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- The road is getting rockier, but "Magnificent Seven" had a stellar year in 2023. We think the risk of holding these stocks is high.
- U.S. energy production has risen to record levels and has offset production cuts by OPEC. Oil prices have softened. Nonetheless, we remain overweight this sector as these businesses are capital conserving, cash generating machines.
- Recession in 2024 remains a risk, and earnings estimates for the S&P 500 are probably too high.
- Thanks to the downtrend in inflation, the markets are discounting several cuts in short-term interest rates by the Fed in 2024. The markets may be too optimistic.
- As we saw at the beginning of 2023, when most analysts were negative, predicting the near direction of stock prices is fraught with error. Over time stocks go up because earnings go up.
- Volatility in 2024 should provide new opportunities for stock investment.

The S&P 500's Wild Ride

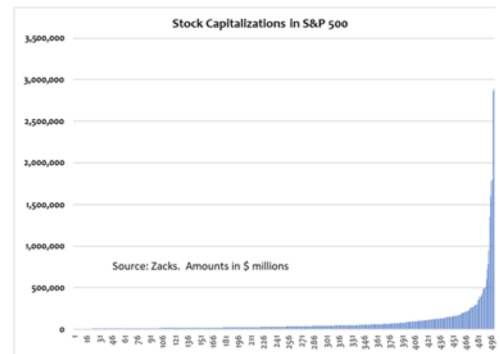
The performance of the S&P 500 has been dominated, both up and down, during the past two years by the Magnificent Seven: Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia and Tesla. These stocks are important because they have captured the imagination of the investing public. Also, their size gives them an outsized influence on the S&P 500, a capitalization weighted index. Please note that capitalization refers to the total value of a company's stock. As shown in Table 1 below, the seven have an average capitalization of $1.74 trillion, versus an average of $729.8 billion for the S&P 500 as a whole, which itself is skewed by those big stocks. Chart 1 below shows the distribution of market caps for all 500 companies. Most market caps are much smaller than the average, and the spike on the right side of the chart represents these big companies and a few others. If we look at the stock right in the middle of the 500 in the index, with half the companies bigger and half smaller, the median capitalization is only $32.4 billion.

Table 1 **The Magnificent Seven**

	Ticker	% of Portfolio	Tot Ret % 12 Months	Tot Ret % MTD	P/E TTM	P/Sales TTM	P/Book TTM	Market Cap ($ Mil)
ALPHABET INC-A&C	GOOG(L)	3.9%	60.7%	1.7%	27.3	6.1	6.8	1,798,174
AMAZON.COM INC	AMZN	3.5%	72.7%	2.1%	77.6	3.0	10.0	1,603,635
APPLE INC	AAPL	6.8%	42.7%	-3.6%	30.3	7.6	48.2	2,886,435
META PLATFORMS	META	2.0%	178.0%	4.4%	27.9	7.7	7.4	950,001
MICROSOFT CORP	MSFT	7.1%	69.3%	2.3%	36.8	13.1	14.3	2,858,671
NVIDIA CORP	NVDA	3.4%	244.7%	10.7%	70.3	30.5	50.9	1,354,103
TESLA INC	TSLA	1.6%	91.2%	-8.6%	73.1	8.3	15.8	722,315
Total/Average		28.3%	108.5%	1.3%	49.0	10.9	21.9	1,739,048
S&P 500		**100.0%**	**23.7%**	**0.2%**	**22.2**	**2.6**	**4.5**	**729,872**

