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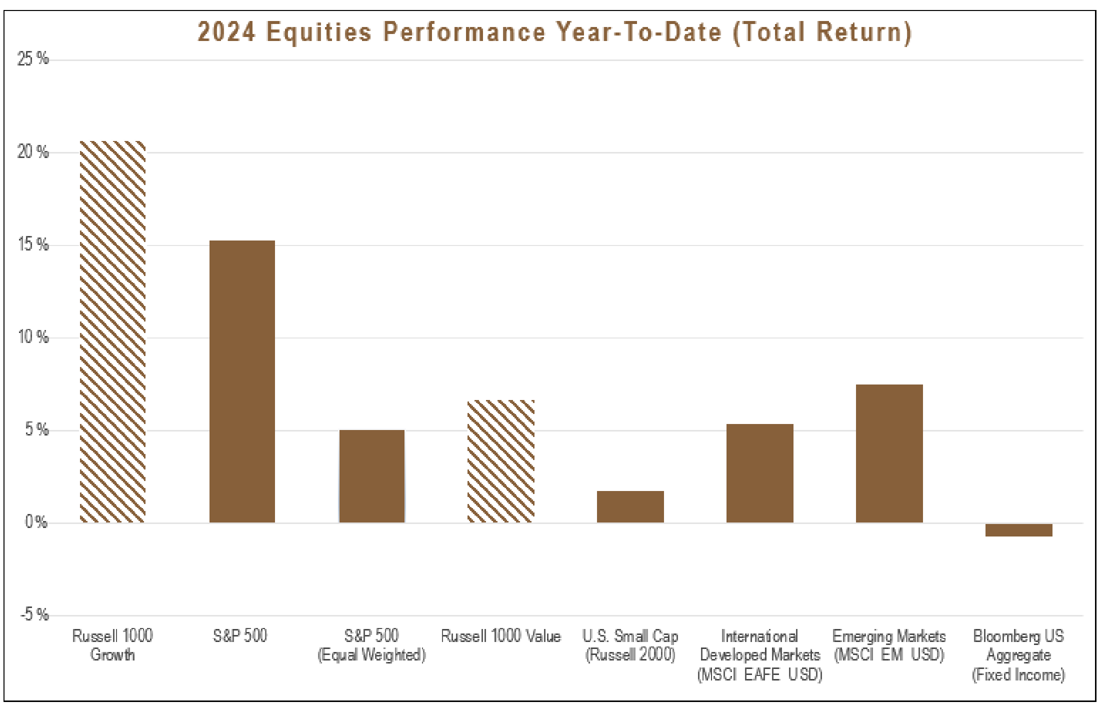
Red, White, and Bull: America's Stock Market is the World's Envy, Not NVIDIA

July 2024

Shortly after sending out our first quarter letter at the end of March, the equity market reversed on angst about inflation and rates. April was indeed an ugly month, with most corners of the stock market down about 4%. This sell-off proved short-lived as the near-term inflation outlook resumed cooling and the Artificial Intelligence (AI) phenomenon picked up yet more momentum, powering the S&P 500, Dow and NASDAQ Indices to new all-time highs through May and June leaving the S&P 500 Index ("S&P 500") up 4% during the second quarter. The market's gyrations this quarter serve as a reminder that not only does the interest rate outlook remain volatile, but the US economy remains resilient; with an extra dose of exceptionalism lately.

Notably, however, the broadening out of market performance that we cited in March has reversed rather dramatically. Since March, the Russell 1000 Growth Index is up over 8% while the Russell 1000 Value Index is down about 2%. Another popular measure is the difference between the market-cap weighted S&P 500 (SPX) and its equal-weighted version (the RSP) where each of the 500 companies has an equal share. The SPX is outperforming the RSP by 3x year-to-date (YTD) due to the greater size and performance of the mega-cap tech companies – thanks to the Artificial Intelligence (AI) phenomenon.



