Common Sense

Weekender

July 15, 2023

There is always light. If only we're brave enough to see it.
If only we're brave enough to be it.
Amanda Gorman

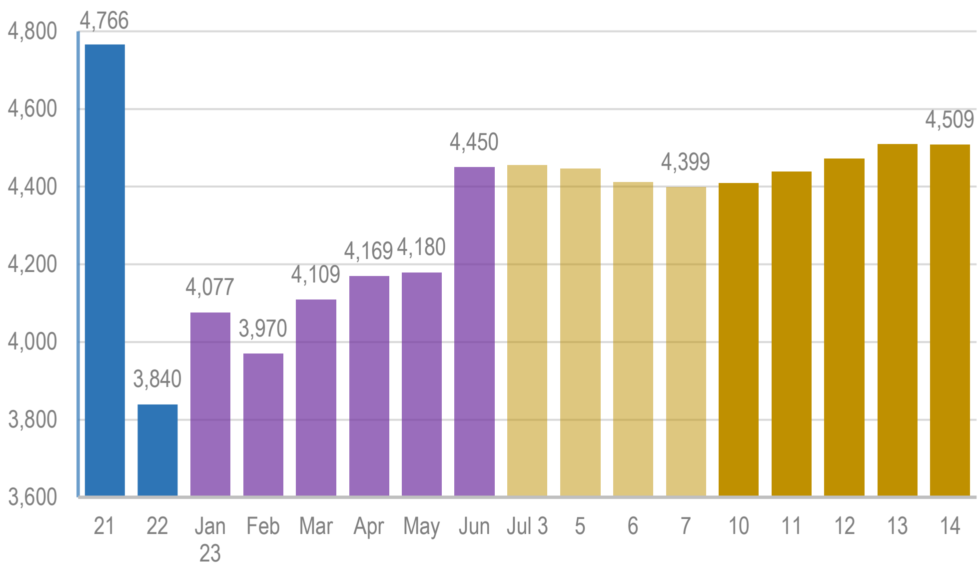
Good morning and welcome to the Saturday, July 15, 2023 *Weekender*. This *Weekender* summarizes critical elements from our third-quarter *House View*. The one more thing segment is about common sense.

We expect the US economy and financial markets to remain relatively strong for the next 6 – 9 months with gratitude to: 1. a persistently strong labor market, 2. an increasingly confident consumer, 3. inflation moving in the right direction, 4. interest rates that are higher than historical levels but consistent with growth, and 5. earnings that are bottoming in the second quarter of 2023 and are expected to recover going into next year. Current strength has been paid forward by the effects of monetary and fiscal stimulus applied before the pandemic's economic impact began. A softer consumer will begin weighing on the economy and financial markets by mid-2024.

Reflexive recovery from last year's losses and artificial intelligence's (AI) heavy breathing have been the primary drivers of financial market performance for most of this year. We expect that as companies begin to make AI investments, markets will begin to tell the whole story of artificial intelligence by focusing on the costs and rewards instead of just the rewards.

Please consult a qualified financial advisor before making any investment decisions. A vital disclosure can be found at the end of this publication.

S&P 500 Index Levels
(Source: Bloomberg)



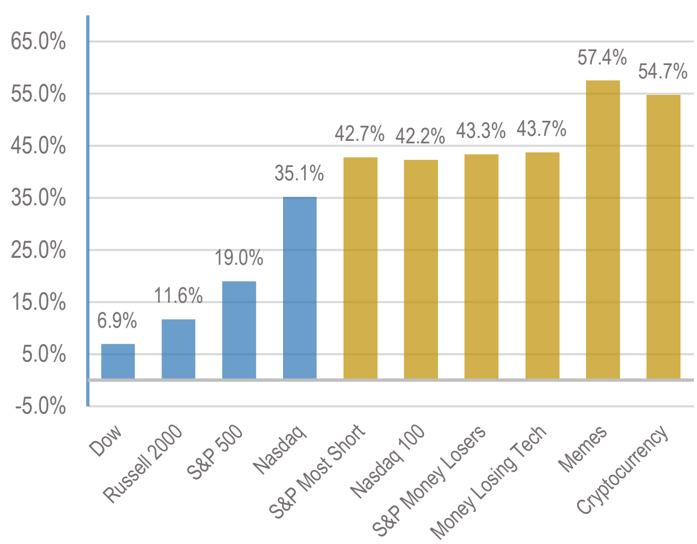
It was a great week for US equity markets which, as measured by the S&P 500 Index, rose by +2.5%.

