Investment Strategy
July 2023

The S&P 500 Index had a fantastic first half of 2023, gaining 15.9%. This has been a reversal from 2022 when both stocks and bonds suffered large declines. The exceptional performance was driven almost entirely by eight mega-sized technology companies while the rest of the market is only up modestly on the year. Meanwhile, economic data outside of job creation continues to deteriorate. Home sales are down, manufacturing is in contraction, and sizable corporate layoffs are occurring regularly. The aggressive moves by central banks are successfully slowing the economy and blunting inflationary pressures. As long as interest rates remain at current levels, financial conditions will continue to tighten, negatively impacting the global economy. Given the divergence between the S&P 500 index and the general economy, we believe the stock market is once again being lifted by irrational speculation that will come to a painful conclusion.

A plethora of overvalued assets deflated last year as bonds fell roughly 20%, the S&P 500 declined 19.4%, and the tech-heavy Nasdaq lost 33.1%. The most speculative, profitless stocks fell by over 50%, with many down over 80%. It was a predictable conclusion to the raging tech bubble of 2021. Coming into 2023, the bear market was due for a relief rally after last year's carnage. Typically, rallies early in a bear market are focused on large companies while smaller ones languish. In these respects, this rebound has been standard behavior. However, the size, duration, and extreme concentration of the rally have been surprising. Looking back, the unusual outperformance of the mega-sized tech companies began in mid-March due to the combination of several bank failures and the release of ChatGPT-4[1]. Neither explains the bull run that has left these major tech stocks trading at extremely expensive valuations. Below is a chart showing the recent financial performance, stock returns, and relevant valuation metrics for these companies.

"Big 8" impact on the S&P 500 in 2023							
Company	**Sales yoy**	**EBIT yoy**	**FCF yield**	**P/E**	**P/Sales**	**YTD gain**	**% of Index**
Apple	-2.5%	-5.5%	3.7%	32.8	7.9	49.3%	7.6%
Microsoft	7.0%	9.8%	2.7%	36.9	12.1	42.0%	6.8%
Alphabet (Google)	2.9%	2.5%	4.7%	26.8	5.4	35.7%	3.6%
Amazon	9.4%	**27.5%**	-0.8%	315.0	2.6	55.2%	3.1%
NVIDIA	-13.2%	-33.6%	0.8%	232.0	40.5	189.5%	2.7%
Tesla	24.4%	-26.1%	0.8%	77.0	10.3	112.5%	1.9%
Meta (Facebook)	2.6%	-1.8%	3.2%	35.7	6.2	138.5%	1.7%
Netflix	3.7%	-13.0%	1.9%	47.4	6.2	49.4%	0.5%
"Big 8" Average	**4.3%**	**-5.0%**	**2.1%**	**100.5**	**11.4**	**84.0%**	**27.9%**
S&P 500 Index	9.7%	4.3%	4.6%	21.0	2.5	15.9%	100.0%

[1] Silicon Valley Bank seized March 10th. Signature Bank seized March 12th. Chat-GPT released March 14th.

Contrary to the narrative, the "Big 8" only grew revenues 4.3% from the 1st quarter of last year to the 1st quarter of 2023. Furthermore, EBIT (earnings before interest and taxes) actually declined by 5% over the same period. Despite this modest performance, the average "Big 8" stock gained 84% so far in 2023! This has left the average group member trading at an eye-watering valuation of roughly 100 times earnings. Maybe more telling is the group's price-to-sales ratio of 11.4 times. For perspective, the former CEO of Sun Microsystems, one of the darlings of the 2000 tech bubble, quipped years later that investors were not thinking clearly when they paid 10 times sales for his company at the peak of the 2000 bubble. In 2023, we have a $1 trillion company (NVIDIA) trading at 40 times sales!

