

Heads I Win, Tails You Lose

"It's not getting up there that bothers me. It's staying up there that I mind."

– Steve McQueen in *The Magnificent Seven* (1960)

The *Magnificent Seven* was originally released in 1960 and was a film about a group of seven gunslingers hired to protect a small Mexican village from a group of pillaging thieves. Starring the likes of Steve McQueen, Charles Bronson, Robert Vaughn and James Coburn; it's critically acclaimed to be one of the greatest films of the Western genre.

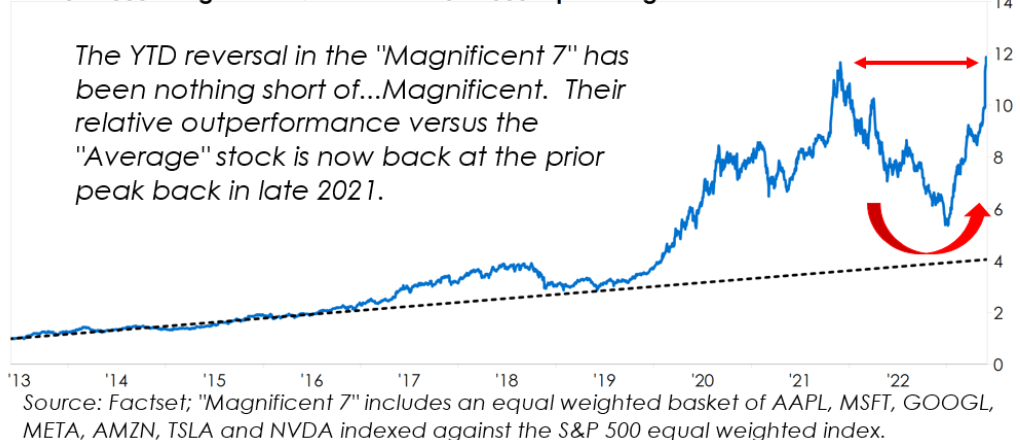
We've dubbed the market's very own "Magnificent 7" to be the S&P 500 heavyweights including Apple, Microsoft, Google, Amazon, Nvidia, Tesla and Meta. These seven companies make up a combined \$10 trillion in market cap representing more than 25% of the entire S&P 500 and equate to almost 40% of US nominal GDP.

The absolute and relative performance of these stocks over the past decade – including most recently – has made this group investors' favorite "can't miss" trade of late.

As can be seen in the chart at right, despite last year's material underperformance of the "Magnificent 7" relative to the S&P 500 Equal Weighted Index ("Average" stock); investors have quickly and voraciously re-embraced these names this year. In fact, indexed over the past

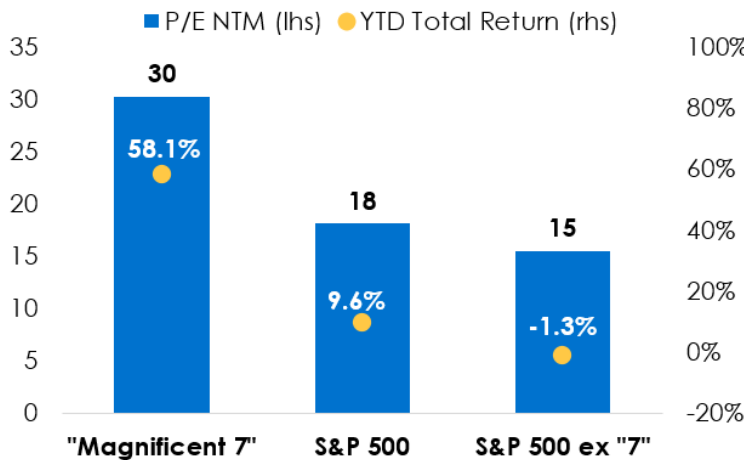
decade shows that the relative outperformance is now back to the incredible peak in late 2021. Remarkably, the "Magnificent 7" has outperformed the "Average" stock by almost 30% per year for the last 10 years. Note that this is well above the long-term trend line that was projecting outperformance for about half of that.

