Waves

Weekender

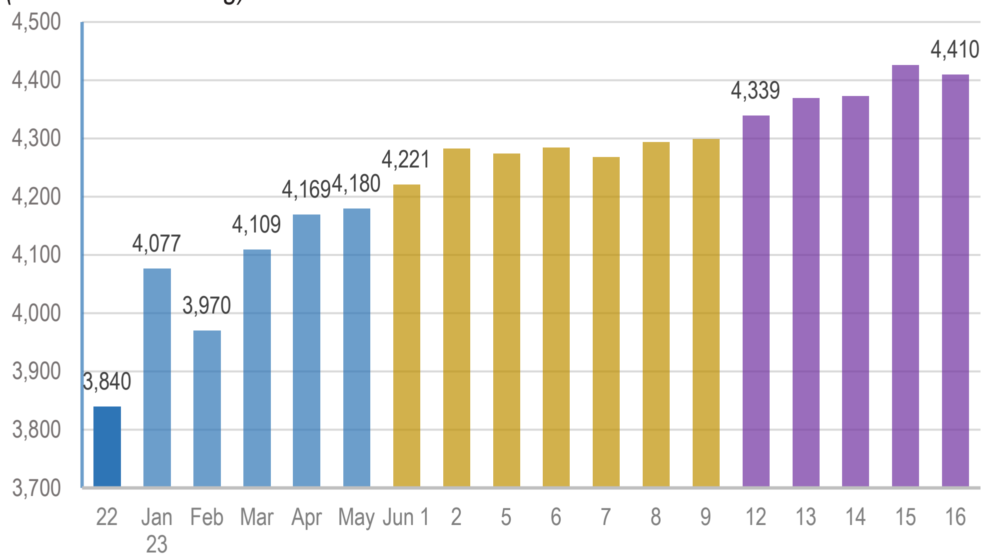
June 17, 2023

The dogmas of the quiet past are inadequate to the stormy present.
The occasion is piled high with difficulty,
and we must rise with the occasion.
Abraham Lincoln

Good morning and welcome to the *Weekender* for Saturday, June 17, 2023. Equity markets in the United States rose 2.6% last week, as measured by the Standard and Poor's 500 index. In a well-telegraphed move, the Federal Reserve did not raise rates at their June meeting. However, their prepared remarks said that rate hikes might resume if the labor market and economy do not cool.

S&P 500 Index Levels

(Source: Bloomberg)

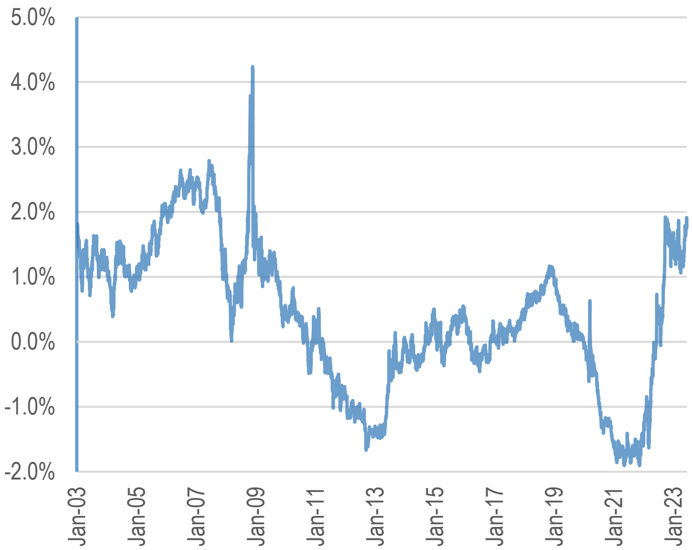


US inflation data holds less gravitas than it did a year ago. Price increases are softening, and the Federal Reserve's interest rate hikes have been the most aggressive in history, giving some credibility to their newfound "watchful waiting" strategy. Over the near term, the Federal Reserve expects interest rates to remain high and inflation to continue to fall, albeit at a milder clip. In such an environment, bonds now have a solid inflation-adjusted yield unseen since before the Credit Crisis.

