

Let the Bitings Begin

Weekender

January 27, 2024

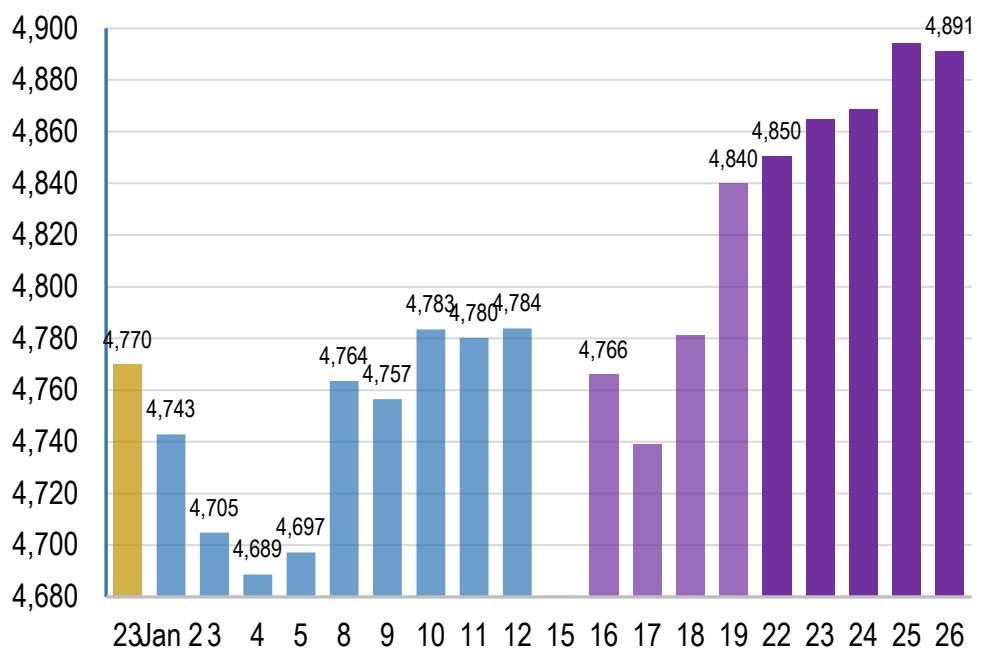
Always be a first-rate version of yourself,
instead of a second-rate version of somebody else.

Judy Garland

Good morning and welcome to the *Weekender* for Saturday, January 27, 2024. Another positive week for equities, with the S&P 500 higher by 1.1%. The arranged marriage of markets, interest rates, and inflation continues to be the primary driver. We expect markets to see other people, like earnings, relatively soon. But for now, everyone seems content.

S&P 500 Index Levels

(Source: Bloomberg)



Equity markets continue to levitate on the magic of lower interest rate expectations. Lower rates, strong economic growth, inflation coming to heel, and a labor market that continues defying gravity all support the economic unicorn called a soft landing.

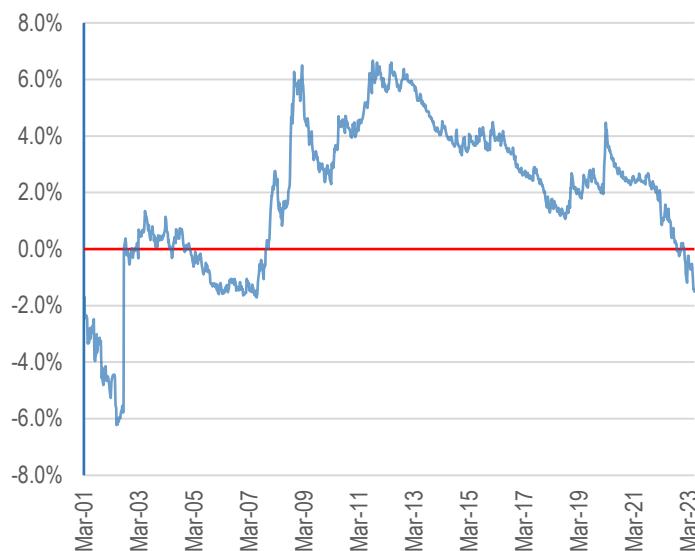
Investors gobbled up a record amount of bonds in January, but the new issue fixed income market is showing signs that buyers are getting a bit full. Investment bankers like JP Morgan have cautioned that risk premiums will likely widen in the coming months, which may push some valuations lower. Holding the debt of the best issuers continues to be our fixed-income strategy.

