Investment Insight
Charts for Client Conversations: Bears Out of Hibernation, Magnificent Seven, Pinch of Rising Rates, Inflation’s Comeback, and More

The charts and themes that tell the current story in markets and investing.

**Bears Coming Out of Hibernation**
The S&P 500 was positive in five consecutive months through July.

Now the ride is getting bumpier. The market has pulled back nearly 8% since July 31. This doesn’t meet the technical definition of a correction — down 10% — but it’s within whispering distance.

**Exhibit 1**

![S&P 500 Drawdown Since July 31](image)

Source: Morningstar Direct. Data as of 10/3/2023. For illustrative purposes. Index shown are unmanaged and not available for direct investment.

The Volatility Index (VIX) has also woken from a slumber. The “fear gauge” has risen nearly 50% in recent weeks.
**Exhibit 2**

The VIX

Since Aug 31, the VIX has increased by 90%.

Source: CBOE. Data as of 10/3/2023. For illustrative purposes. Index shown are unmanaged and not available for direct investment.

However, this is normal. Markets don’t go up in straight lines. The S&P 500 has been positive in 32 of the past 43 years, but the average year has seen an intra-year decline of at least 14%.

**Exhibit 3**

Annual Returns and Pullbacks

S&P 500 Index. Max Drawdown Represents the Biggest Intra-year Decline

Market pullbacks — and the fear associated with them — always create fertile breeding ground for negative headlines. And these headlines make it easy for investors to question things.

As Bill Gates once said:

"Headlines, in a way, are what mislead you, because bad news is a headline and gradual improvement is not."
Markets and investing are generally the story of gradual improvements.

If you look at a list of top-performing stocks over the past decade — Amazon, Home Depot, Domino’s Pizza, etc. — the story would be lots of gradual improvements that compounded over time. None of these companies went from A to Z in a single day, quarter, or year.

But when markets get bumpy, we emphasize the bumps and ignore gradual improvements. In effect, the pessimists start to rule the day.

There are a few specific risks investors seem to be focusing on.

**The Magnificent Seven**

The U.S. stock market has been concentrated among seven large technology companies — the *Magnificent Seven* — which has become a reoccurring debate.

The *Magnificent Seven* are up 92% year to date, on average, while the other 493 companies in the S&P 500 are only up 3%, on average.

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### Exhibit 4

**Returns YTD**

- **Magnificent Seven**: Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla.
- **The Other 493**: 3%
- **S&P 500**: 13%

Source: Morningstar Direct. Data as of 10/3/2023. For illustrative purposes. Index shown are unmanaged and not available for direct investment. Performance is based on gross of fees. Past performance is no guarantee of future results. References to specific securities or other investment options within this piece should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell a specific investment. We will not be responsible for any trading decisions, damages or other losses resulting from, or related to, the information, data, analyses or opinions or their use.

A common argument is that the market is weak, because it’s dominated by so few companies. If these few companies begin to struggle, the entire market will struggle.

The argument is certainly based in logic.
However, a refute would be: You don't even need to leave the S&P 500 to find good stocks with lower valuations.

While the S&P 500 trades at the high end of historical valuation ranges, how much of that valuation premium comes from these seven companies? Quite a bit.

The Magnificent Seven — on average — trade at a price-to-sales (P/S) ratio of 10.8 times. If you exclude those seven, the other 493 companies trade at a P/S ratio of 3.5 times.


Of course, this type of analysis lends itself to the joke: *If you don’t count the bad stuff and only count the good stuff, then everything’s great!*

Point being, broad index valuations aren’t cheap but if you look under the hood, they may not be as stretched as you think. And if there’s a deeper pullback in expensive stocks, then it's possible that the cheaper stocks could potentially pick up some of the slack.

**The Pinch of Rising Rates**
Consumers are beginning to feel the squeeze of rising rates. One example is car shopping.

The average new car loan is up nearly 40% since 2018.
The same story is playing out in housing.

The average rate on a 30-year fixed mortgage now sits comfortably above 7%, at its highest level since 2000. That’s up from roughly 3% at the start of last year.

Americans now need to spend 41% of total income on their mortgage — the highest level since 2007.
Median home prices sales in the U.S. are now above $400,000 for the first time ever. This is up more than 40% since 2020.

