FISCHER STRALEM

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Dear Client:

There is a well-understood, inverse relationship between the 10YR U.S. Treasury bond yield and the P/E of the S&P 500, at least over the intermediate term. The basic principle is that, in a rising interest rate environment, fixed-income provides a better alternative to equity income because rising rates are often associated with lower growth rates (if not recession), which are historically bad for equity valuations and earnings. If inflation is high and interest rates aren't high enough to tame rising prices, however, stocks can outperform bonds because earnings can still rise in nominal terms while the purchasing power of interest payments is eroded by inflation.

This is where we find ourselves today and, despite the 10YR yield nearing 5% for the first time in many years, the S&P500 is +21% higher YTD even as earnings and cash flow multiples trend lower. While the Energy sector has received the most attention for "boosting shareholder value" at the expense of investment capital, it appears more broadly that dividends and stock repurchases are likely to make up a greater portion of the total return in the coming cycle, while unprofitable companies lose their ability to perpetually access cheap capital.

These unfolding trends are hard to miss yet remain masked by investors' enchantment with the aptly-named "Magnificent Seven" stocks -- Apple, Microsoft, Facebook, Amazon, Nvidia, Google, Tesla -- which have dominated the performance of the S&P 500. We wrote about them earlier this year, but this concentration warrants further scrutiny. If they were their own sector, these seven stocks would be the S&Ps largest by a wide margin, representing a whopping ~28% of its market capitalization. Incredibly, this minuscule, 0.01% of S&P 500 stocks represent 70% of the S&P500's rise thus far in 2023 and pushes back against the rate/valuation thesis as the collective forward P/E of The Seven is currently an elevated ~38x, versus the S&P 500's P/E of 20x (which drops to a very reasonable 15x without these names). So, what gives?

Setting aside their first-mover advantages in artificial intelligence, these stocks appear less vulnerable to high interest rates because these companies are less dependent on debt than most and generate *substantial* cash flow. Indeed, these companies have a negative net debt position, meaning they have more cash than debt. As a percentage of revenue, they carry the lowest interest expense of any sector in the S&P 500, are flush with cash, and have tremendous flexibility to issue dividends or buy back shares. Their cash flows make them able to make their own luck, at least for now, and imply a very painful short squeeze for anyone brave enough to try. In a sense, this renders them "defensive" stocks. We wonder to what extent the sectors traditionally defined as "growth" and "value" are likely to change. Lest we forget, the Energy sector made up ~30% of the S&P500 in the 1970s (and was categorized as an Up-Market, New Products stock in Stralem portfolios). Today, Energy is ~4.2% (and a Down-Market, Price/Cashflow holding).

There are always changes in leadership and this time will surely be no different. Today, to the extent to which the Magnificent Seven represents 30% of the Index yet only 17% of its net income, we are inclined to own but under-weight these companies. Valuation may seem passé in 2023 but it is difficult to get excited about the price appreciation potential of a "sector" trading at 6.5x sales and 38x earnings. And, lest we forget, many of these stocks massively underperformed in 2022: Apple -28%, Microsoft -28%, Facebook -51%, Amazon -51%, Nvidia -51%, Google -39%, Tesla -69%. The S&P500 was -19% in 2022 so that, over the trailing two years, as a sector, the Magnificent Seven has barely beaten the S&P 500. As always, it's important not to lose perspective!

Regards,

Adam S. Abelson
Chief Investment Officer
U.S. Large Cap Equity Strategy

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