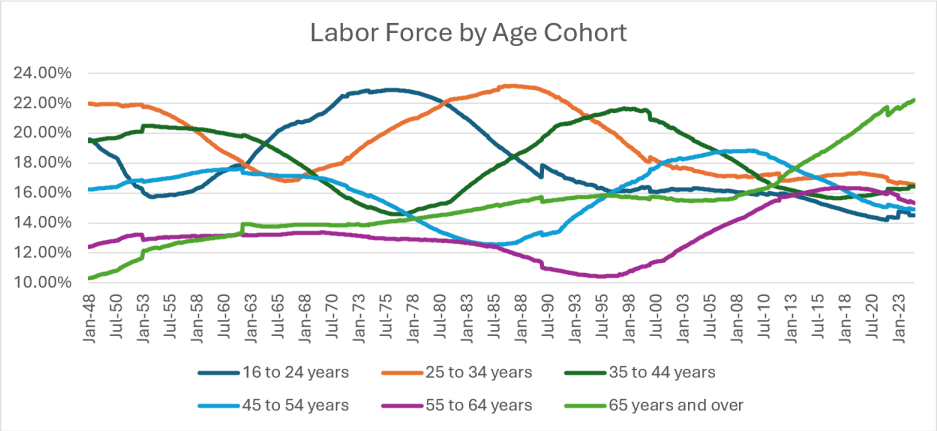

Figure 3 - Source: US Bureau of Labor Statistics, Labor Force Statistics

Remember, there is a distinction between being a member of the labor force and not working and being unemployed. To be considered unemployed, you need to be both out of work and looking for work (emphasis added), whereas to be considered part of the labor force (whether working or not) you simply need to be age 16 or over. This means that retired Boomers are still considered part of the Labor Force.

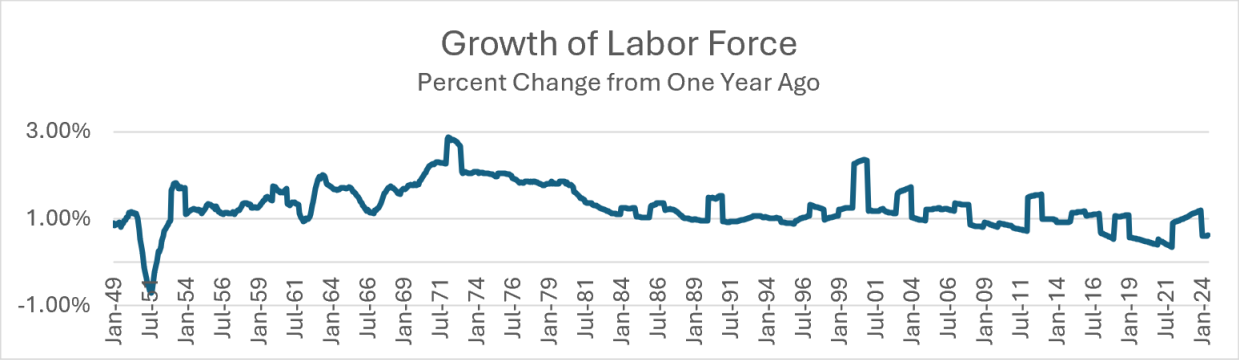

Figure 4 - Source: US Bureau of Labor Statistics

The impact of the Boomer Generation on the labor force can really be seen when looked at through the lens of the growth rate of the labor force. As you can see from Figure 4, the growth rate of the labor force peaked in 1972 (the oldest Boomer was 26 and the youngest was 14), began a decline until the mid-1980s when the labor force growth rate stabilized, rose marginally from the mid-1990s stabilizing again at the turn of the century and then began declining roughly coinciding with the Great Recession. Another way to look at this is as while Boomers retire, they stay in the labor force and the younger generations are not large enough relative to the size of the labor force to move the needle on growth rate. We believe this is creating the issues surrounding the ability (or inability) of employers being able to find qualified employees, a reason why there are more job openings than unemployed people and a reason why businesses need to find efficiencies to make up for the skill differences between the retiring (and retired) Boomers and the younger generations. Hence the need for AI.

