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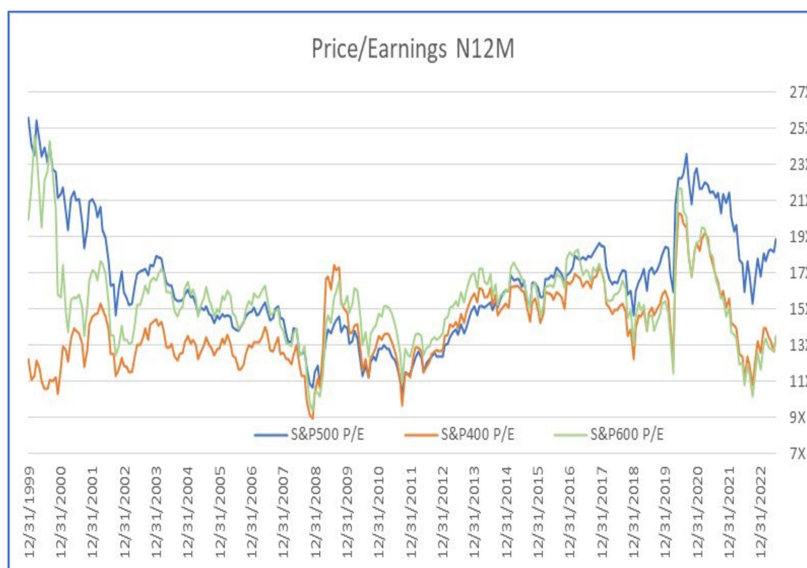
ASSET MANAGEMENT

John's Market Outlook – June 27, 2023

Last quarter we started with banks; this quarter we'll start with artificial intelligence ("AI") and it will be a little more complicated.

The type of AI called "machine learning" is well established in specialized uses. Earlier this year, OpenAI publicly released ChatGPT, a general-purpose large language model ("LLM") type of AI. Anyone can type into their internet browser and ask the LLM to find a hotel, make a list, answer a question, write a poem, or just "converse" about whatever. The response can be entertaining, useful, and (*cautionary note*) often wildly inaccurate. MSFT and GOOG are investing heavily in LLMs Bing (MSFT/OpenAI) and Bard (GOOG). LLMs have also been developed by META, AAPL, IBM, and many startups. In addition to their own capabilities, LLMs can be an easy-to-use user interface to other AI and non-AI applications. LLM uses in customer service, healthcare, business processes, coding, design, games, social media, etc have software companies jumping on the bandwagon. LLMs are compute-intensive, benefiting cloud computing providers (AMZN, MSFT, GOOG) and semiconductor companies (NVDA, AMD, MU, etc). Businesses may someday reduce costs with LLMs; for now, investors are only focused on AI providers.



The result was a sudden jump in the largest technology stocks that left the broader market lagging. In the second quarter so far, the S&P 500 is up 6% with almost all of that from the 7 largest tech names which are now 22% of the index.[1] The narrow rally has taken the S&P500's valuation and concentration to highs reminiscent of 2001 (see chart). Mid-cap (S&P400) and small-cap (S&P600) stocks, largely bypassed, are at historically low valuations, as are many other S&P 500 stocks outside of big tech.

[1] Year-to-date, 7 names represent over 100% of the S&P 500's gain, with the rest of the index flat.

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The Federal Reserve did not raise rates in June, but expects to raise rates by 0.5% later this year. Inflation remains far above the 2% target with "core inflation"[2] not responding to higher rates. The Fed is pausing to see if bank credit contraction will slow the economy and if wage growth and housing costs will weaken. Like other central banks[3], the Fed will resume rate increases if inflation fails to slow significantly this summer. The US government raised the federal debt ceiling. The compromise will remove some stimulus, via spending caps and the end of student loan forgiveness.

The economic picture remains mostly negative, with a possible positive. Leading economic indicators continue declining. The labor market remains very tight. Headline CPI is slowing, but core inflation remains over 5%. The yield curve is increasingly inverted. See the Appendix for charts.

The possible positive is that S&P 500 earnings estimates *did not decline* this quarter. After falling every month since last spring, consensus estimates for 2023/2024 were unchanged over the last couple months. Investors are watching to see if earnings resume declining or start rising when 2Q earnings are reported next month. If earnings growth re-accelerates, we'd have to evaluate whether it is a durable inflection in the economic cycle, or temporary.

Portfolios still have very substantial "dry powder", in Treasury bills and money market funds, which yield over 5%/yr with almost no risk. These "pay us to wait" for better market opportunities. I still look to purchase quality assets at reasonable prices later this year.

