So Little at Stake

Weekender

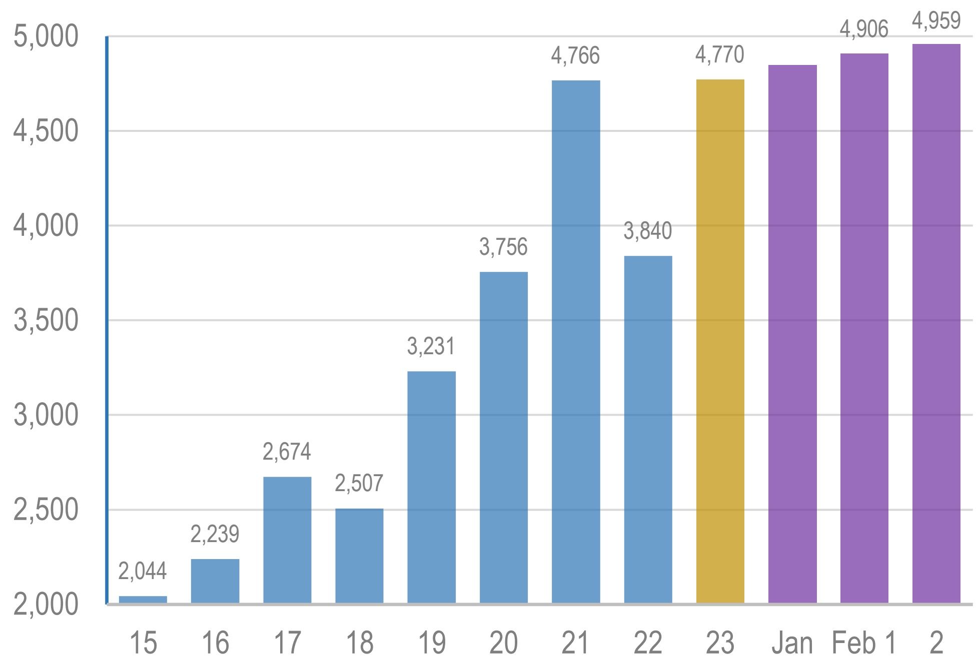
February 3, 2024

Creativity is intelligence having fun.

Albert Einstein

Good morning and welcome to the *Weekender* for Saturday, February 3, 2024. Happy birthday, Bubba. Another week that seemed to defy Newtonian physics and the laws of gravity. The S&P 500 closed at a record of 4,958.61, a 1.4% jump from last Friday's close.

S&P 500 Index Levels
(Source: Bloomberg)

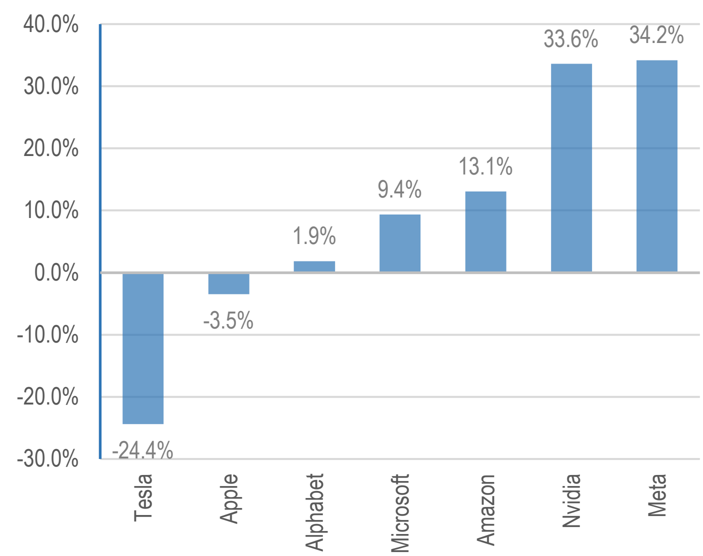


The Dow Jones Industrial Average, S&P 500, Russell 3000, and Nasdaq 100 all closed at record highs. The primary market catalyst was a cacophony of data showing the economy was on solid footing and inflation was heading in the right direction, except for wages. Wage inflation is rising, but contrary data could not get in the way of a market that wanted to go higher.