Most equity markets, sectors, and factors have earned remarkable gains year-to-date. China and Hong Kong are notable exceptions. The Middle Kingdom remains mired in an economic slowdown despite aggressive government resuscitation. In the United States, approximately 80% of equity gains for the year are being driven by an unrealistic euphoria over the potential of artificial intelligence. Artificial intelligence is pushing the riskiest assets resulting in a "junk rally" like it's 1999.

Year-to-Date Returns

January 2 - July 14, 2023

(Source: Bloomberg)



Warren Buffett suggested that over the short-term financial markets act as a voting mechanism, placing bets on where the future may be, like artificial intelligence. Over the long term, financial markets act as a weighing mechanism, measuring the risk-adjusted value of a company's after-tax cash flows. Over time, there is a 0.96 correlation between cash flow and stock price.

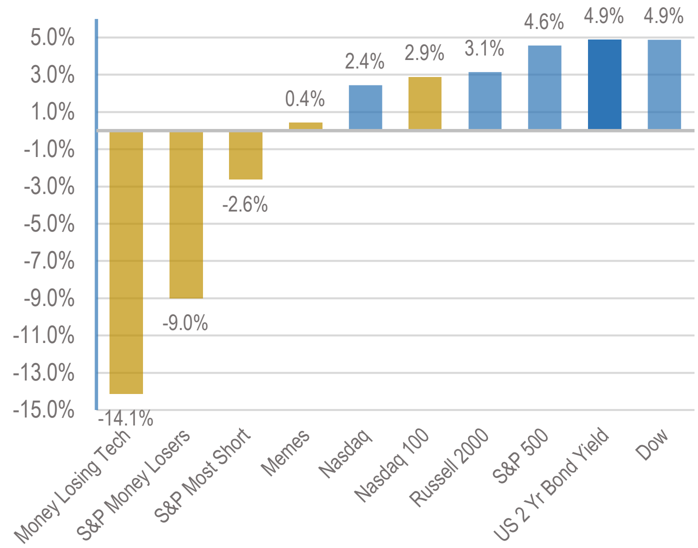
We are compelled to believe that artificial intelligence (AI) will fundamentally change almost every aspect of human existence over the space of a generation. It's far too early to choose winners and losers, although investing in AI picks and shovels is compelling. We believe markets are inappropriately bowing to "would-be" AI royalty long before they are crowned.

Meanwhile, US government two-year bond yields represent a risk-free return for investors. As of Friday's close, the bond earned a 4.8% yield. Besides the Dow Industrial Index, no other group earns a yield higher than the bond yield. Risk factor indices have dramatically outperformed traditional areas. Their tepid earnings yield measures that should compel investors to run away.

Earnings Yield by Group

July 14, 2023

(Source: Bloomberg)