While the S&P 500 index enjoys a huge rally due to its largest components, the actual economy continues to slow, and a steady march of companies are running into financial difficulty. Although consumers are spending on services like food and entertainment, the manufacturing sector is already experiencing a recession. The cost to move goods by ship, train, and truck have all collapsed due to soft demand. We are also hearing reports of falling occupancy for Airbnb's. The bottom line is that consumers haven't been able to keep up with surging prices over the past two years as everyday goods seemingly cost 20-30% more. Combined with more restrictive debt markets, people are struggling which is forcing them to change behaviors or take on expensive loans. For instance, credit card debt initially declined during COVID, but after a recent surge is now up roughly 18% since the beginning of 2020. To tease out the overall health of the U.S. consumer, we can review a recent earnings report from beloved General Mills.

General Mills is in every supermarket in America selling well-known brands including Cheerios, Betty Crocker, Annie's, Yoplait, Pillsbury, and many others. Most consumers grow affinity for these brands at a young age and stay loyal to them their whole life. Importantly, General Mills produces products that are similarly consumed across various income levels. This allows us to gain a better understanding of all of society while something like travel might be overconsumed by the financially well off. General Mills recently reported "rosy" results as of May 28th that showed 3% revenue growth over the same quarter last year. Management cheered this report and announced a 9% dividend increase. Under the surface, there were major shifts that we did not see during the last major recession. In their North American retail business, General Mills jammed through an 11% price increase over the past year which led to an 8% drop in sales volume. In their international markets, they raised prices 18% and suffered a 15% drop in volumes. Conversely, General Mills grew volumes strongly throughout the 2007-2009 recession as consumers saved money by eating at home. As an example, my brother spent several months weaning his three kids off the "big food brands" and onto cheaper alternatives. It is unlikely that he will EVER go back to those brands unless they significantly cut their prices or his income meaningfully increases.

While we are using General Mills as an example, similar comments were made on recent conference calls from the major retailers Wal-Mart, Target, Costco, and the dollar stores. The story emerging is that stressed consumers are reaching their limits. While blue collar workers are beginning to see some of their biggest pay increases in recent memory, everyone's income has failed to keep up with the surge in prices over the past few years. Keep in mind that the entire rest of the world has also experienced this inflation and they generally have much less discretionary income. Unfortunately, we don't see relief on the horizon. The insurance industry is rolling out major rate increases to compensate for the higher cost of repairing cars and houses. The freeze on student debt payments is also ending in September as legally **mandated** by our last debt ceiling agreement. The resumption of student debt payments should be considered a significant tax increase because the average loan payment is $413 a month. The suspension of payments for the last three years has allowed (generally) young people to buy a car or rent a larger residence (and they did).

These factors leave the economy dependent on the wealthiest generation in human history: baby boomers. The majority of this cohort is now 65-75 years old and many have accumulated a substantial amount of wealth. This has left the strongest group of consumers insulated from the recent ravages of inflation[2]. However, the average new retiree is in no way protected from the "Big 8". Surveys show they hold more of their retirement portfolios in stocks than ever before. The problem is that since this group is no longer working, they will adjust spending quickly if their assumed paper wealth (stocks, bonds, real estate, etc.) turns out to be worth significantly less. This phenomenon is a dangerous byproduct following an era of economic euphoria and is known as the "*bezzle*". These newly impoverished consumers react by broadly curtailing spending, sending the economy into a severe downturn. We fear that this relationship will be more powerful than ever before with the major wealth holders no longer working[3]. Therefore, short-term U.S. Treasury bonds continue to be a critical component of every investor's portfolio. Earning roughly 5% while taking no risk is a no-brainer in today's market. We also continue to focus on companies that provide basic needs and own physical assets rather than firms providing luxury products or services. These types of companies are also out of favor and trading for reasonable valuations with large dividends. The bottom line is that we remain focused on playing defense until excesses are flushed from the system and opportunities significantly improve.

Sincerely,

Keating Investment Counselors, Inc.

[2] Credit card delinquency data indicate that stress is building for 20-60 year olds while 60+ is fine
[3] Never really happened to my knowledge

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