There was a bit of under-the-table market skittishness highlighting the schizophrenic way investors placed bets in 2024. During most fundamentally driven bull markets, initial public offerings typically lead out. But this time, or at least this year, is different. The Renaissance IPO Index has decreased by -4.4% since January 2, 2024. Meanwhile, the S&P 500 is higher over the same period by 4.6%. Investors seem committed to sticking with the same partner who brought them to the dance last year, large-capitalization technology and the Magnificent Seven, with Tesla not quite as magnificent as the others.

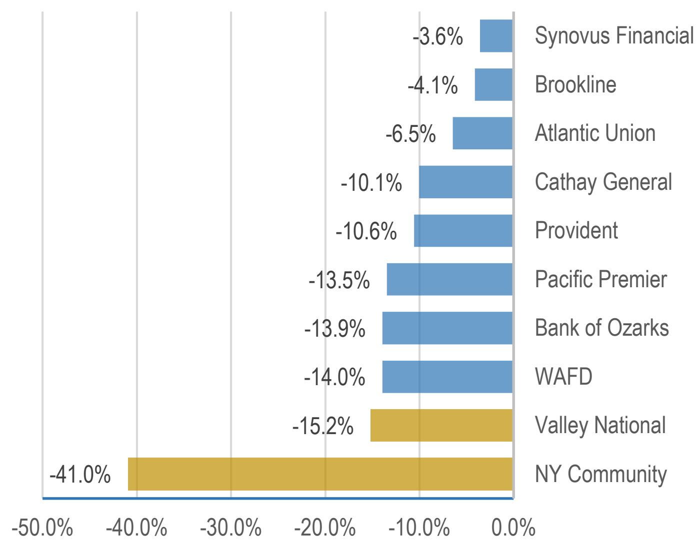
The Magnificent Seven are the clear outperformers for the entire year, contrary to what most, including us, thought would happen. Overvaluation in the largest tech companies continues to be unnerving, yet the march continues.

Magnificent Seven Year-to-Date Returns
January 2 - February 2, 2024
(Source: Bloomberg)



Less than a year after the failure of several regional lenders, including Silicon Valley Bank, regional banks took all the headlines from the annals of stocks not performing well last week. The KBW Regional Banking Index fell 7.7% last week, its worst performance since March 2022, when a mini-bank crisis was brewing. New York Community Bancorp is now lower by -41.0% year-to-date after announcing it would cut its dividends to strengthen its capital position driven by losses in its commercial real estate lending portfolio. Troubled commercial portfolios will likely be an increasing concern for some regional banks. However, we do not anticipate systemic financial weakness since commercial lending is a small portion of most large banks.

Regional Bank Year-to-Date Returns
January 2 - February 2, 2024
(Source: Bloomberg)



Valley National Bancorp from Morristown, New Jersey, has high exposure to commercial lending, with almost half of its loan book tied up in the commercial space. Commercial real estate has been severely influenced by higher interest rates and a work-from-home trend that continues to evolve. Regional banks will likely experience a considerable increase in regulatory scrutiny over the next few years because of their concentrated commercial exposure. Higher scrutiny will keep them in headlines, which is rarely positive.

