Once and Future King (Nvidia)

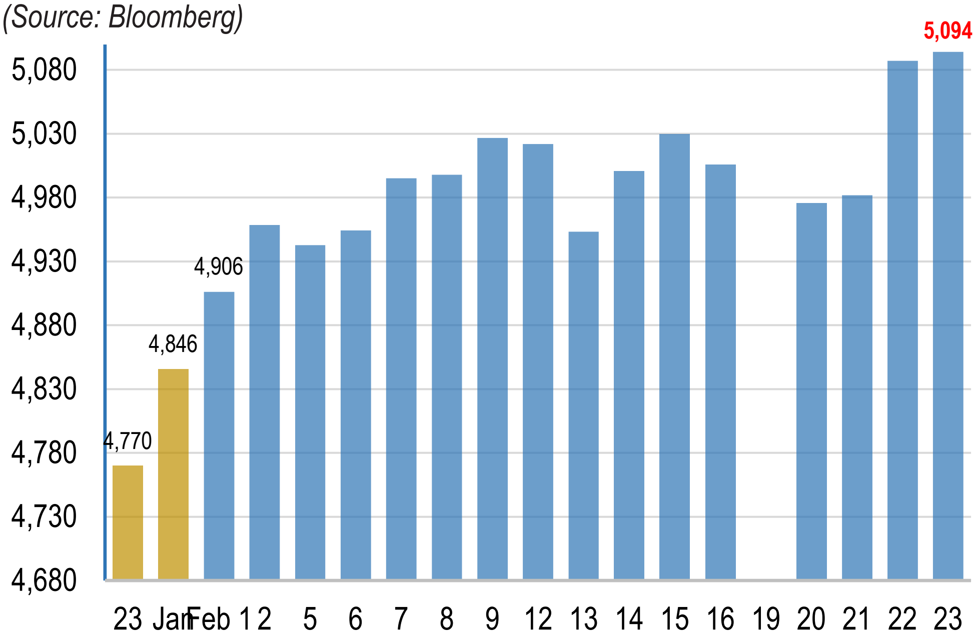
Weekender

February 24, 2024

Good morning, and welcome to the *Weekender* for Saturday, February 24, 2024. It was another week of record highs for the dominant US equity market indices thanks to the magical elixir of artificial intelligence, which continues to imbibe markets since it took hold in mid-2023. The S&P 500 has been levitating since then, with only a few tepid pauses. On the week, the index was higher by 1.8%. While the AI theme was broadly dominant in markets, the engine driving the train was artificial intelligence chip maker Nvidia, which has become a proxy bellwether for the "realness" of artificial intelligence. More on that in a minute.

S&P 500 Index Levels

(Source: Bloomberg)



Aside from Nvidia, perhaps the week's biggest story was how quickly many of the year-end targets for the S&P 500 fell in the first two months of the year. Inflation data came in higher than expected, suggesting the Fed may not move quickly to reduce interest rates. A tight labor market and willing consumers indicate they shouldn't need to. Credit markets are knee-deep in the same juju as equities. Demand for fixed income is so strong issuance is likely to hit another record in

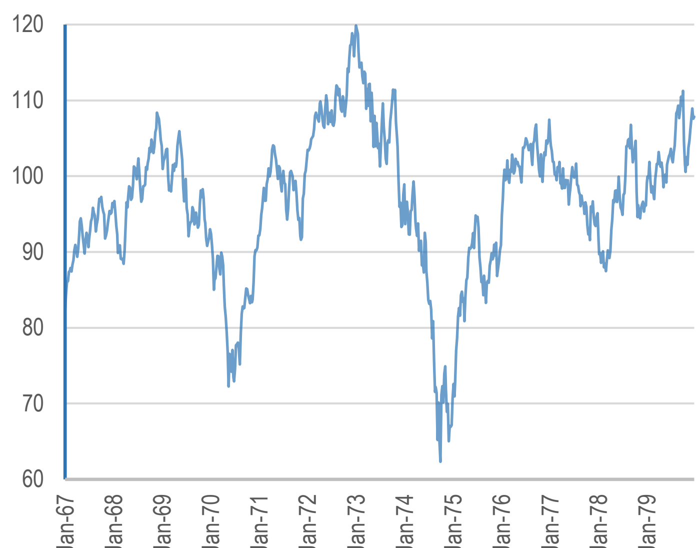
February. This is, of course, good until it isn't. Eventually, the United States will need to deal with the reality of its third-world financial condition. But not yet. We expect the can to continue to be kicked down the road to another generation who did not benefit from the largess heaped upon them.

Most members of the S&P 500 have released earnings for the fourth quarter of 2023 in addition to the entire year. Sales increased by 4.2%, and profits rose by 7.2%. Generally strong results and confirmation that the three-quarter earnings recession has ended. There was no discernable trend or theme to the results. Some companies experienced strong unit demand while others did not. Most companies were helped by the ability to charge higher prices to a consumer who seemed relentless for more stuff and things to do.