S&P 500 Heavy Weights vs S&P 500 Equal Weight
— S&P 500 "Magnificent 7" relative to S&P 500 Equal Weight



This trade has taken on a life of its own as investors have become emboldened by a “Heads I Win, Tails You Lose” mentality. That’s because both Bulls and Bears have argued these names win in both scenarios. Bulls point to the much higher secular earnings growth rates for the “Magnificent 7” while Bears point to the scarcity

The “Magnificent 7”...and the Rest



Source: Factset; "Magnificent 7" includes a market cap weighted basket of AAPL, MSFT, GOOGL, META, AMZN, TSLA and NVDA. YTD returns are as of 5/31/23.

of growth elsewhere given the late cycle setup. As a result, year-to-date stock market performance has been increasingly concentrated and narrow. As can be seen in the chart at left, it quite literally has become the “Magnificent 7”...and the rest. A market cap weighted basket of these seven stocks is up almost 60% year-to-date while the rest – the 493 other stocks in the S&P 500 – is down 1%. It probably shouldn’t be surprising that the next twelve month price to earnings ratio (P/E NTM) – a common valuation metric – is much higher at 30X for the former than it is at 15X for the latter. Of course, investors argue that higher valuations are warranted because

secular earnings growth rates are at a premium in the “7” relative to the rest.

We find it interesting that – when comparing these seven stocks to the rest of the market on several key stats – Bulls and Bears might both find themselves disappointed relative to the expectations set. In the table at right, the “7” have significantly higher valuations even after accounting for their higher secular growth rates. The P/E to Growth (PEG) ratio is now more than 75% higher than the rest of the market. In short, Bulls are already paying for higher secular growth prospects and then some. Conversely, Bears argue that earnings growth in the “7” are impervious to any challenging environment. Yet the earnings stability score for this cap weighted basket has been more volatile than the broader market over the past five years and their stocks’ sensitivity to the S&P 500 (Beta) has been notably higher as well. We’re not quite sure this suggests growth prospects are completely unaffected by a bearish backdrop. In short, good companies don’t always make good stocks when sentiment suggests a “Heads I Win, Tails You Lose” proposition.

	PEG	Earnings Stability	Beta
"Magnificent 7"	2.3	25%	1.4
S&P 500	1.6	22%	1.0
S&P 500 ex "7"	1.3	21%	0.9

Source: Factset; "Magnificent 7" includes a market cap weighted basket of AAPL, MSFT, GOOGL, META, AMZN, TSLA and NVDA. PEG is defined as P/E NTM over LT EPS growth over the next 3-5 years. Earnings stability is defined as the mean absolute deviation in actual EPS growth from the 5 year long-term trend. Beta is defined as the security basket's return sensitivity to the S&P 500 over the last 3 years.

