The Wrap Up

Soft Landing: Don't Stop Believin'

It’s been an interesting week for equities, with plenty of earnings to dissect, an FOMC meeting with rate hikes, GDP data and sharp intraday movements for the indexes. With all that there was to unpack, we want to assess what we are learning about the health of the economy today and what is forecasted for the quarters ahead.

This week three large tech companies shared their quarterly results: Microsoft, Alphabet and Meta, with the common theme amongst the three being AI. Microsoft, whose stock retreated after their soft guidance, set the tone for the upcoming quarters by updating us on two realities regarding AI: generative AI is a multi-year story, with the expected impact on earnings to be gradual but still very significant, and capital expenditures (capex) will need to increase in order to continue this story, with 2024 capex estimated at $40-50B (a strong jump from the already massive $28B spent in the previous year).

Both Meta and Google rose after reporting their earnings, however, we can attribute that more to a recovery in ad spend, than a significant change in their trajectories. Meta, after having shed a quarter of its workforce and intending to run as lean as possible into 2024, forecasted $27-30B of capex for fiscal 2023, with a strong increase expected for the year ahead. Of note, share buybacks have slowed down from $9B the previous quarter to only $900M this quarter, likely due to the large spending commitments.

Google parent, Alphabet, also forecasted increases in capex (with a 10% increase for the quarter) as outgoing CFO Ruth Porat commented that the focus is on growing expenses slower than revenue in 2024. Their earnings beat and strong guidance had a lot to do with strength in their Cloud division, with an annual revenue run rate of $32B. All three firms were keen to mention their intention to further integrate AI into their offerings, with a fair amount of excitement around the potential of these offerings and what that could signify for future growth, with an emphasis on the word ‘future’. With year to date returns sitting at 159%, 46% and 38% for Meta, Google and Microsoft respectively and other AI ideas also more than doubling the return

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of the S&P 500, the AI rush is perhaps a little ahead of itself in pricing that future growth today, even if there is little doubt about the massive potential in the near future.

Beyond the reporting of the big three, we had results from General Motors, which continued to crush expectations across the board. GM has managed to increase its earnings and free cashflow outlook for the year, however, the shares experienced a small decline and have barely moved over the last 6 months (only up 2.7% against the S&P 500). One analyst commented that in spite of the strong result and forecast, the muted share price movement suggests that either the market does not have the confidence that the consumer can continue to hold up against higher financing rates and elevated pricing or that they do not believe in GM's ability to succeed in its electric vehicle push. The consumer fear also manifested within the earnings of Enphase, a residential solar equipment company, whose third quarter guidance left investors disappointed. We expect companies whose results are sensitive to interest rates to continue to experience headwinds as higher costs weigh on consumer demand.

Although interest rate-sensitive spending will continue to be under pressure, the consumer continues to spend, overall, as seen in results from Visa and Mastercard as well as in Q2 GDP figures. GDP grew by 2.4% in the quarter, surprising forecasters and prompting central bankers to adopt the soft landing scenario as their base case. That's right, the strength of the labour market and the resilience in spending has the Fed believing the US will avoid a recession, with inflation returning to 2% by 2025. While the Fed has had credibility issues since the onset of this inflation cycle, at a macro level, this hiking cycle has accomplished its primary objective of slowing down inflation (with the most recent figure slightly higher than 3%) with minimal damage. Today, unemployment sits at the same level it was when the rate hikes began, with defaults rising only slightly. At this moment, we must give credit where it is due and acknowledge the work of Mr. Powell and his team.

Although they have done well so far, the work of central banks is far from over; relative to consumer and government debt levels, interest rates are still very high and the longer they remain at these levels, the more consequences we may face. The greatest areas of concern are centered around debt servicing and the impact that it can have on the economy. As more time passes, more debt will mature and be renewed at these higher rates. As consumers and governments adjust and reallocate their spending, the risk of slow growth or even, recession, continues to remain elevated. Housing will also be an area to follow closely; in the short term, people will not move as many have locked in 30 year rates well below current interest rate levels (which also explains why new home builders have had a strong year). In the medium term, the inability of people to move around can have an impact on economic developments as the economy has historically relied on a mobile population.

If we can update our outlook at this moment, it has gone from 'cautious' to 'still cautious with a little bit of optimism'. As our approach to portfolio management balances long term ideas with short term macro developments, we continue to participate in this year's rally, while proactively trimming outperformers and reinvesting the proceeds into more defensive, income generating ideas. We, along with our clients, gladly accept this year's market strength, however, we will not become complacent on risk and will continue to manage funds cautiously until we have further clarity around the impact of higher interest rates.

Healthy Distraction

Last weekend, moviegoers were treated to the release of two high profile pictures; *Barbie* and *Oppenheimer*. Both have already been deemed commercial and critical successes, and although the movies are very different from one another, that has not stopped some from watching them as a double feature, a phenomena referred to as

'Barbenheimer'.

Whatever your tastes, it seems as though the summer movie slate is quite strong, with several high profile movies playing all at once. Beyond *Barbie* and *Oppenheimer, Mission Impossible – Dead Reckoning Part One, Indiana Jones and the Dial of Destiny* and *Transformers: Rise of the Beasts* are other summer blockbusters that are available to watch.

Although the beautiful summer weather usually encourages outdoor activities, this year's rainy summer has created many opportunities to go the movies. If the rain this weekend alters your plans, a visit to your local movie theater may not be such a bad idea!