Source: Zacks

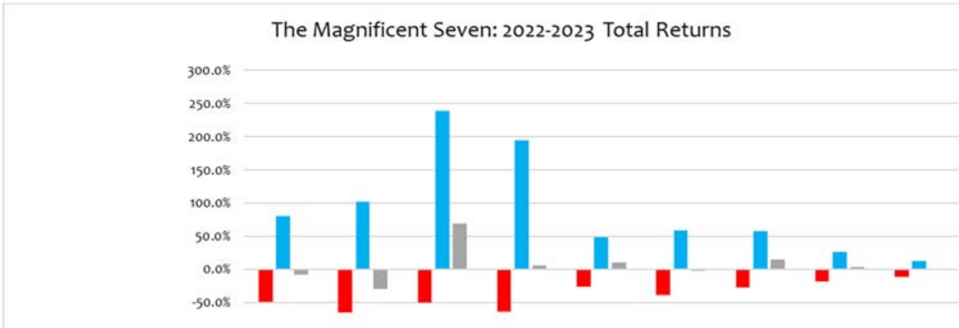
Chart 1



Source: Zacks, FVCM

Because of their size, these seven stocks tell us a lot about stock market performance, as measured by the S&P 500. Start with Amazon (AMZN) in Chart 2 below. Keep in mind that if a stock falls by 50% from $100 to $50, it then has to increase 100% to get back to $100. In 2022 Amazon was down 49.6%. Last year, with all the hype about the Magnificent Seven and AI, it rebounded 80.9%. Over the past two years, Amazon is down 8.9% despite 2023's big bounce back. Tesla doubled in value in 2023 but is still down 30% over two years. The biggest winner has been Nvidia, which makes semiconductors used in artificial intelligence (AI) applications. When Microsoft announced its $10 billion investment in Open AI in early 2023, it set off something of a frenzy. Not wanting to be left behind, many companies started investing in AI and buying the chips from Nvidia, which has raised prices tremendously. In the late 1990s, nearly every company wanted to put ".com" in its name, or at least talk about how much they're investing in the Internet. Today, a great many companies have used earnings calls with analysts to talk about their investments in AI. The cap weighted S&P 500 was up 26.3% in 2023, but coming after the 18.1% decline in 2022, the two-year return was only 3.4%. Weighting all 500 companies equally, the S&P 500 was up 12.7% in 2023 but is fractionally lower over the two-year period.

Chart 2



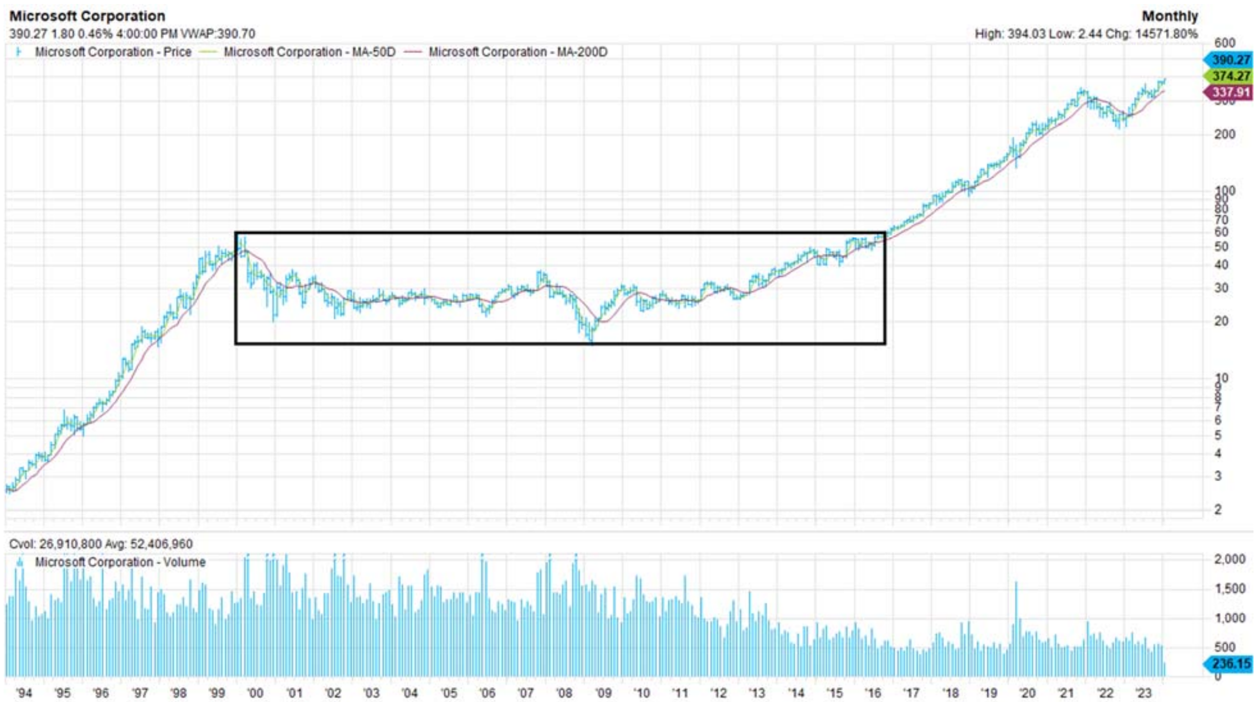
	AMZN	TSLA	NVDA	META	AAPL	GOOG	MSFT	S&P 500	S&P Equal Weight
2022 Total Return	-49.6%	-65.0%	-50.2%	-64.2%	-26.1%	-38.7%	-27.7%	-18.1%	-11.6%
2023 Total Return	80.9%	101.7%	238.9%	194.1%	48.7%	58.8%	57.5%	26.3%	12.7%
2022-23 Combined Total Return	-8.9%	-29.5%	68.7%	5.2%	9.8%	-2.6%	13.9%	3.4%	-0.4%

