CORDA

TOGETHER WE'RE INVESTED

The Magnificent 8 and Everything Else

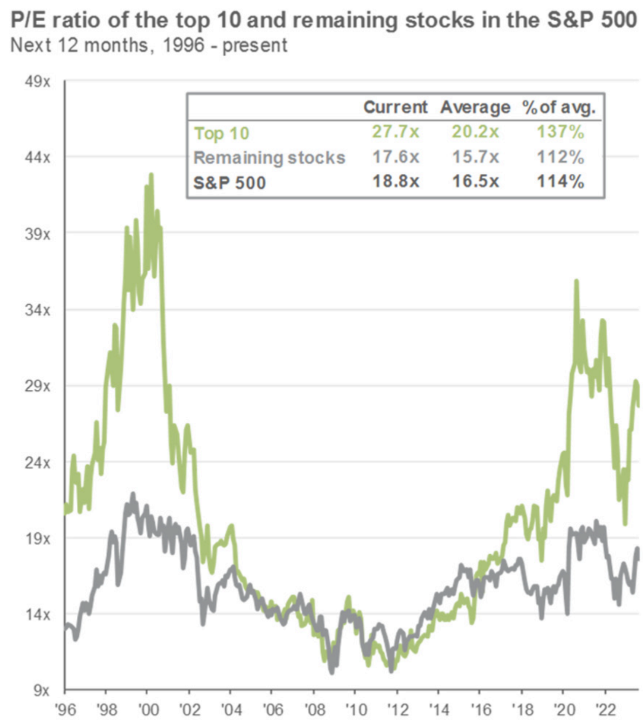
September 30, 2023

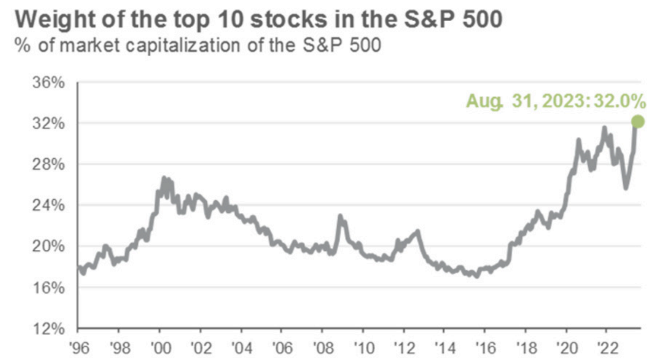
We are headed into the home stretch of 2023 and the market and economy continues to befuddle the most seasoned of investors and consumers. We've been grappling with the recession narrative for almost two straight years. Recall in Q1 and Q2 of 2022, U.S. Gross Domestic Product (GDP) was negative for two consecutive quarters, the necessary economic condition to declare an official recession. However, one theory suggested the near record low level of unemployment was a contrary indicator proving the U.S. was not undergoing broad economic weakness. Fast forward about 18 months now, and we find the Federal Reserve Bank of Atlanta's GDPNow model predicting a robust 4.9% growth in GDP for the third quarter that ends today. That's a far cry from where we were at the beginning of 2022! So where is this economy headed in 2024, that is the question, right!? *Time will tell.*

Well, as you know, we are not economists and rarely ever make macro forecasts, especially as what we like to call our "bottoms-up" process keeps us focused on corporate results. Typical bottoms-up approaches start with local or company-specific variables and then expand outward. That's how we operate. What we do know is that in the next 12 months there will be a barrage of election coverage that will "spook" the market, although that will be temporary. Assume for a moment we are a football coach, and our focus will be squarely on "blocking and tackling." As you know, we will continue to use that bottoms-up approach to our analysis and seek to determine the health of our businesses and how they might fare in the years ahead. Seeking to game the election outcome would not be a wise decision. Over many years of investing, we have witnessed investors who went to cash or had cash on the sidelines that never got invested all the while they were waiting for the "election to be over." You can bet they are full of regret to this day. The Morgan Housel quote comes to mind in this instance; "all past declines look like an opportunity and all future declines look like risk." If you don't expect there to be drama, then you are missing what the news cycle and elections are all about. If an investor thinks he/she can somehow control the narrative or know something that someone else doesn't and can use that information to make an accurate investment forecast, then they might be genius, or just extremely lucky. We'll never know!

It's not just the election year ahead that has investors on alert, but our crystal ball says that with the uncertainty surrounding a recession that may or may not materialize, or where interest rates may rise to, or for how long they might "stay higher," what we do know is that the uncertainty will slowly wash away and morph into something that appears to be "more certain" - *and the market will discount all of it.* The media will want you to believe nothing is right in the world. That's how they draw eyeballs. There is a record amount of money being stashed in money market funds. Isn't that telling? The public has grown tired of the volatility surrounding the equity market since 2020 and are resigned to holding cash. That smells like an opportunity to us. Recall, real life is not an algorithm. Volatility is normal, and it is the cost of admittance to earn those ever-pleasing historically high returns from the stock market.

