Mid-Year, 2023: A Reminder, The Stock Market Is Truly A Market Of Stocks

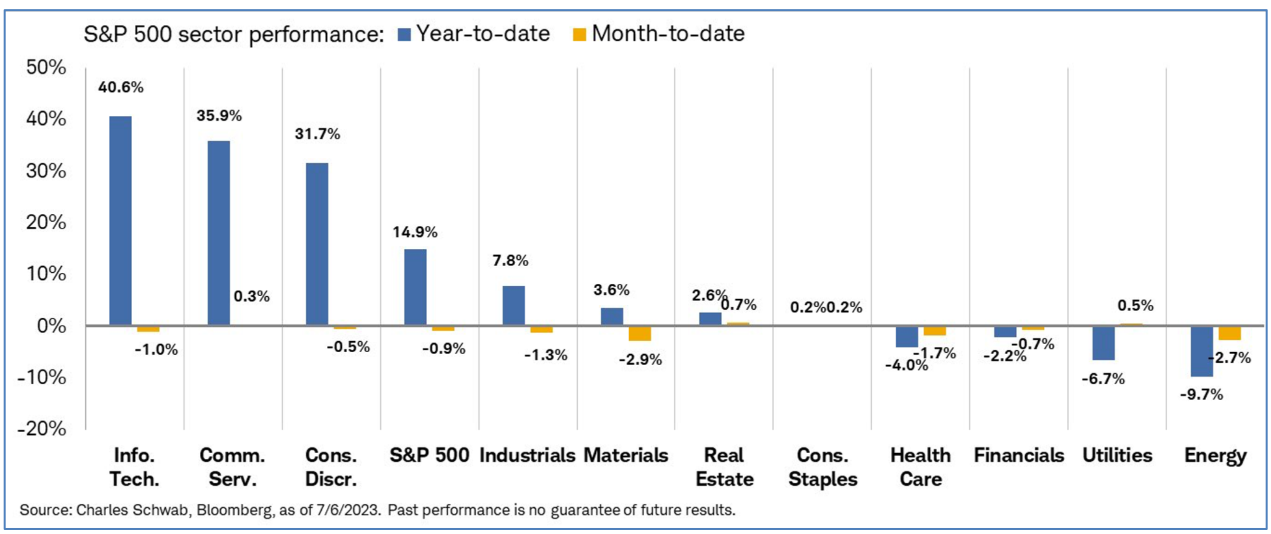
Three months ago, we discussed that investors' uncertainty created stock market volatility resulting in numerous opportunities to start the year. Halfway through the year, we were not alone in this thought. As of June 30, 2023, the stock market (as measured by the S&P 500 Index) was up nearly 16% for the year. On top of that, it has gained 20%+ since its October lows, setting off the proverbial ***bull market***.

This term is somewhat meaningless, but it gives the media something to headline. I think some savvy media commentator coined both bull market and bear market while assigning the qualification of a 20% move from the recent highs or lows set. The current iteration has sent the talking heads off on whether this is a bull market with legs or a move that provides false hope only to see the bottom fall out of it driving the market lower.

Of course, neither argument influences our nearly three-decade-old investment approach (i.e., we invest in stocks when we think the price is right… period). But this *specific* stock market rally does remind us that the stock market is a market of stocks. Though many times lost on the average investor, it succinctly explains the first half of the year.

