Third Quarter 2024 Investment Outlook

It's All About ~~Marcia~~ Jensen

"The next industrial revolution has begun. AI (artificial intelligence) will bring significant productivity gains to nearly every industry and help companies be more cost and energy efficient while expanding revenue opportunities."

– Jensen Huang – CEO Nvidia Corp.

"Many people seem to believe that AI will be the most important technological invention of their lifetime but I don't agree given the extent to which the internet, cell phones, and laptops have fundamentally transformed our daily lives, enabling us to do things never before possible."

– James Covelle – Goldman Sachs global co-head of stock research

"All I hear all day long at school is how great Marcia is at this or how wonderful Marcia did that. Marcia!, Marcia!, Marcia!"

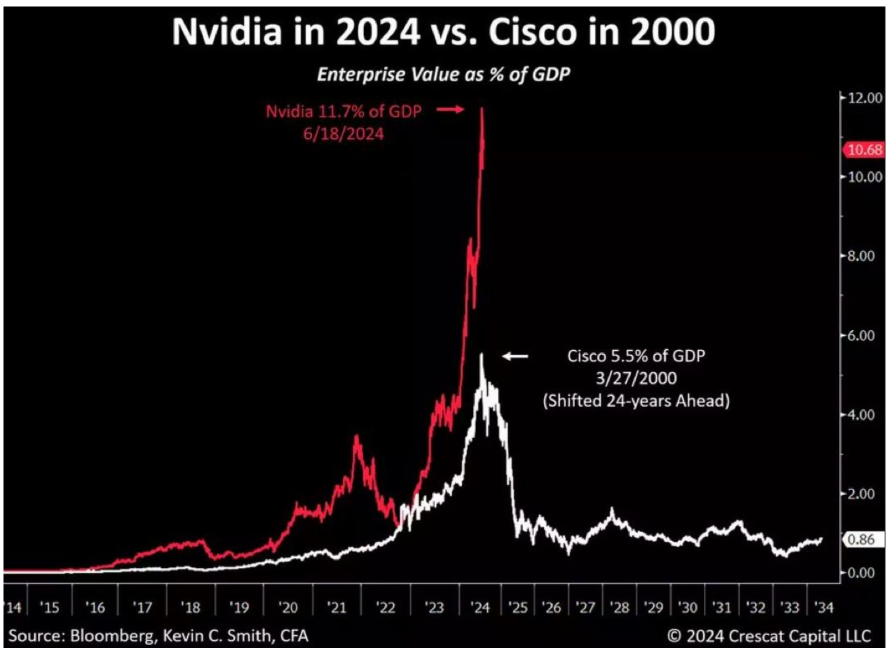
– Jan Brady – The Brady Bunch - 1971

The middle child of large families have always had it tough. They are not the first child who receives excessive amounts attention from both parents and grandparents. No, the middle child gets the hand-me-down clothes and used toys from the first child. They are not the last child (my baby!!) who the middle child is forced to babysit and responsible for making sure they don't die while the parents are out to dinner. A form of slave labor. The highest profile middle child was Jan Brady of The Brady Bunch, the popular early 1970s TV show about two divorcees who get married and bring together their 6 children along with wise cracking housekeeper Alice. Mike Brady had three sons and Carol Brady had three girls with Jan the middle girl between Marcia and Cindy. Marcia was the skinny, attractive older sister who got all the boys' attention and Cindy was the cute as a button younger sister. Jan of course had braces too and was in her very awkward early teen years. Peter was the middle boy but Peter had no drama impact on the show's story lines. Peter's job was to make fun of older brother Greg and had younger brother Bobby as his sidekick and partner in crime.

