What a Wonderful World

Weekender

September 28, 2024

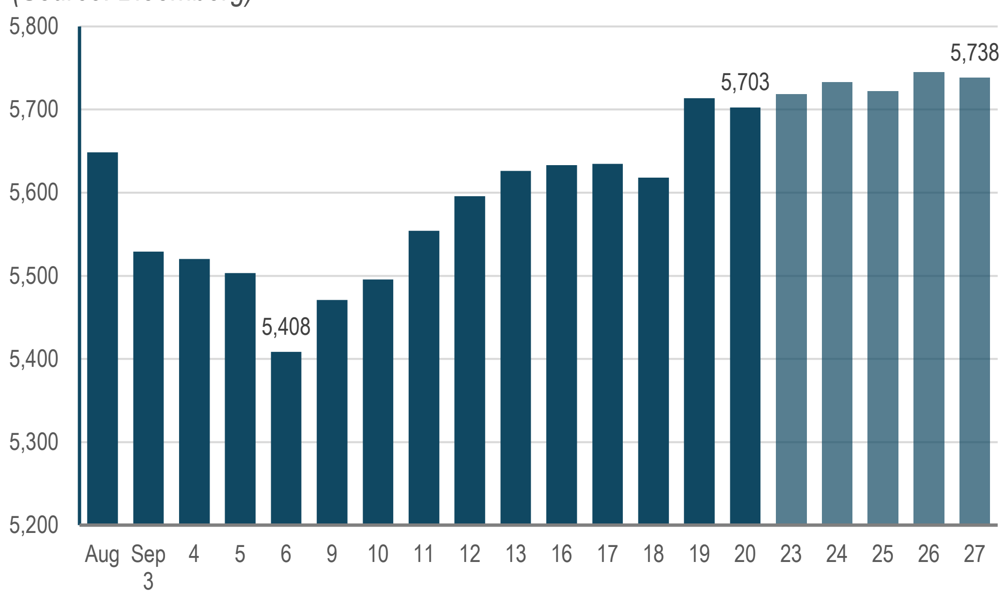
Some of you young folks been saying to me, "Hey Pops, what you mean 'What a wonderful world'? How about all them wars all over the place? You call them wonderful? And how about hunger and pollution? That aint so wonderful either." Well how about listening to old Pops for a minute. Seems to me, it aint the world that's so bad but what we're doin' to it. And all I'm saying is, see, what a wonderful world it would be if only we'd give it a chance. Love baby, love. That's the secret, yeah. If lots more of us loved each other, we'd solve lots more problems. And then this world would be a gasser.

Louis Armstrong

Good morning, and welcome to the Saturday, September 28, 2024, *Weekender.* It's been a few weeks, but we are back at it again. Equity markets, as measured by the Standard and Poor's 500, were higher by 0.6% last week. Equity markets have been primarily flat for ten days, following the Federal Reserve's initial rate reduction since the pandemic-era peak, prompting markets to search for a new prevailing narrative that explains the complicated global economic, political, and social environment.

S&P 500 Index Levels

(Source: Bloomberg)



Most of the world's central banks are reducing the level of monetary constraint in their economies. Mainly tamed, or at least safely corralled, inflation does not seem to pose an existential threat. Some of inflation's sticky bits, like shelter, are likely to slow the rate of inflation's decline, but they are unlikely to alter the central bank's path. We expect the target interest rates to fall by at least 1.5% over six months.

Looking further afield, international equity markets have disproportionately benefited from the bias shift among global central banks. Goldilocks, largely in hibernation since the pandemic began, seems to be regaining consciousness. Everything looks just right. Corporate profits are growing, inflation is coming to heal, and interest rates are following suit. The labor market, although slowing from a degree of extreme pandemic tightness, is robust and resilient to economic shocks.