So, is it different this time? Possibly. However, that does not mean that we should ignore the valuation issues inherent within the market cap weighted S&P 500. In fact, we looked at the return of the S&P 500 versus the S&P 500 Equal weight over the last thirty and twenty years and discovered something interesting. As you will note from Figure 5 below, the S&P 500 Equal Weight index actually outperformed the S&P 500 for long periods of time, with the S&P 500 outperforming the equal weight index during the dot-com era.

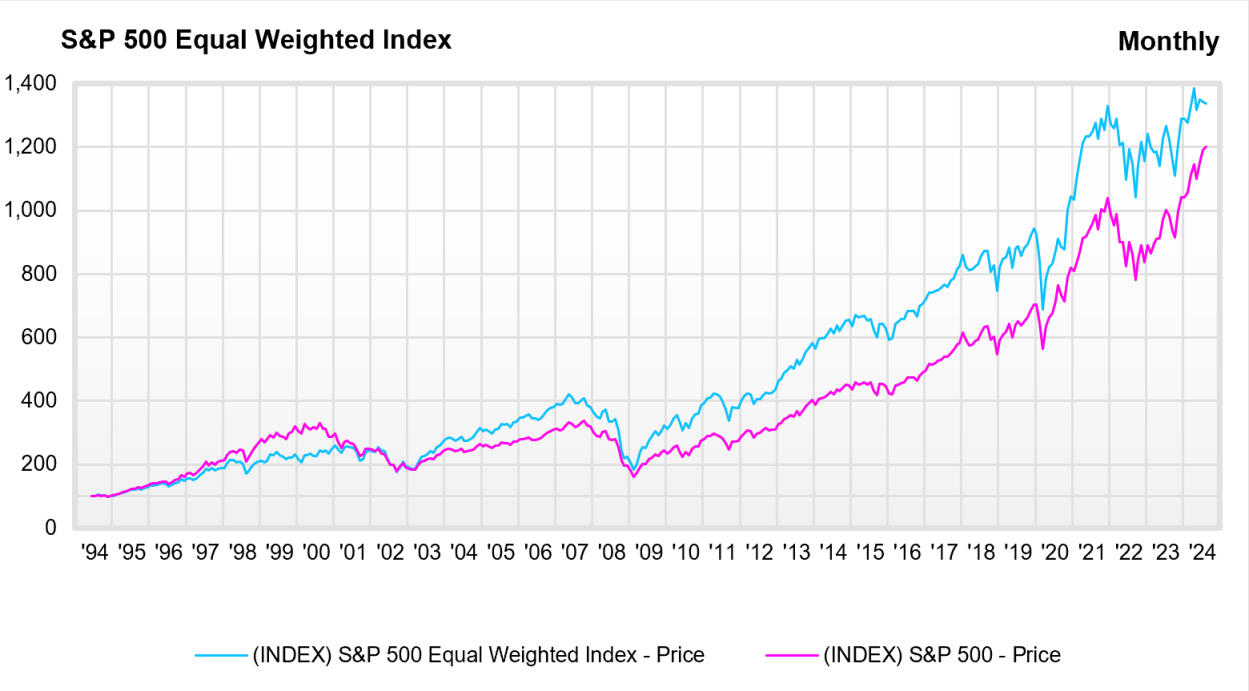

Figure 5 - Source: Fact Set

If we compare performance over the last twenty years, we see much the same thing. The S&P 500 Equal Weight Index outperforms over long periods of time, but we see something we find to be very interesting. Looking at Figure 6, we see that the S&P 500 performance has eclipsed that of the S&P 500 Equal Weight Index as of June of this year.

