Artificial Juju

Weekender

July 8, 2023

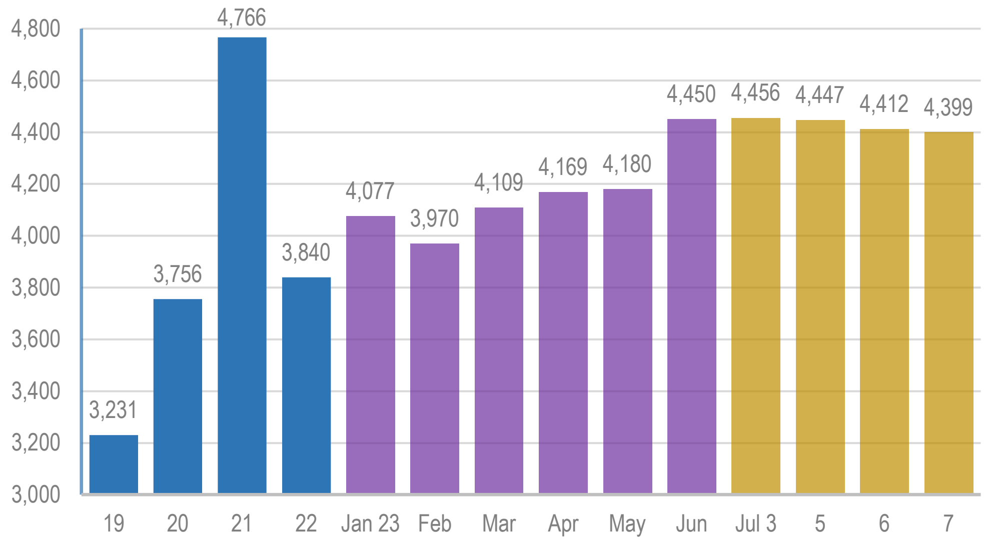
The only thing that feels better than winning is winning when nobody thought you could.

Hank Aaron

Good morning and welcome to the Weekender for Saturday, July 8, 2023. US equity markets, as measured using the S&P 500, were lower by -1.2%. The falling print was primarily due to economic data showing that the US economy continues to expand, labor markets remain firm, and inflation is sticky. Hence, markets are discounting a longer period of higher interest rates. Such good news flies in the face of a recessionary scenario held by most and suggests that the US Federal Reserve's dominant rate narrative of needing to keep rates higher for longer may be a thing.

S&P 500 Index Levels

(Source: Bloomberg)



Over the next few weeks, economic and profit data releases for the second quarter will create a more secure footing from which a realistic future path for the economy and financial markets can be conjured. We will consolidate these data points in our third quarter *House View* which will be summarized in a coming *Weekender*.

This *Weekender* is relatively short in sympathy for the shortened Fourth of July weekend. Its purpose is to highlight the current state of US equity markets. In the next *Weekender,* after crucial inflation data is released, we will summarize our *House View* for the third and fourth quarters and beyond.

The prospect of economic recession in the United States, dancing like sugarplums in the dreams of most economists and investment strategists, is finding scant support. However, this time is different. Recessions generally spur increases in government spending and monetary ease as a potential salve for the ravages of economic contraction, spurring an increase in aggregate demand and economic expansion. This time was bass-ackwards. An infusion of government largesse and monetary profligacy was applied to the global economy before any evidence of any economic injury. It will take a while, still, before all the dust settles and we can see the future more clearly.

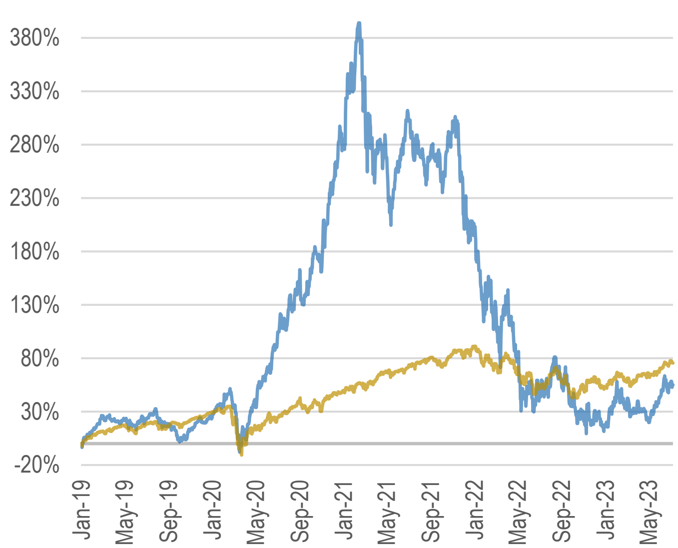
Thanks to the kindness of strangers, especially US taxpayers, pandemic wallets were filled with cash, and from the comfort of pajamas, popcorn, Netflix, and parental couches, a new generation of investors cum traders was born. Robinhood provided a free trading platform, and Reddit provided unregulated, and mostly unvetted, investment advice. The equity risk profile skyrocketed in the face of a wave of cash.

