ALTA CAPITAL MANAGEMENT
A member of Guardian Capital Group Limited

MARKET LETTER

June 2023

When Good News Is Good News

The second quarter of 2023 finished strong with the S&P 500 up 8.3%, continuing the strong uptrend we saw during the first quarter and putting the first half market return at 15.9%. The market is now squarely in bull market territory, up 27.5% from the October lows, but still 7.5% off its January 2022 peak. Even through a debt-ceiling standoff, the failure of a handful of sizeable regional banks and continuing geopolitical unrest, the stock market made new gains. Recent market strength has confounded many market observers, as they pointed to stagnating if not declining earnings, still stubborn inflation, the Fed continuing to raise rates and a stock market as a whole that appeared expensive. These conditions by and large still exist, but as we pointed out in our last market letter, the US already experienced a bear market in 2022, and the even rarer outcome of bonds and stocks both delivering negative returns in the same year. Indeed, the market is a forward-looking pricing mechanism, having already discounted uncertainty, stubborn inflation and risk of recession. Even after unprecedented rate hikes, the most widely anticipated economic recession has not yet occurred and rate sensitive sectors like housing, the labor market and the economy as a whole have all slowed down. From rolling recessions, could we be transitioning to rolling expansions?

As we sit at the mid-point of 2023, economic data to date have shown that the current US economy is more resilient than previously expected and at the same time significant progress has been made on the inflation front. Initial claims have jumped 30% over the last nine months, from 190,500 to 246,800. While this looks like a big jump, after adjusting for labor force growth, jobless claims compared to previous cycles have not reached the thresholds signaling an imminent recession. Other recent economic indicators pointing to underlying strength include manufactured goods orders, rising consumer confidence and spending, and positive real wage growth. Per leading economic indicators, a recession is not yet on the horizon. On the inflation front, the US producer price index dropped from an 11.7% peak in March 2022 to 1.1% in May 2023 and the US consumer price index dropped from 9% to 4% over that same period. The Fed has raised rates from 0% to 5% over the past 15 months and those hikes have already had an impact on the most interest rate sensitive parts of the US economy, housing and regional banks. However, the lasting impact of such a rapid increase in the Fed Funds rate is yet to be determined. The inflation conversation is not yet over, and after a pause in June, the risk remains that the Fed needs to hike rates further to get inflation to its 2% target. In such a scenario, the Fed could prove too successful in fighting inflation and as it falls, the economy could plunge into a deep recession. Contrarily, if inflation currently is overstated as some believe, then the market can start viewing good economic news as positive for earnings and stocks.

In addition to continued market strength, two remarkable trends gained momentum during the second quarter: narrow market leadership with performance concentrated among a handful of megacap technology names, driven in large part by the second trend, newfound investor fascination with artificial intelligence. During the first half, the top seven stocks in the S&P 500 have gained 67% vs only 6% for the remaining index stocks. It is not uncommon for a subset of stocks to lead markets and when this happens, the market generally clocks in further gains. Separately, worrying parallels have been drawn with the late 90s dot.com bubble and, while market and media fascination are comparable, there are notable differences. The top stocks driving the market year-to-date are highly profitable companies with strong free cash flow generation, including Alta holdings Apple, Google, Microsoft and Nvidia. Tech stocks as a whole have ROEs in the mid 30s, vs only in the high teens back in 1999, and the P/E for the group is significantly lower, at about 25x vs twice that at 50x in 1999. With the best performers in the group expected to grow earnings in the mid 30% range, a 25x earnings multiple would be justified.

Whether or not this market continues its uptrend, we will stay true to our process. Megacap tech led out of the gate, while many stocks have been left behind year-to-date. In our view, the high concentration of market leadership defines a stock picker's market. Our expectation is that some of the recent laggards will catch up.

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