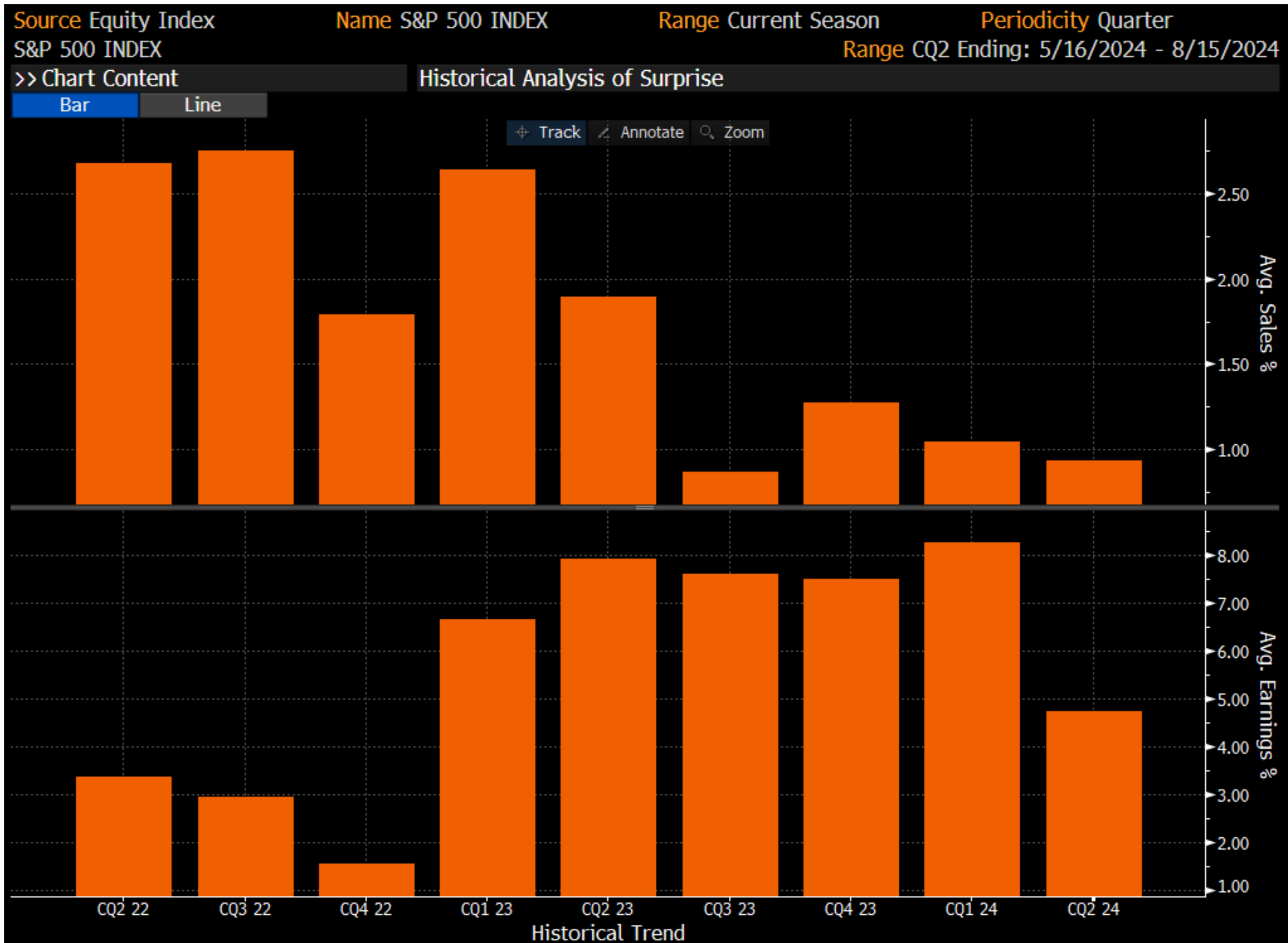
Earnings, Economy and the Fed

So far this earnings season, 376 of the S&P 500 Index members have reported earnings. Results have been generally positive with earnings in the aggregate surprising 4.72% to the upside (relative to consensus estimates), and sales surprising 0.93% to the upside.[1] Year-over-year, aggregate earnings have grown 11.03% for the companies that have reported thus far, while sales have risen by 5.08%. Though seemingly positive, it's notable that the magnitude of earnings and sales beats have declined compared to prior quarters. In the long term, markets track earnings; but the short term is all about results relative to expectations. With the S&P 500 having traded at 23.5 forward earnings estimates prior to the start of this reporting season, the 6.3% decline over the past two weeks is, perhaps in part, an indication that results have not adequately surpassed elevated growth expectations.



