ARCHIMEDES
INSIGHTS & ANALYTICS

Margin Compression

Weekender

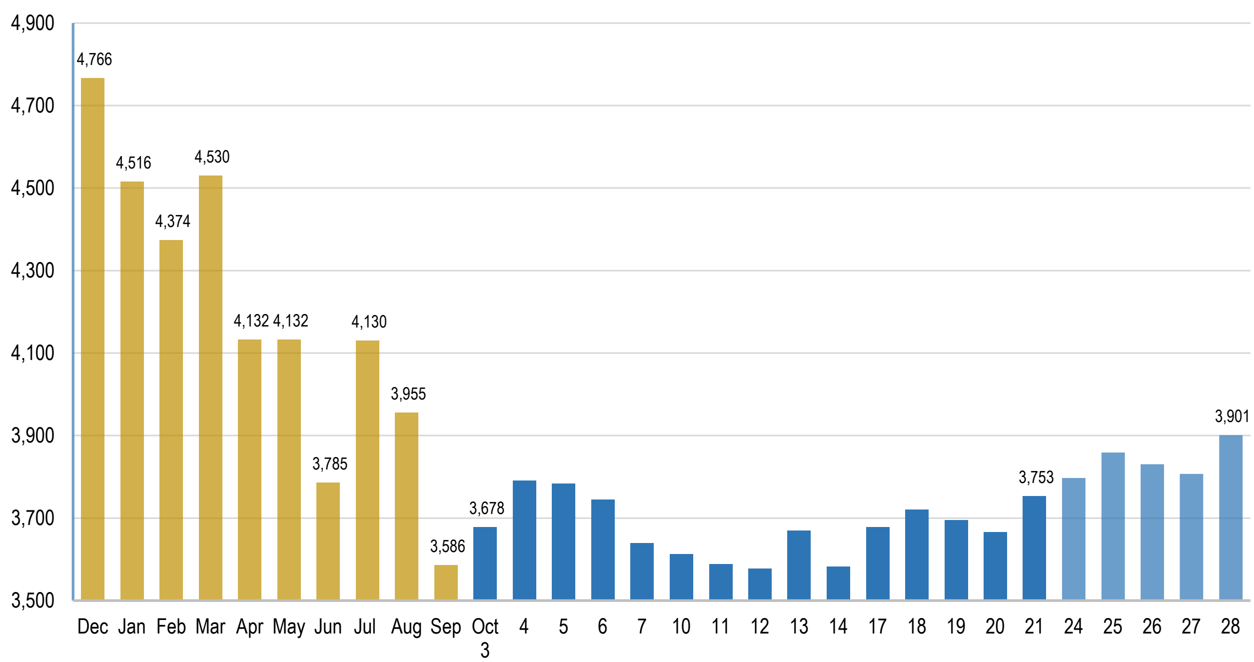
October 29, 2022

Good morning and welcome to the *Weekender* for Saturday, October 29, 2022. It was, quite literally, a week for the record books. The S&P 500 equity index, intended to be an equity manifestation of the US economy, was higher by 4.0% on the week. Friday alone, the index was up by 2.5%.

Rallies like the one we experienced through the month of October tend to fizzle shortly after they appear. However, November and December are also sponsors of what is called a Santa Claus rally, where the good vibes of Holidays settle the nerves of Nellie and her cousins. July was the last time markets rallied with such ferocity, when hope of an interest rate pivot was in the air. The rally didn't last long.