However, signs of growing consumer stress are popping up. Consumer savings are exhausted. Debt to income levels are rising to dangerous levels, pushing defaults higher. Auto loan defaults are now the highest they have been for fifteen years. Aside from these and other quantitative indicators, a generational desire to "put it to the man" is causing a wave of debt defaults where borrowers who could otherwise afford their payments choose to step aside and stop paying. This phenomenon is particularly prevalent among student loan borrowers who realize their liberal arts degree does not generate the income necessary to repay the cost.

Even so, the labor market continues to send "all clear" signals. Job openings are plentiful, and despite the headline value of tech company layoff announcements, anyone who

S&P 500 Weekly Levels
January 6, 1967 - December 28, 1979
(Source: Bloomberg)



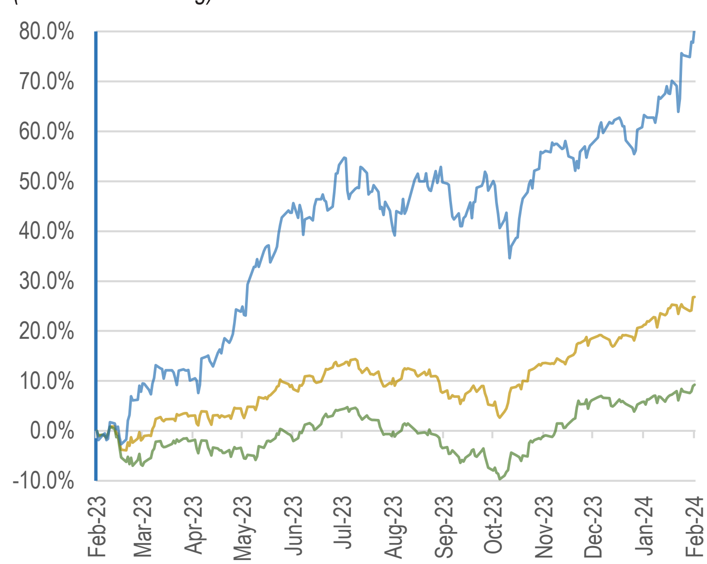
wants a job can find one. Inflation is the only prominent boogeyman lurking on the horizon. While the general trend in almost all inflation measures continues to be in moderation, the so-called "last mile" as inflation gets closer and closer to the Fed's 2.0% target is much more difficult to attain than many anticipated.

While timing remains uncertain, data support an oncoming stagflation period. An environment similar to the 1970s. Inflation seems likely to stay taut, even while continuing to decline. The investment take-home from the 1970s was flat equity markets from 1967 to 1980.

Size Matters

The S&P 500 Index, like many other indices, is weighted by the equity value of each component, meaning larger companies have a disproportionate impact, whipping the index higher and lower as large company market values rise and fall. The S&P 500 is higher by 26.8% over the last year. Another version of the S&P 500, which is equally weighted, is higher by only 9.2% over the same period. Meanwhile, the magnificent seven are higher by 80.9%

Mag 7 (Blue), S&P 500 (Gold), S&P 500 Equal (Green)
February 23, 2023 - February 23, 2024
(Source: Bloomberg)



As the stocks of pivotal companies, think magnificent seven, continue to rise, they become much more influential in all aspects of the investment world. Since the incremental equity-targeted dollar of investment hits the market through a passive vehicle like an exchange-traded fund, large companies that make up the indices tracked by the funds rise blindly without regard to valuation or prospects. Consequently, the big influential players always have a bid behind them as long as investors have a marginal dollar to invest. This dynamic makes active investing increasingly challenging.

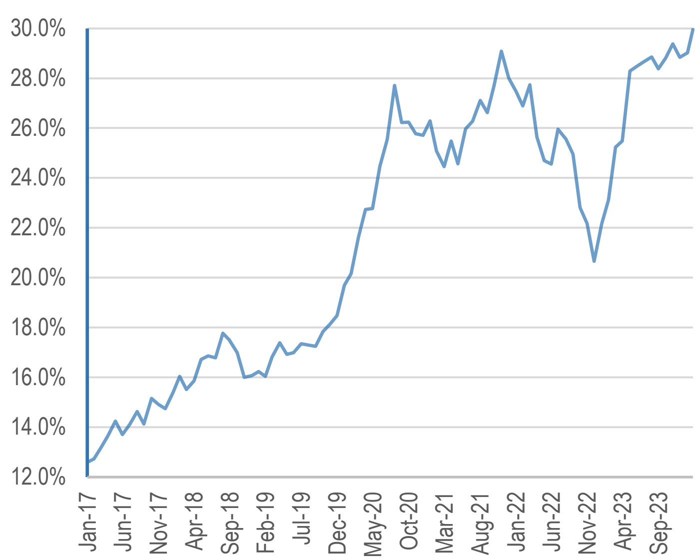
As of yesterday's close, five US companies (Microsoft, Apple, Nvidia, Amazon, Alphabet, and Meta) had more than $1 trillion market capitalization. At the crack of 2023, there were only three. Tesla was a club member in January 2022 but lost the laurel during that year's general stock market drubbing. Microsoft became the first trillion market cap company in August 2019 when Goldilocks was still alive. Apple came on the scene a month afterward. Each of these companies individually has a market value that exceeds the annual economic output of most countries in the world.