Source: Zacks, FVCM

AI is Real, but Beware

Much of the conversation in the financial press and among analysts is now about whether AI is still in the early stages of growth and development, suggesting, therefore, that the Magnificent Seven have lots of appreciation ahead. This kind of discussion is somewhat amusing because it is similar to what was happening during the Internet bubble in the late 1990s. The Internet was originally created by the U.S. Department of Defense in the 1960s and has been developing since. The Internet's commercial development accelerated in the 1990s but was still very primitive when the Internet bubble popped in March 2000. Did the Internet develop greatly after 2000? Of course, it's difficult to overstate how much the Internet has changed business and commerce over the past 20 years. But look at the chart of Microsoft below. It was fantastic during the bubble years, but if you bought Microsoft in early 2000 at $59 per share, you were looking at losses with a low of $18 in 2009. It wasn't until 2016 when you would have been able to break even on your purchase in 2000. The point is that AI is real, and it is likely to have tremendous effects on business and commerce in the years ahead. But that does not necessarily mean that the stocks are a good buy at this point.

Chart 3

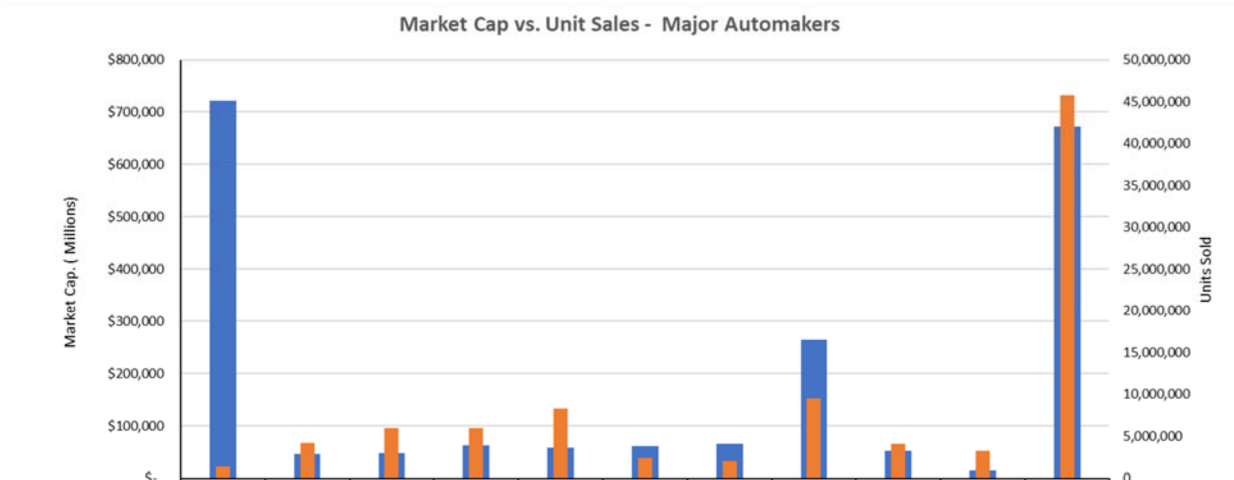


Source: Factset

Risk is in the Eye of the Beholder

Rather than trying to guess whether certain stocks like the Magnificent Seven will go up or down in the year ahead, investors may wish to consider the risk of owning them. In the academic world, like university classes in finance and investments, risk is typically defined by some measure of stock price volatility like standard deviation or beta. One major problem with those measures is that the data is not stable. Historical data may convince an investor that they own a stock that is marching steadily forward until some previously unanticipated development occurs. Such unanticipated events cause stocks to move sharply higher or lower, rendering the historic data meaningless. Another way of looking at risk are measures of valuation. For example, Chart 4 shows the market capitalization of various automakers around the world. Tesla's market valuation of $722 billion exceeds the combined valuations of Toyota, Volkswagen, Stellantis, GM, Ford, BMW, etc. For a sense of proportion, Tesla's sales of 1.4 million cars in 2022 was miniscule compared to the 45.8 million cars sold by those other companies. How is it possible that little Tesla is worth more than all those other companies combined? Sure, Tesla has a brilliant and eccentric founder, and they do have great engineers doing great work, but other companies have great engineers and will look to compete with Tesla. At the end of the day people buy stock because the company will make profits and pay dividends. It may seem like a high school popularity contest sometimes, but eventually it's about profits. By our standard, investors in Tesla are taking extraordinary risk because the valuation of the stock appears so disproportionate to its many competitors.

