

PALOS

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Weekly Commentary

Issue No. 27 | July 6, 2023

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The Magnificent Seven: Leaders or Loners?

The American Western film *The Magnificent Seven* is a 1960 classic directed by John Sturges and featured a star-studded cast of Hollywood tough guys that included Yul Brunner, Steve McQueen, Charles Bronson, Robert Vaughn, James Coburn, and Eli Wallach. In last week's newsletter we briefly touched on a group of companies that, working off the original film's title, have been coined "The Magnificent Seven" by CNBC's Jim Cramer. This group of seven mega-cap companies include Alphabet (formerly Google), Amazon, Apple, Meta (formerly Facebook), Microsoft, NVIDIA, and Tesla. Combined, the market capitalization of these seven companies exceeds US\$ 11 trillion. As of last Friday's close, Apple alone surpassed the US\$3 trillion mark making it the largest company in the world by market cap and slightly larger than the entire market cap of Canada's S&P/TSX Composite Index!

So far in 2023, the Magnificent Seven have been driving first-half gains in the two most prominent U.S. indices, namely the **S&P 500 Index** (+ 15.9% year-to-date) and the **NASDAQ Composite Index** (+ 31.7% year-to-date). Of note, these indices are "cap weighted" thus the higher the Magnificent Seven go in price, the more dominant and influential these companies become; a proverbial case of the tail wagging the dog. To give some perspective, and in their respective order as mentioned above, year-to-date gains as of June 30 for each of these stocks are +36.3%, +55.2%, +49.3%, +138.5%, +42.0%, +189.5% and +112.5%. Eye watering returns for sure!

Naysayers and bears on Wall Street contend that this year's rally is nothing more than a result of the dominant performance of these seven heavyweights and there is an element of truth to this. What remains to be determined in the second-half is whether the remainder of the S&P 500 (i.e., the 493 stocks not part of the group of seven) can play "catch up" with the leaders and drive markets even higher, or, will the Magnificent Seven see a correction and drag stocks lower. One way of analyzing the prospects for the "493" is to use **technical analysis** (a.k.a. studying the charts). One of the technical tools at our disposal is the study of **market breadth**. Also referred to as the **Advance/Decline line (A/D Line)**, breadth measures the relative change of advancing stocks (price is increasing) versus declining stocks (price is declining) within the index. If more stocks are advancing than declining, this implies that the "bulls" have assumed control and that price momentum should take stocks higher. The A/D Line recently made a new high supporting the bulls.

Another widely used measurement is the **High-Low Index** which records the number of stocks making new 52-week highs with the number making new 52-week lows. A **moving average oscillator** of the High-Low data is used to smooth out volatility. The result is a useful indicator that can confirm or negate the establishment of a new trend higher (bullish)

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or lower (bearish). The recent trend is bullish. The **Volatility Index** (VIX) uses options prices to measure the rapidity of change in stock prices and is viewed by professionals as a measurement of the level of fear. Generally, when stock prices fall the VIX rises and, conversely, when stock prices rise the VIX falls. Recently, the VIX has been trading at the lowest levels since before the start of the pandemic (February 2020), another confirmation that justifies recent bullishness. The U.S.-based **Russell 2000 Index**, which is comprised of 2,000 small-cap, primarily domestic companies, is a good barometer for future economic prospects. We've seen significant divergence between the mega-cap tech stocks and small caps since late 2021 and this is understandable. Investors usually view small caps as riskier assets. The Russell put in a technical "double bottom" with support at dual lows established in late March and early May. Performance has been markedly strong since then and this is a bullish event. The **Dow Jones Transportation Index** (DJT) is comprised of economically sensitive railroads, trucking companies, airlines, marine shipping, and delivery services. The DJT is a closely monitored leading indicator given its sensitivity to the economy. Technically, the DJT chart is approaching its April 2022 level following a low that was established last September. Another reason for the bulls to be encouraged.

Finally, recent data suggests that inflation may have peaked. Any signs of central bankers winning the inflation battle bodes well for a possible cessation of aggressive interest rate policies. Fed chairman Jerome Powell is on record as stating that two or more increases are in the cards, but many strategists believe that rate hikes over the past 15 months will take time to impact the economy. In our view, we're certainly closer to the end of rising interest rates as many signs now point to an eventual slowdown, which is what the Fed wants. Whether a soft landing can be navigated or not remains to be seen. If the economy does enter a recession, as the inverted yield curve is implying, the question is how bad will growth be impacted? This is unknown.

So, circling back to the opening question, will the Magnificent Seven be confirmed as the leaders of the pack or, will they be the loners that had a tremendous run while the laggards maintain their sideways trend? There are certainly many positive signs suggesting that the bulls have the upper hand in the tug of war with the bears. Time will tell but there is clearly reason for optimism.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$8.19	4.17%
Palos Equity Income Fund - RRSP	PAL101	\$6.69	3.47%
Palos WP Growth Fund - RRSP	PAL213	\$10.92	-12.21%
Palos-Mitchell Alpha Fund ³	PAL300	\$9.41	16.15%
S&P TSX Composite (Total Return with dividends reinvested)			5.77%
S&P 500 (Total Return with dividends reinvested)			18.38%
S&P TSX Venture (Total Return with dividends reinvested)			9.08%
Chart 2: Market Data ¹			Value
US Government 10-Year			3.84%
Canadian Government 10-Year			3.27%
Crude Oil Spot			US \$70.64
Gold Spot			US \$1,929.50
US Gov't 10-Year/Moody BAA Corp. Spread			193 bps
USD/CAD Exchange Rate Spot			US \$0.7552

¹ Period ending June 30th, 2023. Data extracted from Bloomberg

² Fund is priced annually

³ Fund is priced weekly on Tuesdays

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