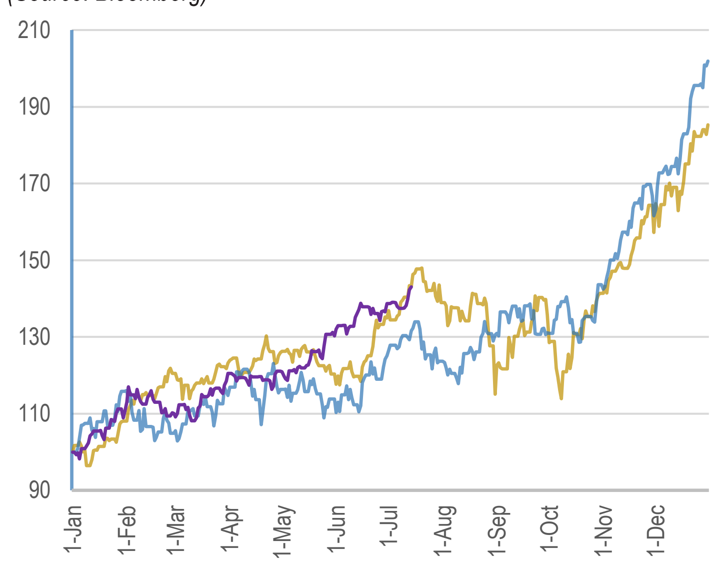


This is a graph of the Nasdaq 100 on an annual basis from January 1 through December 31 for 1988 (gold), 1999 (blue), and 2023 (purple). Similarities do not predict market outcomes. However, they are some-

Nasdaq 100 (Indexed to 100)

January 1 - December 31

(Source: Bloomberg)



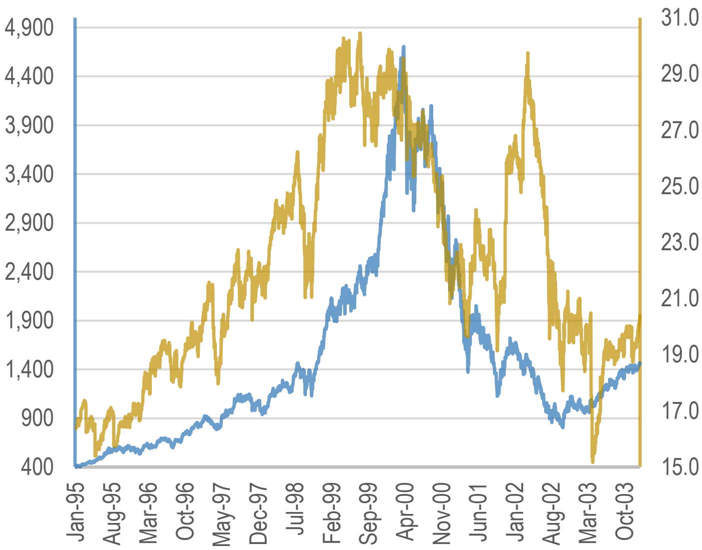
times helpful analogs since market bubbles in one area broadly increase the general risk-taking behavior throughout the market, which lifts all boats to some extent, whether seaworthy or otherwise.

This graph shows the Nasdaq 100, the blue line and left axis, against the PE ratio of the S&P 500, the gold line, from the beginning of 1995, when the internet bubble began to the end of 2003 when equilibrium was restored to financial markets. The bubble in the Nasdaq 100 seeped broadly into valuations elsewhere, like the S&P 500.

Nasdaq 100 (Blue) and PE Ratio for S&P 500 (Gold)

January 1, 1995 - December 31, 2003

(Source: Bloomberg)



From January 1, 1995, through December 31, 1999, the Nasdaq 100 rose by 271.9%, reaching an index of 3,707.83. Over the next two years, the index fell by 57.5% and bottomed in the fourth quarter of 2002 when it hit 804.64. On December 5, 1996, then Federal Reserve Chair Alan Greenspan spoke to the American Enterprise Institute about his concern that the growing internet bubble could cause systemic consequences to the US and global economies. He said the markets were in a state of "irrational exuberance." Despite the advice, from the date of Greenspan's speech, the Nasdaq 100 rose another 454.2% before it peaked on March 27, 2000. Markets can remain irrational longer than anyone expects.