As for sectors and asset classes:

- The US remains favored, along with closely-linked Canada and Mexico. Positions in Mexico include Wal-Mart de Mexico (WMMVY) and Fomento Economico Mexicano (FMX). Japan's recovery is taking hold; positions added include Sony (SONY), Tokyo Electron (TOELY), and Tokio Marine (TKOMY).
- Europe's recovery is slowing; our names there are mostly defensives such as Danone (DANOY), Coca-Cola Europacific (CCEP), and Roche (RHHBY). China's recovery is stalling, with the government reluctant to add stimulus due to China's debt load (higher than US).
- Mid-cap and smaller stocks offer significantly more attractive valuations than large-caps (see chart above). Many energy, real estate, and consumer names look particularly cheap.
- New healthcare positions include Lilly (LLY), while exited names include Dow (DOW), Expeditors (EXPD), and PVH Corp (PVH).
- I have added to technology names, where valuations are reasonable; adds include Salesforce (CRM) and NXP Semi (NXPI). We hold most of the big tech stocks (MSFT GOOG META AMZN etc), but less than their S&P 500 weight.
- Banks remain mostly a "wait and see", as regulators may force large banks to raise capital.

I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Thank you!

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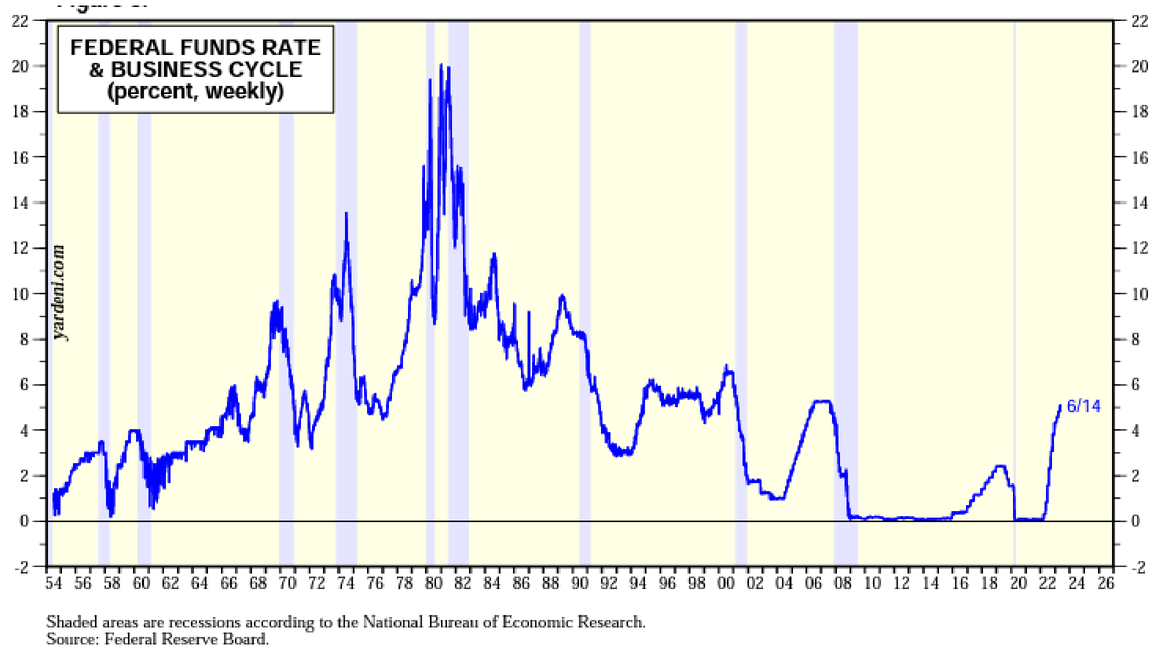
[2] Core inflation omits food and energy. Its largest parts are services (wages) and housing (rents, prices).