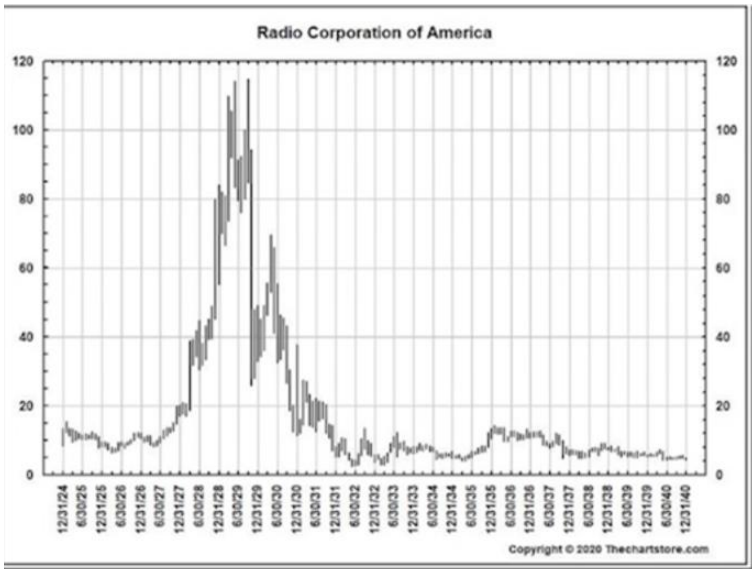
Who is the Marcia of today? That would be Jensen Huang, the CEO of Nvidia, who is getting way more attention from global investors than Marcia ever did from the boys at Westdale High School. Nvidia is a semiconductor company that makes graphic processing units that go into servers in the data centers that support the AI wave currently dominating global technology spending. All you hear nowadays in the financial markets is how great Jensen is at this or how wonderful Jensen did that. Jensen! Jensen! Jensen! Even though she is now in mid-60s, Jan is annoyed at how much attention Jensen is getting because it's resurfacing some bad childhood memories. Apparently, Marcia told Jan she bought Nvidia stock 5 years ago and is flaunting her wealth at Brady family reunions.

For many younger investors today, Nvidia appears to be one of the greatest investments in stock market history but there have been other examples of a stock being considered a no-brainer, guaranteed winner. In the 1999/2000 Tech Bubble it was Cisco Systems, the networking infrastructure company whose technology facilitated the explosive growth of the internet. Investors became enamored with Cisco and its share price soared until the Tech Bubble burst in early 2000 and it was determined that Cisco's growth rate wouldn't remain at elevated levels forever. Cisco peaked at $80/share in March 2000 and declined all the way to $12/share by September 2002 and trades today around $46/share and has never gone back above its all-time high in 24 years. Today, Cisco is a cheap technology stock with an attractive dividend yield.

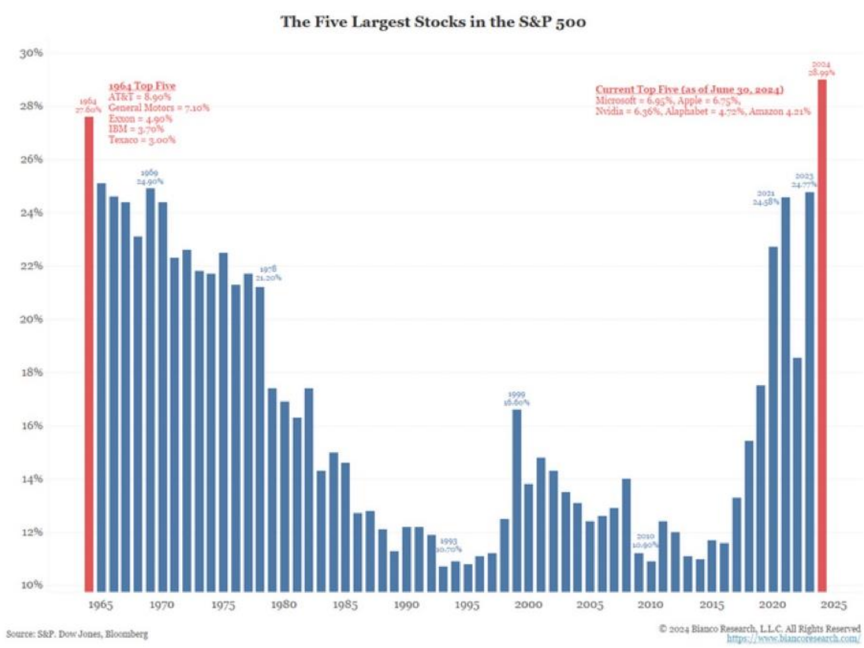
Nvidia is the Cisco of today. Nvidia is literally carrying the U.S. stock market on its back. It gained 37% in the second quarter, soared almost 150% during the first six months of 2024, and a whopping 192% over the last 12 months. Jensen Huang is a rock star as far as investors are concerned. He is followed around in public even when shopping for food and women ask him to sign their bras. Rumor has it that Taylor Swift is jealous of Jensen's notoriety. The Nvidia story is so rare that it is tough to find a legitimate comparison but the next chart puts Nvidia's recent gains in context with what Cisco represented to the U.S. stock market and U.S. economy 24 years ago. The chart shows the enterprise value of both companies relative to U.S. Gross Domestic Product (GDP) during their respective time periods. When Cisco hit $80/share it peaked at 5.5% of GDP in March 2000. In mid-June 2024, at $136/share (after a 10-1 stock split), Nvidia represented 11.7% of U.S. GDP and its valuation surge makes Cisco's 1999/2000 surge look lame in comparison. The AI wave that Nvidia is powering and which has made it the most important company in the world could very well be a momentous economic changing event for years to come. However, capitalism is often cruel, as outsized gains from one company attracts more competitors looking to get in on the growth and eventually undermining the leadership of one dominant company. This is especially true with technology stocks. Cisco was dominant until more networking companies moved up the technology curve and Cisco could no longer charge premium prices for its products. There are numerous high quality chip companies globally looking to do the same against Nvidia and capture market share of the explosive growth of AI. Stock market history suggests that Nvidia's dominance is not sustainable in the long run.