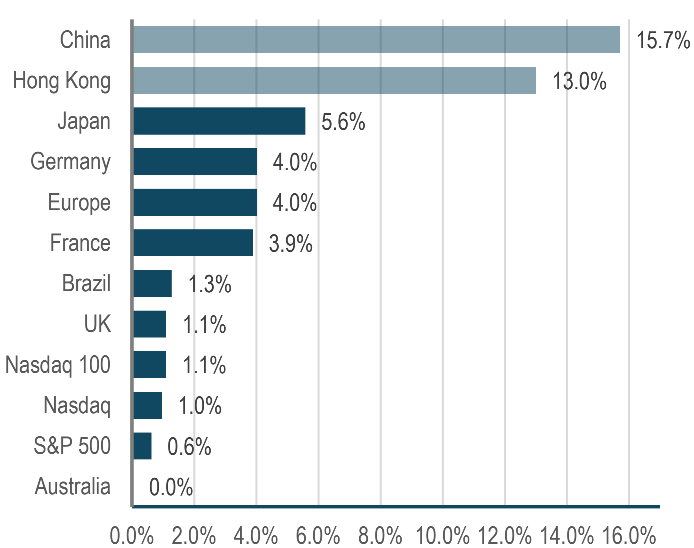
Financial markets seem to be breathing a sigh of relief that the long climb in interest rates is over. The mountain has been climbed, the peak reached, and in relief, the gradual descent is signaling relief. Equity markets around the world are engaged in an indiscriminate relief rally.

China's stock market was 15.7% higher on the week, pushed higher by the hopeful effects of a string of monetary and fiscal announcements designed to lift its moribund economy from the edge of recession.

Weekly Country Returns

September 23 - 27, 2024

(Source: Bloomberg)



Most major economies, Japan excepted, are actively shifting monetary policy away from restriction in favor of loosening.

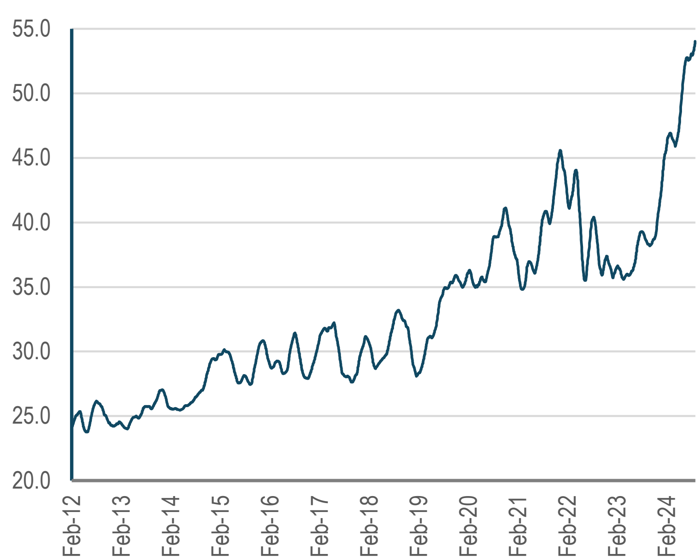
On a year-to-date basis, the S&P 500 and the tech-heavy Nasdaq are running neck and neck, posting 20.3% and 20.7% gains, respectively. In the face of such remarkable gains, touching on valuations seems appropriate. The S&P 500 trades at a lofty 27.2x estimated earnings, approximately ten points above its non-pandemic average. Some pundits blame this on the nosebleed levels of the Magnificent Seven or a broader group of punters involved in artificial intelligence. But this view, as convenient as it may be, does not explain the situation well.

Costco released earnings this week, which missed on revenues, although profits beat estimates. The company is a phenomenally run business with a model that seems all but bulletproof. Over the last twelve months, the company grew its revenue by 5.0%. Analysts expect it to grow by 7.4% in 2025 and 6.6% in 2026. It is solid but uninspiring and nowhere near worth paying 54.1x earnings.

Costco PE Ratio

January 3, 2012 - September 27, 2024

(Source: Bloomberg)