Returns on the equities of companies that don't make money (the blue line) and released scant data eclipsed the boring members of their parent's S&P 500. Trading infants took over chat rooms, and CNBC predicted a market future where investment principles

Cumulative Return for S&P 500 (Gold) and Money Losers (Blue)

January 1, 2019 - July 7, 2023

(Source: Bloomberg)



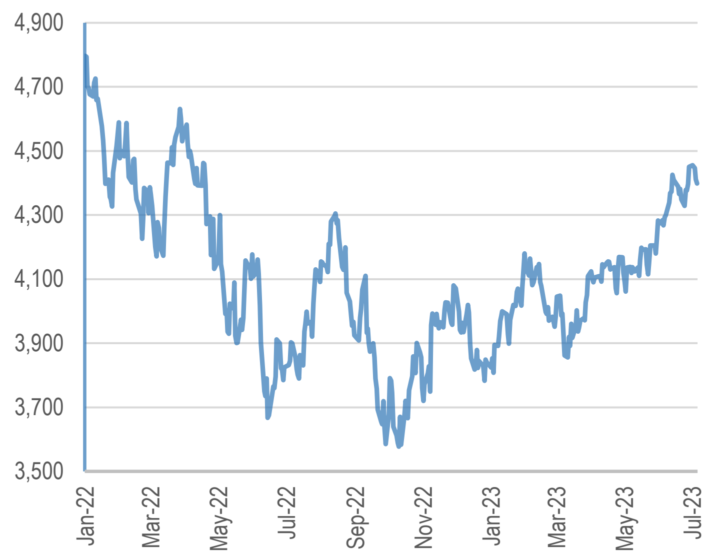
were without consequence and Warrant Buffett was irrelevant.

Through most of 2022, US equity markets fell as the Fed began to apply tighter monetary policy designed to slow the economy and bring inflation back toward its target range of 2%. Equity markets bottomed on October 12, 2022, trading at a PE ratio of 16.1, a bargain in historical terms. Sensing an unusual opportunity, buyers took over the higher prices as they tried to get a better handle on the future of inflation and interest rates. Then, seemingly out of nowhere, artificial intelligence (AI) took over the face of the market. In their May conference call, Nvidia, the maker of sophisticated graphical processing units, released first-quarter earnings that exceeded estimates and provided such a positive outlook for the future that it made everyone take notice.

S&P 500 Daily Levels

January 2, 2022 - July 7, 2023

(Source: Bloomberg)

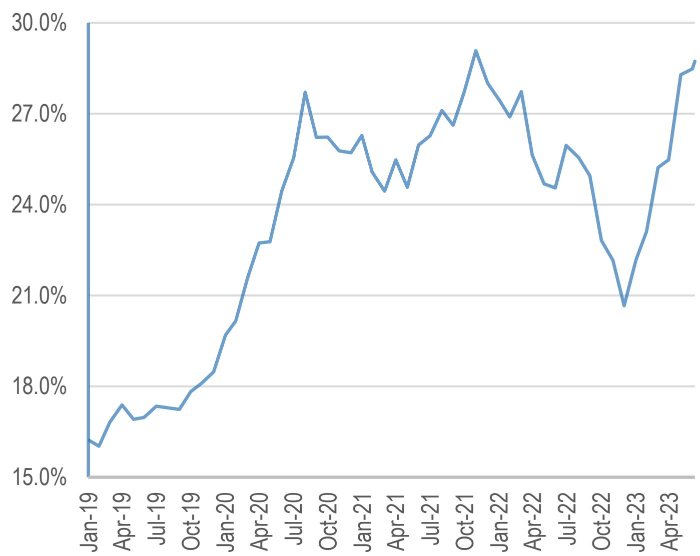


Artificial intelligence is in its "fun plastic trinket" stage of development. Even its most ardent supporters and boosters hold only a preliminary view of how it may impact society. Still, it's likely to create a new world order that humankind has never experienced. Identifying clear winners in the order is still premature, so investors leaned on the usual suspects, euphemistically called the magnificent seven. They include Nvidia, Meta Platforms, Tesla, Amazon, Apple, Microsoft, and Alphabet.