Source: Neuberger Berman, FactSet. Information as of 06/30/24

Amongst these giants, NVIDIA (NVDA) has been the indisputable star of the show, up a further ~40% since our March letter, and ~150% for the year so far. Thanks to this most recent move, concentration in the S&P 500 has reached an all-time high with the three largest companies Microsoft (MSFT), NVIDIA (NVDA) and Apple (AAPL) representing over 20% of the entire Index. For reference, peak concentration of the top three during the dotcom “bubble” of 2000 was 12% (Microsoft, Cisco, and General Electric). At its recent peak this quarter, NVDA had single handedly contributed over 30% of the entire S&P 500’s year-to-date (YTD)! This is an incredible amount for one company. In doing so, it momentarily surpassed both Apple and Microsoft in size. Over the last couple years, the market’s returns have concentrated around an ever-smaller group of names, from the “Magnificent 7” (Apple, Microsoft, Amazon, Alphabet aka Google, Meta aka Facebook, Tesla, and NVIDIA) to the “Fantastic 4” (Microsoft, Amazon, Alphabet, and NVIDIA) to the “Lonely One” (NVIDIA)… While we remain positive on the prospects for NVDA’s business (not a contrarian viewpoint), there is no denying that it has become a crowded investment which subjects it to greater volatility.

The reality, however, is that excluding the rise in stocks across the AI complex, the broader market is having a perfectly respectable year, up ~10% at the mid-year mark as shown in the chart below. This is in line with average long-term equity returns but is notable for defying rising US Treasury yields since December 31st.

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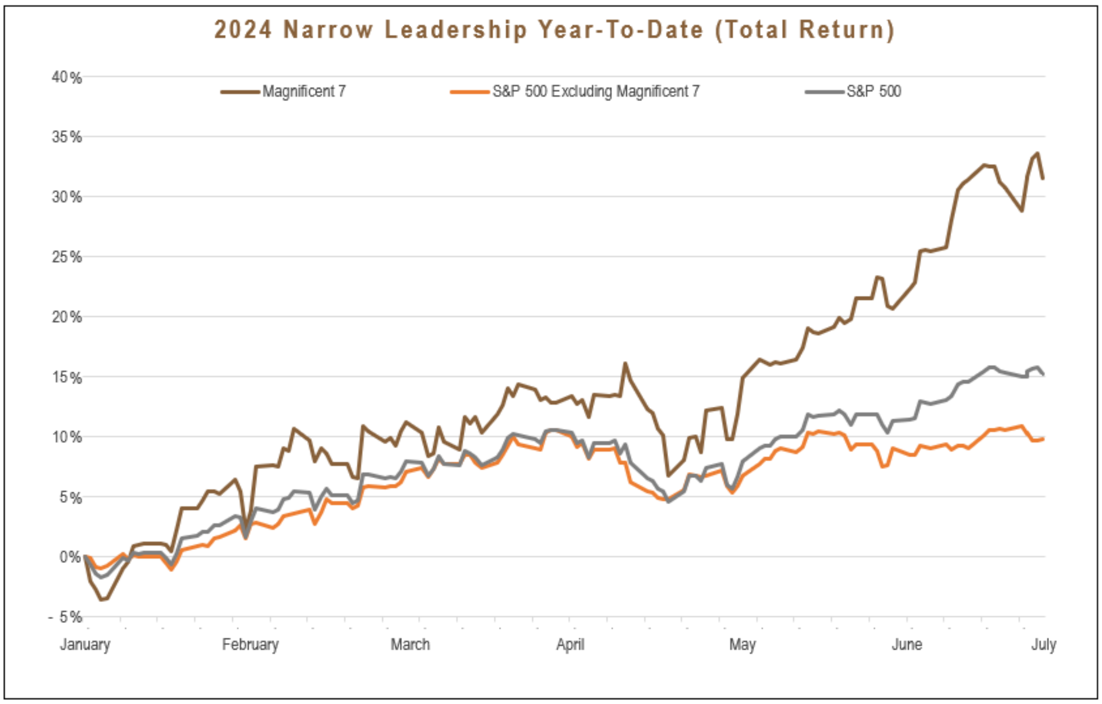

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The falling probability of Federal Funds interest rate cuts in 2024 has made it difficult for bonds to perform. As a result, the Bloomberg US Aggregate Bond Index, a proxy for broad bond performance, is down ~1% YTD. The June Consumer Price Index (CPI) reading (due in July) may have a pronounced impact on this short-term outlook. By then, the U.S. election will have taken center stage. Elsewhere in the world, a handful of the numerous recent elections have already presented surprises, such as Modi losing his majority in India, Taiwan electing a more assertive president towards China and Mexico lurching to the left while the hard-right advances coalitions in France. We are prepared for the second half of 2024 to provide even more volatility-inducing headlines than in the first half, especially with the most consequential election to US Markets of all, our own. That, however, does not change our view that the American economy remains the envy of the world – possibly more than ever.

