Alley Company Quarterly Letter
Anatomy of the Stock Market

October 13, 2023

The dichotomy between investor skepticism and the strong performance of many market-leading technology stocks has made for an interesting year.

The 24/7 news cycle is littered with talks of the Federal Reserve's mission to combat inflation, which seemingly involves their willingness to inflict a recession on the U.S. economy. This is enough to weaken the resolve of the most steadfast investor.

Conversely, innovation continues to flourish in our market-based system that rewards entrepreneurialism and the implementation of leading-edge ideas. Advancements in technology are infiltrating all walks of life, both business and personal, and making the case for optimism about the future.

The stock market has been in a steady uptrend during 2023, producing double digit gains throughout the year as measured by the S&P 500. This index is a market-capitalization weighted index where the largest stocks have the most impact on performance.

So far this year, seven large-capitalization stocks, mostly technology companies, conveniently labeled the "Magnificent Seven" (Apple, Microsoft, Meta Platforms, NVIDIA, Alphabet, Amazon, and Tesla), have dominated the performance and they now comprise an outsized 27.2% of the total index of 500 stocks.

A few factors are driving the performance of these stocks: 1) the emergence of artificial intelligence as a growth opportunity and economic productivity enhancer, 2) a recovery bounce after significant corrections in 2022, and 3) strong earnings results across each company.

The table below illustrates the year-to-date (YTD) performance of these stocks, their respective weightings in the S&P 500, and price-to-earnings (P/E) ratios based on consensus forward earnings estimates.

Stock	YTD 2023 performance[1]	S&P 500 weighting	P/E ratio
Apple	+34.5%	7.0%	29x
Microsoft	+32.1%	6.5%	29x
Alphabet	+47.6%	3.9%	23x
Amazon	+53.7%	3.2%	58x
NVIDIA	+184.7%	2.8%	38x
Tesla	+98.8%	2.0%	71x
Meta Platforms	+148.5%	1.8%	22x

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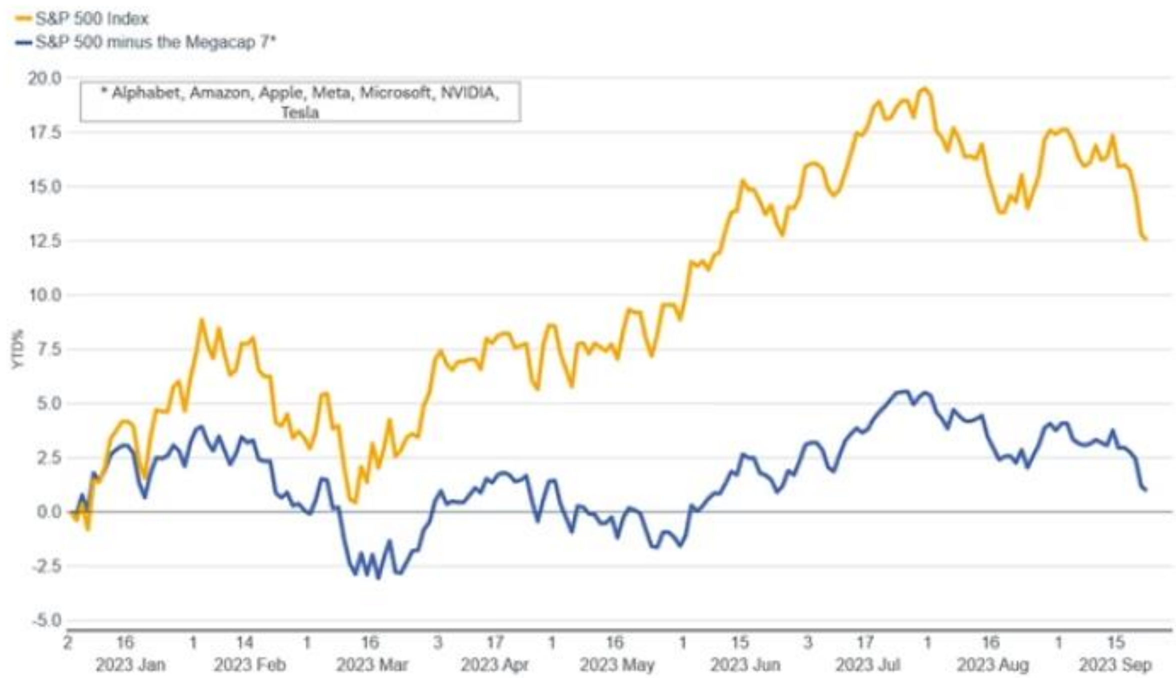
The anatomy of the market becomes even more interesting when one looks at stocks beyond these seven. The S&P 500 equal-weighted index, where every stock has equal impact on the index's performance, is basically flat in 2023. Similarly, the S&P 500 market-capitalization weighted index *excluding* the Magnificent Seven is also approximately flat year-to-date as depicted in the graph below. This indicates that under the surface, the broader stock market *excluding* the Magnificent Seven stocks, continues to digest the recession and inflation concerns that caused the 2022 stock market decline.

Magnificent Seven Driving S&P 500



Charles Schwab, Macrobond, S&P Global, MSCI data as of 9/23/2023.

Portfolio diversification is an age-old axiom in investing that speaks to the importance of risk management. Over the long run, diversification is a valuable tool and serves as a discipline to avoid unbridled concentration that can develop in indexes. For example, the technology sector in 2000 and the financial sector in 2007 developed lofty concentrations in the S&P 500. **Actively managed portfolios that heed the importance of diversification can avoid concentration risk.**

During the current instance of index concentration, and in the face of the most advertised prospective recession in recent memory, there is reason for optimism. Inflation, the impetus for the Federal Reserve's aggressive hike in the Federal Funds rate, has come down from a high of 9% in June of 2022 to around 3% in the latest reading, while the economy continues to grow, albeit at a moderating pace. This is good news as it portends the Federal Reserve getting close to the end of their rate-hiking cycle.

Sir John Templeton, founder of the Templeton Funds and a highly respected investment mind, opined, "**Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria**." From this perspective, the skeptical mood of investors and market pundits combined with a resilient economy and declining inflation provides adequate support for market strength going forward.

The S&P 500 is currently trading at approximately 18.5 times consensus forward earnings estimates.[2] The Magnificent Seven stocks previously discussed comprise 27.2% of the index and collectively are trading at approximately 27 times consensus forward earnings estimates.[3] We think they are dominant companies, are growing earnings and cash flow impressively in the vibrant technology space, and generally deserve to trade at a premium P/E ratio.

The remaining 72.8% of the S&P 500 is trading at approximately 16.5 times consensus forward earnings estimates, a very reasonable multiple historically.[4] Based upon our analysis of the current environment, this is an attractive valuation level and underscores our view that the majority of the market could join select technology stocks and be in for better times ahead.

Regardless of where the markets are going in the near term, our advice is two-fold: Always stay invested in a diversified portfolio of great U.S. companies for the long pull and put money to work regularly with a dollar-cost-averaging approach as America is still the best wealth creation machine ever invented.

[1] As of 9/22/2023
[2] Source: Yardeni Research, Inc.
[3] Source: Yardeni Research, Inc. and Alley Company calculation.
[4] Source: Yardeni Research, Inc. and Alley Company calculation.