S&P 500 Month-End Levels

December 2021 - October 28, 2022

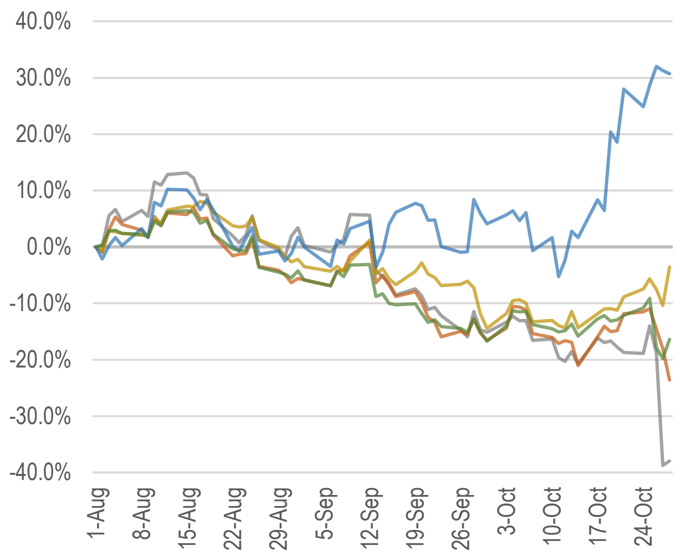


So why the weekly rise? First, the market was oversold. Having reached a level of maximum pessimism, the fact that the world has not come completely unhinged is a net positive. Second, almost all inflation metrics have begun to bend, and the prospect of a potential interest rate pause by the US Federal Reserve in the coming months lured some investors to jump the gun. Third, as we have discussed, bear markets always leave quality companies in the hedgerows with legitimate debris. In such an environment, savvy investors snap up quality names trading at historical discounts on price and valuation, despite prevailing economic uncertainties.

Fang (Meta, Apple, Netflix, Alphabet, and Amazon) stocks were a catalyst for equity markets going into the pandemic. Since the beginning of August, Netflix, the blue line, has broken from the pack after the company introduced a new ad-driven layer for customers who don't fancy a monthly subscription. Apple (gold), Meta (grey), Alphabet (green), and Amazon (pumpkin) have continued their downward trek. Meta, Alphabet, and Amazon are experiencing considerable earnings weakness. Apple is surprisingly resilient.

Fang Stocks, Cumulative Return

August 1, 2022 - October 29, 2022



US economic prospects remain mildly recessionary. Europe is likely in a recession already. Asia is certainly slowing but their COVID responses make it difficult to tease apart what is sustainable and what is not. Inflation has bent in almost every area but is nowhere near kneeling. Earnings are telegraphing a story of slowing revenue growth and margin compression. Fundamentally, economic, inflation, interest rate, and earnings data are coming in largely in-line with past *Weekender* discussions.

This will be a relatively short *Weekender.* Next week we will publish our comprehensive *House View* for November.

Market Narrative

Despite last week's strong equity performance, in general, for the technology sector, it was a horrible, no good, very bad week. Except for Apple. Among semiconductors, Intel, left for dead by investors for years, was the poster child for moderated expectations. Hit hard by a post-pandemic computer slowdown, earnings expectations have been cut consistently over the past year. Last week, they released third-quarter numbers that came roughly in-line with analysts' dimiminished expectations. Then the turd. For the fourth quarter, analysts had been expecting $0.66 per share. The company provided guidance closer to $0.20. Ouch!

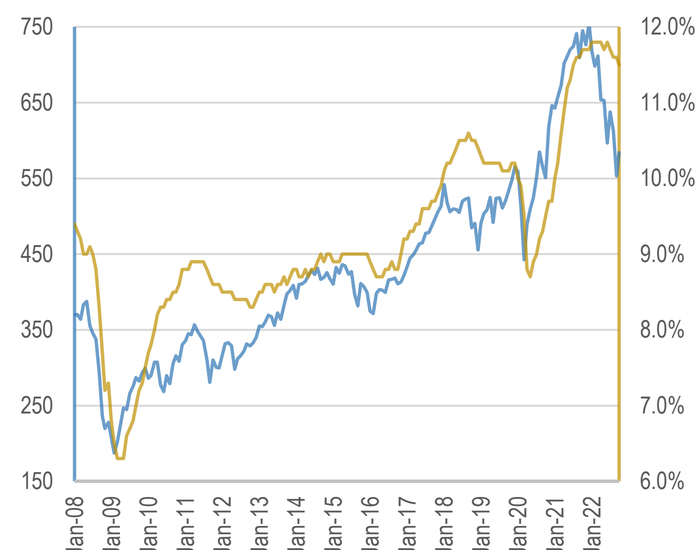
On the whole, semiconductor supply is moving from shortage to surplus at a very fast clip. Many industry groups will be following a similar path. Plans for capacity expansion are almost all being shelved and capital expenditure budgets are being cut to the bone.