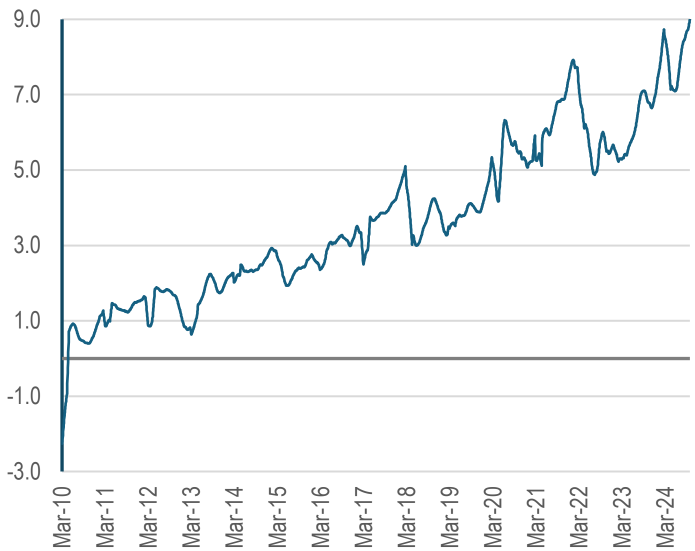


Backing up again for a little perspective, the price-to-earnings ratio for the S&P 500 minus that of the MSCI World Index, excluding the United States, has never been this deferential to the US. US equity markets are much more expensive than the rest of the world. We believe some of this discrepancy is justified. Germany is in recession, which means the rest of Europe will soon follow. China has a bevy of structural issues that will likely never be surmounted. On a risk-adjusted basis, we remain overweight the US investment products, relative to the rest of the world, with a bias toward value. That said, we expect to move away from our more passive investment approach in emerging and international markets and begin using a more targeted approach, similar to that used in US market investments.

US PE Ratio Minus Rest of the World

January 4, 2010 - September 27, 2024

(Source: Bloomberg)

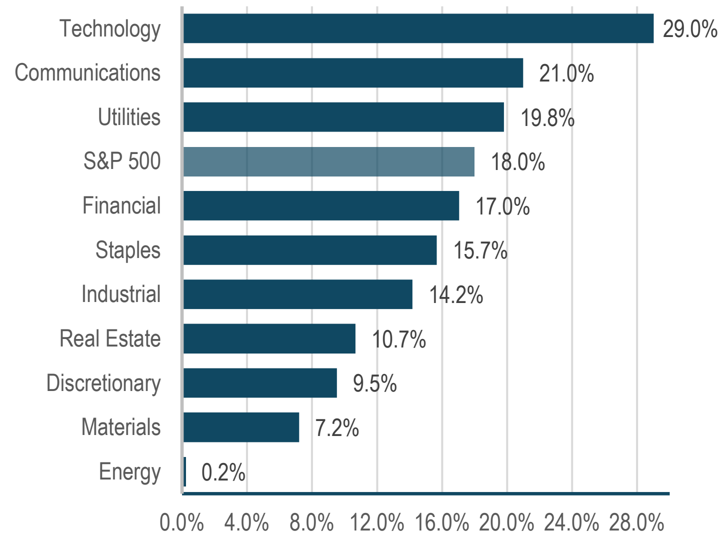


The strong year-to-date returns mentioned previously owe their gains to technology, communications, and, paradoxically, utilities. Together, they constitute the sector representation of the artificial intelligence trade. While we have benefitted from being long this space, we are beginning to shift our relative exposure to other areas of that market that have been quietly growing with the AI vacuum.

Year-to-Date Sector Returns

January 2 - September 27, 2024

(Source: Bloomberg)

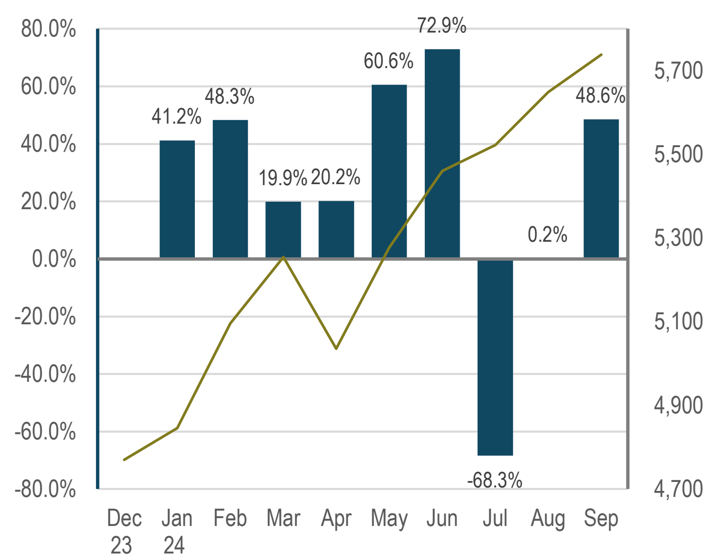


We actively hold six of the Magnificent Seven members. Our investment thesis on them remains unchanged. Consequently, we plan to continue to keep them for the long term despite their lofty valuations. Their year-to-date gains have been the primary source of returns for the broader market. The graph below is a little counterintuitive and may require a bit of explanation. The gold line and right axis is the monthly level of the S&P 500. The bars are the percent of the contribution of the Magnificent Seven to the index's gain or loss for the particular month.

