KLCM Advisors, Inc.

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The Magnificent Seven

By all accounts, 2022 was a difficult year for most investors. The major indices suffered sizable losses as many of the previous cycle's winners were sold. Entering 2023, the bullish case was that inflation would slowly subside while the economy continued to slowly expand—stagflation light if you will. The bearish counterargument was that inflation would not subside and, as a result, the Federal Reserve would continue to hike interest rates until economic activity contracted sharply enough to finally vanquish inflation. Determining whether the bulls or bears would be proven correct would likely take many months and be the subject of much debate. The implication for the stock indices, given relatively high valuations and increasing interest rates, was muted at best.

In the midst of this malaise, on November 30, 2022, ChatGPT was released to the public. According to Wikipedia, ChatGPT is an artificial intelligence chatbot developed by OpenAI based on the company's Generative Pre-Trained Transformer (GPT) series of large language models (LLMs). ChatGPT is built upon OpenAI's foundational GPT models, specifically GPT-3.5 and GPT-4, and has been fine-tuned for conversational applications using a combination of supervised and reinforcement learning techniques. ChatGPT has gained attention for detailed and articulate responses spanning various domains of knowledge. However, a notable drawback has been its tendency to confidently provide inaccurate information—**Maybe it's human after all!!**

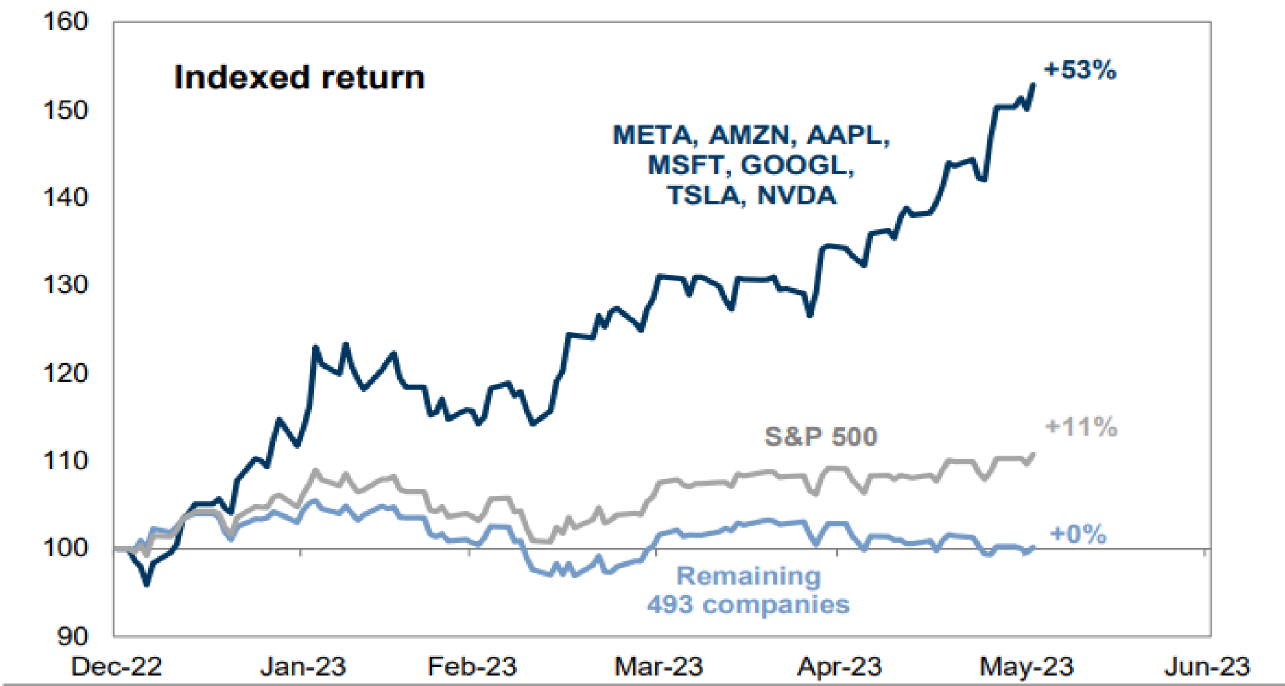
What started as a novelty that could write a song or poem given a subject and some instruction has now morphed into the next big thing. Prevailing wisdom is it will change the world. Suddenly, investors started pondering how many business processes could be automated and how much money businesses could save. Most of these savings would be centered around an ability to reduce the number of employees needed to do "mundane" tasks. Entire departments like human resources, accounting, and customer service could be outsourced to a chatbot. In many ways, a market with many participants seeking a narrative finally found one. Artificial intelligence (AI) was here, and it would help existing businesses run more efficiently pushing down inflation by reducing demand for human labor. Even better, the total addressable market was every activity on Earth!

The race was on to determine which companies would benefit the most from this new megatrend. The Magnificent Seven was born -- Microsoft, Apple, Google, Nvidia, Tesla, Amazon, and Meta. These companies either produce the chips necessary to power these large language models (NVDA), provide cloud computing services to AI startup companies (MSFT, GOOG, AMZN) are building their own AI platforms (MSFT, GOOG, META), or possess large use applications like autonomous driving or virtual reality headsets (TSLA, AAPL).

The enthusiasm with which investors have piled into these stocks is nearly unprecedented. As the following chart shows, these stocks, which started the year with a total market capitalization of $6.9 trillion, have risen on average 53% as of June 1. **These seven stocks now comprise nearly 28% of the S&P 500.** They currently trade at nearly 36X forward earnings, excluding Tesla, which is the same valuation they traded at near the end of 2021 when interest rates were 0%, and the economy appeared to be sustainably growing. **Economic growth is less certain today and the risk-free rate that competes**

for investment dollars is 5%!! Through May, the pull of these stocks led to a double-digit increase in the S&P 500 index, however, the other 493 stocks returned essentially nothing. June offered a broad rally that enabled the "remaining 493 companies" to post 5% returns year to date while the Magnificent Seven finished up 58%.

Mega-cap tech has led the way higher YTD
Data thru June 1, 2023



Source: FactSet, Goldman Sachs Global Investment Research

There have been many periods of investing defined by various narratives ranging from the Nifty 50 of the 1970s, The Four Horseman of Tech in the late '90's, FAANG from the 2010s, and now the Magnificent 7. In the moment, it is impossible to determine how high, high is. Warren Buffett has said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." When markets behave like a voting machine, they tend to ignore a business' underlying fundamentals and are driven by speculation, sentiment, and momentum.

While the Magnificent Seven certainly appear to have unassailable positions today, so did Sears, Revlon, and Xerox in the 1970s and Dell and Intel in the late '90's. Over time, we anticipate that if the hype of AI meets reality, the other 493 companies in the S&P 500 will benefit as they utilize the technology to run their businesses more efficiently. If the reality of AI does not match the hype, then it is likely that the market will weigh in on the valuations currently afforded some of today's darlings.

We have been holding more cash and have owned a portfolio of stocks with much lower valuations and higher dividend yields than the market. These are mature businesses that have the ability to raise prices and generate free cash flow, which they can either invest back into the business or return to us as shareholders. In fixed-income accounts, as rates rose last year to levels we have not seen in a decade, we began extending the duration of our portfolios to lock in these higher rates for longer periods of time. In both stocks and bonds, the current uncertain environment provides the opportunity to invest capital at higher expected rates of return. Given this improved set of choices, now is a great time to revisit your plan.

Enjoy the summer!!