

Equities: Frothy, But No Bubble

April 2024

The S&P 500 Index ("S&P 500") rose nearly 11% in the first quarter. A strong start to the year — in fact, even stronger than last year. The key drivers are the continued performance of a few stocks, primarily those benefiting from the Artificial Intelligence (AI) theme (more on that later). Conversely, bonds have had a rough start to 2024. Expectations for a rate cut from the Federal Reserve have evaporated due to hotter-than-expected inflation. Broad bond market indices (the Bloomberg U.S. Aggregate Index) declined by 0.8%. As with every quarter, there were many moving parts, but in some ways, not much changed from last year. We share our analysis on why the stock market is not in a "bubble," what we believe are the key market drivers (spoiler alert: it's earnings growth), and how we handicap some of the risks in the market today.

Voting Season?

"In the short run, the market is a voting machine but in the long run, it is a weighing machine." This adage from value investor Ben Graham means that investor emotions can influence stock prices in the near term, but ultimately, earnings and returns determine their actual economic worth. Currently, markets are exhibiting palpable enthusiasm for AI. Except for a few select areas, however, we are not convinced there is sufficient evidence to characterize the entire market as being in a "bubble."

To speak about the "market" in aggregate does not provide enough context, as there are really three markets: the momentum market, the broad market and the value/dividend market.

The momentum market is benefiting from excitement around Artificial Intelligence. Many companies involved in this area of the market have seen a combination of multiple expansion and growth in earnings expectations. The hype around this theme is reaching lofty levels; nearly 40% of all S&P 500 companies mentioned the words "artificial intelligence" on their most recent quarterly conference calls, the highest on record.

We believe that AI and other large language models are very helpful tools that are likely, in time, to lead to tangible cost savings and revenue opportunities for many companies. However, the trend is still very early, with only a handful of companies seeing actual earnings benefits. The scene is reminiscent of the dotcom bubble, which centered on investors' enthusiasm for how the internet would unleash incredible new business models. This prediction would ultimately prove to be true, but it took a further 10 years for Apple, Microsoft, Google, Amazon and Meta (Facebook) to hit their stride. Recently, financial commentators have compared NVIDIA (NVDA) shares today to Cisco (CSCO) shares in 1999 – 2000. Combined with Bitcoin surging through \$70,000 and the Nikkei (Japan) breaking through its 1989 peak, the word "bubble" has crept into the daily lexicon. The parallels appear convincing on the surface, especially since AI isn't yet making anyone much money except for NVIDIA. To us, however, this is a superficial reaction.

NVIDIA and the AI Bonanza

NVDA shares rose more than 80% in the first quarter! (And that is after +239% in 2023!) The company's market capitalization surpassed first Google, then Amazon; it now trails only Microsoft and Apple. In February, NVDA posted strong quarterly earnings, beating estimates by 10% and sending the stock up 15%. This surge represented the most market capitalization ever

added in a day by any company (\$276b), surpassing Meta from just one week earlier. It was NVDA's second most important quarterly earnings after its famous May 2023 release, when it beat expectations by three times. Herein lies the key difference between NVDA today and CSCO in 2000.

We acknowledge that they are both equipment providers to a pivotal new technological movement (the "internet" in 2000 and "AI" in 2024). Their one-year stock charts ending on their peak price bear a striking resemblance. And they've both reached a similar level of popularity among investors; but note, however, that CSCO's peak multiple in 2000 was 149x earnings. NVDA, in contrast, is trading at 33x next 12 months' EPS. This isn't to say that the stock is not "expensive" by most measures, but it represents an important difference between investors' exuberance today versus in the tech bubble.