Magnificent Seven Contribution to S&P 500 Returns

Janary - September 2024

(Source: Bloomberg)

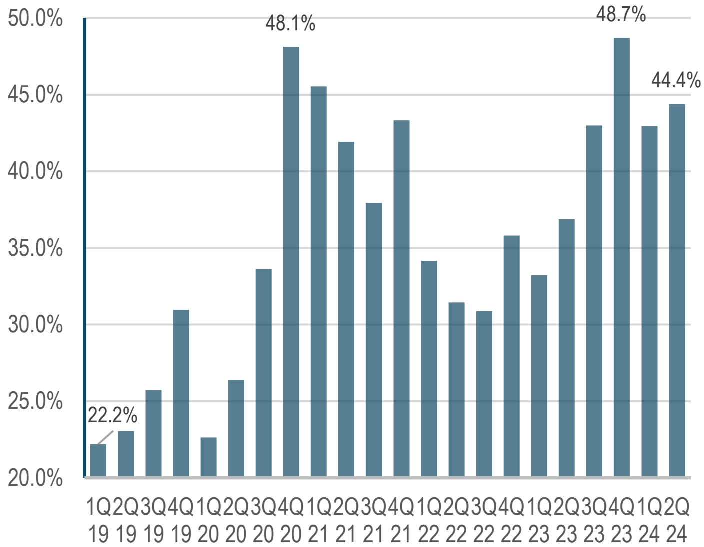


While the Magnificent Seven's dominance in returns has been remarkable, the group's dominance along fundamental lines has also been equally stunning. For the second quarter of 2024, the Magnificent Seven accounted for 44.4% of the total operating cash flow of the combined 503 members of the S&P 500.

Magnificent Seven Contribution to S&P 500 EBITDA

1Q 2019 - 2Q 2024

(Source: Bloomberg)



Economic Narrative

Over the last three weeks, economists and investment strategists have begun to weigh the likely impact of a lower interest rate environment. A new narrative is forming. From our view, two critical questions should be answered. First, why did the Federal Reserve believe it could begin lowering interest rates? Second, why did it think they should?

Persistent declines in inflation, regardless of the preferred measure, gave the Federal Reserve justification for beginning to remove a degree of financial constraint on the economy by lowering interest rates. On Friday, the Fed's preferred inflation measure, Personal Consumption Expenditures (PCE), recorded a print of 2.2% for August compared to the previous year. While this is still above their 2.0% target, the glide path continues to show an encouraging trend.

As a highlight of the downward inflation trend, annualizing the three-month moving average of the month-over-month PCE suggests that inflation is well in hand, registering a tepid 1.6%. Consumers are not necessarily celebrating this news since prices are much higher than their pre-pandemic set point. However, the rate of price increases has come to the point where the Fed has a green light to continue lowering rates.

Magnificent Seven Contribution to S&P 500 EBITDA

January 2018 - August 2024

(Source: Bloomberg)

We believe the US economy continues to run hot, although it has come off boil. The most important part of the Fed's interest rate action is the signal it sends to the market that the days of restrictive policy are over. The Citi surprise index shows that economic data meets expectations and leaves the negative revisions territory. This typically corresponds with periods of above-trend economic performance.

We do not believe the US economy will enter a recession without damage to the labor market, self-inflicted or otherwise.

Self-inflicted labor market pain will likely be slow to come, especially given the shift to accommodation by global central banks. However, we are seeing increasingly consistent talismans that suggest the consumer is getting stretched. Product markets are already in recession, and services, which account for 66.7% of US economic output, are just beginning to slow.

Citi US Economic Surprise Index

May 11, 2023 - September 27, 2024

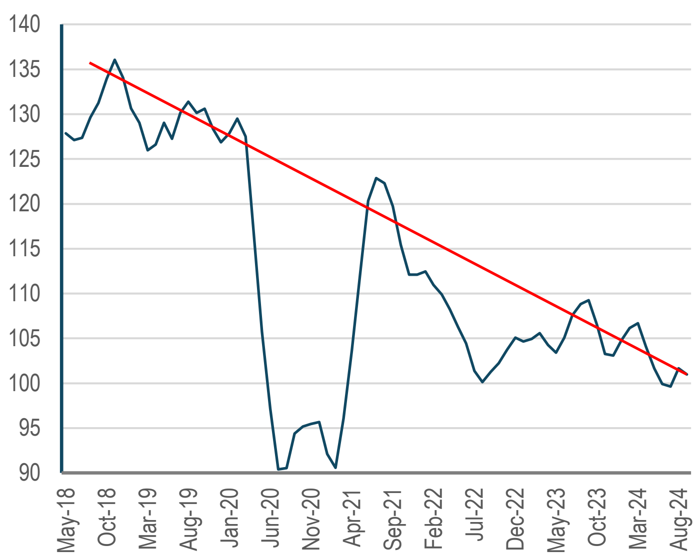
(Source: Bloomberg)