Nasdaq 100 Levels

January 1, 1993 - December 31, 2003

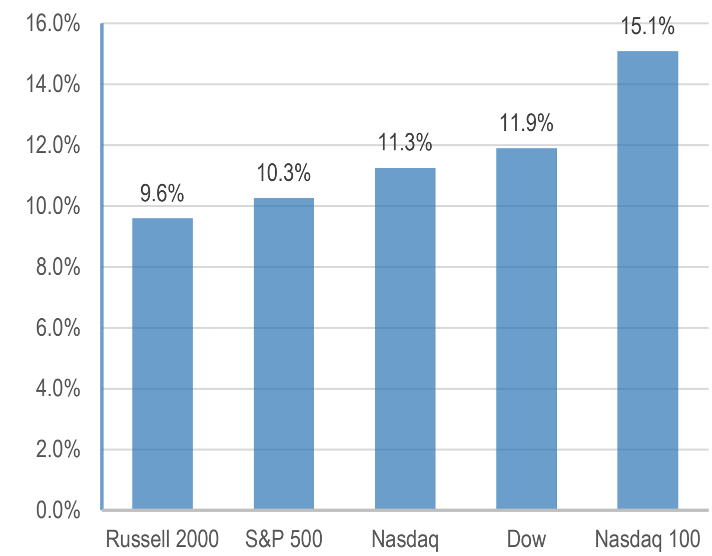
(Source: Bloomberg)

Bubbles always pop. But even after the popping, when the internet bubble's excess sluffed off, investors earned an annual return of 11.3% from the beginning of 1995 through the end of 2003. A remarkable gain. Other equity indices generated similar results over the same period.

Average Annual Returns

January 1, 1995 - December 31, 2003

(Source: Bloomberg)



As risk gathers steam in financial markets, bubbles tend to form. Most bubbles are formed through the most dangerous leavening agent available to the human mind, the fear of missing out (FOMO). During periods when FOMO is dominant, reliance on fundamental valuation metrics tends to fade. In such periods, riding the wave and being a friend to the trend often becomes the dominant investment strategy.

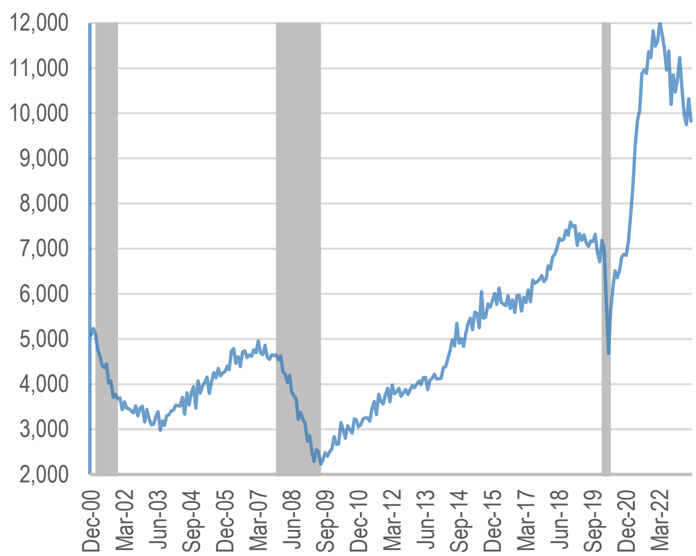
Being a disciplined investor is the best way to earn consistent returns targeted toward financial planning goals. That said, the broad excitement about the future of artificial intelligence will likely have a levitating effect on equity securities generally. This may compel one, at times, to hold onto positions that seem expensive. Investors still need to "buy right," which means patience and persistence will be essential. While our portfolios have some exposure to the "usual suspects" in artificial intelligence, we are more heavily weighted to reasonably priced stocks. We expect their valuations to benefit from a general equity re-rating as valuation multiples rise in sympathy with areas tied to the artificial intelligence boom.

Economic Narrative

This section summarizes some critical economic perspectives from our third-quarter House View. US and global economic performance depend on five factors: continued labor market resilience; consumer strength; inflation; interest rates; and earnings.