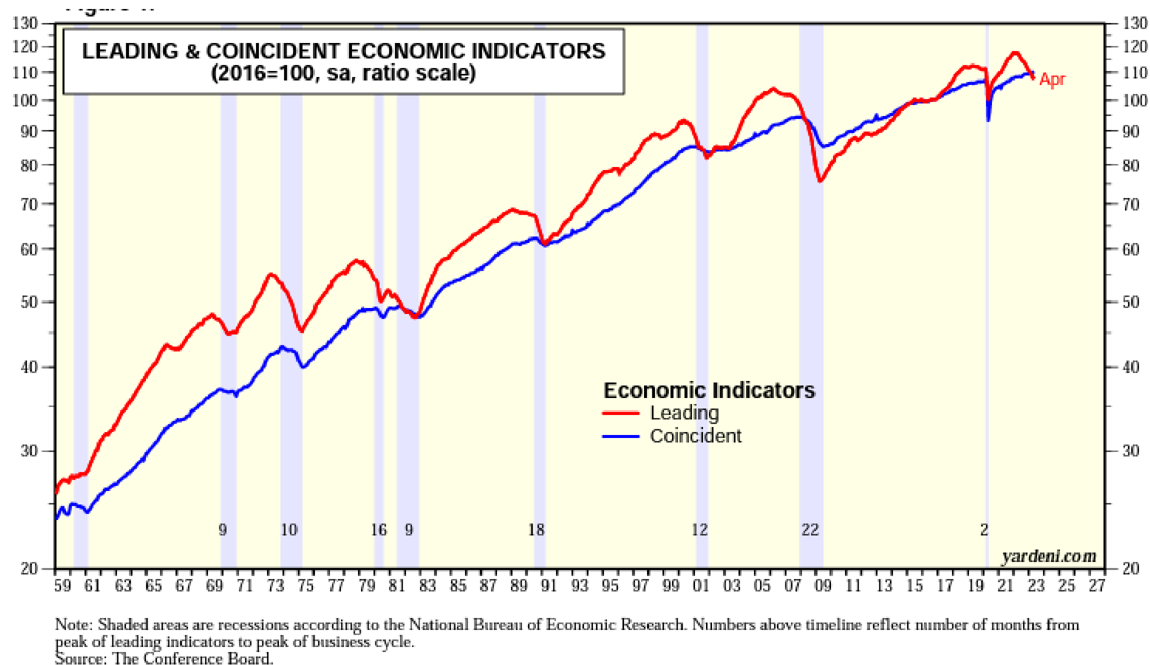
[3] The Banks of Canada and Australia resumed rate hikes after pauses. The Bank of England accelerated rate hikes.

APPENDIX TO MARCH 2023 OUTLOOK – SELECTED CHARTS AND TABLES

The Fed funds rate is still at 5.00-5.25%. The Federal Reserve "paused" rate increases in June, but expects to raise rates to 5.50-5.75% by the end of this year.

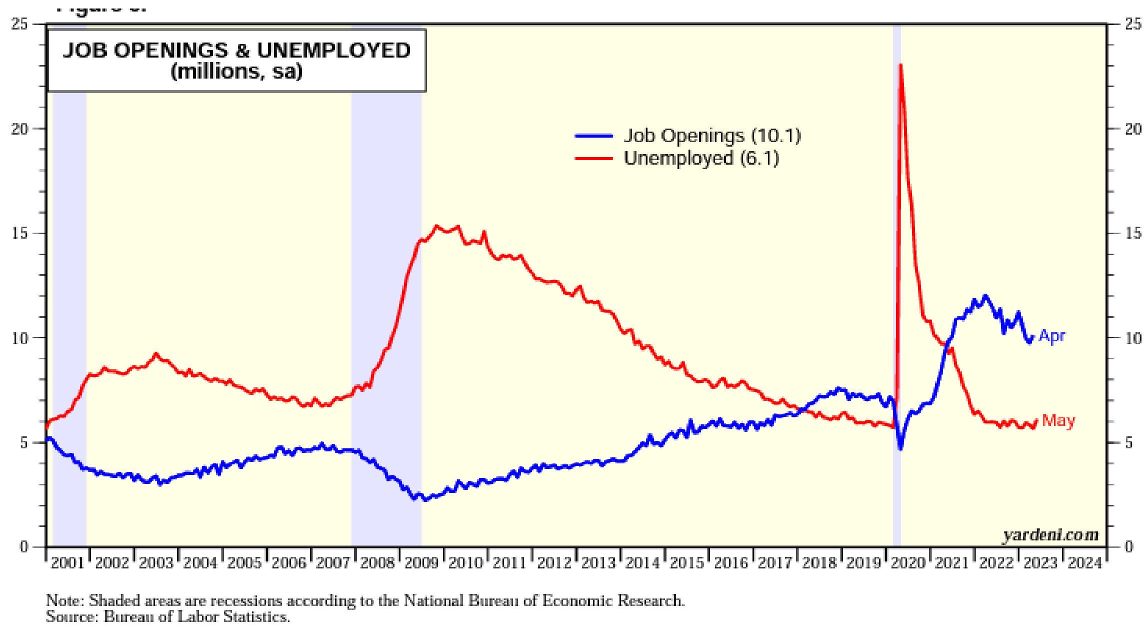


Leading economic indicators (red) have fallen further.