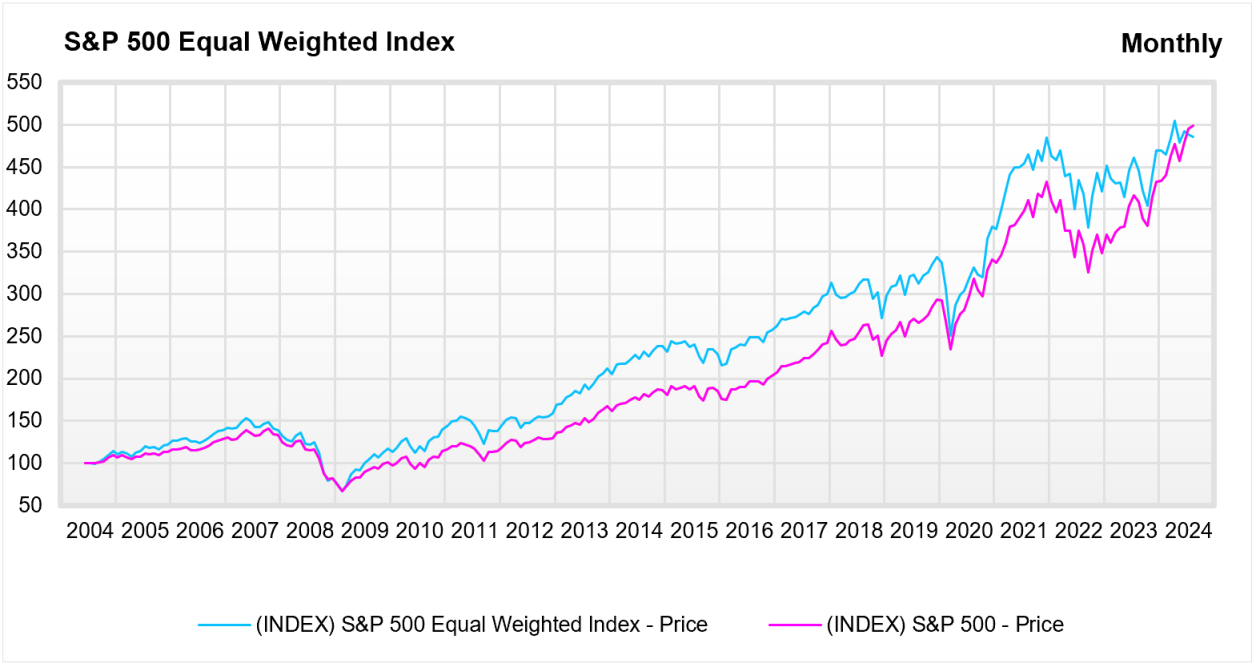

Figure 6 - Source: FactSet

As we wrote in a piece titled "How Much Risk Are You Taking?", we believe that this is due to the significant outperformance of the Magnificent Seven (really the Magnificent Five this year) relative to the rest of the companies that make up the S&P 500. While we can't be clear of the meaning of the performance of the S&P 500 climbing above that of the S&P 500 equal weight, we do know two things: 1) the outperformance of the S&P 500 relative to the S&P 500 Equal Weight can exist for several years, and 2) when it reverses itself, we believe the results are likely to be unfavorable – as they were in 2000-2002.

(Interestingly, the Russell 2000 Index, which is often viewed as a proxy for small cap stocks, is suffering from a similar fate. The Russell 2000 rose approximately 1% through the first half of 2024, but Super-Micro Computer – a $15 billion market cap stock – represented the index's largest holding at more than 1% of the index's total market value. According to an article in Barrons, Super-Micro drove almost two percent of the Russell 2000's return for the first half, meaning the index would have lost money in the first half of the year without it. However, because Super-Micro is now too large for the small-cap Russell 2000, it was removed from the index at the end of June.)

The Economy

We had titled our last quarterly piece, "What if the Fed Does... Nothing?", and so far, the Fed has not (yet) moved to cut rates. We had thought that the six (or seven) cuts the market had expected was a bit unrealistic, as we did not believe that the US economy would enter a recession. So far, the economy has cooperated with growth remaining in expansion territory.

We had also said that investors needed to actually listen to what the Fed was saying and that they had been reiterating that inflation was too high. While the Fed has continued to point out that inflation is running above their 2% goal, there have also been more rumblings that they are "making progress" towards their goal.