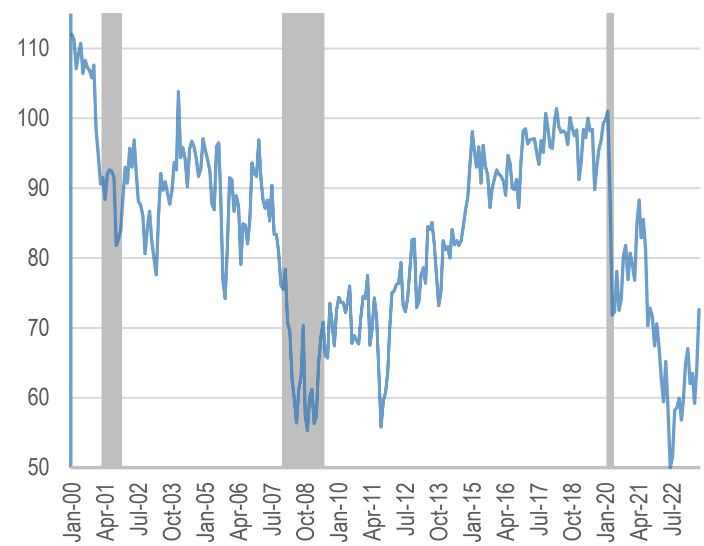
Labor. Unemployment in the United States currently stands at 3.6% of the total labor force, close to the historic low of 3.4%. Job openings continue to exceed the unemployed by almost a two-to-one margin. Wages are rising broadly in line with inflation, a sign of healthy pricing. The labor market is robust. We have often discussed our view that an economic recession is unlikely without a significant dislocation in the labor market. Such a dislocation, at present, is not in the cards.

Job Openings in 000
December 2000 - May 2023
(Source: Bloomberg)



Consumer. US consumer sentiment jumped in early July, levitating to an almost two-year high. Most of the pandemic drop in sentiment was driven by the ravages of higher inflation. While nowhere near the Federal Reserve's 2% target, inflation is in retreat. We expect price levels to continue falling over the next 12-18 months, although at a slower rate. Easy inflation gains are already achieved. The hard gains are still to come.

Consumer Sentiment
January 2000 - July 2023
(Source: Bloomberg)

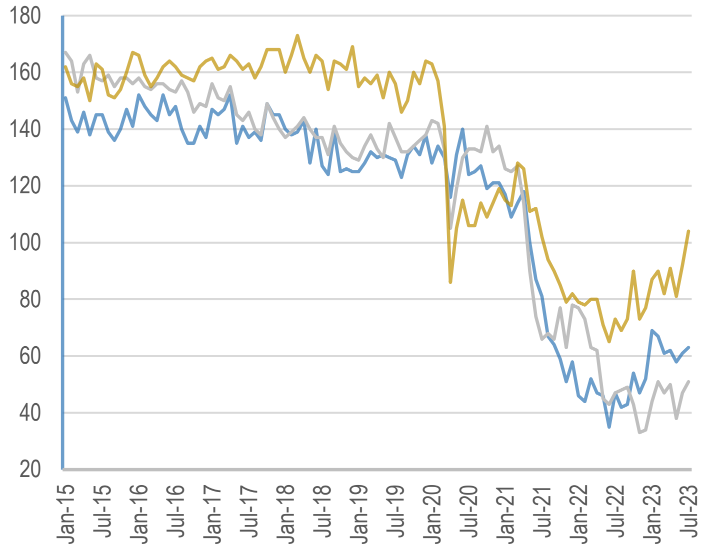


The sentiment survey includes an assessment of buying conditions for a range of products, including automobiles (blue), durables (gold), and homes (grey). Conditions have bottomed and are returning toward trend despite higher interest rates. We expect rates to begin falling next year, which should provide a little support for the consumers. At the same time, several meaningful consumer headwinds remain. Pandemic fiscal support has been spent, savings drained, and credit cards maxed. Returning student loan payments in a month will magnify tighter spending constraints.