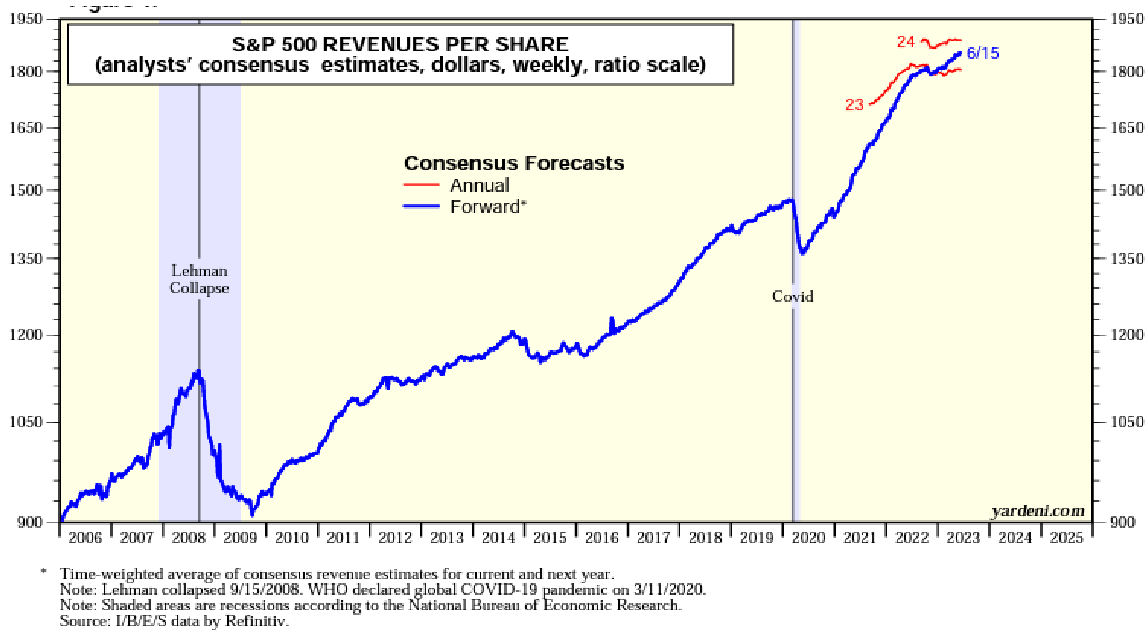


Coincident indicators represent the economy as it is now. Leading indicators represent the economy as it is likely to be in the future. The shaded periods are recessions.

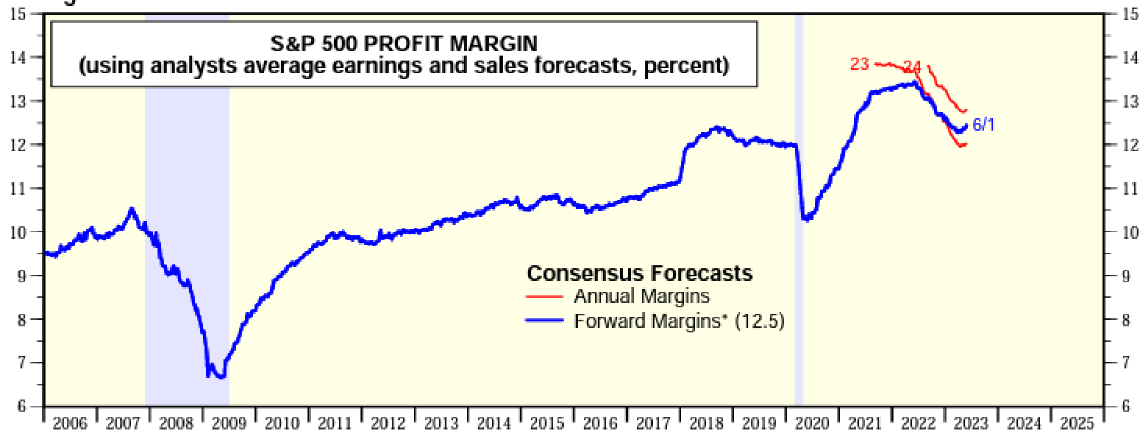
The job market has softened in recent months (job openings down, unemployment up a bit), but remains very strong with more open jobs (blue) than persons seeking work (red).