GDP has moved down from the 3.4% rate in Q4 2023 to 1.4% in Q1 of this year (2024). This is below the rate of growth projected by the FOMC in its June 2024 Summary of Economic Projections (also known as the "dot plot"), which shows that the Median expectation of the FOMC members is expecting GDP growth of 2.1% this year slowing to 2.0% in 2025 with inflation (defined as PCE inflation) running hotter than their goal out to 2026. Does this mean that they are going to ignore the economic slowing that is taking place? We don't think so, in fact we had indicated at the beginning of the year that the Fed was likely to cut a couple of times in the back half of the year and we are sticking to that call.

Outlook for the Remainder of 2024 and a First Look at 2025

How long can the outperformance of the Mag 5 continue? To quote one strategist we listened to a couple of decades ago (in reference to the dot com era and the valuation concerns then), "it will work until it doesn't, and when it doesn't it is likely to be very bad." The only problem is that no one knows when that moment will occur and to quote Sir John Maynard Keynes, "The markets can remain irrational longer than you can remain solvent." Meaning, (like the earlier quote) it is impossible to consistently time tops and bottoms.

What I have found over my thirty-five years in the investment business (including the downturns of Black Monday, the tech wreck, the Great Recession and Covid) is that avoiding big risks tends to serve investors better over time than taking big risks and hoping you can get out in time. Looked at another way (and something we have told investors over the years), while it is certainly fun making money when things are going really well, it is better to hold onto your money when things turn down. As a result, that is the lens through which we tend to view the investment landscape. So, what kinds of things are we seeing (or trying to avoid)?

As we said above, we expect that the Fed is likely to cut short-term interest rates a couple of times in the second half of the year – likely two 0.25% cuts. We would also not be too surprised if the Fed cuts a few times next year, but don't believe that they need to get as aggressive this cycle as they have in the recent past. As a result, we believe that the yield curve will likely normalize with longer rates higher than short rates both through shorter rates coming down and longer rates working higher. This likely means that fixed income returns will continue to be sub-par (we view long-term bond returns of 6% as "normal"), and we believe the Bloomberg Barclays Aggregate Bond Index (the Agg) could likely end the year roughly flattish (around zero return). If rates normalize, we would also not be surprised if the Agg ended 2025 in similar territory.

As we indicated at the beginning of this comment, at the beginning of the year we decided to shift exposure in our tactical portfolios away from the Mag 7 (now 5) by shifting to an S&P 500 Equal Weight portfolio. We still believe that decision was the right one, if for no other reason than it reduces the risks to which we expose ourselves. While market cap weighted large-cap and tech-focused benchmarks are all up more than 15% year-to-date, we believe that the potential rewards aren't worth the risks.

Large-cap stocks are likely to continue to outperform for the balance of the year, but we believe that smaller cap options hold better value and face less (potential) risks – particularly if the Fed begins cutting rates later this year. While it might not be enough to win the performance derby for 2024, lower (short term) rates could set up 2025 to be a different story.

Now that we are fully entrenched in political silly season, it is hard to write a market commentary without mentioning elections. There have been snap elections in both France and the UK with those currently in power losing. In France, Emmanual Macron's party lost to Marie Le Pen's populist National Rally, and in the UK, Labour ousted the Conservatives in its most sweeping victory in ages (although the results might not seem as cut and dried as they may seem). Not to be outdone, the US presidential election saw its first presidential debate, leaving Democrats scrambling to shore up President Biden's support in the wake of what can best be described as his "shaky" performance. While not publicly taking sides, we believe that the performance reinforces many voter's concerns, and that many wanted other choices. Regardless of who the eventual victor is, we think that the impact to the markets could be significant – particularly as markets sort through potential policy shifts. We will try addressing this in greater detail as we get closer to the election, and we take a closer look at where we see both obstacles and opportunity in 2025.

We have been saying through our various publications that paying attention to risk and/or trying to find ways to reduce portfolio risk should serve investors well. We continue to believe that to be the case. We quoted an old investment saying in our recent piece about risks (How Much Risk Are You Taking), that says: "Bulls make money, bears make money, but pigs get slaughtered." This saying is talking about investor greed – not that greed is necessarily a bad thing. However, we believe Warren Buffett had it right. "The time to be greedy is when others are fearful and to be fearful when others are greedy." We believe that now is the time to be fearful.

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