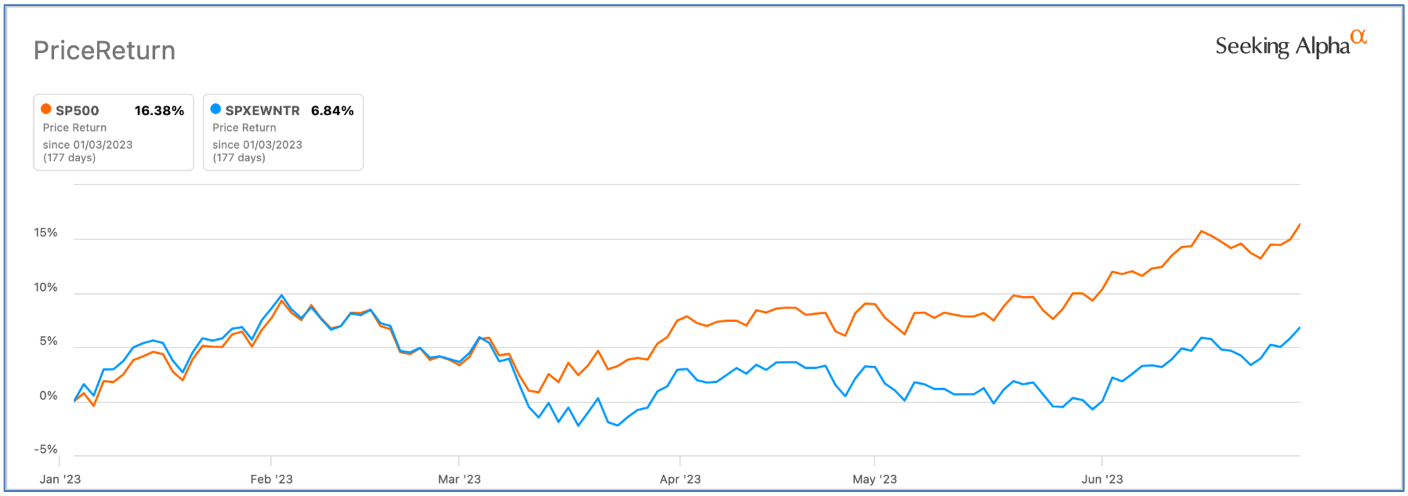
You see, the S&P 500 Index is a market capitalization-weighted index. Meaning the larger the company, the more it impacts the index price. For instance, Apple is the world's largest company as measured by market capitalization (which hovers around $3 trillion today). As a member of the S&P 500 Index, it accounts for over 7.5% of the index price. Therefore, if Apple's stock price moves 1%, it will be much more impactful to the index price than if the 400th largest company, Akamai Technologies, with a weighting of .038%, was to move 1%.

Currently, the top ten companies in the S&P 500 Index make up over 30% of the market capitalization of the index. Leaving nearly 70% to the other 493 companies (believe it or not, the S&P 500 these days comprises 503 companies). The ten stalwarts continue to grow and took off in the first half of the year (starting in October 2022). And guess what? Eight of the ten all have a common theme… tech companies.



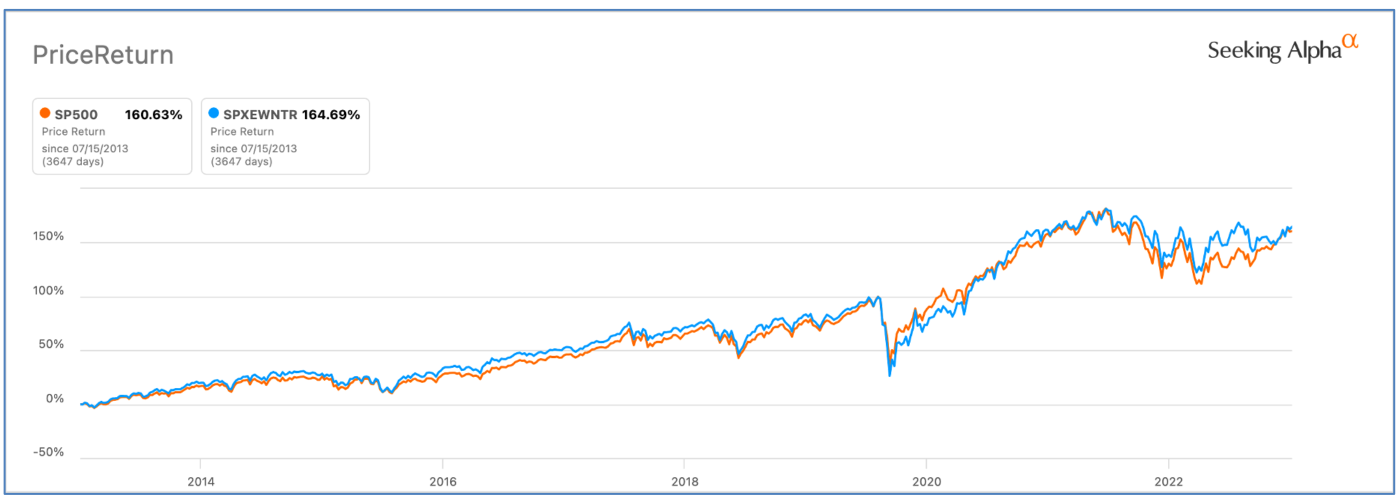
While these companies didn't come out of nowhere, they have all seen their stock prices rebound from the recent corrections in 2022. Other sectors have helped lead the S&P 500 Index higher it is clear that technology is leading the way. Many presume this is due to the recent AI (Artificial Intelligence) bonanza. Whatever the stimulus, when ten stocks make up 30% of the index and three of these have 100% returns in the first six months of the year, they are not only carrying the index returns but overshadowing the opportunity of the rest.

