What has driven market returns so far in 2023?

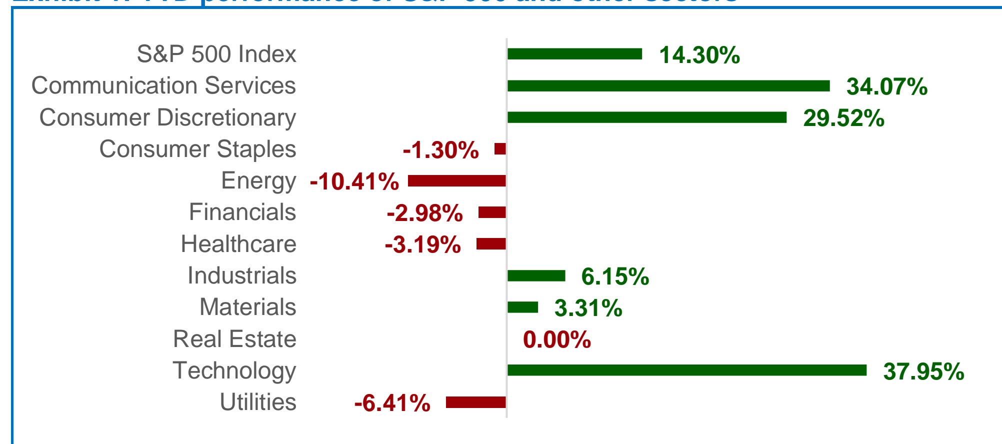
Has the bull run really begun after a pause in 2022?

As of June 2023, the S&P 500 has officially entered the bull market, posting over 20%+ returns since its October 2022 lows. Does this mean all sectors have recovered from inflationary pressures, consumer weakness due to high interest rates and recessionary fears?

The S&P 500's stellar returns, on the surface, may indicate investors' changing sentiments towards a revival from the macro concerns that weighed down the index in 2022. However, using the SPDR select sector ETFs, a sector-wise breakdown shows that Technology (XLK), Communication Services (XLC) and Consumer Discretionary (XLY) have posted +37.95%, +34.07% and +29.52% year-to-date (YTD). XLK and XLC jointly account for about 37.5% of the S&P 500, and the news around AI has clearly driven this performance. The Consumer Discretionary/ Cyclicals (XLY) sector, which is generally sensitive to macro pressures, has also recorded higher returns. A look into XLY constituents clearly shows that strong performance from Amazon (AMZN, +49.74%) and Tesla (TSLA, +122.80%) (jointly account for about 41% of XLY) helped offset the weakness in other discretionary stocks. Including TSLA and AMZN, the market heavyweights within XLK and XLC also had a significant role to play in the S&P 500's YTD performance. XLK, XLC and XLY combined account for approximately 47.8% of the S&P 500 index.

S&P 500 returns in 2023 YTD were heavily tilted towards Technology (XLK), Communication Services (XLC) and Consumer Discretionary (XLY) sectors.

Exhibit 1: YTD performance of S&P 500 and other sectors



Source: sectorspdr.com

YTD returns of comparatively recession-resistant sectors such as Consumer Staples (XLP, +0.16%) and Healthcare (XLV, -2.68%) show that most investors may have shifted their investments towards growth. This begs the question, "Are growth companies showing early signs of recovery from earlier feared demand weakness?" In reality, most of the major tech companies still show a sense of concern or caution over the demand environment during recent earnings calls. Despite such an outlook, market sentiment towards the tech sector has been overly bullish since the beginning of the year as companies cut down expenses to maintain margins and free cash flow. Adding to that, the launch of generative AI and AI-related investments has driven the sector's returns significantly higher.

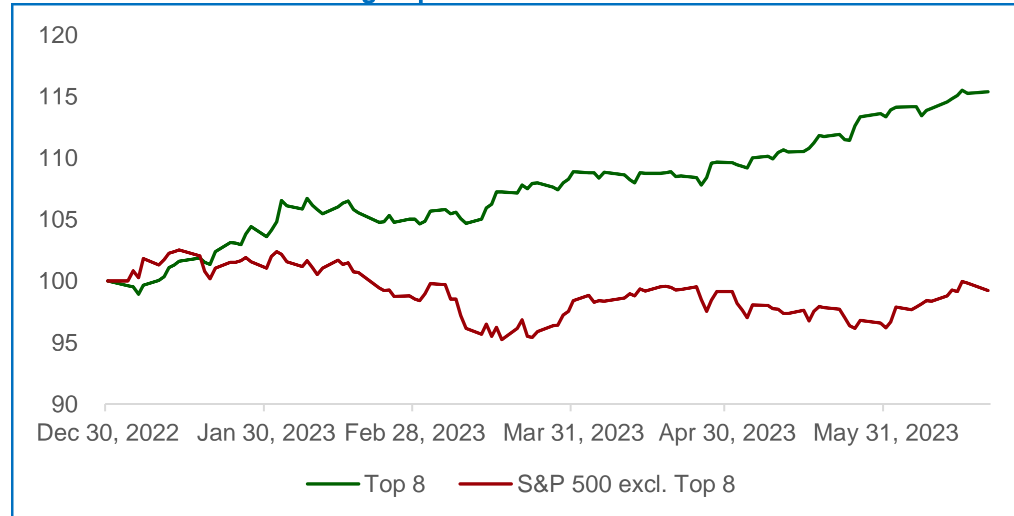
Can all this AI hype meet its expectations?