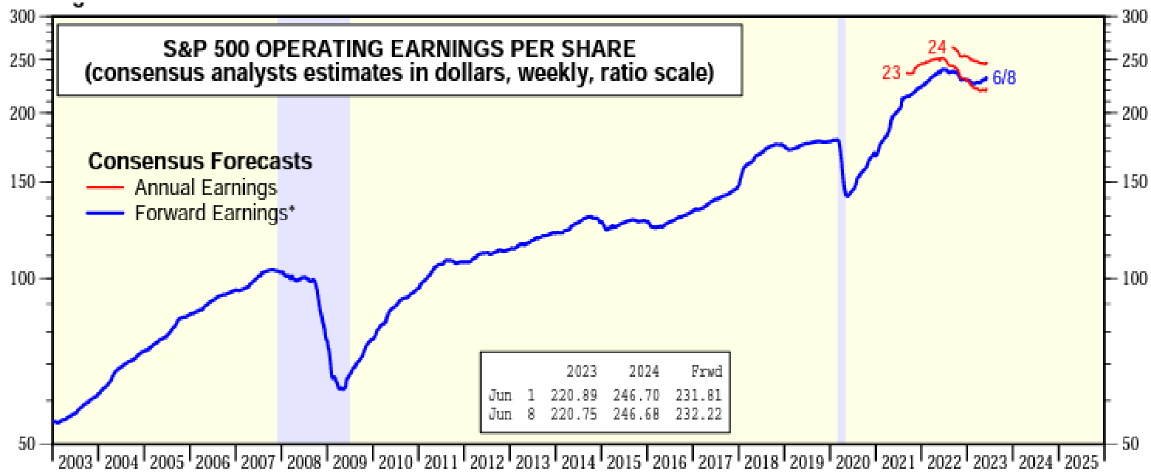
S&P 500 consensus forecasts have flattened out in the past quarter.



The chart above shows forecast **revenue**. Red lines show progression of forecasts for calendar years 2023 and 2024. The blue line shows the "next 12 months" forecast. The 2023 forecast has flattened; 2024 forecast has improved. Inflation is supporting revenues - most of the forecast decline is margins and earnings, as shown next.



S&P 500 profit **margin** rose to record highs during the pandemic. That gain is temporary. Margins have been falling toward pre-2020 levels. In the last month margin estimates have ticked up. In a moderate recession, should fall further.



	2023	2024	Frwd
Jun 1	220.89	246.70	231.81
Jun 8	220.75	246.68	232.22

Forecast S&P 500 2023 **earnings** declined to $221 in March, and have flattened there in the past quarter. That still implies +2% growth over 2022. In recession years, earnings typically declines -10% or more. A *very* mild recession or mid-cycle correction may see earnings flattish.

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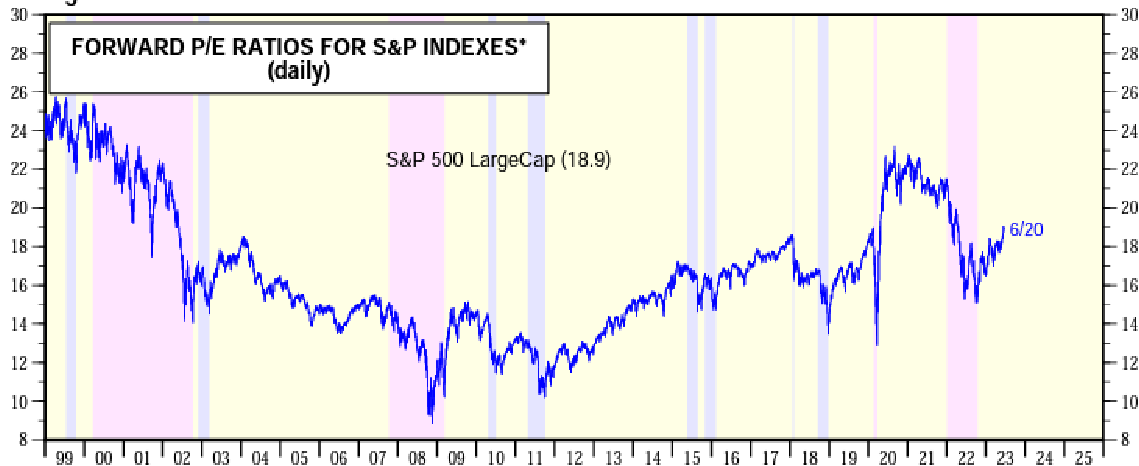
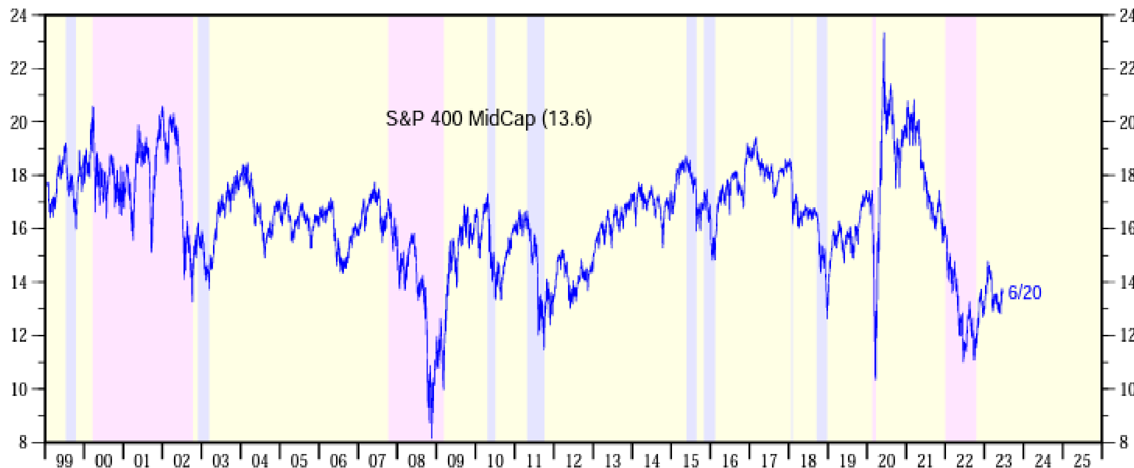
The S&P 500 price/earnings ratio had declined to the pre-pandemic range (15-17X), but in the last quarter jumped up to 19X. Other than the Covid years, this is the highest valuation since the 2000s.