Consumer confidence metrics, released Tuesday, came in well short of expectations. Meanwhile, consumer sentiment, released Friday, shows a significant rise. Consumer confidence data is susceptible to changes in the labor market, which is softening, while inflation, which is falling, weighs heavily in the consumer sentiment readings. Paradoxically, they confirm that labor is weakening, although still robust and non-recessionary, and inflation is coming in for a landing close to the Federal Reserve's 2.0% target.

Consumer Confidence

May 2018 - August 2024

(Source: Bloomberg)

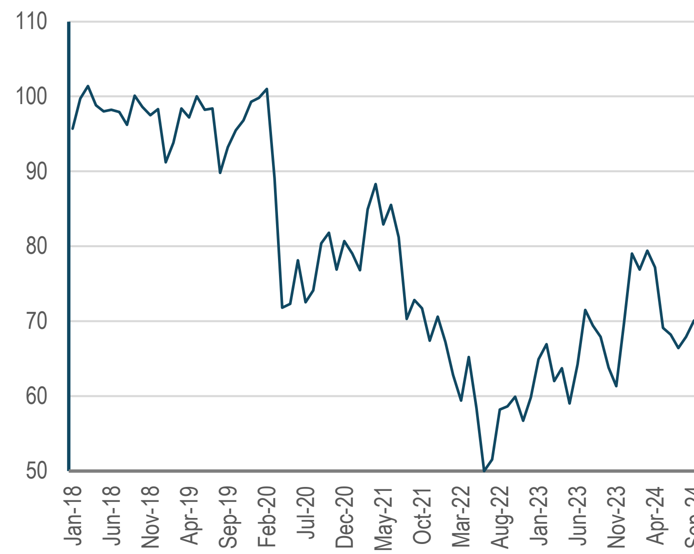


Tuesday's consumer confidence reading was lower than expected, driven by a broad decline in many measures tracked by the survey—fewer hours worked, fewer job openings, a persistent sense that prices are just too high, and a drop in respondents who believe jobs are plentiful. Although data do not yet support such a conclusion, an increasing number of people think the economy is already in contraction.

Consumer Sentiment

January 2018 - August 2024

(Source: Bloomberg)

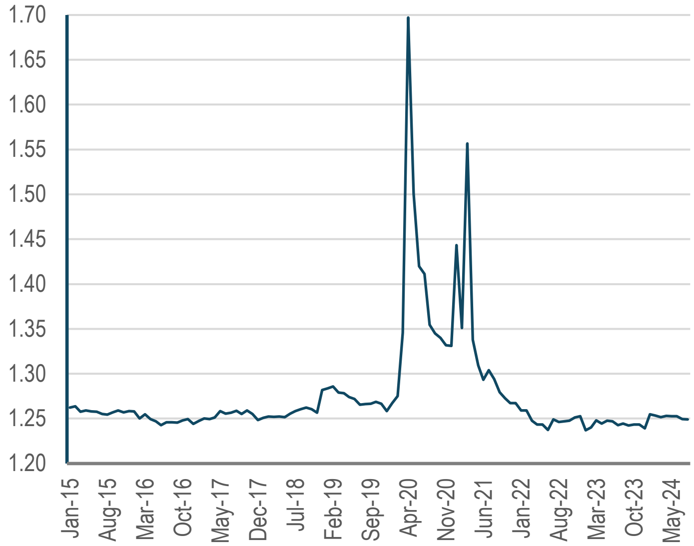


Income and spending data, released Friday, missed economist estimates and showed continued signs the US consumer is getting full. Lower-income consumers are feeling stretched after spending all their ill-gotten pandemic booty, draining savings, slowing wage growth, and ramping up credit cards—not enough to retrench but enough to slow down. Meanwhile, corporate spending and investment continue to grow.
The ratio of consumer income to spending was 1.25, which is in line with the long-term average.

