JULY 18, 2023

Spears Abacus 2Q23 Commentary

I. Market Overview

A snapshot of the most recent quarter is almost indistinguishable from the one that preceded it. At least in terms of equity markets. In the second quarter, the S&P 500 was a touch stronger than the first (8.7% vs 7.5%). Combining the two yields a year-to-date total return of 16.9%, bringing that benchmark to within 10% of its all-time high. Given what seems to be a challenging environment*, this strength has surprised many. Peeking behind the aggregate statistic reveals that, more broadly speaking, stock markets have not been quite as friendly as the Index suggests.

***Challenging Environment**

- *Rapid rise in short-term interest rates*
- *Near banking crisis (impending regulatory changes)*
- *More stubborn than predicted inflation*
- *Debt ceiling standoff*
- *Accelerating tension in Russia/Ukraine*
- *Stalled recovery from China*

By far the most prominent feature in 2023 has been the outsized influence of a small handful of very large companies. Eight stocks were responsible for more than two-thirds of the performance of the S&P 500. Without them, the benchmark would have been up by only about 5%. Still respectable for a six-month period, but hardly noteworthy.

As always, it is more helpful to examine specifics than gloss over generalities. The Mega-Cap 8, like the FAANG stocks of the last decade, are a familiar gang. Not surprisingly, technology is a common theme uniting the group. Each company is either a provider or beneficiary of dominant technologies. Some fall into both camps. So far this year, the Mega-Cap 8's average return is an eye-popping 84%.

This statistic requires context. This same group averaged a negative return of 46% in 2022. The cruel math of negative results is evident. Only two, Apple and NVIDIA, have surpassed previous high-water marks, and Microsoft is close. Meta, Tesla, Amazon, and Netflix remain between 25% and 40% below previous highs.

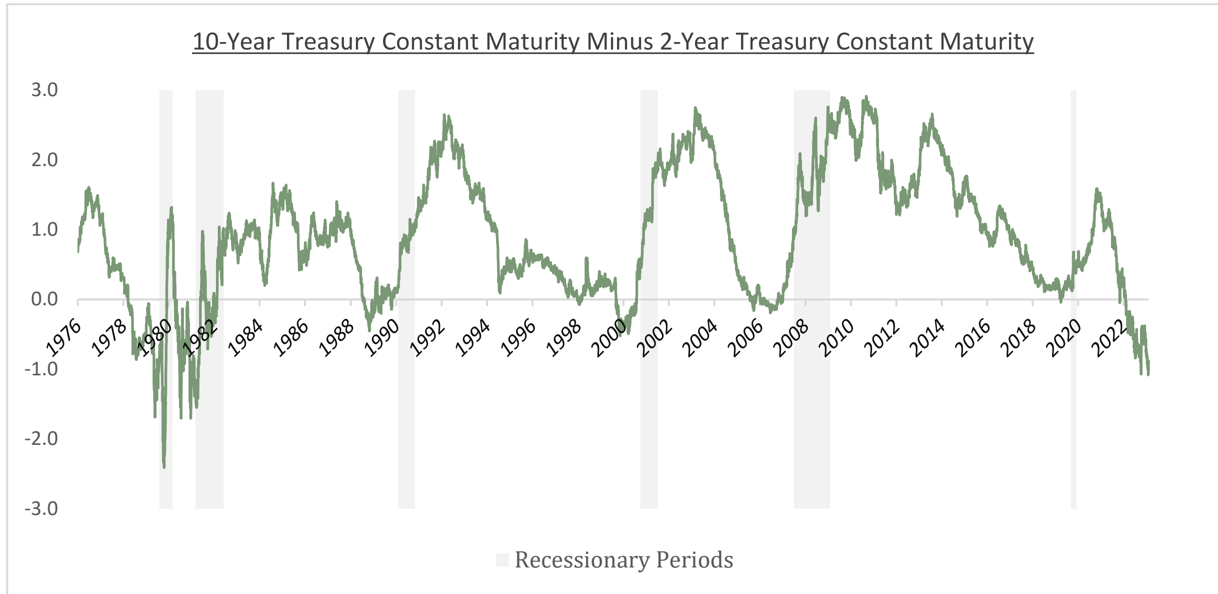
When eight so decisively outperform 492, it begs the question of how this anomaly will be resolved. Will the leaders fall back to the pack, or will the laggards catch up? To help to find the answer, we make two observations. First, the Mega-Cap 8 are hardly monolithic. While each trades at a higher-than-average valuation, there is a significant range from the lowest (Alphabet) to the highest (Tesla). Second, the remaining 492 companies trade at an average valuation of 16.5 times consensus 2023 earnings estimates, implying that there are bargains to be found.

Mega-Cap 8 Valuation[1]	2023 PE
Alphabet Inc. Class C	22.3
Meta Platforms Inc. Class A	24.0
Apple Inc.	32.1
Microsoft Corporation	35.1
Netflix, Inc.	39.3
NVIDIA Corporation	55.9
Amazon.com, Inc.	81.5
Tesla, Inc.	82.3
Average	*46.6*

[1] Source: Factset. Based on consensus 2023 earnings per share.