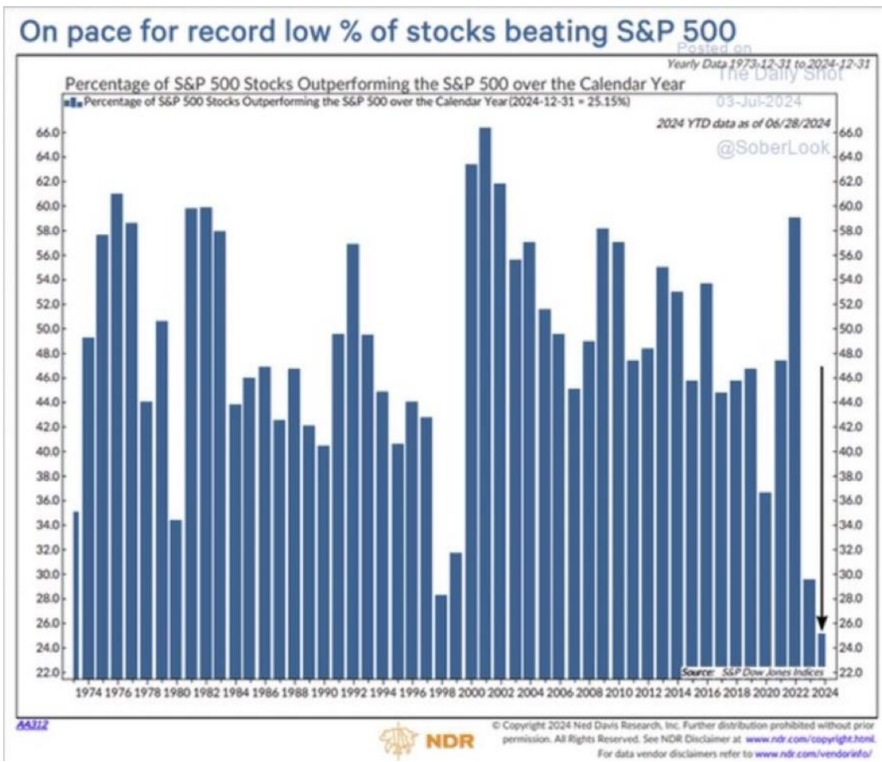
Many say NVDA has multiple years of outsized growth in front of it because AI is a groundbreaking and revolutionary technological advancement. Maybe that's true but it is not the first time such a case has been made in history. How about radios? Imagine how groundbreaking that technology was at the time when people were getting information over telegraph lines, horseback, or waiting for the newspaper to arrive. Below is the chart of Radio Corporation of America, eventually known as RCA. It dominated U.S. radio sales (no offense to Zenith fans) and saw explosive growth and investors went gaga over the stock in the 1920s. However, despite having another decade plus of double digit annual revenue growth ahead of it, the stock peaked in the late 1920s. The stock price collapsed (partially due to the Great Depression) and it never regained its former parabolic price peak. As shown previously, the same has been true for Cisco Systems 24 years after its March 2000 price peak.