Buying Conditions

January 2015 - July 2023

(Source: Bloomberg)



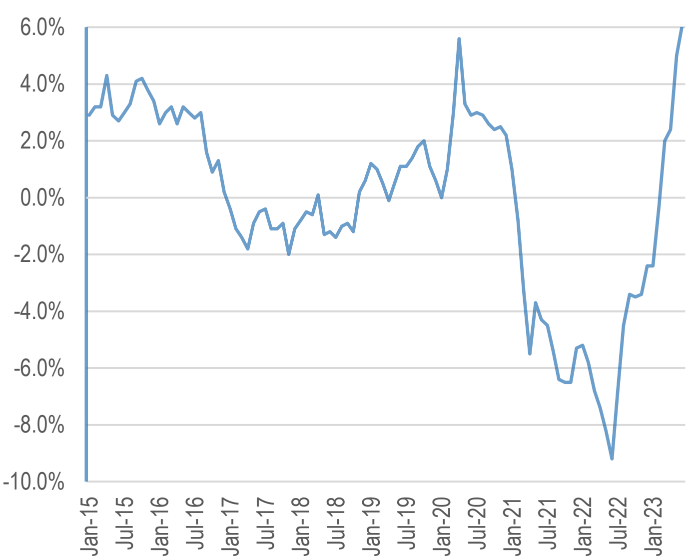
We expect the ravenous demand for consumer services like travel and tourism to soften considerably over the next 6 – 9 months, which will negatively impact spending in the future.

Inflation. Consumer inflation fell more than expected, and producer inflation was flat. Other inflation gauges buried within the purchasing managers indices (PMI) also show price softening in manufacturing and services. Consumer price inflation is dramatically outperforming producer prices which is a positive indication of lower future consumer inflation and higher corporate margins.

CPI Minus PPI

January 2015 - June 2023

(Source: Bloomberg)



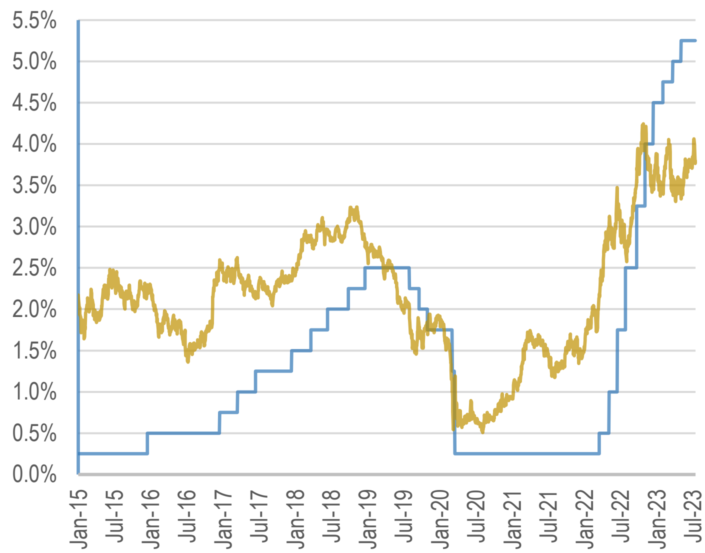
Several inflationary factors, like housing, have long lag times before they are reflected in official readings. Going into the holiday season, discounting will have a powerful impact on product pricing. The factors and the impact of base effects will continue to push inflation lower through the rest of the year.

Interest Rates. Interest rates remain high and will likely be upward sticky for the rest of the year. However, we believe peak rates are in the neighborhood. While policy rates may continue to rise at the Federal Reserve's next one or two meetings, market rates will sing their own tune, tied to rate expectations 6 – 12 months away.

Fed Policy Rate (Blue) and US 10-Year Bond Yield (Gold)

January 1, 2015 - July 14, 2023

(Source: Bloomberg)



For the past two years, global central banks have implemented higher rates and tighter monetary policy to control inflation. This coordinated response has ended. Asian economies, particularly China, have moved to a stimulatory position. Most other countries are preparing a shift into neutral.

For decades, the Federal Reserve's last interest rate increase of a cycle precipitates long-dated treasuries' outperformance of shorter-duration instruments. Long-dated bonds have more acute price sensitivity, given changes in interest rates. As market rates come down, prices will rise. This is a once-in-a-generation opportunity.