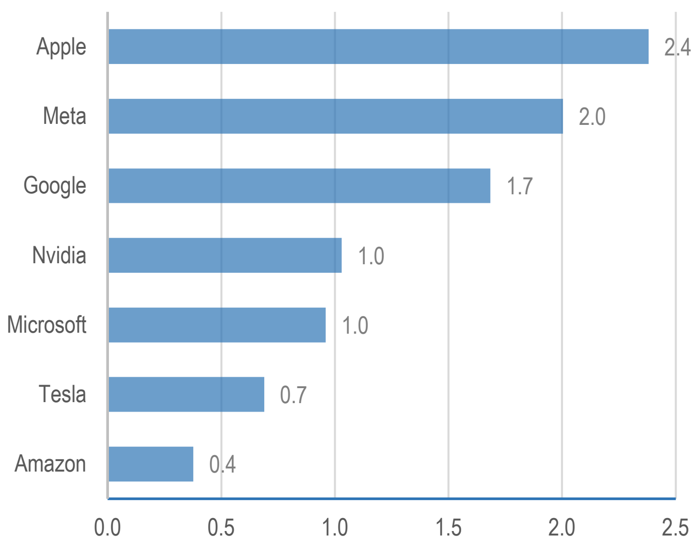
Born Again Meta

Just over a year ago, Meta seemed to stall into mediocrity and irrelevance. Friday, the company's stock rose by 20.3%, the most significant one-day increase in market value in history for any company. A solid fourth quarter 2023 earnings report riddled with comments from CEO Mark Zuckerberg about how he believes the company is a better company running lean than he ever expected. AI was also a powerful catchphrase throughout the company's earnings presentation.

Meta Share Price
January 2, 2019 - February 2, 2024
(Source: Bloomberg)

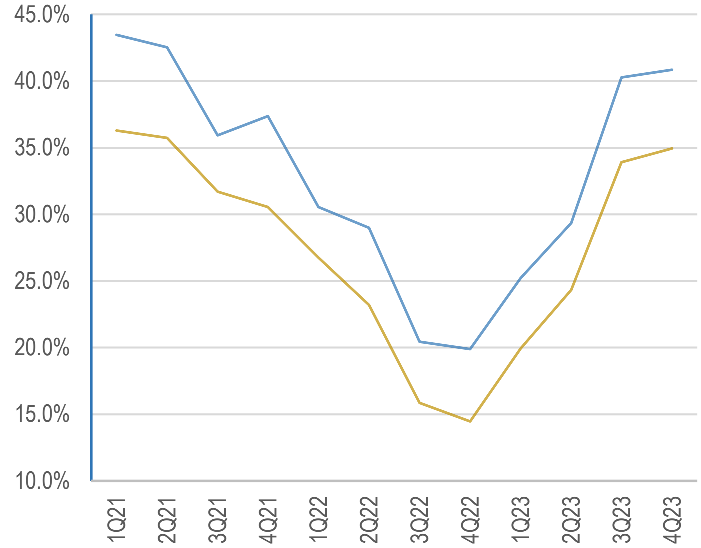
Meta generates approximately $2.0 million in revenue for each employee, which is remarkable compared to most of its peers in the Magnificent Seven. However, it represents little more than a return to the company's 2016 levels.

Revenue per Employee (Million)
February 2, 2024
(Source: Bloomberg)



While equity markets have rewarded the company for stepping back from the brink of irrelevance, data suggest all the company has done is return its operating and net profit margins to their pre-irrelevant levels. We admire Mark Zuckerberg's conversion to running a company with discipline and returning it to its previous glory. However, when the company's price-to-sales ratio is divided by its revenue growth rate, it trades at 0.37, the highest level in history.

Meta Operating (Blue) and Net (Gold) Margins
1Q21 - 4Q24
(Source: Bloomberg)