As investors have crowded into the tech stocks expected to be the biggest AI beneficiaries, the U.S. stock market has become extremely top heavy. The Top 5 stocks in the S&P 500 Index now represent nearly 29% of the index, exceeding the prior peak of 27.6% in 1964 (AT&T #1, General Motors #2) and up substantially from 10 years ago when the Top 5 largest stocks were under 12% of the S&P 500 Index.



For the past 18 months, narrow sources of return have dominated U.S. stock market performance. The next chart shows the percentage of stocks in the S&P 500 Index that outperformed the index each year going back to 1974. On the far right is 2024 and it shows only 25% of stocks in the S&P 500 Index are currently outperforming the index. This follows 2023 when only 29% of stocks outperformed the index. The last two years registered the lowest number of stocks outperforming the S&P 500 Index although there are still 6 months remaining in 2024. However, the last time the fewest number of stocks outperformed the index was in 1999 and 2000 when the U.S. stock market was in the Tech Bubble. In the years that followed, stock returns broadened quite dramatically and the number of stocks outperforming surged higher.

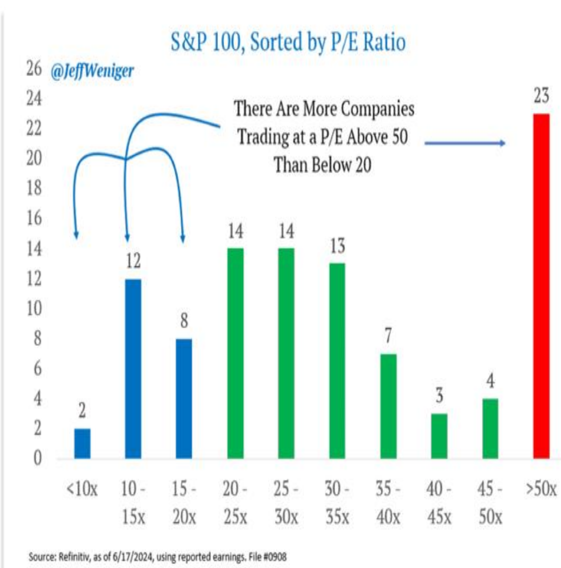


The next chart shows the contribution to annual returns of the Top 10 stocks during positive stock market return years. For the first six months of 2024, the Top 10 largest stocks contributed 77% of the S&P 500 Index return (15.3%). The only year the U.S. stock market returns were narrower was 2007 when the Top 10 contributed 79%. 2008 was a year many stock market investors would like to forget.

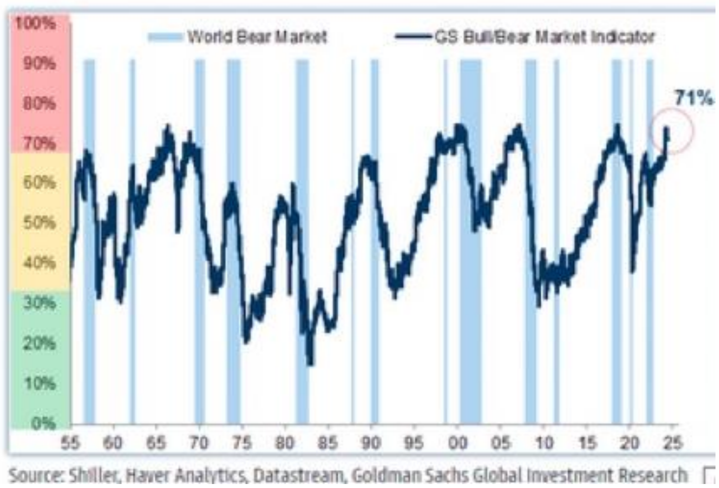
Annual S&P 500 Contribution of 10 Largest Weights During Positive Performance Years

