CORNERSTONE
INVESTMENT PARTNERS, LLC

Large Cap Market Review

Q2 2023

"A fella I once knew in El Paso, one day he just took all his clothes off and jumped in a mess of cactus. I asked him the same question, Why? He said It seemed to be a good idea at the time."
Vin Tanner (Steve McQueen), "The Magnificent Seven"

In 2013, Bob Lang and Jim Cramer coined the term "FANG" to refer to four market-leading stocks, Facebook, Amazon, Netflix, and Google, that "represented the future." Over the last decade, that term has been tweaked and adjusted to fit whatever serves as the market's current darling. We're sure there are more examples, but we can at least remember FAANG, FANMAG, FAAMG, and MAMAA. The latest example is "The Magnificent Seven."

This quarter's lack of market breadth has been stunning and is worth discussing (see our recent thought paper on our website for more detail on this topic). A big driver of this move recently has been excitement around AI (Artificial Intelligence) and any stock that may benefit from this, whether directly or indirectly. Since scale is so significant in the current generation of AI development, the biggest Technology/Communications companies moved significantly higher and led the market. Not surprisingly, these price moves have come mostly via multiple expansion, as estimates have not materially moved outside of a few companies. **The speed at which valuation-driven drawdowns in 2022 (the Russell 1000 Value outperformed the Russell 1000 Growth by over 2000 basis points) have been forgotten suggests something between a leveraged mania on one hand and willful ignorance on the other.**

We are watching AI incredibly closely, and it has applications (both in the world as a whole and our own business itself) that could change the world for both the better and worse. The only factor in the Cobb-Douglas function of GDP growth ($Y=A*\Delta K*\Delta L$) that can have a non-diminishing impact on total GDP is Productivity (A), and seeing how a widely-applicable technology may increase the output of both Capital (K) and Labor (L) is thrilling. As such, **this excitement may prove justified by subsequent earnings growth, but it is also likely that valuation spikes like this portend future disappointment.**

We've talked in the past **that it not only matters what stocks you buy but, more importantly, what you pay for them**. The NASDAQ-100 Index is up more year-to-date this year than any since and including 1999. After the tech bubble burst, it took almost 15 years for the QQQ to hit its prior highs. The Nikkei 225 still hasn't regained its 1980s peaks. Only about 1/3 of the 1970's-era Nifty 50 outperformed the S&P 500 over the next 30 years or so.

The Magnificent 7 stocks trade at over 40x next-twelve-month forward estimates on average. While some of these trade at valuations closer to market multiples, their average rank in our Fair Value Model is approximately 600 out of 800, meaning that they would, as a whole, appear to be at best fully valued based on a reasonable assessment of their demonstrated growth profile.

Markets entered the quarter on edge as deteriorating estimates, weak macroeconomic data, and high inflation cast a dark shadow over sentiment. However, economic data have come in significantly better than feared recently, broad market earnings estimates have stopped going down, inflation has continued to moderate, and excitement around AI has driven pockets of enthusiasm. One way to look at economic data versus expectations is from Bloomberg's Hard Economic Surprise Index, which tracks the degree to which published economic data differ from forecasts. This index has rallied sharply and sits at one of the highest levels in the past decade. Inflation has also continued to soften. After peaking at 9.1% in June, the latest inflation reading came in at 4.0% in May, the lowest in two years.

While it would be nice to be able to declare victory over an economic hard landing, that would seem premature. Bloomberg's survey of economists shows that 65% are still projecting a recession within one year. Also, the NY Fed recession probability model remains extremely elevated and has never given a false signal at such a high level. While headline inflation has slowed, many of the slower-moving components underlying it have not. Much of the recent disinflation has been driven by energy prices, which were down 12% in May and can be volatile and driven by exogenous factors. This can be seen in the Atlanta Feds sticky-price CPI, a weighted basket of items that change price relatively slowly, which is still running at over 6% and is only down modestly from the peak. Additionally, **there is a considerable divergence between market prices and leading indicators such as ISM new orders, indicating that the market is pricing in a sharp rise in the ISM. Should this not come through, then the broad market is unlikely to continue its recent upward march.**

It is hard to downplay just how concentrated the broad market is. The S&P 500 has 24% of its weight in the top five names, and the Russell 1000 Growth has 41%. 82% of the year-to-date contribution to S&P performance comes from just ten stocks, versus 32% on average. Over the last three months, only three of the 11 sectors and fewer than 15% of securities in the S&P 500 have beaten the market.

While recent market movements give us pause, we think it has delivered active management an attractive opportunity for future outperformance. History suggests that the current weak breadth in the market is unlikely to persist for long, and a stronger period of market breadth, during which a higher percentage of stocks in the index outperform the index as a whole, is an attractive environment for active managers who are positioned differently from the broad market indexes. **We have seen three markets this narrow in the past 20 years. In the subsequent two-year periods following those narrow markets, even without picking a particularly skillful manager, the median large cap value active manager outperformed the Russell 1000 Value in all three periods and the S&P 500 in two of the three periods.**

The market is made up of a collection of millions of individual decisions. Many, or even most, of those individual decisions in this current environment could be rational for a given investor, and we hope it seemed like a good idea at the time. **But we have seen throughout our careers that times change, and we continue to manage our portfolios and positions in the same steady way**. We look for mispriced opportunities at companies with strongly embedded characteristics. We remain laser-focused on fundamentals to ensure that we are confident our companies can thrive during good periods and withstand weaker ones. As we noted last quarter but wish to reiterate, we continually examine our portfolio and our convictions to ensure that we hold stocks trading at material discounts to our conservative assessments of their worth. We remain excited about our stocks over a multi-year time horizon.

Sincerely,

The Cornerstone Investment Team

Past performance does not indicate future results. As with all investments, the possibility for profit is accompanied by the risk of loss.