US 5-Year Real Bond Yield

January 2, 2003 - June 16, 2023

(Source: Bloomberg)

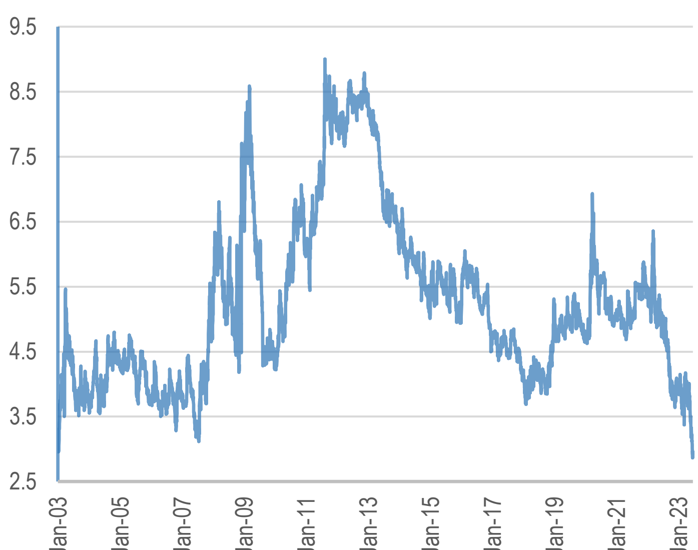


The earnings yield of the S&P 500, relative to the real yield of the five-year US government bond, is back at pre-Credit Crisis levels. On this basis, the S&P 500 is significantly overvalued, and bonds are undervalued.

S&P 500 Earnings Yield Minus US 5-Year Real Yield

January 2, 2003 - June 16, 2023

(Source: Bloomberg)



The blind opportunity set of artificial intelligence (AI) continues to push markets forward, although a handful of companies are disproportionately pulling the sled. Macro events are increasingly discounted in favor of the market's unstinting support of a future when bots will rule their human minions. Inflation, a hawkish Federal Reserve, global political dysfunction, a possible recession, a depression in commercial real estate, and frothy valuations don't seem to matter.

Even for seasoned (i.e., old) market analysts like me, the speed with which the AI narrative has enveloped global equity markets that seemed adrift in the doldrums in February is unprecedented. But all agnostic markets are simply believers in search of a cause. ChatGPT provided a gateway into a new religion. Nvidia's stunning AI-driven earnings report followed the hype with the hope that companies could make a little money with their AI ventures. Suddenly artificial intelligence was the market's raison d'être.

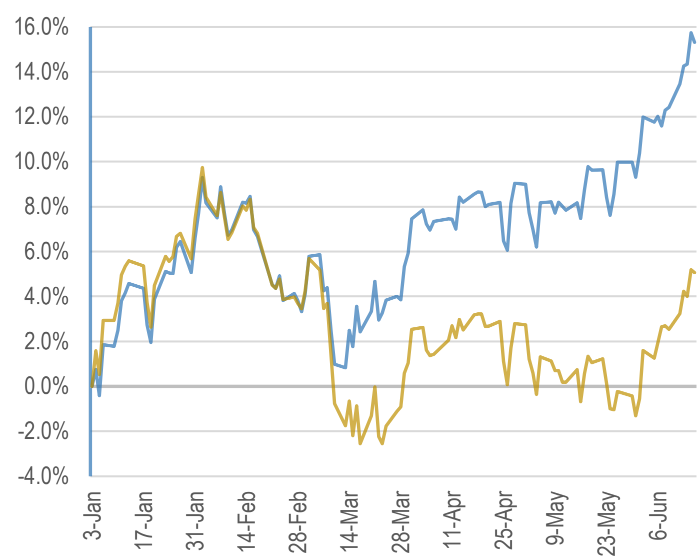
Artificial intelligence, writ large, is likely to be the most pivotal advancement for the human species since the emergence of metal tools. The market for AI will likely exceed $3 trillion at its peak. But most AI technologies will wither on the vine as nothing more than shiny objects. Over the long-run, AI must make money or save money.

