Mediocre 493 May Begin to Match Magnificent 7

Equity markets have enjoyed a tremendous November rally that allowed the S&P 500 to break out of its downtrend pattern and retest the July 31st peak. Now that the market has recovered the lost ground, investors are wondering whether the momentum can carry through the year-end and break out to new highs. While there are many factors at play, including the Federal Reserve and geopolitical events, the ability of the market to maintain November's positive price action will likely depend on whether investors buy into the broader market and not just the handful of mega-caps that have driven the year-to-date gains.

It's no secret that the stock market gains year-to-date have been unevenly distributed, so much so that the 7 companies responsible for most of the market's performance have earned the moniker "the Magnificent 7". These stocks – Apple, Amazon, Google, Meta, Microsoft, Nvidia, and Tesla – are collectively around 30% of the S&P 500 index weight and nearly 50% of the Nasdaq 100 Index weight. They are also responsible for nearly all the year-to-date gains in those indices. The rest of the market, for the S&P 500 let's call it the "Mediocre 493", has been essentially dead money all year long (2023), after a very challenging last year (2022).

Back on June 2nd, we issued a commentary noting that market breadth, the term for more evenly distributed stock market gains, was lacking and needed to improve before markets broke out of the sideways consolidation pattern. You can see this poor breadth reflected in the McClellan Oscillator, which measures momentum in the ratio of advancing to declining stocks. Breadth improved in June and July to carry the market to its peak, before deteriorating as the market rolled over and entered a significant downtrend. With November's breakout, we can see that the McClellan Oscillator is once again firmly positive, and the gains have been more evenly distributed within the S&P 500.

S&P 500 Year-to-Date Performance with McClellan Oscillator

SP500.I S&P 500 4,566.47 +11.58 +0.25% D

McClellan Oscillator 27.67

Higher McClellan Oscillator reading means more stocks are participating in the gains

Source: MarketInOut.com, Vestbridge Research

The fact that the recent rally has been driven by more than just the Magnificent 7 is encouraging, and there is more fuel left in the tank if investors embrace the "soft landing" narrative. More than 40% of S&P 500 companies are trading below their respective 200-day moving averages, so there is substantial upside to prices and potential for further breadth expansion. What could trigger investors to spread the love beyond the Magnificent 7 and into their neglected brethren? Earnings haven't convinced investors, as they have been strong across the board this year and broadly improved in the third quarter. Unfortunately, we will likely need a shift in messaging from the Fed to convince investors to get on board with the Mediocre 493.

Fed members have toed the line in recent speeches and policy meeting minutes, completely dismissing the idea of rate cuts while some Fed members have even expressed a desire to hike rates further. The market expectation, reflected in Fed Funds Futures, is that the Fed will in fact cut rates as soon as March. This disconnect is nothing new, the market didn't believe that the Fed would go as high as it did for most of the rate hike cycle. With data

showing more and more convincing evidence that inflation is decelerating - and in some subcomponents, declining – it's hard to argue with the market's refusal to buy what the Fed is selling (no rate cuts soon). The Fed hasn't stated it wouldn't cut rates; it simply said it needs to see convincing evidence that inflation is on the path back to 2% before cuts are discussed. So even a slight shift in messaging to convey that discussion of cuts is on the table would be a cause for massive celebration in equity markets.

When this Fed pivot occurs is anyone's guess. But with economic data suggesting that we can continue to hold off a recession for at least a few more quarters, it seems that we have bought enough time for the Fed to officially end its aggressive rate hike cycle. At that moment, investors holding the neglected segments of the market, the Mediocre 493, and Mid and Small Caps, should be handsomely rewarded. For investors with patience and appropriate risk tolerance, extending exposure beyond Large Caps and into Mid and Small Caps should provide even more upside if the rally broadens out.

Thank you, as always, for the opportunity to serve you.

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