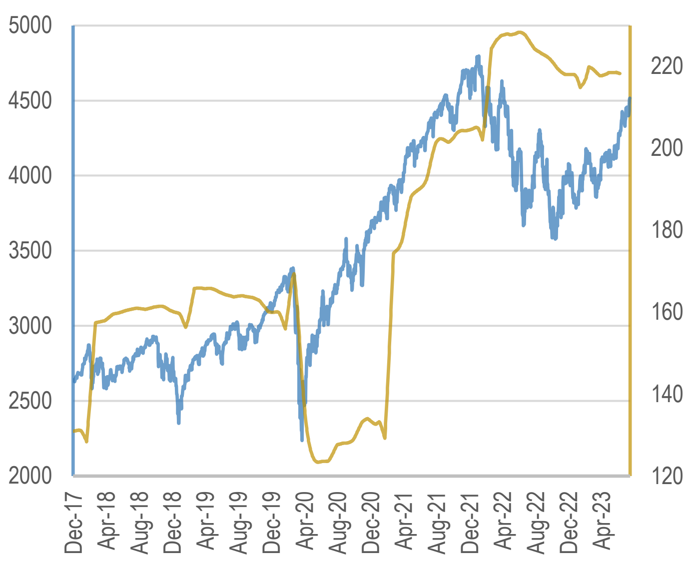
Earnings. Second-quarter earnings reports kicked off this past week with megabanks. Higher interest rates caught many of the banks off guard for some reason. JP Morgan was not one of those. Profits for the bank hit a record. Despite higher borrowing costs, an increase in lending helped lift second-quarter profit at JP Morgan, Wells Fargo, and Citigroup.

Jamie Dimon, the Chief Executive of JP Morgan and default elder statesman and all-around "adult in the room" representative for public companies, expressed his view that the economy continues to be resilient. Dimon reported, "All of our lines of business saw continued growth in the quarter." Net income was higher by 67% on the quarter reaching $14.5 billion, although $2.7 billion came as a dowry of sorts from the shotgun marriage with First Republic officiated by the Federal Reserve.

However, looking deeper, within the numbers are troubling increases in loan loss provisions, indicating that the consumer is starting to feel stress.

The second quarter will constitute the nadir of corporate profits. Constrained profit margins from higher operating costs are beginning to shift. As consumer inflation rises more than producer inflation, profit margins expand.

S&P 500 (Blue) and Earnings Estimates (Gold)
December 2017 - July 2023
(Source: Bloomberg)



One More Thing

One more thing. On January 10, 1776, a 48-page pamphlet was published by Thomas Paine, answering one of the most pressing historical questions ever posed. What are the reasons and conditions that justify a people to rise, dislodge their oppressors, and insist on self-governance? At the time of its publication, democracies were rare. Although the American colonies were ablaze with powerful orators decrying the injustices suffered in the New World, before Paine's thoughtful inquisition, the pedestrian justifications for colonial separation had not been compellingly enumerated.

His ideas were straightforward and unapologetic. Although convinced of his conclusions, he was still determining if others would be willing to adopt his radical prescriptions. He wrote, "Perhaps the sentiments contained in the following pages are not YET sufficiently fashionable to procure them general favor." He could not have been more mistaken. His pamphlet was the match needed to push the American Revolution forward.

The United States was forged in struggle. A standard lot of almost all democracies. But not all struggles are physical. At least not initially. Paine's simple ideas about what government "should" do instead of what it "could" do captivated a cobble of colonies that would unite and form a new nation.

It is not unlikely that we are at a similar point. More useful time should be spent re-asking the same question repeatedly. Not what government can do but what it should do.

Conclusion

That's it for this *Weekender*. In our next *Weekender*, we will summarize our third quarter 2023 *House View* by analyzing five powerful economic cycles: 1. Business; 2. Inventory; 3. Housing; 4. Credit; and 5. Liquidity. Have a wonderful week.

Disclosure Statement

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