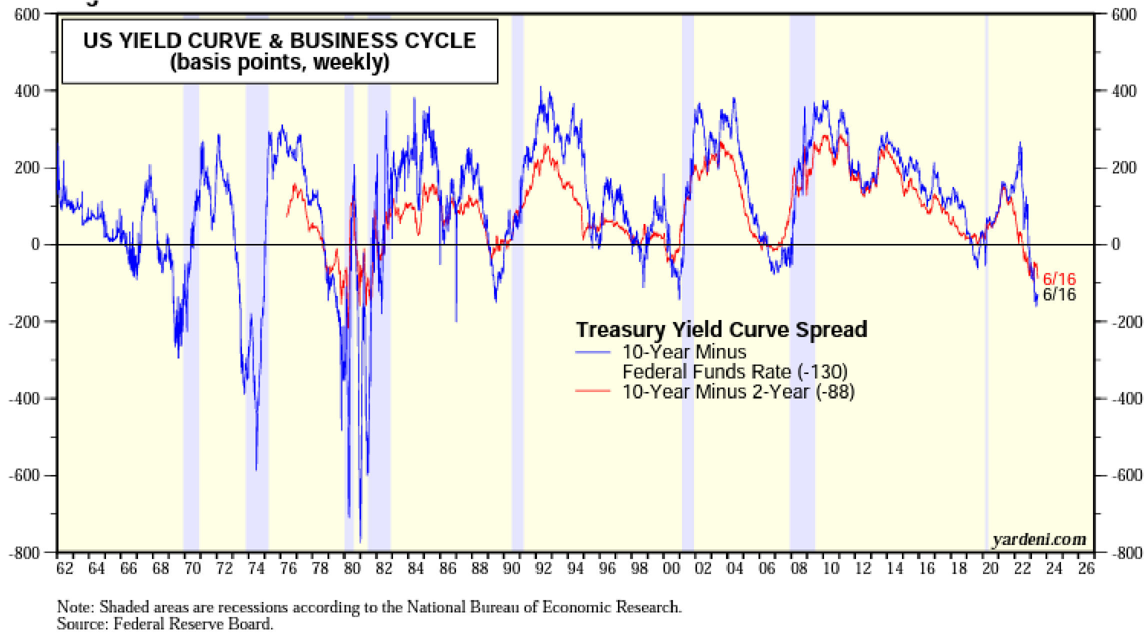
Since the S&P 500 has climbed by about +7% in the past quarter, while forecast 2023 earnings is unchanged, the market has gotten *more* expensive in recent months.

For mid-cap and small-cap stocks (S&P 400 and S&P 600), the price/earnings ratio is still very low.