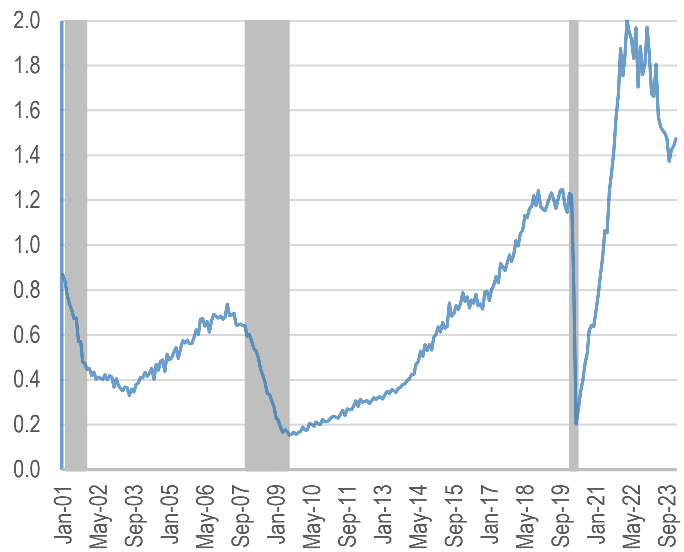


Labor Market

For the last few months, employment data suggested the labor market was softening slightly, although it is still robust by all historical comparisons. Jobs data released on Friday bolded the "robust" moniker and deleted the "slowing" clarifier altogether. US companies increased payrolls by a whopping 353,00 while economists only expected 180,000. Related data showed a 4.5% uptick in average hourly earnings, casting some doubt on the prevailing narrative that inflation would glide smoothly onto the back of the Fed's 2.0% target. While the data remains inconclusive, it's starting to stack up in favor of a Fed that keeps its powder dry for a while. Most of the past months of 2023 were also adjusted higher. We expect wage increases to moderate in the coming months due mainly to some data farts inherent in the January resetting cycle.

Meanwhile, job cut announcements compiled by Challenger, Gray, and Christmas came in at 82,300 lower than a year ago when labor markets seemed hot. Despite the power of press headlines about notable companies laying off workers, they are not meaningful enough to move the needle. That said, in January, "restructuring" was the most cited reason for job cuts, followed by plant, store, and unit closing. Even so, powerful forces are at work in the labor market. 1.5 job openings are looking to be filled for every unemployed person available to work.

Job Openings per Unemployed
January 2012 - December 2023
(Source: Bloomberg)



We believe the preponderance of economic data continues to support our view that a recession is unlikely without material deterioration in the labor market. So far, the labor market remains robust; inflation is falling but slower. Consumers continue to spend, although increasingly by using their credit cards when their incomes are exhausted, and the government, despite adequate natural demand, has trillions of spending on tap, waiting for bureaucrats to finalize the rules and processes required before it can be circulated.

Earnings

As of Friday, approximately 23.0% of US companies have reported fourth-quarter and 2023 year-end financial results. In aggregate, sales have increased by 2.9%, lower than the inflation rate, and profits are higher by 1.8%. The results show continued deterioration of margins and much more tepid top-line growth than expected. The mediocre results have not had any dampening effects on financial markets.
These results capture the growth rates of many companies that lost money in 2022 but returned to profitability in 2023. These companies skew aggregate results considerably. We dug to get a more thorough view of the profit picture.

Some observations may be illuminating. Magnificent Seven companies account for 11.0% of reported revenues but 31.6% of profits. All members of the Magnificent Seven have reported setting up markets for much less favorable results from the remaining three-fourths of the market in the wings. We do not believe markets are discounting this outcome and that it sets up 2024 in a much more negative earnings light than previously believed.

Revenue and Earnings Growth
(Source: Bloomberg)

	Revenue	Earnings
Communications	5.4%	26.3%
Comms wo Alphabet and Meta	1.5%	8.9%
Discretionary	6.0%	-2.4%
Discretionary wo Tesla	4.1%	4.1%
Staples	18.8%	19.4%
Energy	9.6%	1.9%
Financials	0.8%	-23.8%
Healthcare	9.6%	-16.1%
Industrials	5.9%	-19.0%
Technology	11.6%	25.7%
Tech wo Apple, Microsoft, and Nvidia	1.7%	-14.6%
Materials	2.9%	6.5%
Real Estate	14.6%	394.6%
Utilities	-1.0%	-0.6%
Total S&P 500	5.0%	-6.2%
Total Mag 7	5.5%	8.5%

One More Thing

One more thing. Sayre's law states that, in any dispute the intensity of feeling is inversely proportional to the value of the issues at stake. This is why academic politics are so bitter.