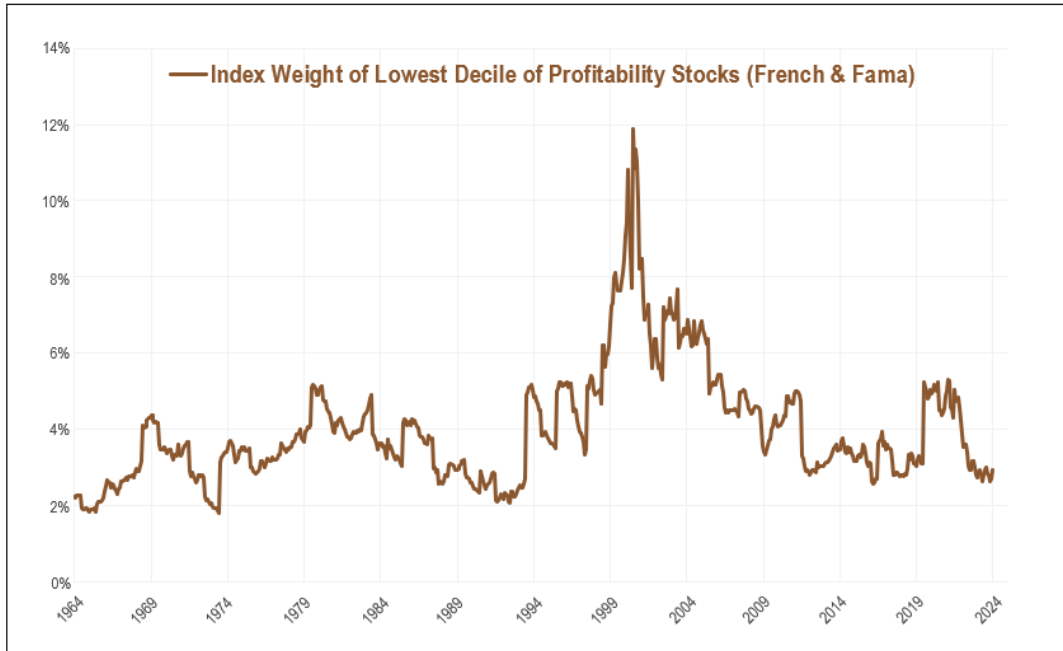
We believe this is an example of a (large) pocket of strength, but that "bubble" is not an accurate characterization of the current market.

Stock Market Performance Is Broadening Out

After concluding 2023 at a record level, the "Magnificent Seven" concentration has continued: five of the Magnificent Seven contributed 48% to total S&P 500 returns in 2024, compared to 62% in 2023. (Two of the seven were actually the largest detractors from S&P 500 performance in Q1 2024. The shine is currently off Apple and Tesla due to weakness in China and missing out on the AI movement.) This year, however, much of the rest of the market has continued to keep pace. One representation of this is that the S&P 500 equal-weighted index is up 8% year to date, versus the S&P 500 index (market cap weighted) up 11%. This broader market—that is, a broad number of stocks—is growing earnings at a healthy pace, and multiples have expanded only modestly. The strong economy has led to a reacceleration of growth after last year's margin and inventory correction cycle. These companies' earnings multiples are not stretched by historical measures. The S&P 500, excluding the 10 largest stocks in the index, is trading at 18x P/E. This level is at the high end of historical norms, but not dramatically so. Valuations reach these levels when investors have confidence in monetary/fiscal policy and corporate earnings growth. In our opinion, strong economic activity bodes well for the continuation of earnings growth and multiple expansion for a broad swath of the market.