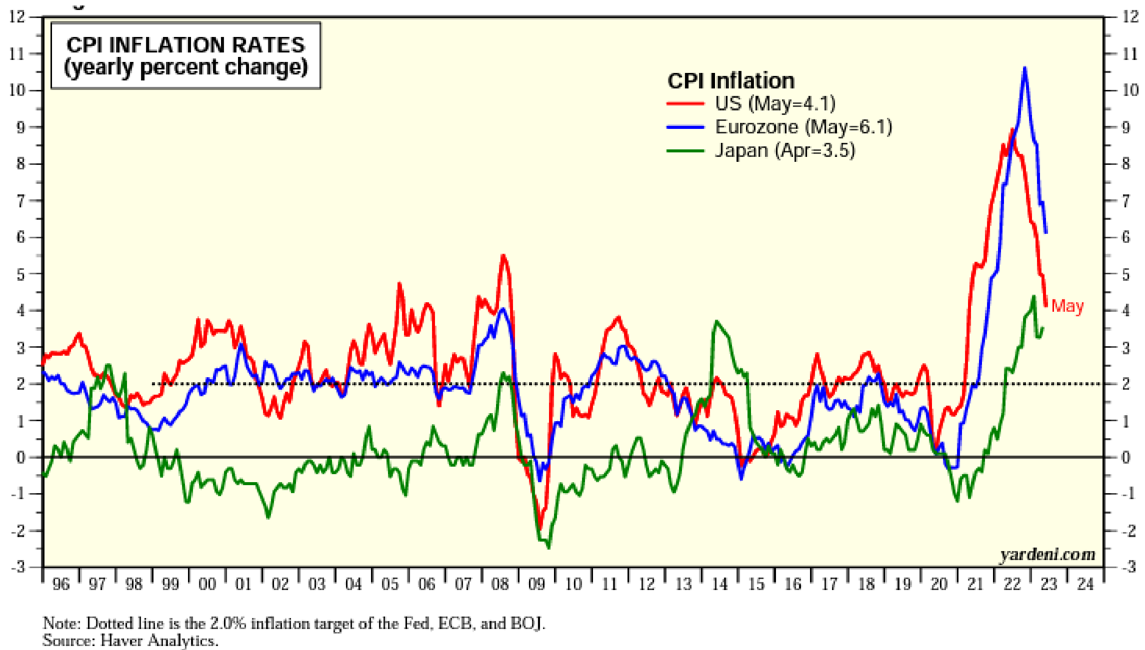
Large company stocks are generally expensive, mid-size and small company stocks are generally cheap.

Yield curve inversion, historically a reliable recession indicator, is increasing.



"Inversion" means long rates are lower than short rates. After a March pause, the inversion deepened. Inversions stress the banking model of borrow short and lend long, and thus contribute to recessions as well as being an indicator.

US inflation has declined sharply, but remains high.



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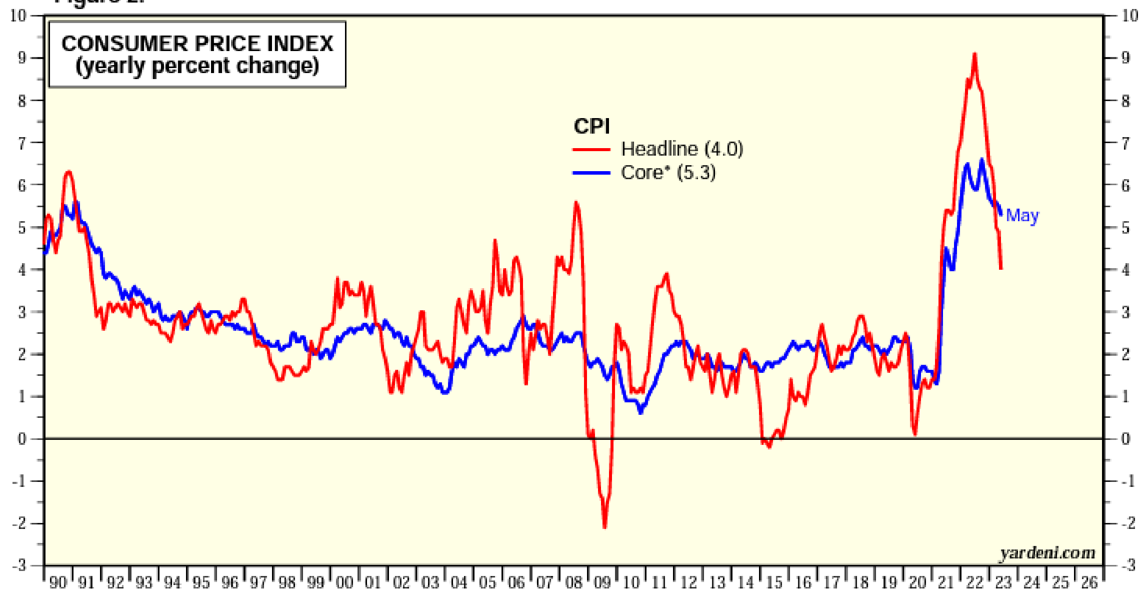
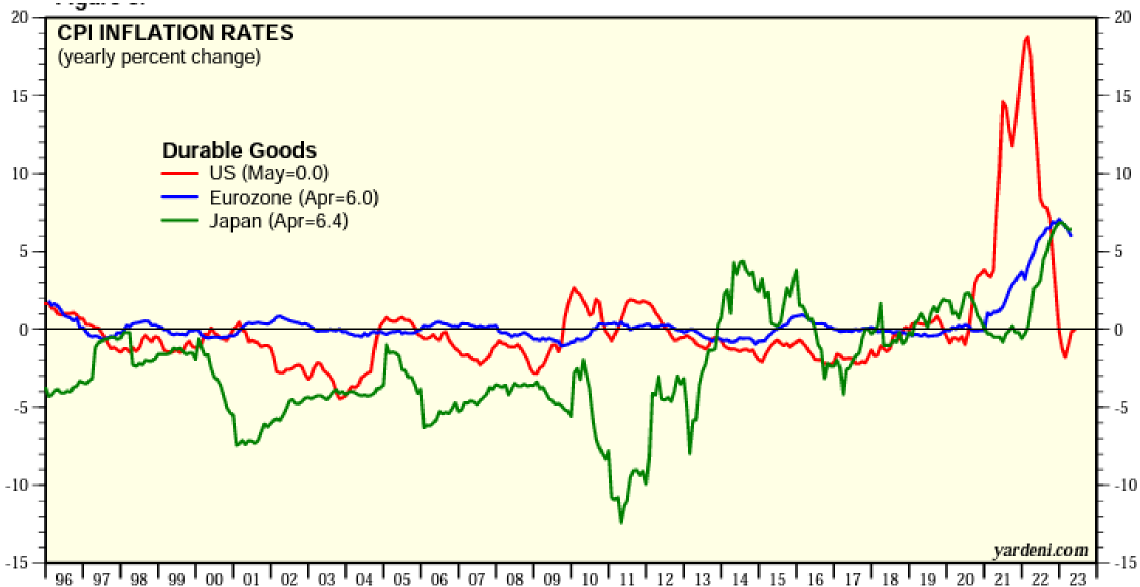
The US and Europe are making progress on reducing inflation, with US “headline” CPI down from almost 9% last year to 4% now. The Federal Reserve’s target is 2%.