With almost 28.8% of all US companies having reported third quarter earnings, the number of companies beating estimates is in-line with the average, although estimates have come down from the beginning of the year. Approximately 24% of companies in the S&P 500 have reported earnings that are short of expectations which is much higher than previous quarters and the most since the beginning of the pandemic in 2020.

In Europe, approximately eighty percent of companies have exceeded sales estimates while only fifty-five percent exceeded earnings expectations. Pressure on margins is a global phenomenon.

MSCI World Index (Blue) and Profit Margin (Gold)

January 2008 - October 2022



For the majority of companies, the squeeze is beginning to show. Profit margins are being squeezed by the steepest inflation in a generation. We expect the squeeze to accelerate as companies enter the holiday selling season with bloated inventories that will require fat discounts to liquidate.

Data released over the week showed that inflation remains persistent enough for the Fed to continue raising rates. That said, data also suggest, especially from the residential real estate sector, that higher rates are already taking a toll. It's not unlikely that by their December meeting, watchful waiting may be the call.

Last week's economic data can be presented in staccato format. Mortgage applications continue to fall, so do home sales, and home prices. Rents are falling as well. Wholesale inventory continues to exceed retail stockpiles, setting up a Christmas season of early and deep discounts.

Consumer spending came in better than expected lending additional credence to a view that without significant deterioration in the labor market, the consumer will continue to spend. Strong spending is a tail wind for the Fed to continue raising rates. However, looking forward, signs of a consumer slowdown are beginning to pile up. Amazon, in their third-quarter earnings release on Thursday suggested the fourth quarter would be tough.

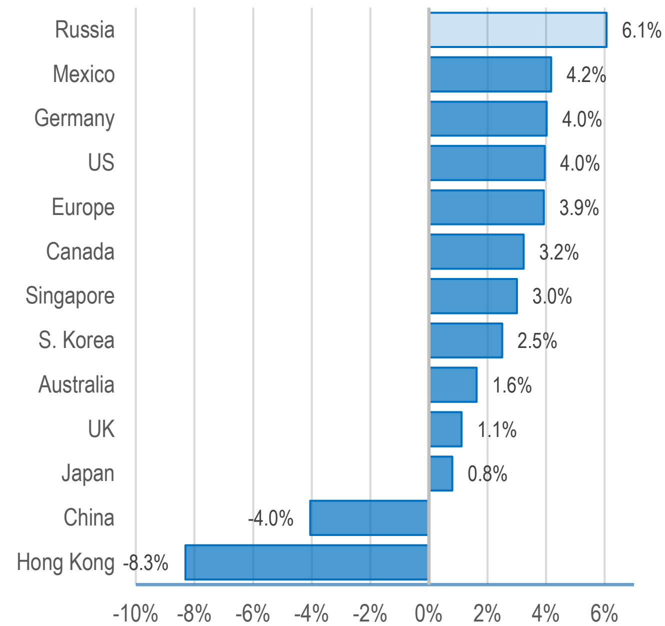
Next week is chock-a-block with economic and earnings data. All important pieces will be incorporated in our House View for November.

Countries

Aside from an un-investable Russia, most countries were higher. China and Hong Kong continue to fall on the back of concerns that economic, market, and political reforms are giving way to a staunch nationalist ideology.