Most pertinent to our portfolios are the large-cap tech earnings, which on an absolute basis have been impressive (see below chart showing quarterly results). Particularly notable were cloud computing segment results from Amazon, Microsoft and Alphabet, which have reached annual revenue run rates (and growth rates) of $105b (19% growth), $81b (30% growth) and $41b (29% growth), respectively. However, with the Nasdaq 100 Index down over 11% since mid-July, the message has also been that results did not sufficiently beat lofty investor expectations.

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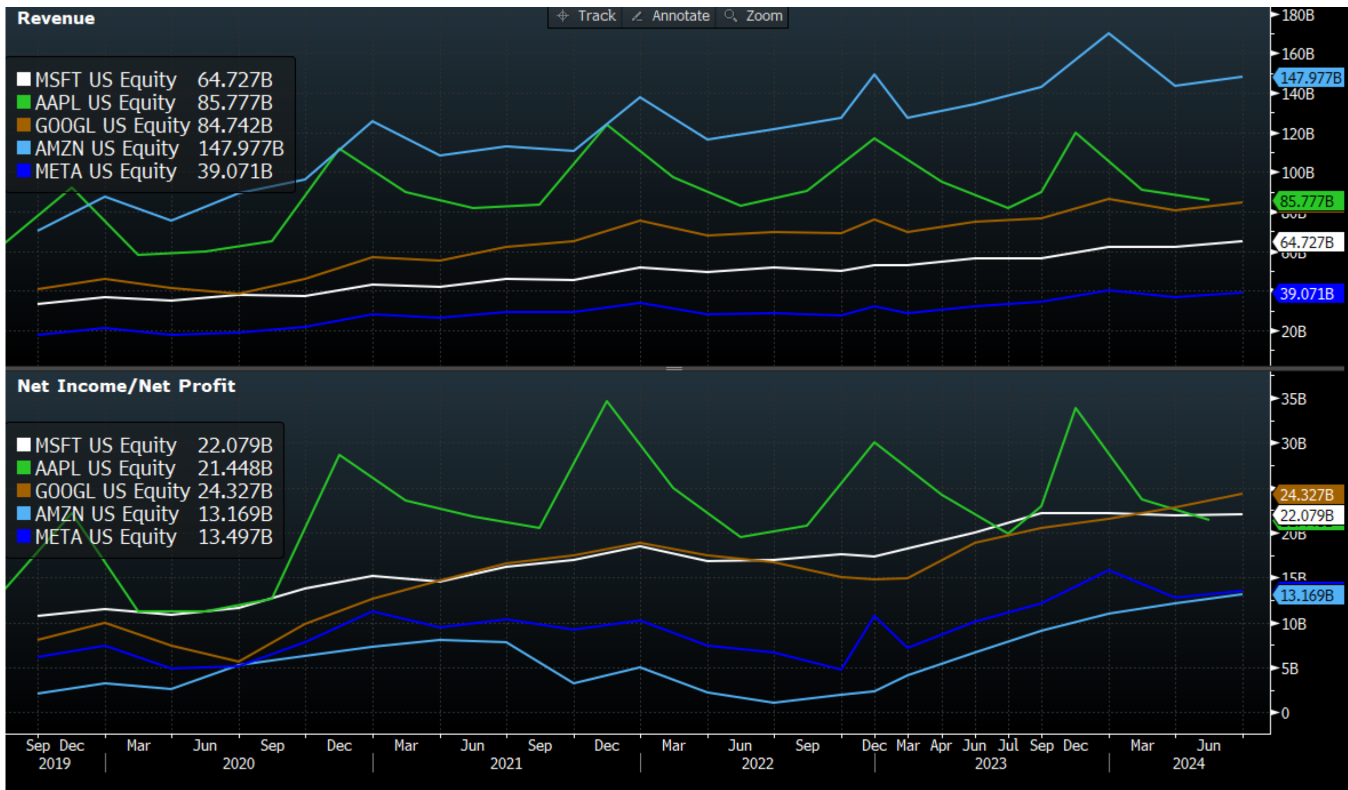

Aside from these firms' financial results, what else may account for the weakness? We think the answer is twofold: 1) soft economic data this week that has pressured all stocks (discussed more below); and 2) investor concerns over the amount of money these firms are dedicating to capital expenditures to support their nascent artificial intelligence businesses.