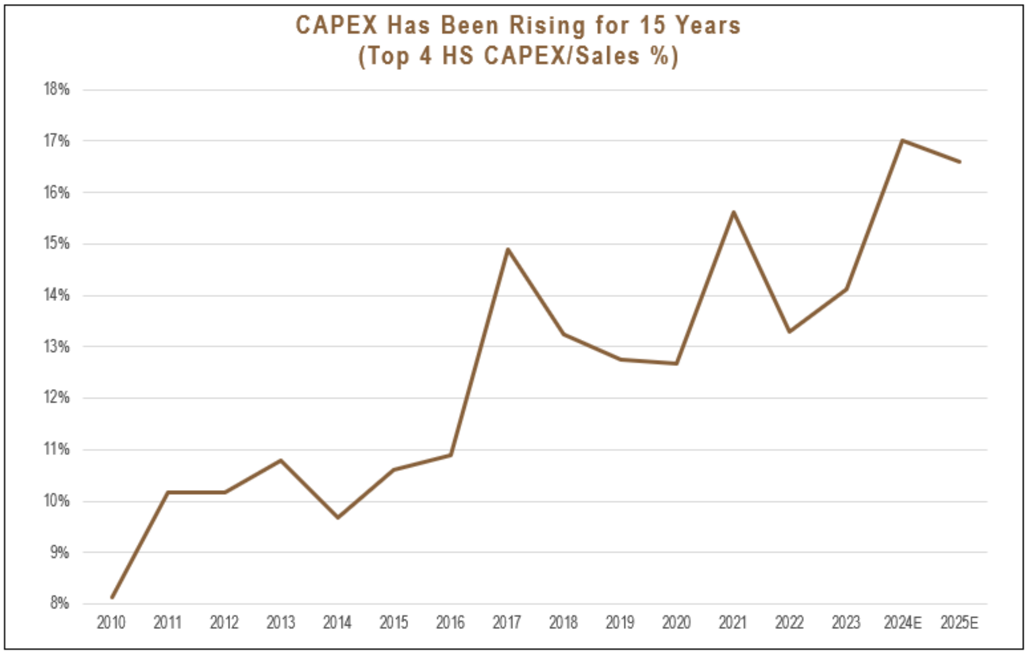
NVIDIA and American Exceptionalism

NVDA's hot streak marched on in the second quarter. In April, investors grew concerned about the company's ability to meet expectations for its May 22nd quarter. Earlier, Amazon, one of its largest customers, suggested it might defer chip purchases until the latest graphics processing unit (GPU) chip was released, thereby causing potential sales weakness for the current version. NVDA's quarterly results proved no such thing. Shortly thereafter, the company formally announced Rubin, its successor chip. Then OpenAI released its latest version of GPT, called "4o" which showed GPT solve a linear equation problem that was written on a piece of paper (very impressive). Later in June came Apple's AI-enhanced Siri and Elon Musk's xAI initiative. These, and several other notable announcements kept the AI fire burning as bright as ever during the second quarter.

Since our last letter, NVDA added $1T in market cap before retracing somewhat. In doing so, it momentarily became the largest company in the world and the 12th in the S&P 500's history to take the crown. Shockingly, 2/3 of NVDA's total market cap has been added since December 31st. So, it is not surprising that its P/E has also expanded from the mid-30s to the mid-40s – not "cheap", but significantly lower than the multiples observed during the dot-com bubble. This is especially true on an earnings growth-adjusted basis. That said, we are cognizant that such rapid and powerful moves are often followed by a period of "digestion" and we expect the stock to become more volatile going forward.