Chart 4



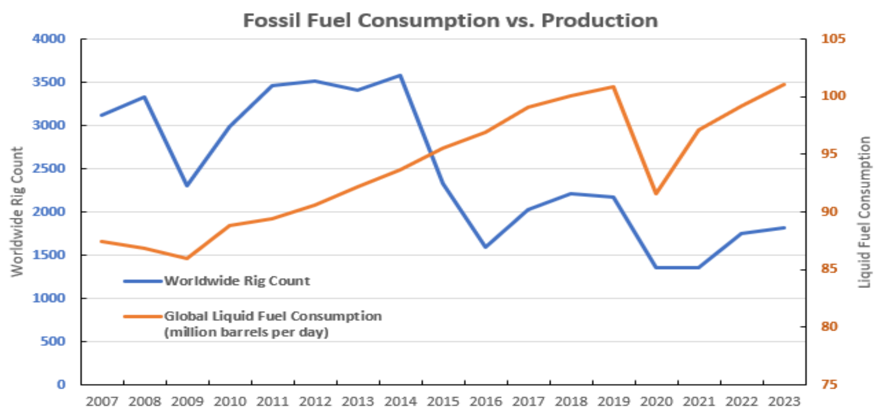
	TSLA	Ford	GM	Stellantis	VW	BMW	Mercedes	Toyota	Honda	Nissan	Combined ex TSLA
Market Cap ($ Millions)	$722,315	$45,874	$48,288	$63,315	$58,222	$60,570	$65,709	$264,372	$52,000	$14,629	$672,979
Global Units Sold 2022	1,369,611	4,235,737	5,941,737	6,002,900	8,263,104	2,399,636	2,043,900	9,566,961	4,074,372	3,225,478	45,753,825

Source: Factset, Factorywarrantylist.com, FVCM

If stock valuations can be thought of as a measure of risk, then the Magnificent Seven are riskier than most stocks. As shown back in Table 1, the M7 have an average trailing P/E ratio of 49, far above the 22 for the S&P 500 as a whole (note: a trailing P/E is calculated using actual earnings over previous 4 quarters). The price-to-book value for the M7 is 21.9, versus 4.5, and the price-to-sales ratio is 10.9, versus 2.6 for the S&P. There is certainly some justification for these higher valuations as these companies are growing, generating cash, and have very strong balance sheets. However, through some subjective evaluation, one should consider that the market enthusiasm ignited by the Microsoft/Open AI deal in early '23 has lead to some excess and risk. Our market philosophy has always been to avoid faddish trading behavior and we continue to do so since we view the risk and volatility as unattractive.

Perhaps the most unpopular sector is Energy. Nonetheless, the energy sector offers good opportunities for investment in companies with strong cash generation and low valuations. Contrary to what many people may think, aside from anomalies like the pandemic, worldwide demand for oil and gas continues to trend higher. N. America and Europe are slow growing mature markets, but there is no end in sight for demand growth from huge emerging countries like China and India, not to mention all of Africa and South America. Interestingly, various measures indicate that global investment in oil and gas has been trending downward (see global rig count in Chart 5). Despite the apparently weaker global investment trends, U.S. engineering has enabled domestic producers to get far more oil and gas from every rig. According to the Oil & Gas Journal, "fourth-quarter 2023 US total liquids production stands at 21.4 million b/d, of which 13.3 million b/d is crude and condensate with the balance composed of natural gas liquids and biofuels. Both totals are global records."

Chart 5



Source: Baker Hughes, EIA, FVCM

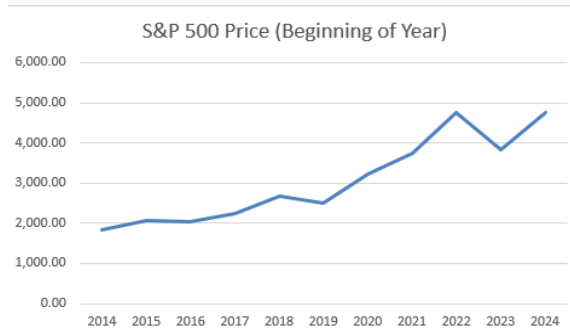
Oil and gas prices have been soft as U.S. production increases have more than offset production cuts from OPEC and the effects of the Russian-Ukraine war. Despite current market softness, we are overweight the Energy sector. U.S. production is expected to level off in 2024 as producers have shifted cash flows toward dividends, debt reduction, and stock buybacks. President Biden has also authorized small oil purchases for the Strategic Petroleum Reserve (SPR). Prior to the 2022 election, Biden sold oil from the SPR in order to "bring inflation down" and help the election prospects for his party. SPR inventories were reduced from more than 620 million barrels to less than 350 million barrels. Energy prices can be volatile and there is a great deal of speculation by hedge funds and others using oil futures, but fundamentals will ultimately determine returns. The S&P 500 energy sector has a free cash flow yield of 10.3%, versus 2.8% for the info tech sector for example. If prices stabilize or rise in '24, these stocks will attract attention. There are, of course, many good investments in the tech sector, but we remain overweight energy as the sector offers good opportunities for diversification.