II. Looking Forward

The yield on the two-year U.S. Treasury note is more than 1% greater than that of the ten-year maturity. This is not normal. As can be seen from the chart below, it has not occurred since 1981. It is common wisdom that this so-called "inverted yield curve" presages a recession. It has done so correctly for the six official recessions in the U.S. over the last 50 years. Those economists forecasting an impending recession generally point to the inversion as evidence. Yet one full year after the yield curve first inverted, the economy is still showing surprising strength.



Source: FRED: Federal Reserve Bank of St. Louis. Data from 06/01/1976 to 07/07/2023.

The glass is half-empty crowd will point out, correctly, that history shows that a recession could begin as long as two years after the onset of an inverted yield curve. A more optimistic view is that being right six times in a row is no guarantee of future accuracy and that the economy could remain robust for the foreseeable future.

There is a trove of data to support either position. Eventually, one will be proven correct. However, it is important to remember that Covid-19 related shocks have been largely unprecedented. We truly are in uncharted territory. Never before has the global economy come to a complete stop. While there have been instances of supply-chain interruption, never have so many broken at the same time. We have never experienced the same degree of demand destruction, followed by a tsunami of pent-up demand. We do not really know whether Covid rendered traditional forecasting tools completely ineffective. But, as seasoned investors, we do know that now is not the time to bet the ranch on tenuous predictions.

Fortunately, we have other tools at our disposal. We have always looked to company-specific analysis to provide guidance. In general, we seek out those businesses that are less impacted by the overall economy. In uncertain times like these, we work doubly hard to maintain that discipline. Should a

recession occur, stock prices will likely retreat, including the prices of the companies we own for you. However, we strongly believe that none will be fatally impaired, no matter how unfriendly the climate.

Such an environment could present meaningful opportunities for new investments. We have higher-than-usual cash balances available to take advantage of attractive higher yields on short-term Treasuries. As mentioned, the average stock is currently reasonably valued. Should future market weakness occur, we will have a shopping list ready.

III. Artificial Intelligence

It was hard to go a day during the second quarter without reading a headline about artificial intelligence (AI.) Among investors, there has been a significant debate about who wins and who loses. The debate is far from settled.

Take for example Adobe, which in the span of just a few weeks went from being viewed as an AI loser to an AI winner. The narrative shifted from “AI is going to render creative workers obsolete, reducing the number of people using Adobe software” to “look what you can do with AI embedded in Adobe software!” From the beginning of the quarter to mid-May, the stock declined over 10%. From mid-May to mid-June, the stock went up almost 50%. In reality, not much changed. Adobe has been integrating increasing amounts of artificial intelligence into its design software for years, and investors today have little more clarity about what the “AI revolution” means for Adobe than they did when the quarter began.

We don’t know what the future holds (we tried asking ChatGPT) but the ongoing debate about how artificial intelligence, large language models, etc. will reduce demand for Adobe’s software, and many other companies’ products and services, reminds us of the Jevons Paradox.

In 1865, an English economist, William Jevons, observed that contrary to intuition, after the introduction of the far more efficient Watt steam engine, England’s coal consumption increased rather than decreased. Put simply, additional coal demand resulting from new applications enabled by the more efficient engine more than offset the improvement in fuel economy.

We think the same lesson applies. People won’t simply be content to use ChatGPT and its successors to accomplish the same things more efficiently. They will use technological advancement to do things that aren’t possible or practical today.

IV. Personal Finance

The steep increase in interest rates over the past 12 months has created a two-tiered population of debtors. Or more accurately, a two-tiered population of debts, sometimes for the same borrower. On one hand, those who incurred debt at a fixed rate prior to the increases are still enjoying historically low interest rates and debt-service payments, and likely will for years, if not decades. Conversely,

variable (or floating) rate loans, and debts more recently incurred, are now at significantly higher rates. The interest-rate payments may render that debt a bad financial decision.

Many borrowers who were able to obtain mortgages at extremely low fixed rates also utilize home equity lines that have floating rates tied to prime. Prime today is 8.25%. Likewise, brokerage margin rates are over double digits, and loans secured by portfolios have rates in the high single digits. Borrowers became accustomed to carrying debt on a permanent basis, as it was not difficult to earn a rate of return higher than the interest-rate cost.

In today's bifurcated debt world, it is even more important to analyze whether a loan is still serving its purpose. For example, with cash accounts earning 5% interest, holding cash is a far better investment than paying off debt with an interest rate that is lower than that level (a fixed-rate mortgage, for example). Likewise, when interest on loans becomes higher than can be reasonably earned through prudent investing, paying off floating-rate debts (like home equity lines of credit) may be the wisest decision.

Given this higher hurdle for investment returns and the rapid moves of rates of interest, we would be happy to work through these decisions with you.

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