NVDA is forecasted to generate $120b+ of revenues in 2024, of which $100b is for datacenters (AI GPUs). Its primary customers are the other mega-cap tech companies, or "hyperscalers" (HS) as they are often called. Specifically, there are four companies, Microsoft, Alphabet (Google), Amazon and Meta (Facebook) which account for up to 50% of NVDA's datacenter sales. Put another way, these large customers will spend nearly $200 billion on computer equipment in 2024 which is about 30% more than they spent in 2023. The number has consistently grown as the year has progressed. Even more impressive is that NVDA is capturing up to 50% of those expenditures. If that share seems high, it is because the "accelerated" computing systems that NVIDIA has pioneered for the modern AI enabled datacenter represent a revolution akin to diesel engines replacing steam engines in the late 1800s; and they consists of much more than the GPUs it is famous for. As a result, its system is far superior to that of its competitors and customers whose core competencies are not chip development. It is therefore looking increasingly possible that the existing $1 trillion worth installed datacenter computing hardware could ultimately be replaced with new accelerated systems, providing ample runway for growth.

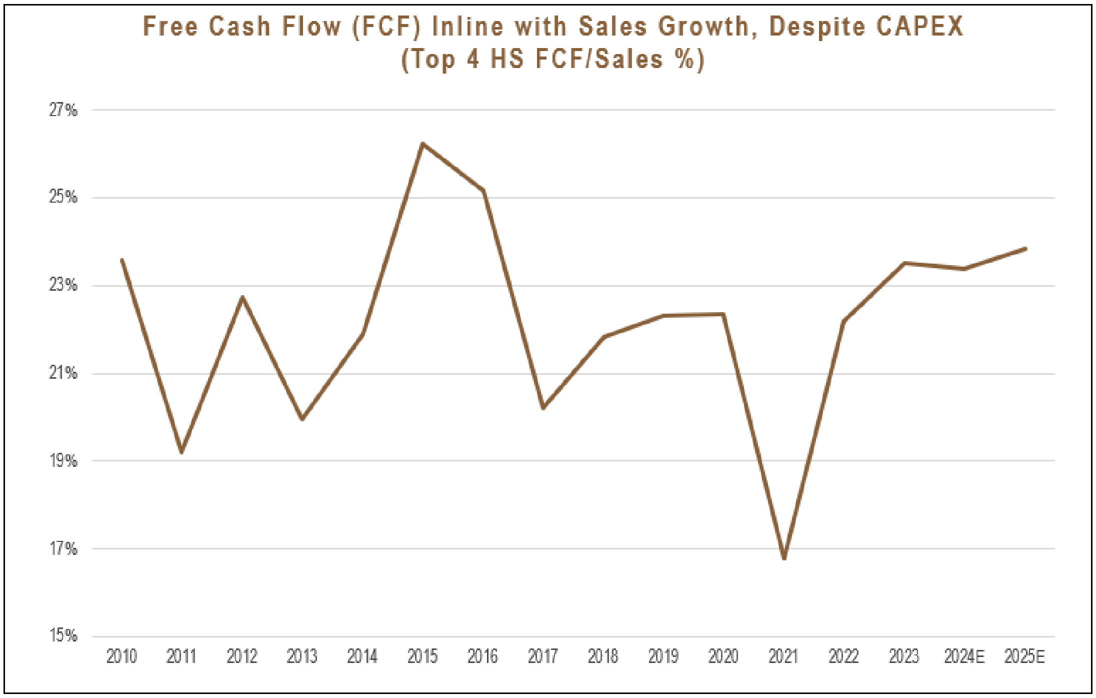
Is this spending sustainable? The chart below depicts the average equipment expenditures ("capex") to sales ratio for NVDA's top four (4) customers (Microsoft, Alphabet, Amazon, and Meta). It shows that while recent capex growth has been impressive, it is essentially in line with the 15-year trend. The reason for this is that these top customers have evolved from pure software businesses to "compute as a service" which is much more capital intensive. NVDA has been a two-fold beneficiary of this trend: first by its rising level and second by capturing more of it.