Country Returns

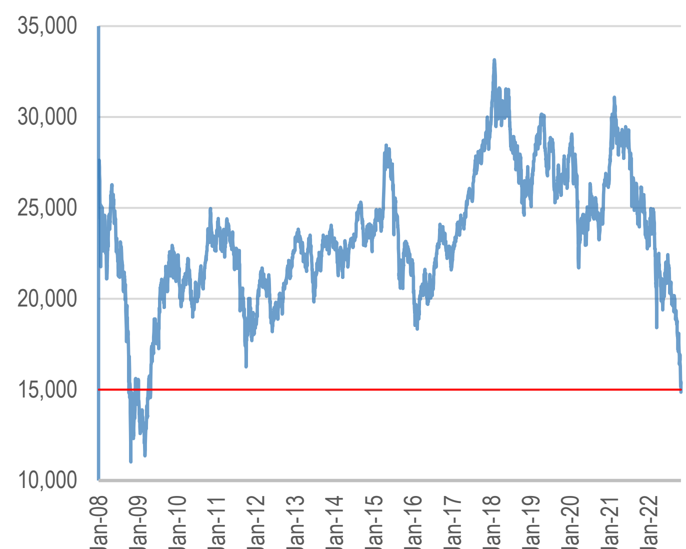
October 24 - 28, 2022



Hong Kong's Hang Seng Index is now at levels not seen since the Credit Crisis. Historically, international investors have used Hong Kong's equity markets for China exposure. The index is now trading at 5.0 times next year's earnings, the lowest valuation since index data has been tracked. China's Shenzhen 300 Index is back at its 2019 levels but is trading at 12.0 times earnings.

Hang Seng Index

January 1, 2008 - October 28, 2022

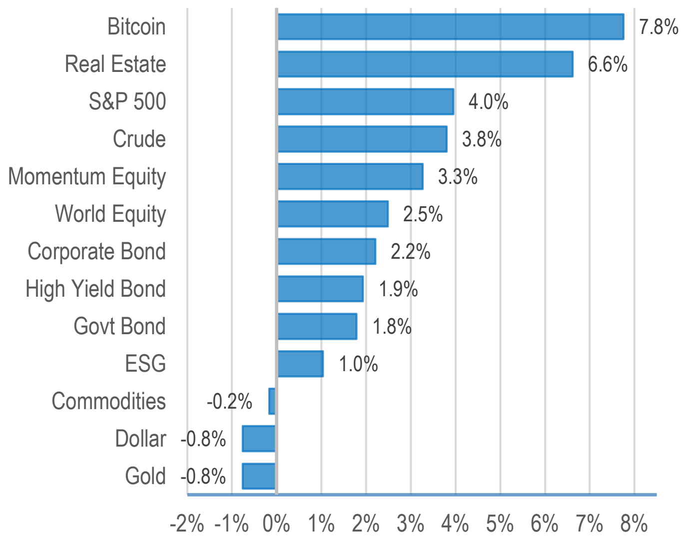


Instruments

Despite strong performance among all equity categories, Bitcoin was the best performer. Interest rate pause and pivot on the brain also pushed real estate higher. The narrative that inflation was in retreat pushed commodities, the dollar, and gold lower.