The most significant seven companies in the S&P 500 by equity value account for 30.0% of the combined market value of all 500 members of the S&P 500 Index. More significant does not necessarily mean bad. However, it's worth considering that what goes up may also come down, and if the internet bubble is any indication, the down part can be remarkably violent and quick.

Largest 7 Percent ot S&P 500 Market Capitalization

January 2017 - February 23, 2024

(Source: Bloomberg)



Pundits increasingly compare the current market environment to the internet sprint that began in 1995 and ended in a pop on March 24, 2000. Back then, the most significant seven companies in the S&P 500 included Microsoft, Cisco, General Electric, Intel, Exxon Mobil, Wal-Mart, and Oracle, a much more diverse group of punters than at present. At the internet peak on March 24, 2000, the market capitalization of their magnificent seven accounted for only 23.3% of the S&P 500's total equity value. Just sayin'.

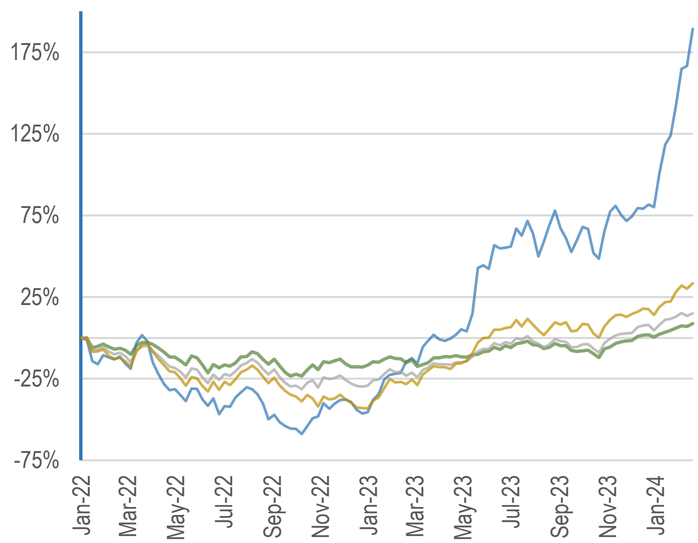
Nvidia

Nvidia released earnings for its most recent quarter on Wednesday. Despite nervousness in the days preceding the release, the numbers blew away expectations. Nvidia stock has been higher by 189.3% since the beginning of 2022. While such a gain would garner attention in any circle, the fact that similar moves in revenue drove an increase and profits is particularly noteworthy. Shares of Nvidia trade at 32.9 times next year's profit estimates. One more year of similar growth and Nvidia shares will be considered a bargain.

NVDA (Blue), Mag 7 (Gold), Nasdaq 100 (Grey), and S&P 500 (Green), Cumulative Return

January 7, 2022 - February 23, 2024

(Source: Bloomberg)



Artificial intelligence emerged from hibernation with a jolt last May when the company's CEO, Jen-Hsun Huang, not known for hype and hyperbole, suggested that an exponential trajectory in revenues and earnings was on the immediate horizon. AI has long lived under a cloud of futuristic comic book promises. So when "Jensen" made the pronouncement, many were skeptical. Almost a year of stellar growth puts everyone on notice. Huang is either a prophet, soothsayer, or both.

Nvidia has been a holding for a while, and we have trimmed it a couple of times to whittle the position back to prudence. We expect it to continue to run as more and more companies meet AI's voracious demands for processing power, storage, and bandwidth. Nvidia, to us, is an unusual company. It provides the equivalent of picks and shovels to the AI gold rush.

As a virtual monopoly in its premium high-performance chip space, Nvidia can charge all the market will bear and maximize its free cash flow. At present, the company is sitting on $25 billion in cash. We expect the company to take several cash-consuming actions, including share buybacks and acquisitions. Both of which are likely to provide continued support to the shares. While we are not valuation agnostic, we do not see anything about Nvidia's price or prospects that cause us concern.

In the near future, we expect myriad competitors in the space where Nvidia currently has an earned monopoly. But for now, it's a unique play on what has the potential to be the most crucial development in human history. Scary stuff included.

That's it for this Weekender. Next week, we will conduct a deep dive into the economic data for January and refine our expectations for stagflation.
Have a wonderful week.

Disclosure Statement

Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors cannot invest directly in an index. Past performance does not guarantee future results. Investing involves risk, including loss of principal.

The statements provided herein are based solely on the opinions of the author(s) and are being provided for general information purposes only. The information provided or any opinion expressed does not constitute an offer or a solicitation to buy or sell any securities or other financial instruments. Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful. The foregoing information has been obtained from sources considered to be reliable, but we do not guarantee it is accurate or complete. Consult your financial professional before making any investment decision.

The stock indexes mentioned are unmanaged groups of securities considered to be representative of the stock markets in general. You cannot invest directly in these indices.