Source: Neuberger Berman, Bloomberg. Information as of 06/30/24

What about returns for NVDA's customers? On this front, it is still early and therefore not fully apparent what the commercial monetization model will be. However, the potential has become clear to many. Microsoft is beginning to roll out CoPilot for Office, which is the most high-profile AI monetization project. There will soon be many more in the fields of science, law and accounting to name just three of a myriad vertical where AI systems can be specifically trained.

We are mindful, however, that the law of large numbers will ultimately catch up to NVDA. The higher its price and valuation go, the more sensitive the stock will become – especially given the speed of its ascent. And of course, competition can change suddenly, not to mention other thorns like geopolitics. Ultimately, however, we continue to view NVDA's position favorably even as the next chapter of AI will center on monetizing the tech's potential. Fortunately, however, its hyperscale customers are not only demonstrating impressive sales growth but also stable and rising free cash flow (FCF) margins (as shown in the chart below) and this includes their enormous capex spending.



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Beyond NVDA, the AI phenomenon has boosted the fortunes of adjacent industries such as industrial component providers, power utilities and energy companies. These are all areas that we have researched extensively given our thesis that the next leg of economic prosperity in America will rely more on infrastructure, industrial and energy supply – all of which we believe will be more effective at combating structural inflation than merely raising interest rates.

Despite the current AI mania, we believe the American economy is still in the early innings of an industrial re-awakening that may reduce its reliance on the consumer, which still represents ~70% of GDP. This comes at a time when broad consumer and labor metrics are beginning to normalize after four (4) years of exceptional performance causing some market watchers to warn that a recession could be percolating.