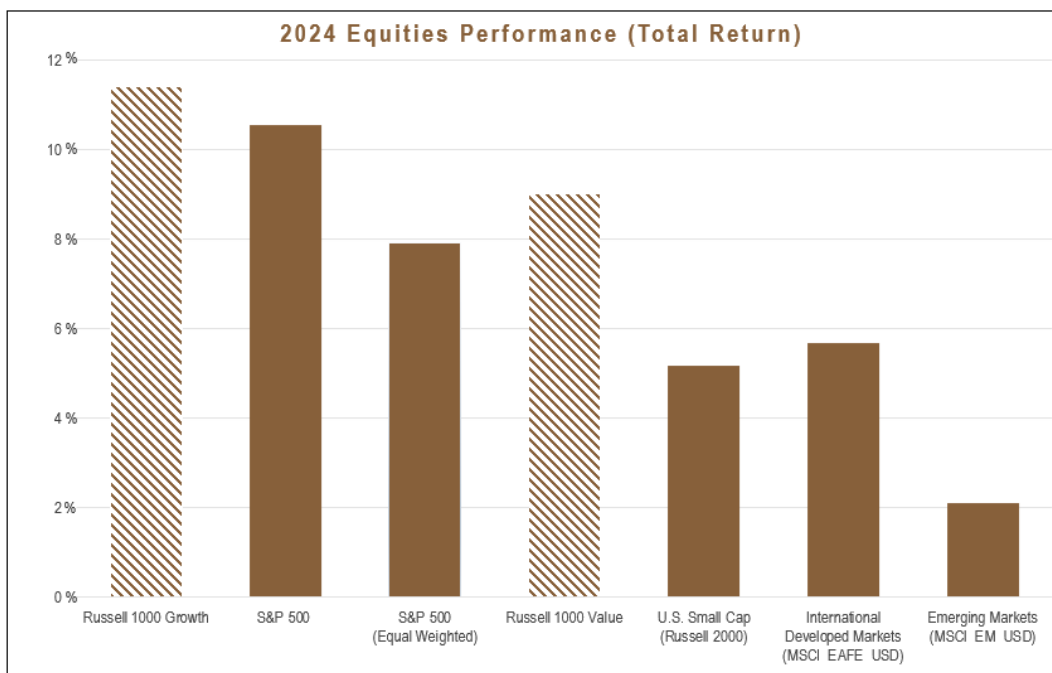
Despite the narrow set of a few very popular stocks, we conclude that the U.S. equity markets are not in a bubble. A few other observations to support our view would be a weak IPO (initial public offering) market and an equally slow M&A (mergers and acquisitions) environment. In past bubbles, IPO markets have been hot, and M&A activity has yielded large, landmark deals. These dynamics are not present in the current market. Beyond a handful of mostly semiconductor-related AI beneficiaries and Bitcoin, we simply are not seeing the same level of seemingly irrational trading activity as we did during the "eyeball" craze of the dotcom bubble in 2000.

In fact, the prevalence of profitless companies has been a common aspect of past periods of investor exuberance. The picture below shows investors remaining quite disciplined as they have not bid up the share prices of unprofitable (speculative) companies anywhere close to the level of the 2021 market rally, which was to us a much frothier environment than today, and certainly nothing close to what was witnessed in 2000. In our experience, bubbles usually come with rampant investor indiscriminate regarding profitability and irrational exuberance. The chart below suggests that whatever pockets of excitement exist today remain fairly contained.



Source: Neuberger Berman, Piper Sandler. Information as of 03/31/24

Some areas of the market have been left behind: small cap stocks (the Russell 2000) remain muted, up “only” 5% for the year, after being up “only” 17% last year versus the S&P 500’s 26% return in 2023; other laggards in the market have been “value” and “dividend” stocks. And yet, the earnings trajectory for these companies has been very similar to the rest of the market. However, the rebound after a weaker 2023 has not been as dramatic for these types of companies. Concern that the pace of earnings growth for these companies will not keep pace with the broader index has resulted in multiple compression. We see many opportunities for investments in companies whose steady earnings trajectory is being underappreciated; however, the catalyst for the market to “re-rate” these stocks, i.e., give them a higher multiple, is difficult to predict, we can see they are trading at significant historical relative discounts.



Source: Neuberger Berman, FactSet. Information as of 03/31/24

Bonds Continue to Struggle

In the bond market, dynamics are reflecting an equally benign outcome for the economy. Short-term rates continue to present the most compelling opportunities as near-term Treasury yields remain above 5%, and longer-term rates are up slightly from the beginning of the year, with the 10-year yielding 4.2%. Rates have increased (reducing the price of bonds), while “spreads” on corporate bonds versus Treasuries have compressed. This “spread” represents the incremental risk of owning a corporate bond with default risk (however small) versus the U.S. Treasuries (which theoretically have no default risk). These historically low spreads, for both investment grade bonds as well as for riskier high-yield bonds, combined with the shape of the yield curve (higher-yielding short-term bonds, lower-yielding long-term bonds), keep us focused on high-quality, short-duration bonds for the meantime.