Year	Top 10 as % of Total	S&P 500 % Perf.
2007	78.7%	3.5%
2024	77.2%	14.5%
2023	68.4%	24.2%
2020	58.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%

As Nvidia and other mega cap technology stocks have significantly outperformed all other stocks, the tech sector's market capitalization and valuations have become overextended compared to its earnings contribution level. The next chart on the left shows how the value of technology stocks in aggregate surged higher (dark line) but are now well ahead of their contribution to earnings (dashed line). There was a similar but more extreme setup for the tech sector when the Tech Bubble peaked in 2000. Either tech earnings are going to have to surge higher to justify current stock prices and valuations or tech stocks will suffer a price correction until this imbalance is rectified. The chart on the right breaks down the Top 100 U.S. stocks by price/earnings (PE) buckets and shows 23 of the top 100 stocks trade at PE multiples of 50X or higher compared to 22 stocks trading at PEs of 20X or lower.

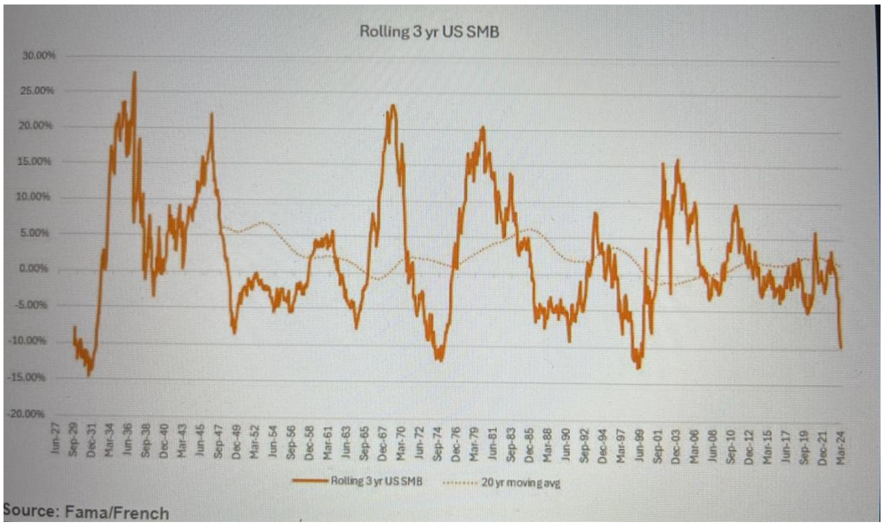


As U.S. stock market return disparities have widened, stock market risk levels have increased. The next chart shows the Goldman Sachs Bull/Bear Market Indicator which is a composite of 6 factors that capture market risk levels. When the indicator moves above 70%, the stock market risk level is high. Going back to 1955, this particular stock market indicator's most extreme reading usually peaked in the mid-70% level compared to its latest 71% reading.