The consensus forecast is that earnings for the S&P 500 will rise 12% in 2024. We doubt it. There are too many traditional indicators flashing red, like the ISM Purchasing Managers Index Manufacturing (below 50, showing contraction), the yield curve (inverted), and the Index of Leading Indicators (declining and in recession territory). According to economist David Rosenberg, the Fed is forecasting nominal GDP growth of only 3.8% in 2024, which would be down from an estimated 6.2% in 2023 and 9.1% in 2022. Assuming that the dollar's foreign exchange value stays at about current levels, nominal GDP growth is consistent with S&P 500 sales growth of only 3%. Profit margins have benefited from producer prices decelerating faster than consumer prices, but if sales growth does indeed amount to only about 3% in 2024, some margin contraction can be expected. Our own model indicates earnings for the S&P 500 to be slightly down this year.

Even if S&P 500 earnings for the year ahead were known, as is the P/E ratio, the return on stocks for the year ahead would still be highly uncertain. Notice in Table 2 below, S&P 500 earnings in 2018 increased to 151.6 from 124.51 in 2017; nevertheless, the total return for 2018 was negative 4.4%. Conversely, earnings fell in 2020 to 122.37 from 157.12 the previous year, while the total return for the S&P 500 in 2020 was 18.4%. The P/E ratio for the market has no apparent predictive value either. This data suggests that stock prices over time move higher in a choppy pattern (Chart 6) because earnings move higher over time (Chart 7). For shorter periods measured in single years, prices oscillate as investors react to changing market conditions and look toward a largely unknowable future. We approach this conundrum in two ways: 1. We recognize that "market timing" is mostly counterproductive and prefer to stay invested. 2. We make decisions about stock investment at a more granular level. Buy and sell decisions are made based on individual stocks, not the broader market, within the context of the economic cycle and market valuations. We do have cash in short-term liquid investments and are hopeful that opportunities will present themselves in 2024.

Table 2 S&P 500	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Price (Beginning of Year)	1,848.36	2,058.90	2,043.94	2,238.83	2,673.61	2,506.85	3,230.78	3,756.07	4,766.18	3,839.50	4,769.83
Earnings (forward)	113.01	100.45	106.26	124.51	151.60	157.12	122.37	208.21	196.95	215.91	214.62
P/E Ratio (forward)	16.4	20.5	19.2	18.0	17.6	16.0	26.4	18.0	24.2	17.8	22.2
Total Return	13.7%	1.4%	12.0%	21.8%	-4.4%	31.5%	18.4%	28.7%	-18.1%	26.3%	?

Chart 6



Source: S&P Global, Factset, FVCM

Chart 7

Source: S&P Global, Factset, FVCM

One of the major factors affecting investor expectations is Fed policy. Because inflation has decelerated quickly, investors anticipate several cuts in the short-term Fed Funds interest rate in 2024. Over the past year, the consumer price index has declined from a 7.1% rate, year-over-year, to a 3.1% rate. The Fed's short-term interest rate target at 5.25% to 5.5% implies a real rate of interest of about 2.3%, which is restrictive. Futures contracts are showing that there is a 53.8% chance that the Fed will cut interest rates to the range of 5.0% to 5.25% at its meeting in March '24. Furthermore, the futures show that the most likely target by year-end will be between 3.75% and 4.0%. Given that we think the chance of a recession in 2024 is fairly high, such a decline in interest rates would not be surprising.

The runup in stock prices in '23 seems to have been based on the expectation of a "soft landing," as well as lower inflation and interest rates. This is a tricky scenario. If we do get the proverbial soft landing, and unemployment stays low (currently 3.7%), the Fed is unlikely to cut rates as fast as currently expected. Investors now expecting several rate cuts could be disappointed. On the other hand, if a recession does occur, interest rates may be cut swiftly. But, in that case, accompanying earnings disappointments could lead to volatility as well. Either way, we would consider it a buying opportunity. As we pointed out previously, stock prices go up over time because earnings go up. There are stocks we are interested in and would happily add to current positions if volatility offers attractive entry points.

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