A great way to see this is to look at the regular market capitalization-weighted index compared to the equal-weighted index. That's right; there is another index that weights all companies the same.



As you can see, something happened in the middle of March when the tech heavyweights began their flight leaving the rest of the index in the dust. The result was a nearly 10% outperformance… the largest ever seen.

Will this divergence continue? Will ten stocks continue to have such an outsized impact on the overall stock market's performance (as measured by the S&P 500)? Well, history says NO.

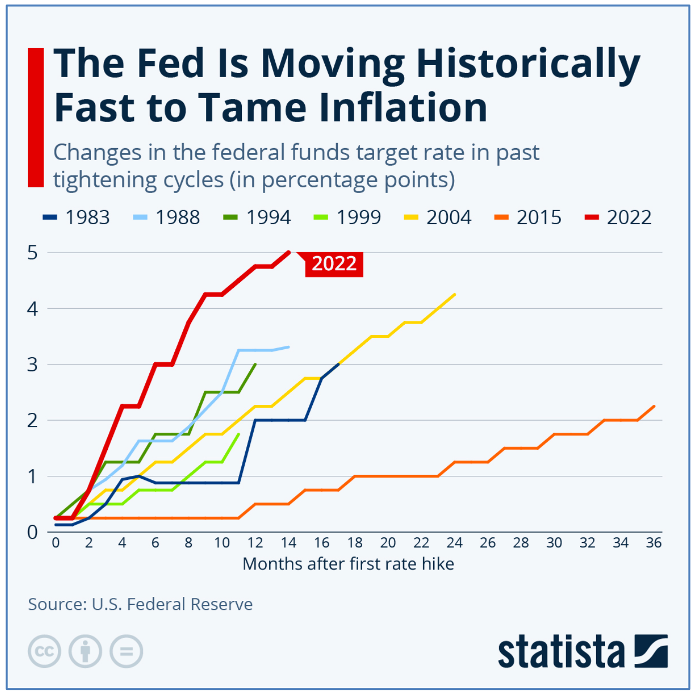


The above chart is the same as the prior one but for the past ten years. As you can see, the market capitalization-weighted and equal-weighted indexes have very similar performances. Over time, there is little doubt we will see market performance more in line with the above. The current iteration proves that the stock market is a market of stocks. A great reminder!

Onto The 2nd Half & Beyond:
We still do not own a crystal ball, so we have no idea what is in store for the rest of the year. But even though we are not in the prediction business, we know more now than we did one year ago… which is a good thing!

The Federal Reserve Bank's (Fed) campaign to thwart inflation through tightening the money supply (i.e., raising the Fed fund rate) while not breaking the economy seems to be working… for now. We are not incredibly concerned about the economy heading into a recession, especially if it comes because of successfully taming inflation. Our economy can and will bounce back but left unchecked; inflation can run wild for a long time, causing severe harm.

The chart to the right demonstrates the aggressive nature of the rate hikes. In little over a year, the Fed has gone from basically a 0% rate to over 5%. This is an unparallel, almost incomprehensible move when viewed on its own. But when we remember that the Fed has held rates at or near zero for the better part of a decade (as well as injected trillions of dollars in Covid relief) … the acceleration to 5% is understandable.



You see, on a macro level (i.e., Big Picture), the Fed's control of the money supply writes the blueprint for economic growth or tightening. In a perfect world, I would suggest moderate growth is the goal, but that does not always happen, prompting the Fed to pull what it deems appropriate triggers. Sometimes getting it right and sometimes not.

Coming out of the Great Financial Crisis in 2009 (a long recession), the Fed was right to lower borrowing costs. But they clearly held rates too low for too long. So, they pulled the right triggers but held onto them for longer than necessary. This seems to be the common playbook… hence the earlier comment about not breaking the economy, yet.

No doubt something similar will play out in the next 12 – 24 months. Fed fund rates above 5% don't typically last that long. So, something must give. When and by how much… who knows. What we do know is that the Fed is in a better position to deal with what comes next.

And as investors, we'll take advantage of whatever the market gives us. As always, that is the key to investing… nothing changes… we buy great companies at good or better prices.

Stay tuned… it should be an interesting, if not exciting rest of the year.

Marcus