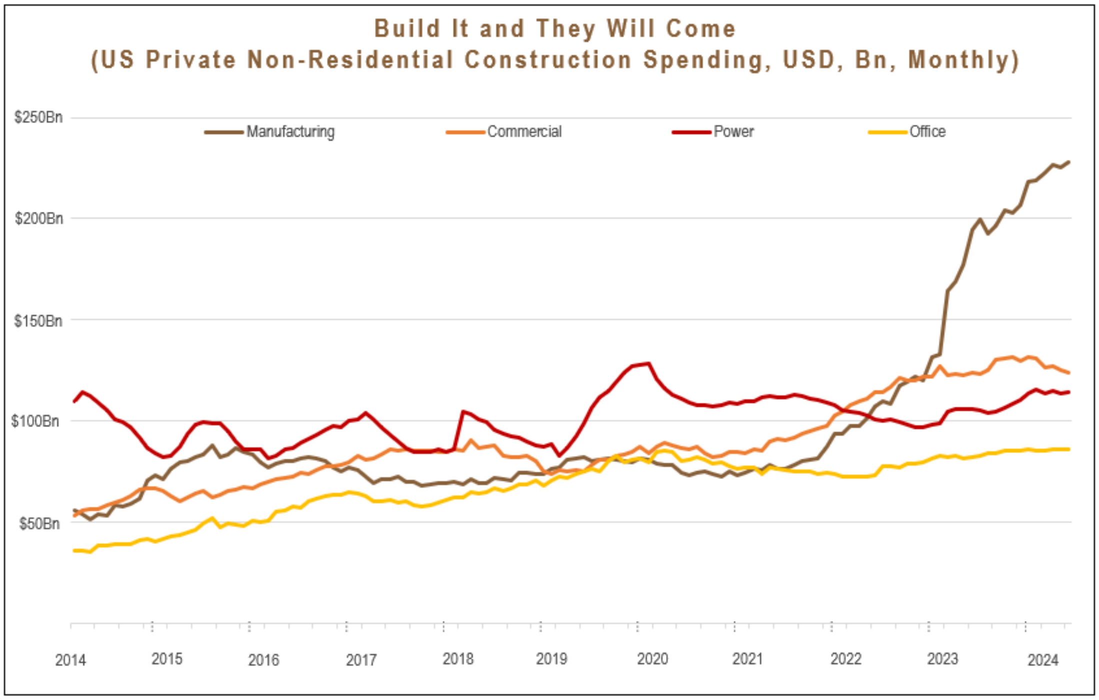
Mixed Signals

We believe that recession forecasts continue to be premature and the economic data are more varied. Recent quarterly results amongst consumer bellwethers have been mixed. For example, McDonalds and Starbucks reported weaker-than-expected sales suggesting mid/low-income consumers have depleted their excess pandemic savings and are finally shifting behavior due to persistent inflation. An $18 Big Mac combo got a lot of attention on the internet this spring… The weak quarter at Starbucks also supported the view that Americans are beginning to retrench on discretionary spending. Wal-Mart and Costco, on the other hand, reported continuing strong sales growth (including volumes) suggesting that staples categories are benefiting from consumers trading back from out-of-home eating to in-home. The data is somewhat inconclusive, however, as other discretionary food concepts like Chipotle, Cava and Sweetgreen have been very strong, and other staples concepts like the dollar stores have remained very weak.

Meanwhile, consumer credit delinquencies continue to rise, although from an abnormally low post-pandemic level. Auto loans are one exception, where the surge in vehicle values in recent years have combined with rising rates and painful insurance premiums has lead to a dramatic increase in the cost of auto ownership, and caused some consumers to fall behind on their payments. On the other hand, overall delinquent debt as a share of consumer disposable income is not elevated and credit spreads across corporate debt remain near record lows – indicating a high degree of confidence amongst bond investors. There are even more mixed signals... While workers are no longer quitting their jobs at abnormally elevated levels (a bullish indicator) new business applications remains around 400,000/month, as compared to ~300,000 prior to the pandemic reflecting a dynamic economy.

These seemingly contradictory metrics are each subject to interpretation. To us, they simply reflect ongoing normalization throughout the economy after four (4) years of unusual patterns. In our minds, the bigger economic story centers around the continuing rise of the American industrial base which we believe will continue no matter the election outcome in November.

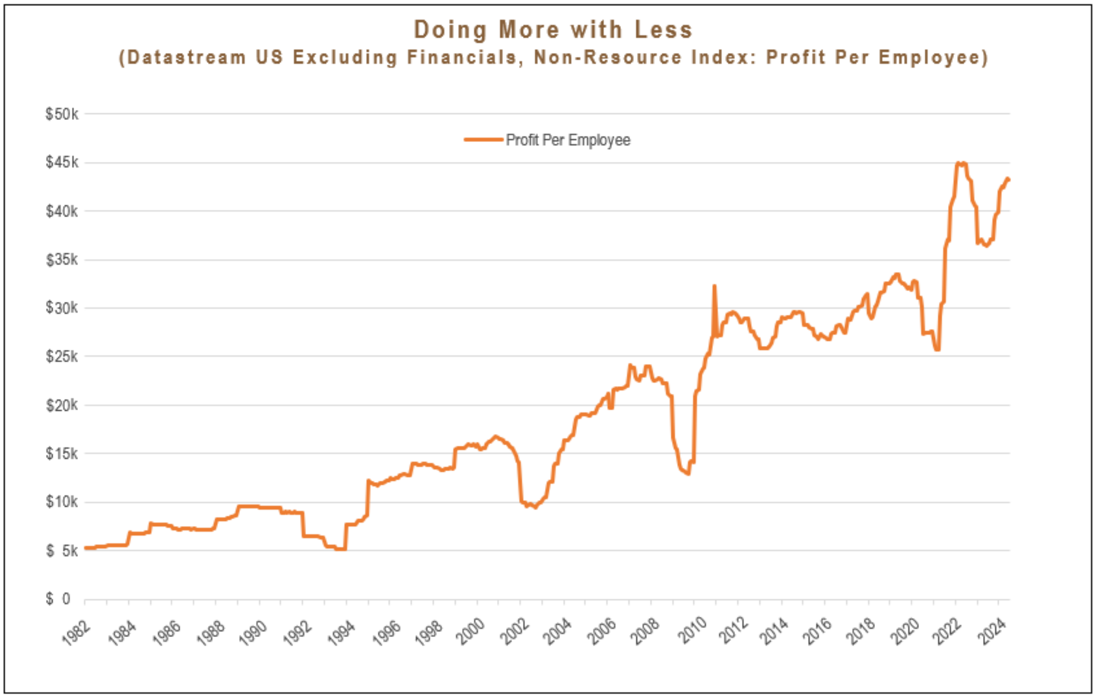
The chart below shows that manufacturing related construction has recently exploded. This comes after nearly 30 years of lackluster advancement. Manufacturing construction now accounts for 30% of total non-residential construction spending, up from 15% pre-pandemic. We believe there is a much more significant multiplier effect to a dollar of manufacturing spending than there is in other areas of the economy and therefore expect this trend to have a meaningful positive echo for years to come.