Glenn Kelman — CEO of Redfin — recently shared his thoughts on the housing market, stating bluntly:

“The housing market is taking a beating. Affordability is at a four-decade low. And nobody is putting a house on the market when they hold a 3% mortgage.”
With that backdrop, Kelman was asked how Redfin — a real estate broker and mortgage originator — is managing its business. He compared its current operations to Rambo — the Sylvester Stallone action series — mentioning:

“It’s a little like when Rambo is asked, ‘How will you live?’ He said, ‘Day by day!’ That’s how we’re managing our business.”

It sounds like a terrible environment, and it is, but Redfin’s stock is up significantly this year. A simple truth about markets is they tend to price in negative news before it happens. Much of the pain in Redfin’s business showed up in last year’s stock price.

There are some additional caveats as well.

Household debt service payments as a percentage of disposable income are 9.8%. Since 1980, the average has been roughly 11%.

**Exhibit 10**

*Household Debt Service Payments as % of Disposable Income*

While debt is rising, people are making more money, and their ability to pay down debt has a solid foundation.

All this leads us to a broader topic the market is trying to wrap its head around, which is inflation.

**Inflation**

Accelerating inflation was arguably the biggest story hanging over markets last year. The opposite has been true this year — we’ve mostly observed decelerating inflation.
The rate of growth in inflation declined in 11 consecutive months starting last June. Falling—or slowing—inflation had been a tailwind.

But the narrative changed in July—it was the first month in more than a year where the rate of growth in inflation didn’t fall, it rose. And it happened again in August.

**Exhibit 11**

U.S. Inflation Rate (monthly)

Inflation declined for 11 consecutive months prior to two consecutive months of rising inflation starting in July.

Source: Bureau of Labor Statistics

We remain a long way from previous inflation heights, but the question is: Are we headed for another inflation spiral?

Costco—one of America’s largest retailers, selling 4,000+ products—was able to shed light on broad inflation trends during a recent earnings call, stating:

“[In the previous quarter], we had estimated that year-over-year inflation was in the 3% to 4% range. Our estimate for (next quarter) inflation is in the 1% to 2% range, and it actually trended downward during the (previous) quarter. So, hopefully, these inflation trends will continue.”

That’s one strong signal inflation won’t spiral out of control.

Another would be core inflation—which removes food and energy prices—and continues to move lower.
Exhibit 12

U.S. Core Inflation (monthly)

Despite the uptick in headline inflation, core inflation has declined in 5 consecutive months.

Source: Bureau of Labor Statistics

Are we again doing the thing where we don’t count the bad stuff?

Well, core inflation is actually the Fed’s preferred measure of inflation. Food and energy prices tend to be very volatile and don’t always explain the underlying inflation trends for the entire economy.

So, why is headline inflation rising while core prices are still moving down?

Mostly energy prices.

Energy prices were up nearly 6% in August, led by a jump in fuel oil (+9%) and gasoline (+11%). Gas prices peaked at more than $4 per gallon in September — their highest level in over a year.
While energy prices are currently hitting consumers at the pump, there’s an old saying “High prices are the cure for high prices.”

In effect, if gas prices get too high, consumers will respond by driving less. This happened in the summer of 2022—when oil reached $110 a barrel—and gasoline demand fell by 4%.

**Reasons for Optimism**

There are always reasons to worry, and right now that feels especially true. However, we should acknowledge a few reasons for optimism as well.

There are two that seem obvious:

1. **Investor sentiment is turning bearish.** American Association of Individual Investors (AAII) survey data shows “bearish” investors at the highest levels in five months.
Negative sentiment has historically been a strong indicator of future stock performance.

2. **The next 12 months will likely have more rate cuts than rate hikes.** Notes from the Fed’s September meeting showed the likelihood of one more rate increase this year followed by two rate cuts in 2024.
An additional caveat would be that bear markets usually happen when we're blindsided by something nobody—or very few—are talking about. Strong investing environments often have risks that are known and being discussed, which seems to be happening now.

Regardless, great long-term results always have chapters about surviving short-term bumps, and the worries that come with them.

Legendary investor Bill Miller has a great perspective on this:

“When I am asked what I worry about in the market, the answer usually is 'nothing, because everyone else in the market seems to spend an inordinate amount of time worrying, and so all of the relevant worries seem to be covered. My worries won't have any impact except to detract from something much more useful, which is trying to make good long-term investment decisions.'”

In short, you can often let the market worry for you.

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