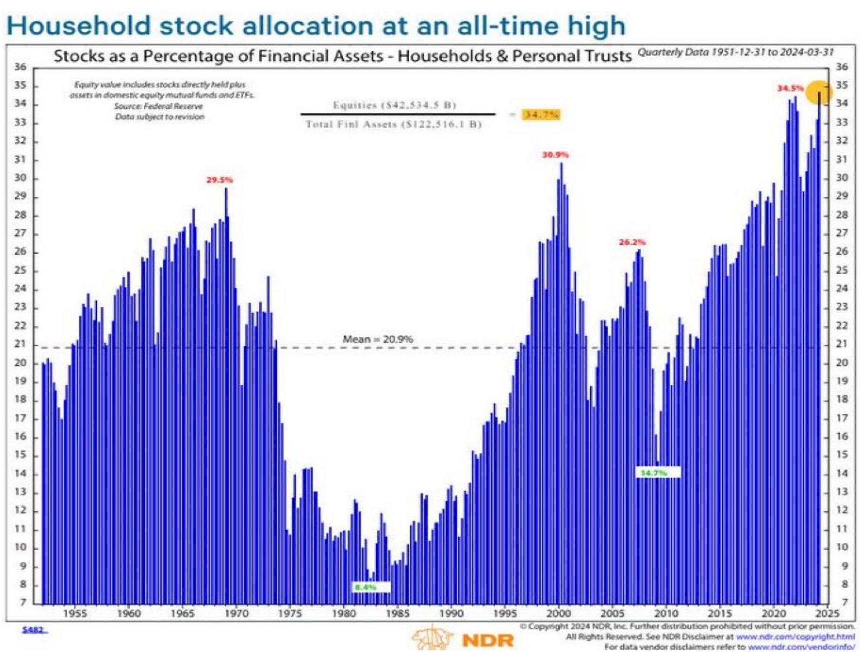


Another indicator of extreme imbalances in sources of returns is shown in the next chart, which compares the annual returns of S&P 500 Index of U.S. large/mega cap stocks minus the Russell 2000 Index of U.S. small cap stocks. Small caps have underperformed large caps for 6 of the last 7 years and during the last two years the underperformance has been as extreme as it was in 1997 & 1998 leading up to the 1999/2000 Tech Bubble peak. 2024 has been the most extreme year of return spreads going back to 1979 or 45 years. The Russell Top 50 Mega Cap Index returned +9.1% for the second quarter and +22.1% year to date while the Russell 2000 Index of U.S. small cap stocks returned -3.3% during the second quarter and only +1.7% year to date.

The next chart shows a rolling 3-year return for the S&P 500 Index minus the Russell 2000 Index going back to 1927. Note that we are now at the extreme lows of underperformance for small caps vs. large caps and that the market has only reached this level of return disparity four previous times over the past 97 year. Also note in the years following extreme return spreads, there was a major reversal in the other direction to the benefit of small cap stocks.

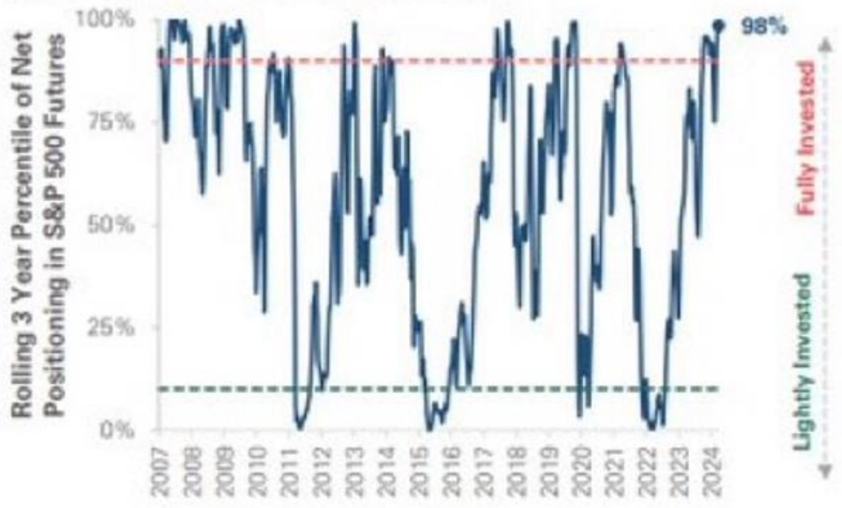


As you might expect, after eight straight months of strong stock market returns combined with unusually low price volatility, retail investors have become extremely confident in owning U.S. stocks. The next chart shows the allocation to stocks of U.S. households going back to 1950. As a percent of their financial assets, the allocation to stocks is now at the highest level ever and indicative of overly bullish market sentiment among retail investors who are no doubt enthralled by the outsized gains of AI related stocks like Nvidia and substantial outperformance of other mega cap tech stocks.



Enthusiasm for U.S. stocks is not just contained to retail investors. Institutional investors are also excessively bullish on the U.S. stock market too as shown in the next chart of net (long – short) positioning of S&P 500 futures. A high reading means institutional investors are already fully invested in stocks with the latest reading in the 98th percentile.