But for now, ephemeral AI market gains are blotting out the rest of the market. The size of its members weighs the S&P 500 index. Consequently, the prominent AI-targeting players move the market considerably. An equal-weighted version of the S&P 500, which gives no preference to size, is only higher by 5.0% in the year.

S&P 500 (Blue) and Equal Weight (Gold)

January 2 - June 16, 2023

(Source: Bloomberg)



Consider how little we know about AI and how it will evolve over the years ahead. Remember the internet bubble, when companies went public at astronomical valuations just by suggesting they were a dot-com? Here is a graph of the price-to-sales ratio for the Nasdaq 100 from the internet bubble to today. A lot of valuation excess is riding on the hope of artificial intelligence.

Nasdaq 100 Price-to-Sales Ratio

March 26, 2001- June 16, 2023

(Source: Bloomberg)

On a year-to-date basis, the S&P 500 is higher by 14.9%, and the tech-heavy NASDAQ is 30.8% above where it ended last year. Market pundits have suggested that equity waters are warm and inviting, and it's time to grab the pool noodle and jump in. If a bull market is defined as higher by 15.0 – 20.0+ percent, we are in a bull market. The question is, why?

Globally, temperatures are registering their hottest early June on record, and the next few months of the primary growing season in the northern hemisphere are likely to see some scorching records broken. Another El Nino weather pattern is expected to emerge within the coming months. Forecasters expect it to be solid this time around. Sweltering temperatures will likely stretch power grids in China, Texas, and Europe. The market implications are profound, ranging from higher agricultural commodity prices and recovery in a severely depressed natural gas complex.

Economic Narrative

Periods of persistently high prices are usually followed by an interest-rate-induced recession which has the predictable effect of weakening the labor market, which, in turn, softens demand. As demand declines, companies typically reduce prices to clear their bloated inventory. Not this time. Greedflation, a partisan term coined by liberal pundits describing the primary cause of inflation as coming from corporate greed, may have some legs.

Since the pandemic, four inflationary waves have pushed prices higher. In an early response to the unknown impacts of COVID, the economy met a virtual grabbag of government-directed handouts, cessation of previously agreed obligations like rent, mortgage, and student loan payments, and a torrential increase in financial market liquidity by the Federal Reserve. These met head-on with a just-in-time global supply chain designed for efficiency and desperately needing more resiliency. Too much money was chasing too few goods. However, inflation from the first wave should have been temporary. Prices have returned to trend as the stimulus waned and supply chains mended.

The second inflation wave came from Russia's invasion of Ukraine. Natural gas and oil prices spiked, but the concerted response from previously allied nations worldwide cushioned price increases. In one year, Europe's energy supply pivoted away from Russia and toward historic allies in the West. A very mild and dry weather pattern throughout Europe helped a lot. Russia's invasion also impacted a bevy of agricultural products, but most are coming back in line with historical levels.

A third wave of inflation comes from higher interest rates that push the cost of products purchased on time to record levels. Consumers ' willingness to live with this insidious inflation makes it increasingly more persistent. Consider how much higher home, car, and credit payments, which last for years, have become over the past two years. Even if interest rates have peaked, the last two years of higher rates have thoroughly acclimatized the financial system.