Instrument Returns

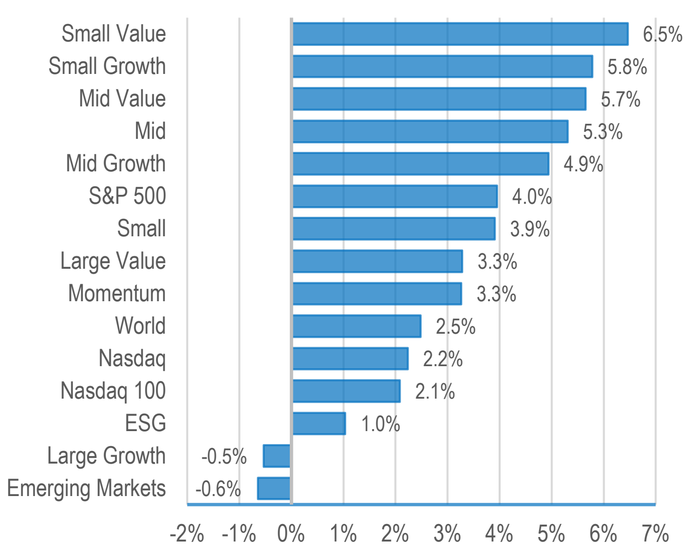
October 24 - 28, 2022



Within the broad class of equity instruments, value continues to beat growth. The technology-laden Nasdaq and technology heavyweights in the Nasdaq 100 faired poorly on the back of notable earnings misses and diminished profit outlooks into the new year.

Equity Instrument Returns

October 24 - 28, 2022

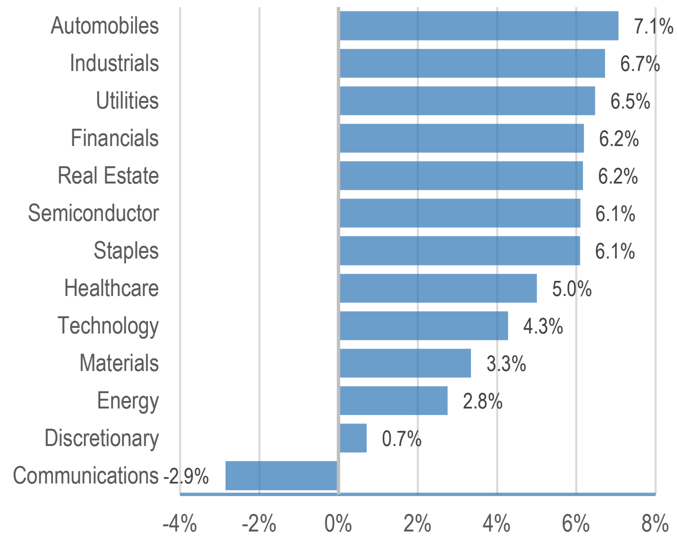


Sectors

As mentioned in the introduction, it was a bad week for technology, generally. But the worst performing sector, by far, was communications. The reason, Alphabet and Meta are classified within the communications sector.

Sector Returns

October 24 - 28, 2022

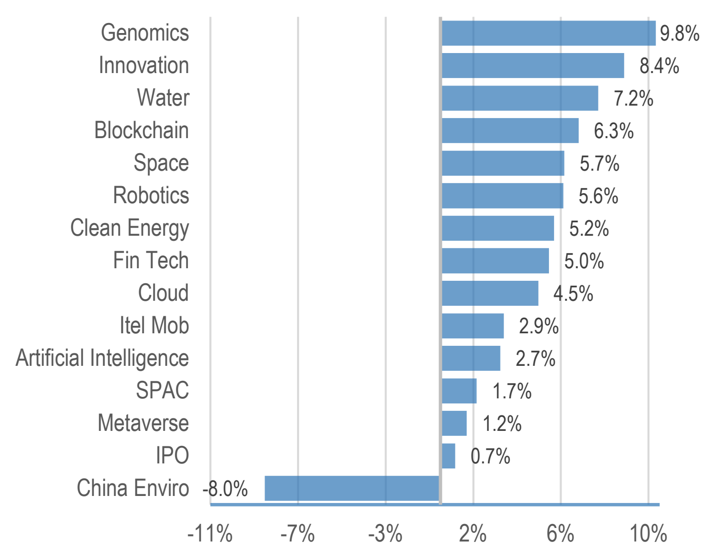


Themes

Themes were all higher except China Environment which suffered the relational downdraft of being associated with the Middle Kingdom.

Equity Instrument Returns

October 24 - 28, 2022



Conclusion

That's it for this Weekender. Next week we will publish our House View for the month of November. Have a great week.