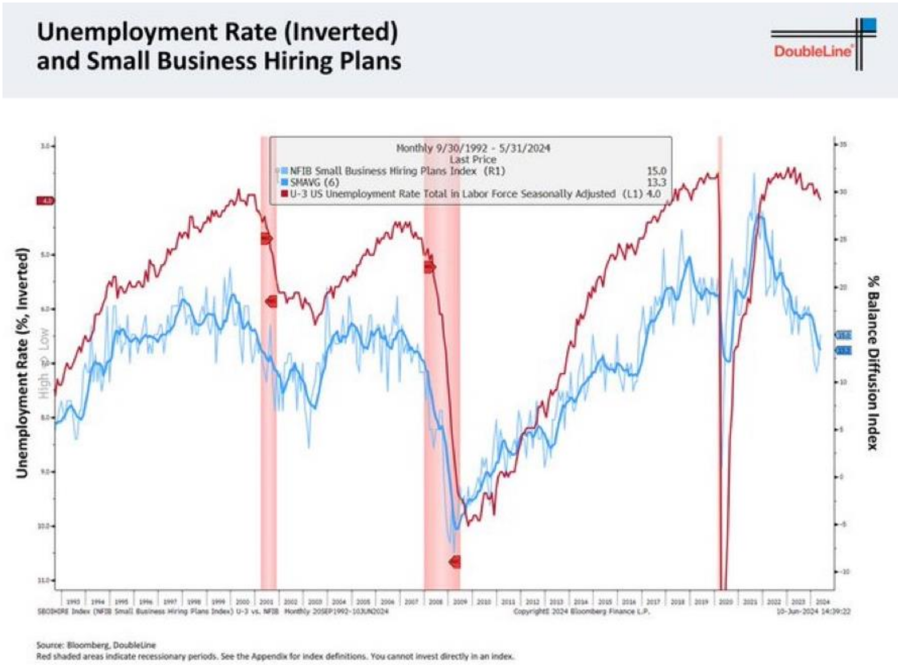
Figure 4: ... and so are Asset Managers



Source: MarketDesk, CME. Note: This is historically a contrarian indicator.

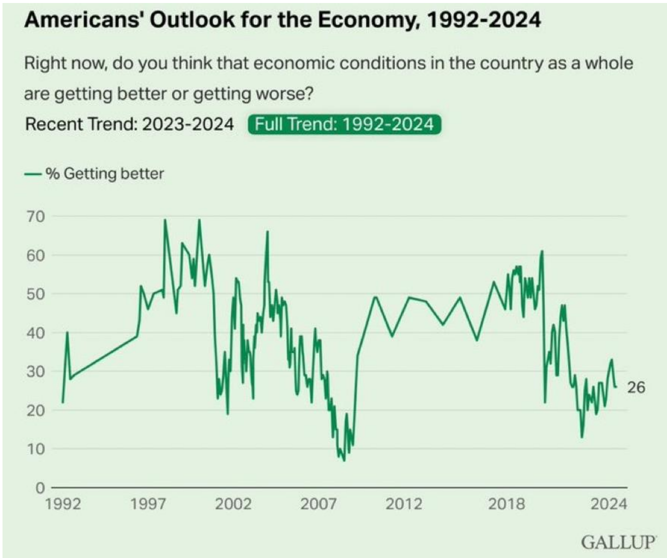
The reason for highlighting all of these extreme market setups is to point out that not only have we been here before but also that extremism does not last forever even though it seems like it will never end. When the worm turns, it can be quite brutal for investors who think trees (mega cap tech stocks) will grow to the sky or a single stock like Nvidia will continue to dominate market returns for years to come. The difficult and impossible part is knowing when the trend will end.

Let's finish with a review of some macroeconomic datapoints. In all likelihood, the U.S. will see more weakness in jobs data as we move into the back half of the year. Job gains have been cooling off over the past several months when taking into consideration the constant negative revisions to the monthly Non-Farm payrolls reports. The next chart shows the small business hiring intentions (blue line) compared to the unemployment rate (red line, left scale inverted). Small businesses are getting more cautious and reducing their hiring plans. The U.S. unemployment rate for June was 4.1% but we can see that based on the past relationship between these two variables the unemployment rate should continue to move higher in the months ahead and just as it has done in the past when small business hiring intentions rolled over.