The Economy

Overall, the economy remains strong. Unemployment stays at relatively low levels, and that includes participation levels (the portion of the population actively working or looking for a job) that have rebounded close to pre-pandemic levels. There are 1.4 jobs for every unemployed person. Wages continue to grow, in aggregate, at or above broad inflation measures. These are the underpinnings of a healthy consumer, which is the largest component of economic activity as measured by Gross Domestic Product (GDP), which itself continues to exceed expectations. The key for the stock market is earnings growth, and earnings growth is generally tied to economic growth. As always, the economic outlook is not perfect, but it remains surprisingly robust. Below, we outline some of the risks as we currently see them.

Risks

Fiscal / Monetary: In the past, we have highlighted the potential for the Federal Reserve (the “Fed”) to “pull away the punch bowl” and tighten monetary policy beyond just raising the fed funds rate. While the Fed has kept interest rates high, they have been more accommodating with their balance sheet. Given current fiscal spending levels, there is the possibility that the U.S. Treasury may need to pay higher rates to entice investors to buy, which would lead to higher interest rates. This could stifle investment, raise mortgage rates and present other challenges to the economy.

Inflation: The U.S. Consumer Price Index (CPI) and other measures of inflation (Producer Price Index, PPI) continue to run a little hotter than expectations, and above the Fed’s 2% target. Disinflation in core goods appears to have stalled. Used cars, apparel, auto insurance and airfare all recently advanced more than expected. These data points further pressure the Fed to delay any interest rate reduction. When we entered the year, expectations called for a first cut in March followed by six more throughout the year. Since then, the first cut expectation has been pushed to June or even July, followed by only two more cuts this year. High inflation tends to have a regressive impact on the U.S. economy, hurting the low-income consumer the most. Rising credit card, auto and mortgage delinquencies among the lowest FICO score consumers reflect some stress in that area of the market. We continue to monitor consumer data points for signs of stress spreading.

Banks: Landmines still exist amongst regional banks. While the issues with New York Community Bank earlier this year were mostly idiosyncratic, Commercial Real Estate (CRE) loan challenges are likely not fully realized. We don’t subscribe to many of the fears about contagion, but we are watching for signs of issues and for interesting opportunities regarding what is believed to be attractive value.

Election Cycle: The Trump election story remained backstage for most of Q1 despite his conclusive victory on Super Tuesday. The presidential election will continue moving toward center stage as we approach the summer. Although we have no way to handicap the outcome of the election, we do anticipate volatility leading into November 5, which presents both risks and opportunities. We also have some idea as to which sectors could be helped or hindered by the various outcomes, so we are managing the portfolios, first and foremost, for companies that can manage through regardless of the outcome, and second, to have a balance in portfolios among companies that may benefit from either outcome.

Conclusion

In the short term, the risks and uncertainties may or may not play out in favor of the stock or bond markets. 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. Currently, we see signs pointing to reasonable returns in both the equity and bond markets. Despite pockets of excess and hype, we do not characterize the market as being in a bubble. In the near term, the popularity contest is unclear. In the long term, we continue to see the U.S. innovating, growing GDP and being one of the best places in the world to invest capital. Ultimately, we think the “weighing machine” continues to be optimistic for U.S. equities in the long run.

Best regards,

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the index proportionate to its market value. The “500” is one of the most widely used benchmarks of U.S. equity performance. As of September 16, 2005, S&P switched to a float-adjusted format, which weighs only those shares that are available to investors, not all of a company's outstanding shares. The value of the index now reflects the value available in the public markets.

The Bloomberg U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

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