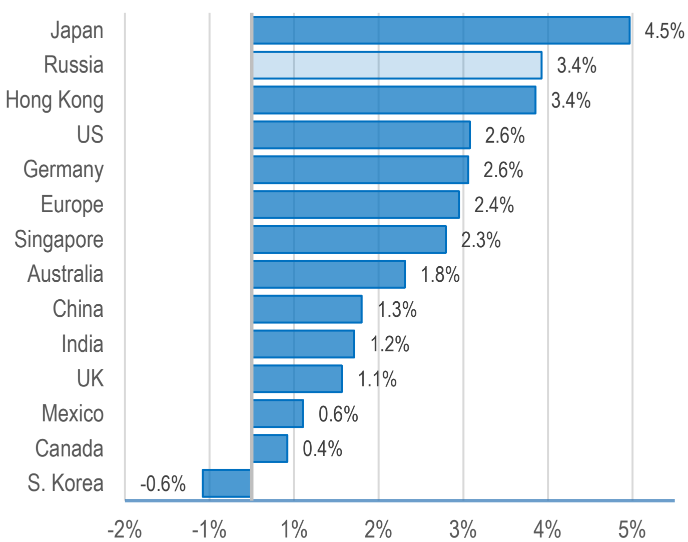
The fourth wave of inflation is breaking on us at present. It is profit-led inflation. Companies don't need to lower prices when consumption remains strong in the face of higher prices. Recent earnings reports for the first quarter point to higher costs but also suggest that most companies have been able to pass on the higher costs to consumers with higher prices. Coined greedflation, profit-led inflation will only fall with the roll of base effects.

Countries

Country performance was mainly higher. Japan continues to post stellar returns. On a year-to-date basis, Japan's Nikkei index is higher by 29.2%, the second-best performing equity market in the world. The Nasdaq is higher on the year by 30.8%. Japan's stock market trades at 22.9x earnings. Much higher than its pre-pandemic multiple of 17.2x. Around the world, equity markets are dearly valued.

Weekly Country Returns

June 12 - 16, 2023
(Source: Bloomberg)

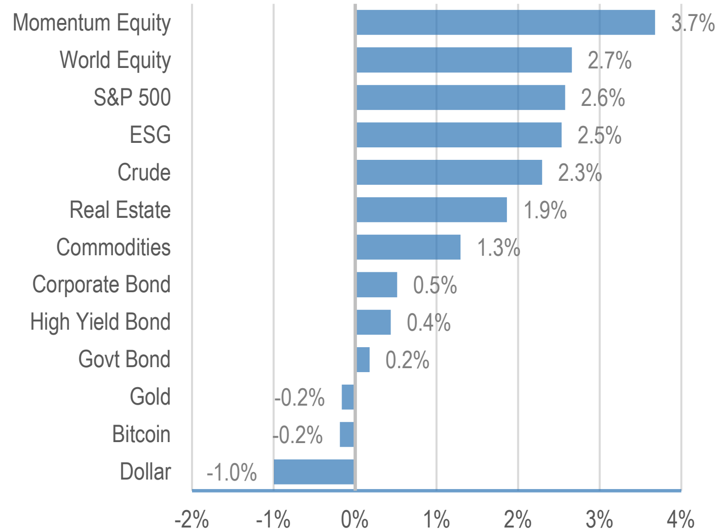


Instruments

A clear bubble is being formed in large capitalization tech—especially those with a whisper of interest in artificial intelligence. Equities-led and fixed income followed in the heady world of concept-driven markets.

Weekly Instrument Returns

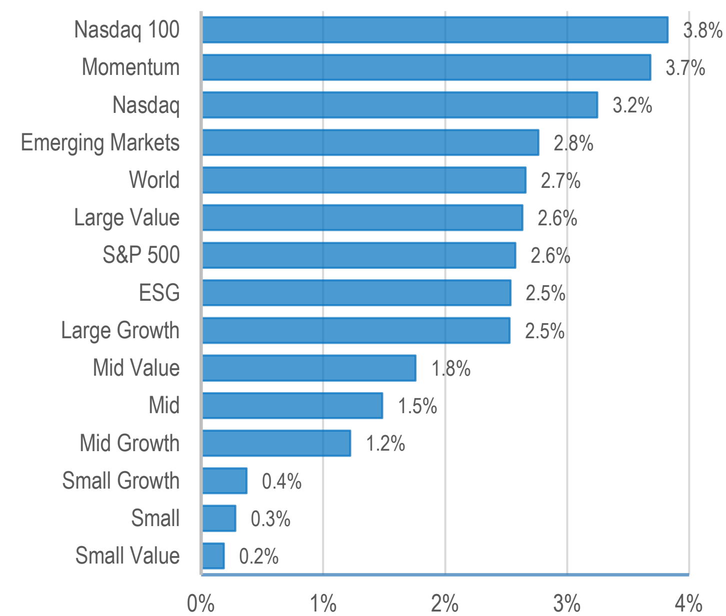
June 12 - 16, 2023
(Source: Bloomberg)



Among equities, the large-capitalization technology space led. However, a non-intuitive trend is also playing out. Value has been beating growth. This trend is inconsistent with the froth being generated in the tech space. We will unpack the drivers of this trend in more detail in the House View to be published on July 1.

