2Q 2023
Market Commentary

Anyone remember the "dot.com" bubble of the late 1990s? With the growth of the internet all the rage, all companies needed to do was change their names to include ".com," and instantly, the Price/Earnings (P/E) ratios shot higher. We see a similar phenomenon occurring with the emergence of today's fascination with artificial intelligence. Just mention that your company's revenues will benefit from AI and your P/E is immediately rerated higher. Most of today's Magnificent Seven (as Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla are now described) benefited hugely from the excitement surrounding AI in the first half of 2023.

The end of 2021 appeared to us to be the top of a growth-stock bubble driven by years of low interest rates (not just low but near 0% interest rates at the short end of the Treasury curve after years of ZIRP by the Federal Reserve Board). Furthermore, with revenues and earnings pulled from the future into 2020 and 2021 by the COVID pandemic, exuberant optimism was built into future growth rates and stock prices. The massive correction in the NASDAQ stock index in 2022 (-30%) appeared to us to be an appropriate adjustment as revenue growth lost momentum relative to expectations built during the pandemic years.

At the end of 2022, with tax loss selling ending and short-covering beginning, it seemed reasonable to expect a meaningful "January Effect" rally to occur. But it didn't stop there. Triggered by Silicon Valley Bank's collapse in March, investor money fled financials and moved into technology and media companies viewed as having safer earnings growth opportunities. This was followed by the coup de grace, Nvidia's announcement that due to AI, 2nd quarter revenues would be a massive $4 billion higher than previously expected. Suddenly, nothing else seemed to matter as a very narrow market rally surged ahead. As the first five months of 2023 came to an end, the Dow Jones Industrial (DJIA) was essentially flat through May 31st. The S&P 500 gained about 10%, but the NASDAQ shot up 25%. Although the stock market rally broadened in June to include nearly all U.S. stock indices, the near 30% gain in the NASDAQ partially reduced the -30% plunge of 2022.

Yet seemingly all of the action was in the Magnificent Seven. These stocks represent about 10% of the DJIA (Apple and Microsoft), 27% of the S&P 500, and over 54% of the NASDAQ. For three of these magnificent companies, Amazon, Apple, and Microsoft, P/E ratios on next twelve month's (NTM) earnings expectations peaked at the end of 2021 at 64.9, 30.3, and 34.0, times earnings, respectively (according to FactSet data); their stock prices promptly fell -49%, -27%, and -29% in 2022, respectively. Yet as of June 30, 2023, these same P/E ratios on forward earnings estimates rallied back up to 61.4, 30.0, and 30.7 times—nearly identical levels. P/E's were supported in 2021 by extremely low interest rates, with the 10-year Treasury bond yield stock at just 1.5%. But this same yield more than doubled to 3.8% by June 30th. Are these stocks, and ones like them, worth the same valuation using today's higher discount rate? We don't believe so. Even with the potential benefits from AI, earnings expectations for 2023 have fallen for these giants over the last year. The risk appears to be more on the downside than a continuation of the rally.

June finally seemed to represent a turning point as a broad-based stock rally ensued. If the overall market returns to weakness, our view is that the average stock will likely hold up better than the Magnificent Seven.

Despite the June Fed funds tightening “pause” (to be different, Chair Powell described it as a “hold”) after ten consecutive months of rate hikes, the Federal Reserve Board seems determined to kill the economy to get price inflation back down to their 2% target. It’s not the terminal level of interest rates that is the problem, it’s the shock to the financial system from the magnitude of the change in such a short period. Proper pricing of credit risk and a proper return on savings should be the eventual outcome of these changes, but banks, lenders of all types, leveraged borrowers, and stock market valuations were NOT prepared for this painful pace of change. While stagflation is currently underway (low real growth and price inflation at or above 3%), one cannot dismiss the risk of two or three quarters of negative economic growth either in the second half of 2023 or 2024.

At the same time, the U.S. economy is highly diversified and weakness in “goods” has so far been more than offset by strength in “services.” High federal deficits continue to support excess spending and demand but have a magnified negative impact now that money is no longer free. The dramatic deterioration in commercial real estate, heightened delinquencies in subprime auto loans, falling affordability of housing with rising mortgage rates, tightening of bank lending standards, and even weakening growth in China, all point to subpar economic growth overall over the next year or two. At the same time, we believe price inflation will remain sticky in the 3-4% range as federal deficits fuel overall demand, the benefit from falling energy prices comes to an end, and core costs continue to rise.

These circumstances make low relative valuation and balance sheet strength all the more important to navigate today’s challenges, and our investment disciplines continue to lead us to such investment opportunities.

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