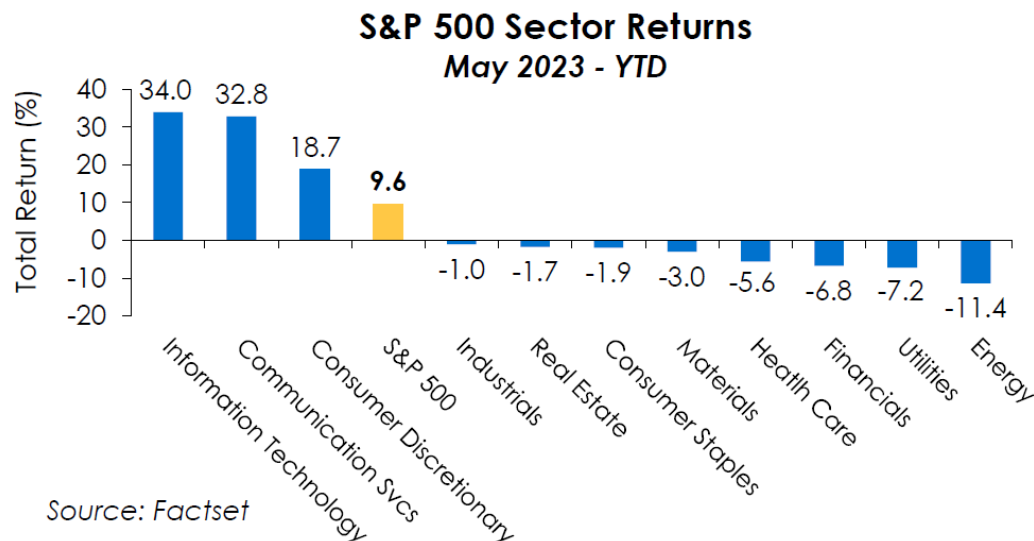
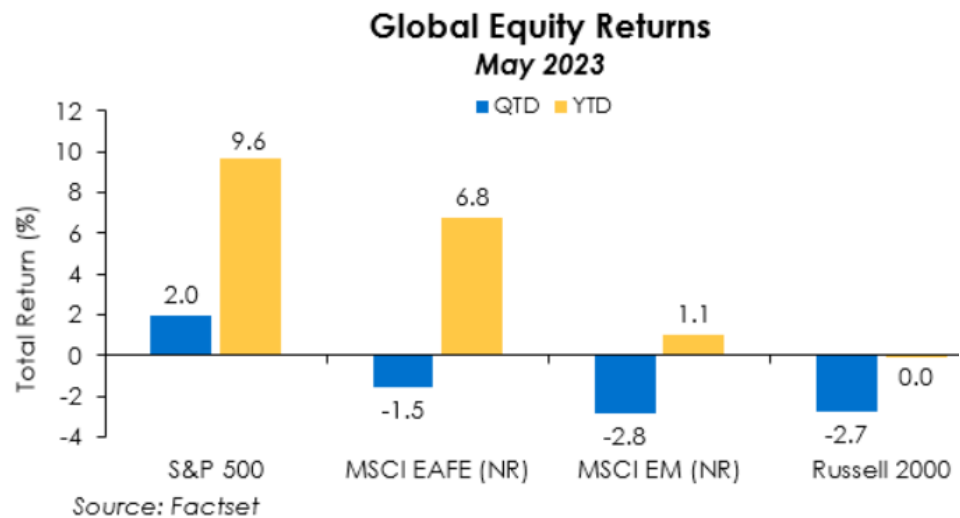


Markets broadly took a step back in May despite the S&P 500 finishing narrowly higher as performance continued to consolidate. Year to date Equity and Fixed Income markets remained (collectively) in positive territory. Meanwhile, Real Assets like Real Estate and Commodities posted negative returns.

Stocks

Year to date, equity performance continued to favor the larger, more developed markets. Domestically, US Small Caps (Russell 2000) underperformed US Large Caps (S&P 500) and sector outperformance continued to favor the concentrated and higher priced “Magnificent 7” within the cyclical growth sectors (Technology, Discretionary and Communication Services).

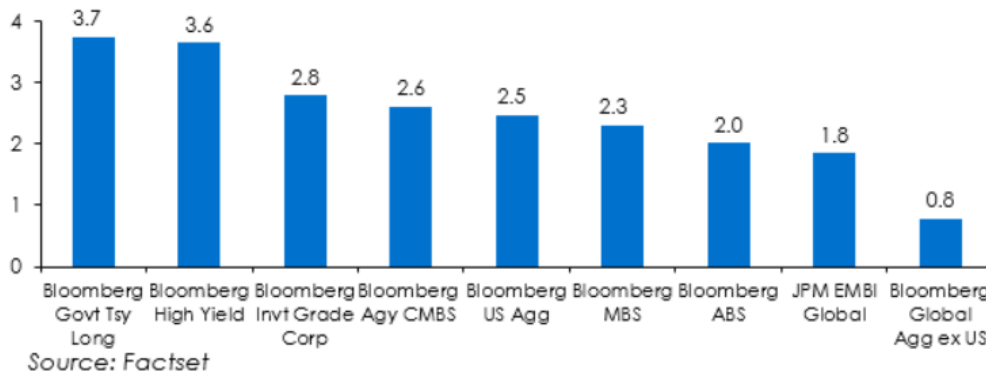
Meanwhile, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed. Elsewhere, the dollar rallied in May creating a challenging environment for overseas investments with Developed Markets (MSCI EAFE) down more than 4%. Still, equity performance in International Developed Markets has been solid – helped by a better than feared start to the year given warmer weather and the avoidance of an energy crisis. Economic reopening in China has been underwhelming leading to more subdued Emerging Market (MSCI EM) returns.



Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 500 basis points (to 5.0-5.25%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer term rates have been volatile but biased lower year-to-date – making a series of “lower highs” amid a moderating (though still sticky) inflation backdrop. Meanwhile, the yield curve remained inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the

Global Fixed Income Returns
May 2023 - YTD



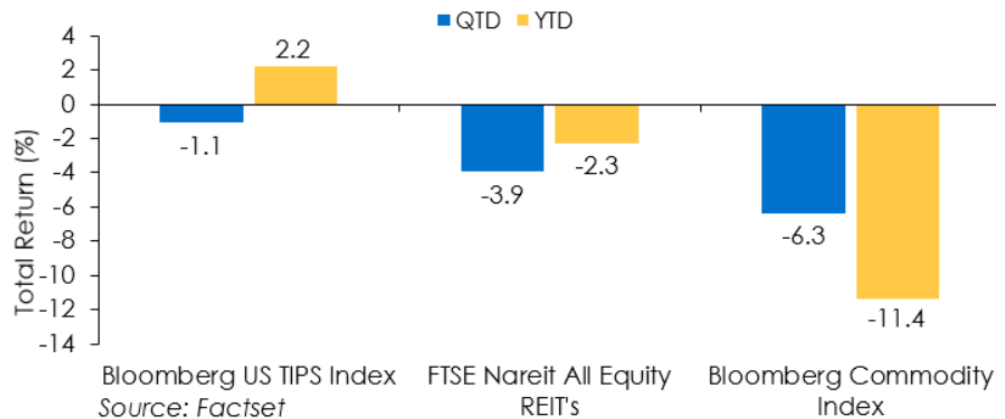
entire Treasury curve having moved below the Fed Funds rate. Lower rates benefited the bond market, in total, with positive broad-based returns year-to-date. As such, duration represented by Long-Term Treasuries (Govt Tsy Long) topped the return list. Corporate bonds

(High Yield, Investment Grade) remained resilient and outperformed as well. Conversely, securitized credit (MBS, CMBS, ABS) and International debt (EMBI, Global Agg ex US) underperformed.

Alternatives

Commodities have consistently finished lower year-to-date as positive returns in Precious Metals continued to be more than offset by weakness in Energy, Industrial Metals and Agriculture. Meanwhile, despite

Alternative Market Returns
May 2023



bounces in January and April, returns in publicly traded Real Estate (REIT's) were pressured in May given the market sensitivity to higher interest rates. Finally, Treasury inflation protected securities (TIPs) benefited from the rate move in bonds year-to-date.



Market Outlook

“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”