* Excluding food and energy prices.
Source: Bureau of Labor Statistics.

Falling “headline” inflation is good, but the Federal Reserve focuses on “core” inflation (excluding food and energy) which remains over 5%.



Source: Bureau of Labor Statistics.

Durable “goods” inflation has picked up slightly to “neutral” in the US and is starting to peak elsewhere.

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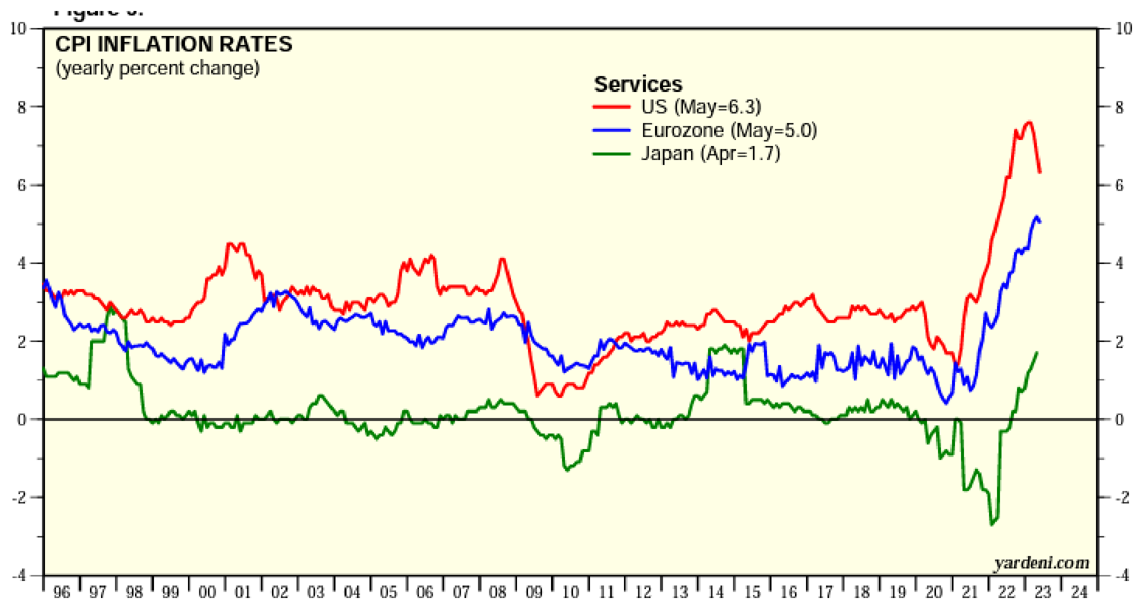

"Services" inflation has peaked in the US, and is still rising elsewhere. Services inflation is driven by wages and housing ("rent"). US rent inflation is *very* high but may be peaking.