Equity investors typically value stocks using one of many multiple comparisons, like price to earnings. During periods of interest rate uncertainty, it's helpful to flip the multiples and look at earnings yield. Earnings yield for the Nasdaq 100, which includes the largest technology stocks, minus the US two-year bond yield, is underwhelming and negative. This is unusual and an indicator that valuations are getting stretched.

S&P 500 Earnings Yield Minus 2-YR Bond Yield

March 30, 2001 - January 26, 2024

(Source: Bloomberg)



We have been waiting for tech outperformance to broaden into the rest of the market. It's happening, but not at the expense of technology stocks. They continue to rise and lead the market. The third quarter of last year was the last quarter of a three-quarter earnings recession, with the forward view suggesting 2024 earnings would post an 11.0% rise compared to 2023.

But we think there is a fly in the ointment. As of Friday's close, approximately 13.8% of US-listed companies had reported earnings. In aggregate, sales growth is up 3.0%, barely covering inflation, while profits are down -3.4%. Most of the earnings drag comes from energy and materials, which have fallen, and costs remain persistently high. Next week, technology companies will begin reporting and will likely help lift earnings closer to a flatline. We will

dedicate our next *Weekender* to a summary of the emerging earnings picture.

Taming the Shrew

Although not fully tamed, inflation seems bridled, saddled, and ready to ride. Price increases have come down from near historic levels and are now close to levels the Federal Reserve will be comfortable with. A soft landing, where inflation and interest rates reach a neutral level with strong labor markets and adequate growth, is increasingly probable.

Historical market comparisons are fun but rarely insightful. With the rise in artificial intelligence, market comparisons to the internet bubble are now in vogue. Equity markets typically do very well in the interregnum between the last fed tightening and when they begin lowering rates. The internet bubble is one remarkable exception.

S&P 500 Returns from Day of Peak to First Cut

Source: Bloomberg

Date	S&P 500	Nasdaq 100	Nasdaq
12/5/1980	0.7%		-1.6%
8/21/1984	-2.5%		-2.9%
5/16/2000	-12.5%	-41.6%	-38.4%
6/29/2006	19.4%	28.4%	22.0%
12/19/2018	18.9%	23.7%	23.2%
7/26/2023	7.1%	12.4%	9.4%

From the day rates peaked on May 16, 2000, to the day the Fed began cutting on January 2, 2001, the S&P 500, Nasdaq 100, and Nasdaq were all down large. Looking at the rate cycle another way, from the date rates peaked to the date they began to rise again on June 30, 2004, they were still negative during the internet era compared to the other rate cycles.

S&P 500 Returns from Day of Peak to Next Rise

Source: Bloomberg

Date	S&P 500	Nasdaq 100	Nasdaq
12/5/1980	21.0%		43.1%
8/21/1984	49.0%		39.6%
5/16/2000	-22.2%	-58.4%	-44.9%
6/29/2006	62.9%	194.2%	133.2%
12/19/2018	73.8%	120.0%	102.5%
7/26/2023	7.1%	12.4%	9.4%

By comparison, equity markets are set up for considerable outperformance if market history repeats itself. However, left out of the comparison is the issue of valuation. We

