OYAT ADVISORS – QUARTERLY COMMENTARY

2Q 2024

<u>Investment landscape</u>

The second quarter of 2024 was generally positive for equities as investors balanced hopes for lower inflation and central bank rate cuts with resilient economic data. Clearly, market sentiment remains driven by central bank actions and the possibility of rate cuts over the course of the year. Investors started the second quarter concerned that the combination of sticky inflation and relatively strong economic data would prevent central banks from cutting interest rates. The global equity market subsequently weakened in April. As the quarter progressed, inflation prints looked more favorable and weakness in key economic components such as US consumer data gave investors comfort that monetary policy easing was again the most likely outcome, and global equity markets rose once more to all-time highs. In the meantime, fixed income markets remained flat-to-down, perhaps reflecting the underlying nervousness of market participants regarding the imminence of rate cuts, despite early downward adjustments by the Swiss National Bank and the European Central Bank.

The guessing game will likely continue through the second half of the year as investors modulate expectations for rate cuts as fresh data on inflation and economic progress hit the headlines. Weaker economic data may raise hopes for lower rates, but it will also heighten fears of a recession and increasing pressure on fragile government finances. So far, old narratives have continued to hold with strong performances from large U.S. technology companies driving global growth stocks to the top of the heap in terms of performance in the second quarter. Stocks linked to artificial intelligence persisted in their efforts to drag indices up as well. Artificial intelligence darling Nvidia climbed nearly 37% in the quarter, stretching the bounds of market concentration and the relevance of valuation.

We don’t need to reinvent the wheel and add yet more text to the flood of commentary on companies like Nvidia, but we do find the situation quite fascinating in the context of history as pointed out by Christopher Bloomstran of Semper Augustus, whose commentary in late June offers valuable perspective on today’s markets:

“Stunning. Nvidia passes Microsoft and Apple as largest market cap. Combined, the three are valued at $9.9 trillion, 21.5% of the entire market capitalization of the S&P 500. The three are today LARGER than the capitalization of the ENTIRE S&P in September 2011, not a market low. Including Google, Amazon, Meta and Tesla, the Magnificent 7 have a $16 trillion combined market value, 34% of the S&P 500 and LARGER than the ENTIRE S&P as recently as February 2016, just over 8 years ago and most definitely nowhere near a market bottom. Nvidia is valued at 42x and 78x trailing sales and earnings on an unsustainable 54% net profit margin. Microsoft is valued at 14x trailing sales and 39x earnings on a 36.4% net margin. Apple is valued at 8.6x and 33x trailing sales and earnings on a record 26.3% net margin. These are crazy valuations for very large companies that can grow sales and earnings nowhere near as rapidly as they did over the past one and two decades. Microsoft and Apple traded for less than 10x earnings at various points over the past 20 years.

This is the goofiest and likely most dangerous concentration of overvaluation I've seen in 34 years investing and throughout financial history. Mr. Market is very good at rewarding business success but to a fault. In the short term, stocks can trade at extremes relative to fundamentals, both on the low side and the HIGH side. At 23x 2024 expected earnings, the market-cap weighted S&P 500 is froth with excess and in my judgment uninvestable. Under the hood, the majority of stocks are not overvalued. The bifurcation between the dear and the cheap reminds me of March 2000. From that point the index has returned 7% per year, spending much of the subsequent decade in the red. You can have extremes of over or undervaluation in the short and even intermediate terms. But in the long run, Mr. Market gets it right."

Extreme concentration and valuation metrics should give investors pause and prompt a review of how diversified holdings really are considering the dominance of a handful of companies in the major indices. Timing markets is difficult, and market darlings can drop as precipitously as they rise once achieving such lofty valuation levels while being dependent on what some experienced investors might refer to as goofy expectations. We might also highlight Mr. Bloomstran's mention of a bifurcated market and the observation that many stocks are not overvalued. With investors guessing at the number of rate cuts and riding large capitalization growth stocks to 42x sales and beyond, we prefer to plod along holding a diversity of high-quality companies trading at attractive valuations. And we do continue to find high-caliber firms that the market seemingly forgot to drag up to stretched valuations. Avoiding the dangerous concentration of overvaluation while owning companies with valuations more than supported by their fundamentals may very well be the leading narrative of the next decade of stock market returns.

In the meantime, there is another fixture of the second quarter's performance worth mentioning. Gold more than held its own against equities in the period, up nearly 3% in USD. Gold reached new highs in the quarter and ultimately sustained high price levels. Continued geopolitical strife or the political turbulence we see in countries such as France may underpin continued strength in the gold price, but ultimately its status as a portfolio diversifier and proven role as a store of value in relation to ever crumbling fiat currencies offer the real incentive to have a material allocation to the asset class.

Ultimately, the second quarter was a balancing act between hopes of rate cuts intertwining optimally with benign economic conditions and fears that the continuing narratives of artificial intelligence and U.S. big technology growth can't hold up their bubbly track records forever. Predicting interest rates and inflation is often a fool's errand, as is knowing how geopolitical events will play out in these rapidly developing times. We remain humble regarding our ability to predict when 'dangerous concentrations of overvaluation' will reverse themselves or when valuations will once again need to rest upon reasonable fundamentals. But we also remain steadfast in our belief that owning scarce and productive assets with a focus on quality businesses trading at reasonable prices will drive admirable risk-adjusted performance over the long-term. A reasonable level of liquid reserves, predominantly in the form of physical gold, serves to optimize the risk profile while offering option value should the market provide exceptional investment opportunities in the quarters to come.

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