Source: Neuberger Berman, PGM Global, US Census Bureau, Bloomberg. Information as of 06/30/24

Furthermore, we see opportunities in other areas of non-residential construction besides manufacturing. Specifically in power (the red line) where the demand for electricity is now expected to inflect from a meager +0.5% annual growth rate to over 2% annually through the end of the decade. This is due to rising penetration of EVs, the electrification of industry, as well as new large-scale manufacturing capacity being added, not to mention the massively power-intensive AI-centric datacenters under construction. This new power demand outlook represents a dramatic change, and one that we believe will present sizeable opportunities.

While we remain positioned to benefit from these medium and long-term trends, the markets are now grappling with the implications of elevated concentration as well as confusion around the overall health of the consumer. As we pointed out, however, we believe NVDA's performance has been justified by its financials and that the remaining 499 stocks in the S&P 500, while overshadowed, have performed very respectably. For this, we can thank resilient corporate profitability propelling analysts' upward earnings revisions for companies in the broad Russel 1000 Index. Specifically, as of May, the number of upgrades exceeded downgrades by 15%, up from a 3% difference in January. This improved profitability comes at a time when companies are becoming less reliant on raising prices as inflation cools. The chart below shows profit PER employee near record levels. More importantly, the long-term trend has been very consistent, and is not one we would bet against.



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Over the long term, companies have systematically found ways to extract efficiencies. In the short term, we believe companies still possess expense reduction opportunities after four years of chasing revenue growth which should further bolster earnings in the coming quarters. It is important to remember that profitability, growth and prevailing interest rates are all important factors underpinning P/E multiples. While rates remain higher-for-longer, profitability and growth have exceeded expectations such that they have offset the impact of rates. To us, this improved outlook justifies the market's expanded P/E from the beginning of the year, and should upward revisions continue, there is scope for further gains.

We believe the exceptionalism of our economy matters far more to our markets than the fractured political discourse. That's not to say there won't be waves. Of that, we are certain. We expect the Trump v Biden contest to move center-stage for the duration of the year, and for it to remain close to the very end. Trump is teasing further tax cuts but threatening to repeal some if not most of Biden's stimulus programs. Markets are not anticipating major cuts as these would be difficult to repeal. On the other hand, tax cuts could exacerbate inflation and the deficit, for which neither candidate has a credible plan. Biden is proposing raising corporate taxes, which could negatively impact earnings, but we doubt Democrats will obtain the necessary majority to do so. We are prepared for a multitude of other geopolitical and social topics to fuel a dizzying set of headlines. Fortunately, the foundation of the American economic system seems to have weathered this storm impressively well so far.

We have written extensively in our past letters about the possibility that inflation will remain structurally elevated, albeit with cyclical dynamics. The supply factors which ultimately govern prices are simply too tight. These center around labor, housing, demographics and infrastructure. In addition to these forces, we continue to watch the US government debt and the rising risk that funding it could cause interest rates to rise as the Federal Reserve (the "Fed") plays a diminished role in purchasing Treasury debt. Beyond the current disinflationary cycle, we see a meaningful chance that the Fed will ultimately abandon its 2% inflation target – especially because is beneficial to a heavily indebted government. We remain positioned for these possibilities and believe U.S. equities should continue to perform well in the face of these challenges – particularly given they are a primary means to participate in American ingenuity – the object of the world's desire. Is it a coincidence, then, that the name of our newest mega-cap company is Latin for the word "envy"?

The most important decision for your hard-earned capital is asset allocation. Strong runs in the equity markets are a good time to reassess your current position and consider where the next few years will take you and your family. We are always here to assist in planning for the best possible balance of risks in the markets, with the potential reward of capital appreciation and income.

Best regards,

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