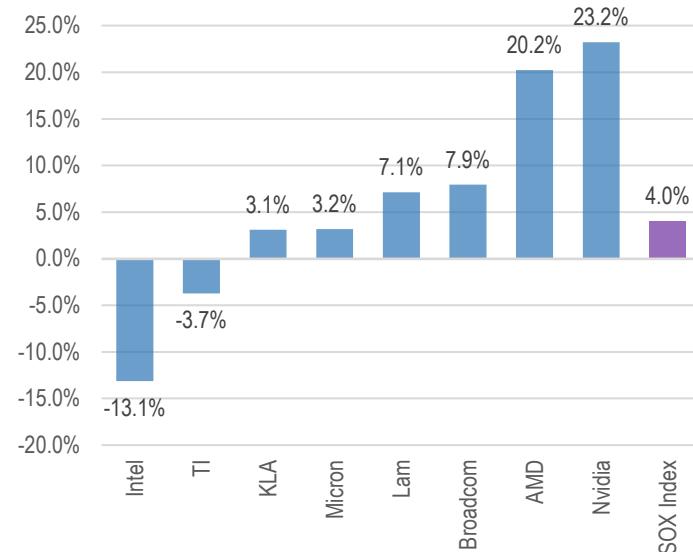
believe equities are too expensive, especially the technology names that have driven so much outperformance. However, we continue to find remarkable value in high-quality stocks outside the Magnificent Seven and artificial intelligence cult members.

AI Lopsidedness Bites Intel

Chipmaker Intel had a bad day on Friday, with their shares down by -11.9%. The company released year-end 2024 earnings that fell within the market's expectations, but their outlook for 2024 was terrible. As of late, Intel shares have been on a bit of a run due to an insatiable demand for performance semiconductor chips. Intel has been making considerable investments to accomplish this objective. But for now, they produce low-end commodity chips, and that market is in a post-pandemic glut.

Year-to-Date Performance

(Source: Bloomberg)



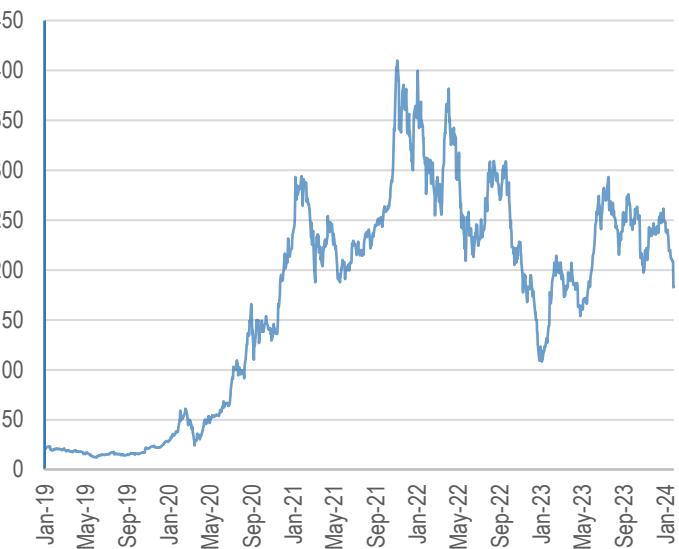
Reality Bites Tesla

In other news, Tesla shares are counter-cyclical to the broader market and the Magnificent Seven. In January alone, the EV makers' stock is lower by -26%, erasing approximately \$207 billion in market value since the beginning of the year. As of Friday, the shares were down for six consecutive weeks, the longest losing trend for the name since 2016, before the company entered the mass-market electric vehicle market with its Model 3. Tesla is finally leaving the dreamscape fairytale world and bumping up hard against the reality that it's just a car company.

Tesla (NYSE: TSLA) Stock Price

January 2 2019 - January 26, 2024

(Source: Bloomberg)