US Personal Income vs Personal Spending

January 2015 - August 2024

(Source: Bloomberg)



China

The People's Bank of China's (PBOC) increased eye-bulging monetary stimulus announcement put a flutter in their equity markets, which were higher by 15.7% for the week. The stimulus is also likely to support other emerging Asian stock markets briefly. While the stimulus is tasty for investors, it ignores the structure problems in the Middle Kingdom. Even so, we expect a short sugar high to maintain Chinese markets for the near term. Lower mortgage rates will do little to lessen the economy's reliance on property. Nor will it cause a flood of buyers in a catastrophically overbuilt residential real estate sector.

China M1 Percent Change

April 2018 - July 2024

(Source: Bloomberg)

Subject to a 4 - 6 months lag, China's newly announced stimulus should add liquidity to the global market for risk assets, providing a modest counterbalance to the US Fed's easing actions. Meanwhile, US-traded Chinese shares are the cheapest in a decade. It's not yet time to jump in, but we are adding some punters to our research list.

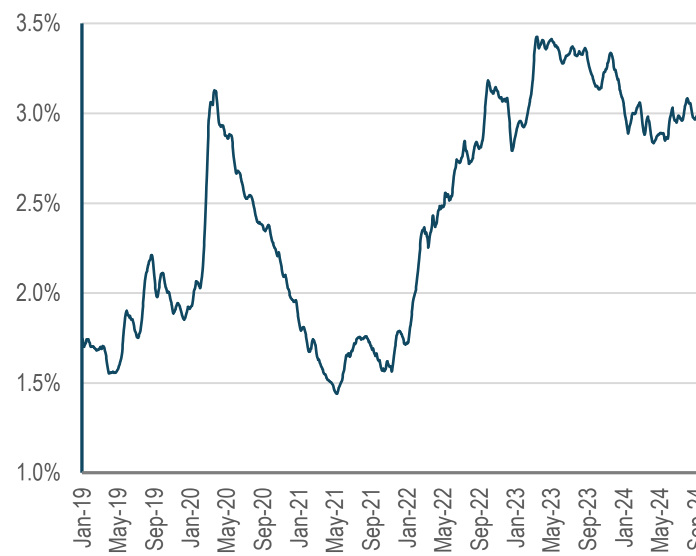
Residential Real Estate

With policy interest rates in retreat, mortgage rates have followed suit. The spread between the average 30-year mortgage rate and the yield on ten-year US government bonds has come off its peak of 3.3% and has only begun to moderate. We expect another 50 basis points of interest rate reductions will light a match under home equity refinancing, which has been dormant for a few years. Higher mortgage volumes will tighten the spread between mortgages and bond yields, providing up to 1.5% of additional mortgage relief, resulting in a general thawing in sales for existing homes.

Mortgage Rates Minus US 10-Year Bond Yield

January 15, 2019 - September 27, 2024

(Source: Bloomberg)

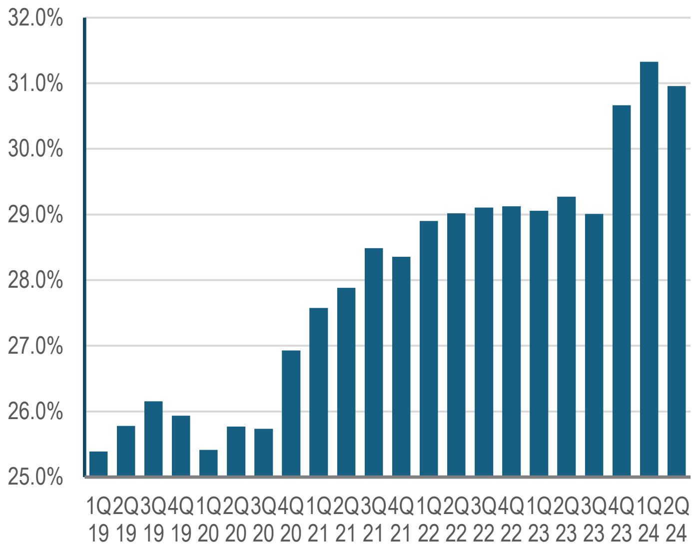


While we are optimistic about the impact of lower interest rates on the residential real estate market, we are less favorable about homebuilders. Lower rates will increase the sales of existing homes and provide increasingly attractive alternatives to new dwellings. Homebuilders are currently experiencing the benefits of peak margins. As alternatives to new homes enter the market, we expect margins to compress.

Homebuilder Gross Margin

1Q 2019 - 2Q 2024

(Source: Bloomberg)



Conclusion

That's it for this *Weekender*. Our next Weekender will reinitiate the One More Thing segment. 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.