Harvard successfully thwarted a run on its board last week. Billionaires Bill Ackman and Mark Zuckerberg attempted to get hand-selected candidates approved to run for board positions. None of the candidates received the required 3,238 signatures from alums. As it happens, technical difficulties blocked signers from completing their registrations, proving Stalin right after all. "It's not the people who vote that count; it's the people who count the votes."

At the core, Harvard's board, faculty, and administration are incensed that billionaires and the Federal Government are demanding accountability for what the school does with the funds they are given. Not all universities are this aloof. In that sense, Harvard's preeminence endows it with a certain incredulity, which can only be satisfied with a powerful reckoning that is way too long in the future.

Finding some petty satisfaction in Harvard's current dilemma comes from a plate of sour grapes. I once applied for admission to a Harvard doctoral program and was summarily rejected quickly and efficiently, making me wonder if my application was ever opened. Even so, the current airing of Harvard's dirty laundry is quite a spectacle.

Recounting all the bruhaha is beyond the purpose of this missive. However, the foundation of the current level of silliness embroiling the school isn't really unique to Harvard. What passes today as a "college experience" has been under development since the GI Bill promised to pay returning infantry to get a college education after World War II. Like many government programs, the intent was admirable, while the unintended consequences were disastrous. The GI Bill allowed students to afford college at the expense of making college affordable. The former focuses on cost containment, while the latter focuses on providing resources regardless of the cost.

Returning soldiers filled universities, forcing them to enter a multi-generational growth phase. But that demographic pig in the python from the baby boomers has been followed by a much smaller cohort of would-be matriculants. Universities nationwide are closing because there aren't enough students to fill their seats. At the same time, students have become choosier, seeking the perfect college experience—easy classes, endless entertainment, and a wholly non-rigorous but pliant environment. With more supply than demand, universities have put students in the driver's seat, convincing them that they are the consumers instead of the product.

The care and feeding of this enlightened generation of students is expensive. Higher costs have not come from more faculty. Instead, an administrative corps has ballooned over the last generation. Harvard employs 1,352 full-time administrators for every 1,000 students. Bloated administrative components dilute the academic experience by coddling students and convincing them they are the consumers of the educational product instead of the product of an educational opportunity. Administrators "talking their book" and "looking for meaning" in their jobs constantly distract students from the rigors of learning by focusing on meaningless murmurings.

Today, college is rarely about learning. It's about checking boxes, taking the required classes, and receiving a certificate attesting to the time served. Publishers provide professors and lecturers with a textbook, PowerPoint slides, test banks, and interactive online learning tools, making the learned sage on the stage entirely superfluous for students with a modicum of initiative.

Professors who try to provide an "old-fashioned" learning environment with discussion, debate, and decorum are rated down to institutional purgatory. Most students don't want to learn. They know what's required to get the degree and exert the least energy needed for success.

In a world of remarkable changes, the ivory tower of higher education remains mostly unaltered and unimproved. Having skirted the powers of disintermediation the internet dispensed on most industries, higher education is about to experience a full field dressing (i.e., gutting) experience. The autistic son of a notable venture capitalist had been at the bottom of all his classes in a typical high school, so he trained an AI bot on his son's conditions and the desired outcomes of each course. Now, the formidable learning challenges have been surmounted, and he sits at the top of his classes.

While this is only an anecdotal example, its outcomes have been repeated thousands of times over the last year, resulting in profoundly personalized curricula designed to facilitate learning at scale and individualization. Enterprising startups are being developed, enabling students to learn at a pace that will condense a four-year college equivalent into one year at a fraction of the cost. Structural changes are also demanded, enabling students to test out of each class instead of attending.

In the not-very-distant future, successful universities will no longer peddle in curriculum but embrace the knowledge-consolidating power of the academy. Learning stuff will no longer be a competitive advantage. While the changes in higher education will be wholesale and ruthless, what artificial intelligence does to primary and secondary education will be even more transformational to the educational complex as well as the social fabric of the world. Hold on tight.

Conclusion

That's it for this *Weekender*. Have a wonderful week. There will be no *Weekender* next week.