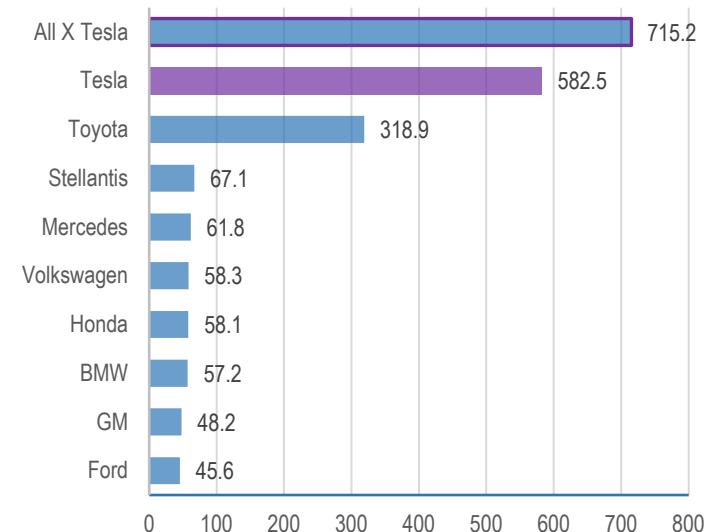


Two years ago, legacy auto manufacturers traded at a discount to Tesla because the whole world was blindly jumping into the world of EVs, leaving the dinosaur legacy car companies behind. Today, demand for electric vehicles in the United States is slumping across almost all brands. To address softer needs, Tesla has been lowering its prices. This should help on the margins, but as part of the company's fourth-quarter earnings release this week, the company announced 2024 sales to be "notably lower" than market expectations.

Since the announcement, several analysts have downgraded the stock. Even longtime bulls are pulling in their

Market Capitalization in US\$ Billions

(Source: Bloomberg)



horns. Dog piling on Tesla adds no value. However, we believe what is happening to Tesla has much broader implications.

Tesla has been hailed as an EV pioneer. Unquestionably true. But their excessive valuations are driven by claims by investors and analysts alike that the company is like a software, environmental, self-driving, artificial intelligence company. None of these descriptions are false. They are just no longer defining. Tesla makes cars and is thus a car company. We expect their valuation to reflect that reality increasingly. We expect similar bites will soften the prices of other names trading on dreams and illusions.

Kindness of Strangers

Buy Buy Buy Spend Spend Spend

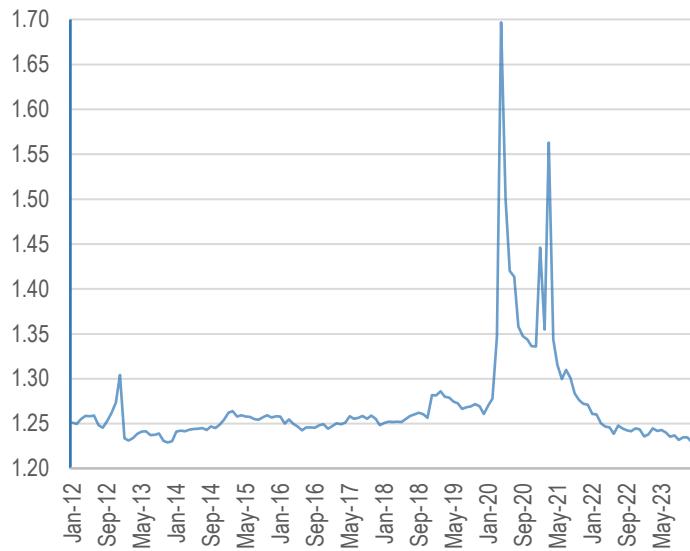
US consumers remain resilient as a strong labor market underpins income and consumer credit growth. While we believe the consumer is likely to remain entrenched as long as the labor market remains tight, spending growth is sure to soften by the back half of 2024. Credit defaults are rising quickly, although from a low base, while savings are all but spent, and consumer credit is peaking out for the lower half of income ranges.

The ratio of consumer incomes to consumer spending shows a degree of stress not seen since the dug-out days following the credit crisis. We continue to expect a material softening in consumer spending. But if the labor market does not break, consumer spending will likely continue to grow, although at a minute clip.

Income / Spending

January 2012 - December 2023

(Source: Bloomberg)



That's all for this *Weekender*. A lot is going on next week. We will try to put it up against our expectations in the next *Weekender*. Have a wonderful week.

Disclosure Statement

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