The Market Has Bad Breadth. Can It Get Better?

In our last letter, we highlighted the "Super Seven": Apple, Microsoft, Netflix, Google, Tesla, Meta, and Nvidia. Ai has helped ignite these stocks and they represent close to a whopping 28% of the S&P 500 Index, which has gained roughly 13% through the third quarter of 2023. That sounds wonderful until you look at how the rest of the market has fared. If we examine the S&P 500 "Equal Weight" index, (which eliminates the overweighting of the Super Seven), it has only appreciated 1.73% as of quarter-end. The Dow Jones Industrial Average was up 2.73%, the Russel 2000 gained a mere 2.5%, and the microcap companies were down 6.29% for the year. A handful of large capitalization stocks doing well, but the majority of individual equities struggling, is the definition of "Bad Breadth".

Interest rates are approaching 5% on the 10-year Treasury, which has sent mortgage rates north of 8%. Mortgage rates have not been this high in over 20 years. High interest rates have substantially increased borrowing costs for consumers, businesses, and governments alike. The Super Seven, for the most part, do not need to borrow large amounts of money and this, coupled with Ai growth drivers, have made them attractive in this current restrictive economic environment. Most other companies are negatively affected by these high interest rates because of their borrowing needs and their tendency to reduce capital expenditure which is often needed to fuel future growth. Other factors weighing on market breadth have been the effects of elevated gasoline prices on businesses and consumers. The Wars in Ukraine and the Middle East, coupled with Saudi cutbacks in the production of oil, have added pressure to these prices. China's economy has been suffering from housing and debt issues, failures of socialism, a brain drain from the Country's crackdown on high tech companies, and tensions over Taiwan unification. These factors and others have added to the bad breadth of markets as a U.S recession seems to lurk around every corner.

Can the average stock begin to act better? Can we solve the Market's bad breadth? The Federal Reserve's aggressive tightening of interest rates to tame inflation appears largely achieved. They will attempt to keep interest rates elevated but at some point next year, we should see downward relief on rates as the economy slows and the cost of financing our ever-increasing debt becomes too costly. The strong U.S Dollar could also depreciate as interest rates moderate, growth slows, and our debt continues to rise. A lower Dollar can help many companies' earnings, especially those with international sales. Though gasoline prices could remain high as the Middle East War persists, we would not be surprised if these prices moderate in 2024 leading up to the Presidential Election. Employment has remained relatively strong, which has contributed to inflation but has also supported the consumer as the economy slows. U.S housing has not collapsed because most consumers own their house outright or are enjoying a low fixed rate mortgage that they refinanced into at materially lower levels during the last few years. This keeps housing inventory from coming on the market as homeowners stay put rather than buy another house at an unaffordable mortgage rate. Relief from high interest rates, energy prices and the Dollar next year could go a long way in improving market breadth as companies could rollover their debt at more attractive rates. Consumers would benefit from lower inflation as the cost of food, energy, and housing moderate.

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Broadly negative investor sentiment can also be supportive of the markets. As worries have grown, investors have piled into short-term fixed income and money markets to earn a positive risk-free real yield. Stocks are in the process of discounting the current challenging environment. If we were to see some relief as stated above, investor liquidity could find its way back into equities as confidence builds that the economy will not fall into a recession.

A few months ago, we commented that the Super Seven are both heroes and villains. They represent growth vehicles in a challenging environment. However, they are also masking the underlying Bad Breadth as seen by the dramatic underperformance of the average stock. Better breadth could soon be on the way as we wind down 2023 and move into next year as the Federal Reserve concludes rate hikes and inflation continues to moderate.

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