Over the last year, Microsoft, Apple, Alphabet, Amazon and Meta have collectively spent $187.9b on capital expenditures – much of which has gone toward building data centers and supplying them with the components necessary to operate (most prominently, semiconductors). Note that this is separate from the $232.7b these firms have collectively spent on research and development over the last year. For the fiscal year ending in 2025, analysts expect these firms to increase capex spending to $236.7b. To date, these expenditures have proven worthwhile, as they have supported growth and have not materially impacted operating or free cash flow margins.

On earnings calls, most of the CEO's have essentially repeated the same line with regards to spending on AI: that there is a greater risk to underspending (and getting left behind the competition) than overspending. As the spending increases, however, investors are going to sharpen their focus on payouts from the efforts. While we think this spending is sensible given the vast opportunity that AI presents, we suspect that investors will begin pushing back on management if AI revenue does not materially increase in the coming quarters. Perhaps that is short-sighted (as the AI opportunity could span decades), but it is a risk to stock performance that we think is worth flagging.

On the economic front, recent data has indicated weakness. Thursday's ISM Manufacturing data signaled a sharp contraction in manufacturing activity and manufacturing employment – with manufacturing employment at its weakest levels since the Covid pandemic and 2008 Financial Crisis. That soft reading, coupled with today's underwhelming employment data (see below chart), has sent bond yields tumbling in anticipation of a weaker economy and less restrictive Federal Reserve. The 10-year U.S. Treasury, which yielded 4.6% as recently as May,

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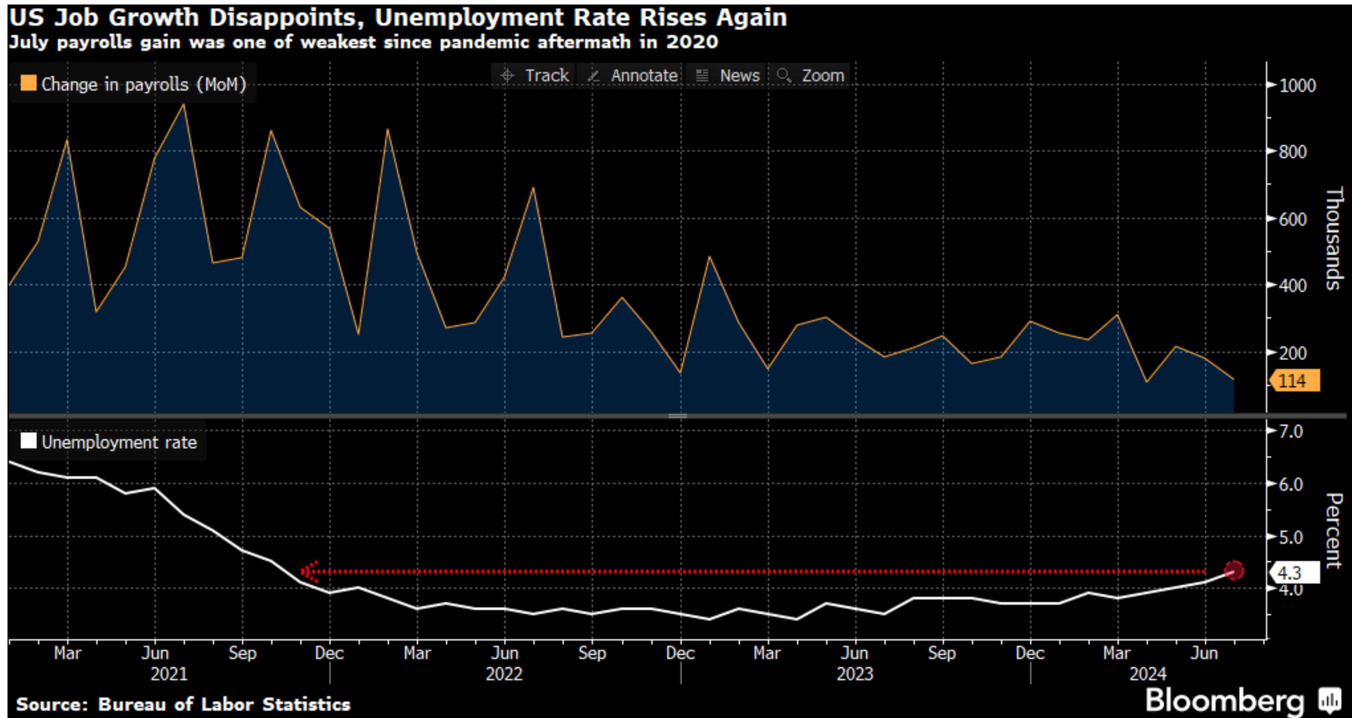
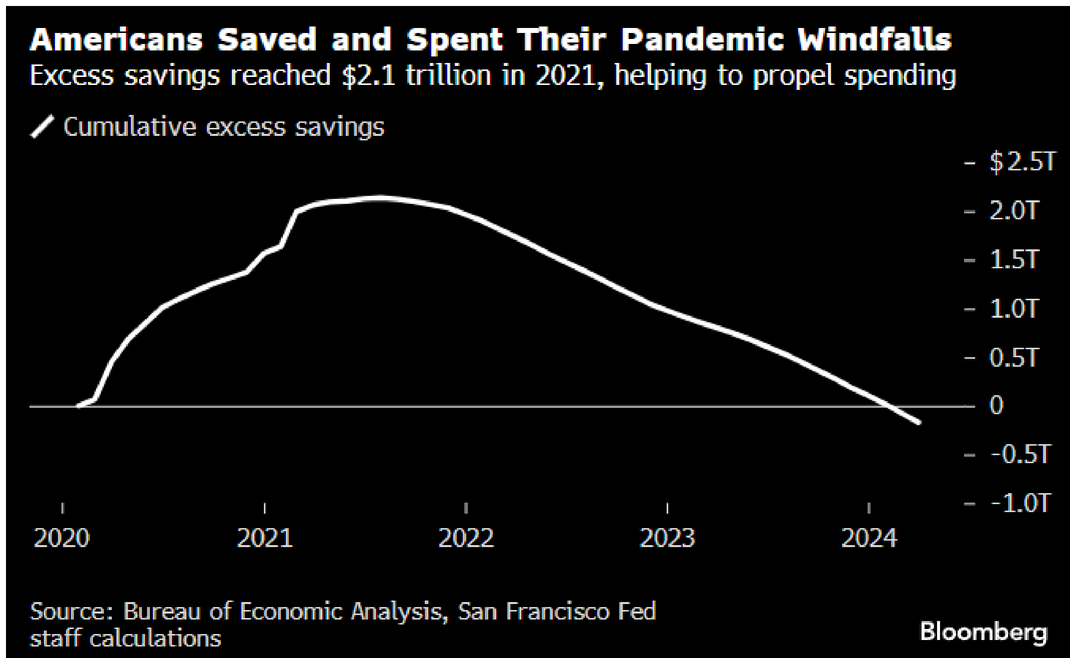
is down close to 50 basis points just this week to 3.82% (as of the time we are writing this letter). Over the same horizon, the 2-year Treasury has moved from 5% down to 3.88%.