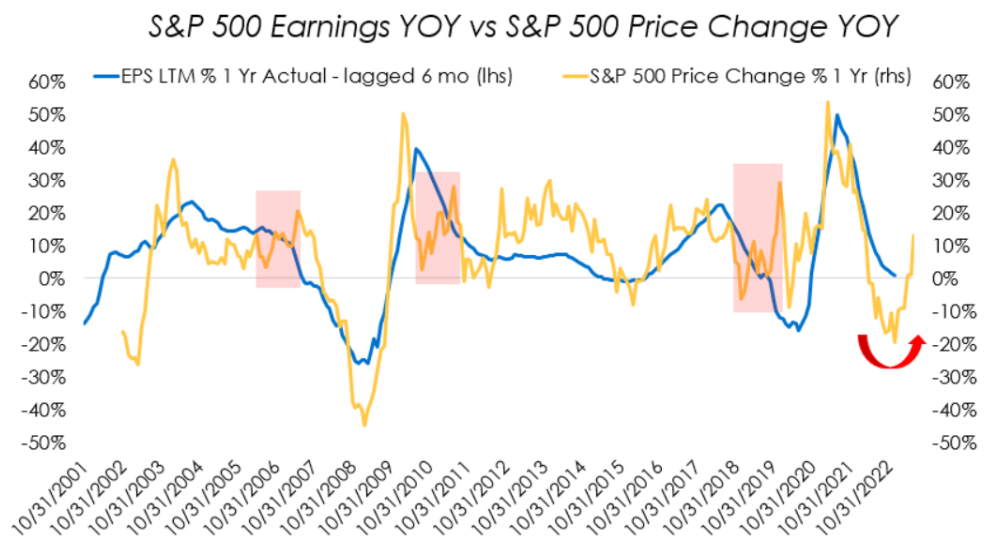
– Bill Bryson, *A Walk in the Woods* (1998)

We’ve dubbed our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (deglobalization, labor markets, energy complex).

At the other end of the spectrum is the cyclical

perspective, which we think currently carries greater weight given its more immediacy and potential divergence from the secular view – at least for a time. As can be seen in the chart above, the S&P 500 seems to be anticipating an acceleration in corporate profit growth. The S&P 500 price change tends to lead S&P 500 EPS Growth by about 6 months. While these two lines tend to be correlated through time, there have been some notable disconnects along the way including 2006-07, 2010-11 and 2018-19 (red shaded regions).

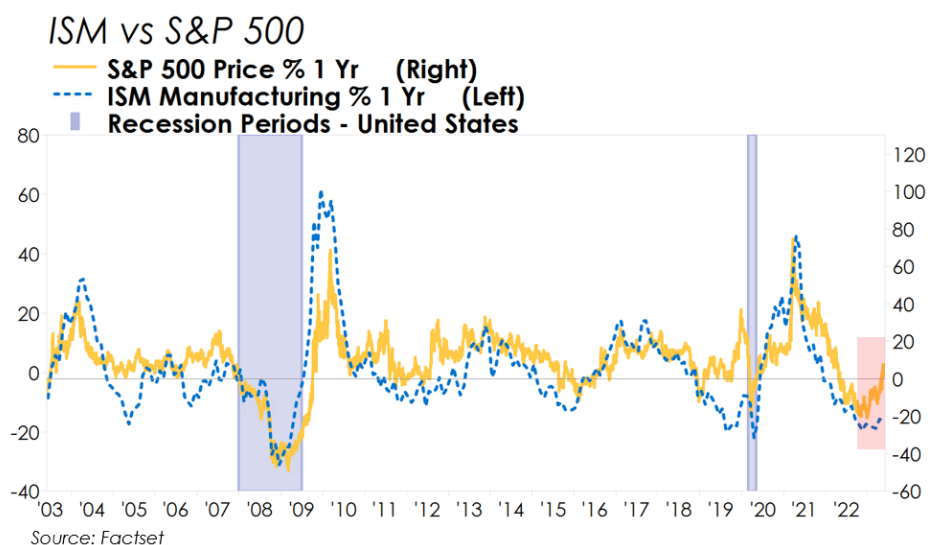


This year the most compelling fundamental basis for the market rally, in our view, has been the improvement in the bottom-up earnings estimates for the S&P 500 (3 month change in NTM EPS) – which troughed (less bad) in early January. Interestingly, in the above three historical episodes, improvement was also seen in the bottom-up earnings estimate revisions, which ultimately proved to be a head fake. We’ve been less sanguine on the corporate backdrop as the top-down (leading) macro data forecasts deterioration and remains at odds with the bottom-up rebound in earnings estimates – and the move higher in the S&P 500. Our more cautious view is based on the following set of conditions:

- We remain in the latter stages of the business cycle. What inning we’re in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle.
- Liquidity is being drained from the economy. Lots of data support this notion including a deeply inverted yield curve, negative year on year money supply growth (approximately \$1,000b off the peak), a dramatic decline in the savings rate and credit standards that are the tightest since 1Q09 (ex Covid) with additional tightening likely.
- Growth is slowing. The combination of the above points to slowing growth conditions. We expect nominal GDP growth to be impacted by last year’s weakening money supply growth with about a 12 month lag. Meanwhile, the leading economic indicator composite is suggesting deteriorating real GDP growth. Finally, our top-down leading profit cycle indicators are pointing to earnings growth still deteriorating six months out. This remains at odds with the consensus forecast for an earnings reacceleration.

One example of a top-down macro indicator suggesting the equity market may be off sides is the ISM manufacturing survey. As can be seen in the chart below, the year over year change in this manufacturing survey has historically been a pretty good corollary with the year over year change in the S&P 500. At present, this survey has remained depressed while the S&P 500 has rallied more than 20% off the mid October lows.

With all of this in mind, we can’t help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). The S&P 500 is

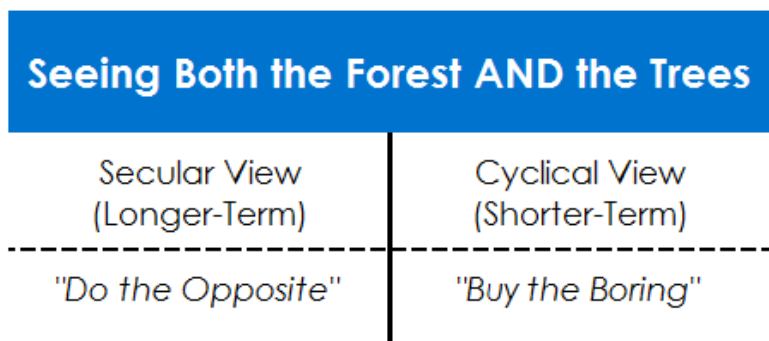


still trading (~18X) well above levels where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X) at a time when earnings are biased downward (based on top-down indicators) and inflation is still elevated (albeit moderating). And with bond yields notably higher, there's now a real alternative to stocks (i.e. skinny equity risk premium). To us, despite robust equity returns year-to-date, this still doesn't appear to be a great set up for risk assets from a cyclical point of view.

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might make sense to keep two simple phrases in mind – "Do the Opposite" and "Buy the Boring":

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to "do the opposite". In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future might now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years might now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we're trading one cyclical risk (Inflation) for another (Recession) argue to "buy the boring". Should growth continue to slow leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.



From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). Over the last several months, we've given an increased weight to the cyclical over the secular as we've maintained an underweight to risk in portfolios given the late cycle setup – siding more with the top-down relative to the bottom-up perspective.

Within equities, our positioning is modestly UW and continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure.



We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a “Heads I Win, Tails You Lose” mentality.

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we’ve previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we’re OW in aggregate with a bit more defensive skew. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there’s lower correlations between stocks and bonds). We’re more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we’re UW Real Estate as a way to further reduce overall portfolio risk.

The information presented in the material is general in nature and should not be considered investment advice, is not designed to address your investment objectives, financial situation or particular needs. Information is gathered from sources deemed reliable but its accuracy or completeness is not guaranteed. The opinions expressed herein may not come to pass, are as of the date of publication and are subject to change based on market, economic or other conditions.

You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

Yellow Cardinal Advisory Group, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. Yellow Cardinal Advisory Group does not provide legal, tax, or accounting advice. The products and services made available by Yellow Cardinal Advisory Group:

Not Deposits | Not FDIC Insured | Have No Bank or Federal Government Guarantee | May Lose Value



The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