Are equities overvalued? That might be a good place to dissect how the market might fare in the months ahead. See here from J.P. Morgan's Guide to Markets Aug 31st edition, slide #11:



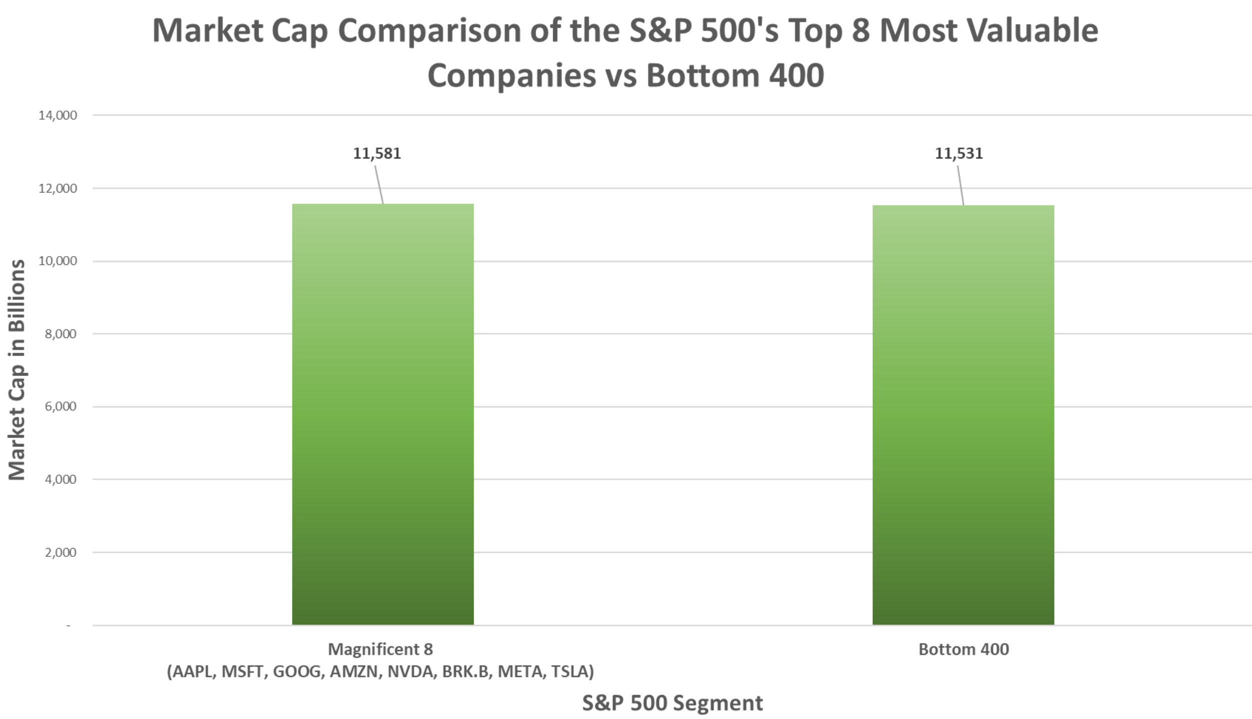


The left-hand side chart shows how inflated the P/E valuations are for the top 10 stocks in the S&P 500 relative to the rest. This trend has been strong year-to-date as growth stocks have rallied. The right side shows how the market capitalization of the top 10 stocks has increased recently despite the earnings contribution remaining muted.

How expensive are stocks then? It's a market of stocks and not a stock market, so depends on where you look! Based on the data above, the top 10 stocks are trading at almost 28 times their future earnings versus their historical average of 20x. That's definitely expensive. But if you look at the other 490 stocks, you can see they're trading at about 18x versus their average of 16x. That's obviously above average, but does this tell us anything about what will happen next? Absolutely not. When John Pierpont Morgan was asked for his market forecast, he wisely responded, "It will fluctuate." Another J.P. Morgan gem is, "Remember, my son, that any man who is a bear on the future of this country will go broke."

There is one significant advantage that we have when it comes to addressing the market and determining its direction. Recall how over 40% of the overall stock market return comes by way of dividends? If forced to make a grand prediction, then we'd answer with a dividend forecast. If a business is paying or has paid a dividend consistently over time, it would be highly unusual for it to decrease or suspend the dividend in the next quarter or two. Out of 30 or 35 businesses that we might own, perhaps one or two might reduce their dividend, but we are plainly counting on most of our holdings to continue to pay and increase their dividend payments in the coming years. Unfortunately, we cannot make any guarantees, but it's as close to a sure thing that we can find in the capital markets. Outside of that, we can seek to control our thoughts and feelings about future economic and geo-political events, but they are mostly out of our control. So why lose sleep about something you have little control over? As we like to say, dividends matter, and the recipe is to take advantage of a meandering market to bolster your position sizes in many of the high-quality companies with secure dividends that you own!

What we do know is that this is a highly concentrated market. The J.P. Morgan data above was analyzing the top ten businesses by market cap, but here we break it down to the top eight businesses in the S&P 500 sorted by market capitalization. What is startling is, when combined, the top eight equal the entire market cap of the bottom 400 businesses combined. Isn't that astonishing? There is about $11.5T of market cap in Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, Berkshire Hathaway, and Tesla all put together. Call them the Magnificent 8! Those 8 are so huge, it takes the combined market cap of every stock sorted by market cap from company #100 on the list all the way to #500 in the S&P 500 to equal the top eight. Wow.



So much of the benchmark return of the indices have been driven by the Magnificent 8 this year and if you own any of them, you should feel fortunate. Now recall, the road hasn't been smooth. All the way back in 2022 many of these share prices were down a lot as the Nasdaq declined 33% that year. Bottom line, there is opportunity in the remaining 492! There may be some catching up to do. So, think positively about the future and expect the usual amount of drama and noise around interest rates and elections in the coming weeks and months. You won't be able to avoid it, but you can adjust your temperament as to how you approach it, and not get sidetracked because of it. Stick to your strategy and don't lose control of your emotions.

Here's to a calm and cool demeanor as we roll into Q4 of 2023.

Best wishes from the CORDA Team.