The weakness in manufacturing and employment is coming on the heels of U.S. consumers beginning to retrench in the face of tighter finances. As Americans have spent through their excess Covid savings, consumer spending weakness has begun turning up in multiple categories from home furnishings to meals outside the home.



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August 2, 2024

Prior to the latest economic data releases, the Federal Reserve's Federal Open Market Committee met this week and maintained its current interest rate policy – holding rates between 5.25-5.5%. In his remarks, Chairman Powell hinted at cutting at the FOMC's September meeting. With inflation approaching the Fed's 2% target, the disappointing economic data and repricing in bond yields have opened the door for the Fed to cut 50 basis points from its current policy rate at its next meeting, and more over the coming year. Right now, traders have priced in an 80% chance that the Fed does indeed cut twice (or 50 basis points) at its September meeting, compared with only a 9% chance of two cuts at the beginning of this week. On the positive side, an easing cycle should provide much needed relief to consumers reliant on credit, as well as corporate borrowers who have struggled with higher costs of capital.

To reiterate a point we often make: we encourage maintaining a long-term focus when investing, focusing on company fundamentals rather than macroeconomics and looking through any economic soft patches. The structural tailwinds for various parts of the economy from technology to re-industrialization to energy remain constructive. And earnings for some of our core holdings reinforce this viewpoint. Accordingly, we are not advising adjustments to long-term allocations. However, we do think it is worth highlighting that the coming months could see investors reassess the near-term business outlook in light of decelerating or contracting economic data. If that affords us the opportunity to purchase high quality companies at attractive valuations, we will be sure to communicate our suggestions in a timely manner.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

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[1] Bloomberg (as of Aug. 2, 2024). All financial and economic data cited herein is from Bloomberg unless otherwise noted.

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