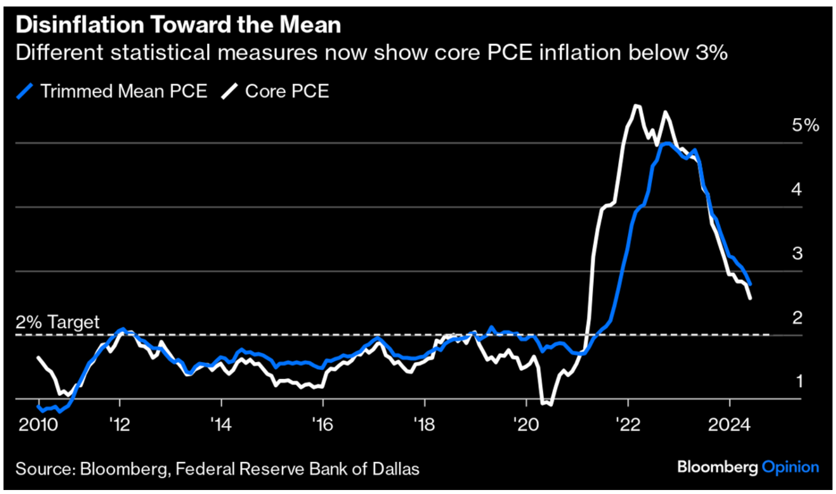


Bloomberg captures the latest economic readings and calculates an economic surprise index. As shown in the next chart, positive economic surprises peaked in late 2023 and have become more negative as 2024 has played out. The June ISM readings for manufacturing and services which came out during the first week of July are good examples. In the ISM surveys, 50 is the demarcation between growth and contraction. The ISM Manufacturing Index for June was 48.5 and has remained below 50 for 19 of the last 20 months. The ISM Services Index for June was much weaker than expected and dropped to 48.8 from 53.8 for May. The ISM Services PMI had been above 50 for 17 of the last 19 months and was last below 50 in December 2022. Services are a much bigger component of the U.S. economy so this latest reading below 50 will undoubtedly lower expectations for third quarter GDP growth.

Despite positive economic growth and a resilient jobs market, the latest Gallup poll of Americans' view of the U.S. economic outlook remains at low levels and took a turn lower in the latest survey. There is no doubt that elevated inflation in recent years has been a major negative factor on consumer sentiment towards the future.



The #1 focus of investors remains on the Fed and when it will be in a position to start cutting interest rates. It is not likely to occur at its July 31st meeting but the market is currently pricing in 75% odds the Fed will cut interest rates 0.25% at its September 18th meeting. Inflation data in recent months has moved lower but not at a fast enough pace for the Fed to have enough conviction to start cutting interest rates. Core PCE, the Fed's preferred inflation gauge, was 2.6% on a trailing 12-month basis and compared to the Fed's annual inflation target of 2.0%. As shown in the next chart below, inflation is declining and is approaching the Fed's 2.0% target. If the job market weakens further in July and August, which should also mean that wage growth weakens and exerts more downward pressure on inflation, then the Fed should be a position to start cutting interest rates by September.



Summary

Jan Brady had it tough as a middle child because everyone thought older sister Marcia could do no wrong. The stock market is similarly enamored with Nvidia and its CEO Jensen Huang. For the past year it's been all about Nvidia!, Nvidia!, Nvidia! and Jensen!, Jensen!, Jensen! U.S. stock market returns have become extremely narrow and the valuations of a select number of U.S. mega tech stocks have become rich. If you haven't owned the Magnificent 7 or index funds where their weights are the largest then portfolio returns during the first half of 2024 looked paltry in comparison. However, Jan eventually blossomed in her own right and Marcia's dominance eventually faded. The same is likely will be true of Jensen Huang and Nvidia's dominance of U.S. stock market returns. If the experience of Cisco Systems in 2000 or RCA in the 1920s is repeated, we may be at or near the peak of Nvidia's stock price dominance even if the AI revolution has many years to run. There is an old market adage that says never confuse a great company with a great stock.

With market risk, valuation levels, and investor sentiment all at the high end of history, and with a contentious election cycle ahead into November, it may be more important to manage risk than chase returns during the second half of 2024.

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July 10, 2024