Weekly Equity Instrument Returns

June 12 - 16, 2023
(Source: Bloomberg)

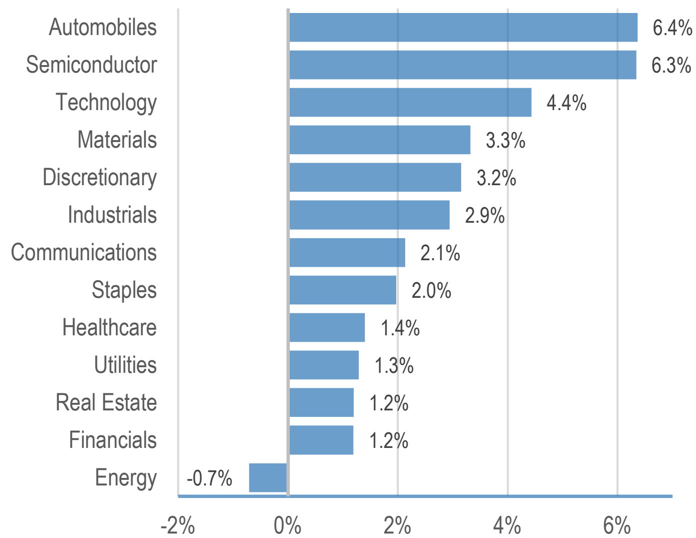


Sectors

Among sectors, the AI trend continued to manifest itself. Self-driving capabilities in automobiles pushed a typically recession-sensitive industry higher. Semiconductors continue to anticipate an AI-related arms race in capital spending and technology benefits from the general halo around artificial intelligence.

Weekly Sector Returns

June 12 - 16, 2023
(Source: Bloomberg)

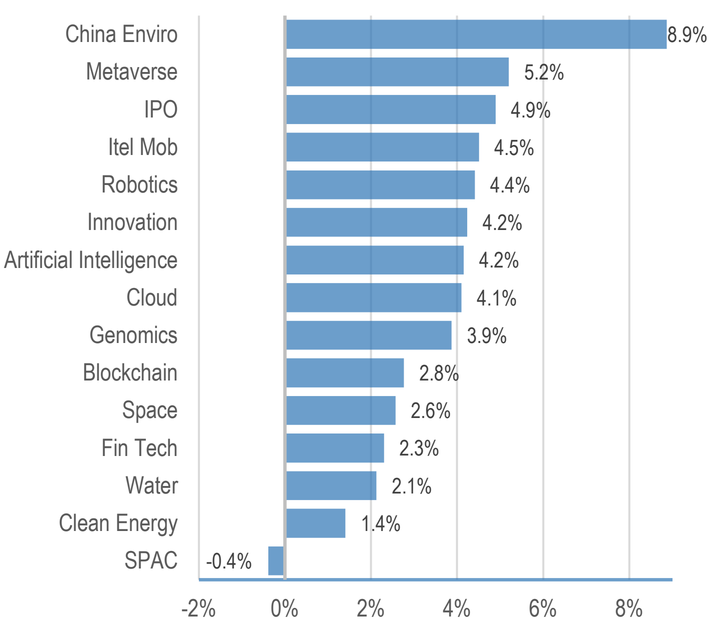


Themes

Almost all themes were higher.

Weekly Theme Returns

June 12 - 16, 2023
(Source: Bloomberg)



Conclusion

That's it for this Weekender. Have a wonderful week.

Disclosure Statement

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