The Magnificent Seven have taken over equity markets. Their combined value accounts for approximately 28.7% of the total equity value of all members of the S&P 500. In addition, over 80% of the year-to-date increase in the S&P 500's value has come from these seven members.

Magnificent Seven Value / S&P 500 Value

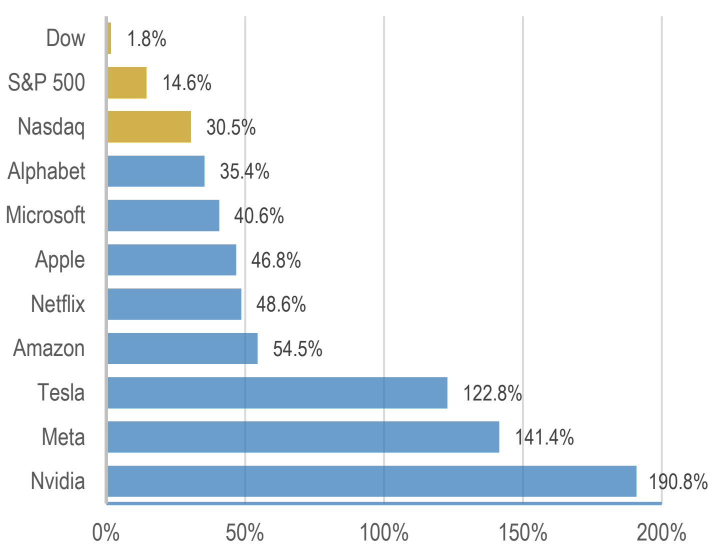
January 2019 - July 7, 2023
(Source: Bloomberg)



Not only have the Magnificent Seven been the drivers of primary equity indices, they have also posted significant gains in their own right. This is a graph of the year-to-date returns of the primary US equity indices against the Magnificent Seven over the same period.

Magnificient Seven Year-to-Date Returns

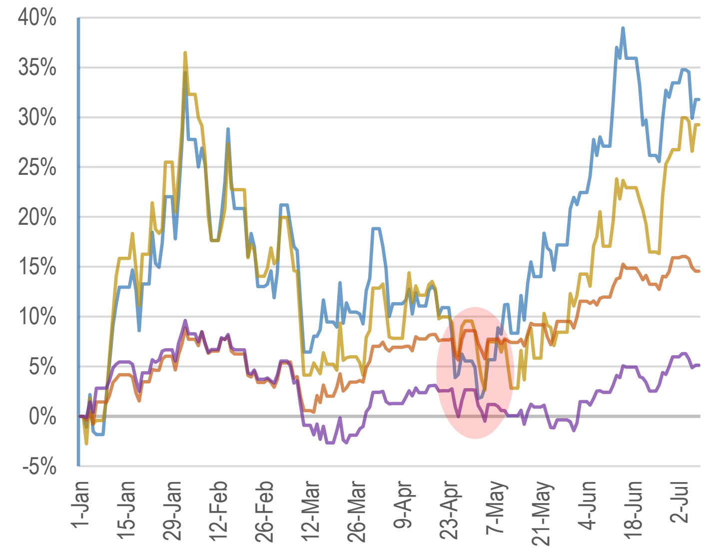
January 2, 2023 - July 7, 2023
(Source: Bloomberg)



Market juju, driven by the promises of artificial intelligence, has launched a new bubble where fundamentals are less important than allegiance to the brave new world of AI. Before the AI boost, markets were entering a very healthy consolidation phase, as seen by the return convergence of companies that don't make money (blue), the most shorted companies (gold), the S&P 500 (rust), and the equal-weighted S&P 500 (purple). Since Nvidia's conference call, marking the beginning of the AI bubble, the risk is back on the table.

Year-to-Date Returns

January 2, 2023 - July 7, 2023
(Source: Bloomberg)



We believe that the prospects, both good and ill, of artificial intelligence will impact companies and civilizations. The gains it ushers in will not sum to zero, and the impact on the economy's manufacturing and service sectors will be remarkable. However, we expect markets to move beyond the AI cheerleading phase and into the show-me state. As this happens, the bubble will burst, and the positive contributions of AI mania to some individual stocks and most equity indices will evaporate. From that point, market leadership will naturally come from stocks with solid fundamentals—more on that in our next *Weekender* and summary of our *House View* for the third and fourth quarter of 2023.