Generally, growth investors tend to chase the "next big thing". With many technology company stocks recovering from their deflated prices since October 2022, the advent of generative AI/ ChatGPT became a major catalyst for the recent performance in major technology stocks such as Microsoft (MSFT), Nvidia (NVDA), Alphabet (GOOG, GOOGL) and Meta Platforms (META). YTD (as of June 20, 2023) the S&P 500 index has provided a 14.30% return. However, a deeper look shows that the top eight stocks (AAPL, MSFT, AMZN, NVDA, GOOGL, TSLA, GOOG and META) in terms of

weightage, which jointly account for about 27.61% of the index, have provided returns of 15.40%. Excluding these eight stocks, the S&P 500 is actually down 0.80% YTD. This clearly shows that market sentiments are heavily skewed towards companies that are perceived as potential AI winners.

Excluding the returns from the top eight stocks, the S&P 500 has provided a return of -0.80% YTD

Exhibit 2: S&P 500 excluding Top 8 stocks have returned -0.80% YTD



Source: Berunda Analysis

We believe AI advancements can help improve performance long term and solve issues across various sectors. However, the current market movement mostly feels like a FOMO ("fear of missing out") rally rather than a logical one. Investors' perceived value of such new technology can be significantly misguided, and we note that such rallies have now become common place in the age of social media. Generative AI and other AI-related product offerings are expected to have numerous use cases across various industrial verticals (*Anyone still remember Blockchain?).* If we take a step back and look at it, the number of viable use cases may boil down to a few as these products start rolling out. And one other thing that the market heavily discounts in its valuation is *Competition.*

Seriously, is Nvidia the only AI chip maker?

We estimate Nvidia's data center revenues need to grow continuously at 50% for the next five years to justify its $400+ price point

Nvidia (NVDA) has proved itself to be one of the leading players in the GPU space with its innovative products. Yet again, the company has challenged its competition with its recently launched AI products that are way ahead of the curve. The market has also rewarded its prudent strategic move with a whopping 192% return in its stock price and crossing the US$1 trillion mark in market capitalization in June 2023. Being a first mover in the AI space, Nvidia will continue to enjoy strong demand in the upcoming months. However, according to our analysis, the current price point of Nvidia of over $430 per share indicates that its data center segment revenues might have to grow at a CAGR of over 50% continuously for the next five to ten years (Possible, yes? But unlikely, unless competitors remain asleep at the wheel).

Significant investments in the AI space from major tech and internet companies like Microsoft, Amazon, Alphabet and Meta Platforms may have so far primarily driven the demand for AI chips. In order to catching up to this trend, other tech companies across the world may also continue to increase their investments in the AI space. But building capacity is not demand, folks, not yet anyway! *Hmm, somehow, this reminds us of all the fiber optic glut that was built in 1990s until the internet bubble popped.*

Despite being an early innovator, as we argue, Nvidia alone cannot remain as major player in the market. Currently, Nvidia is expected to enjoy higher margin returns from its data center offerings. On the other hand, customers may not favor a monopolistic market, which could increase their costs in an already inflationary environment. Such lucrative demand environment would motivate competition to ramp up their R&D and

invite new players in to the field. Recently, AMD recently launched its own AI chip that can be used in large language models (LLMs). Investors should also be well aware of such alternates, which could start chipping away Nvidia's market share in AI chips and pose a risk to the expected 50%+ growth in the data center segment.

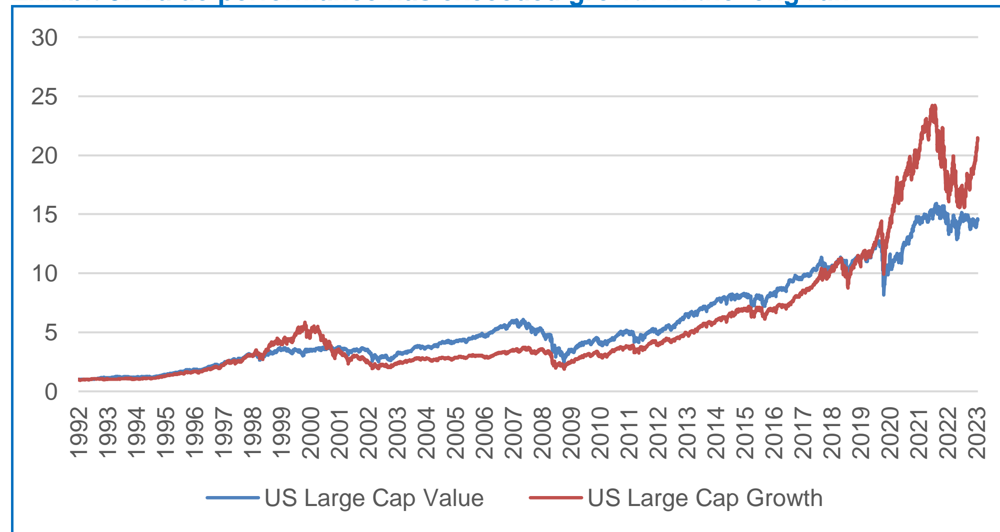
Like the AI chips space, we believe the competition in the AI API space should also start heating up. Even though little late to the game, the launch of Google's Bard ai chatbot in the generative AI segment should intensify the competition with ChatGPT. Similarly, we expect Meta Platforms, Amazon and other tech companies to increase competition in AI offerings.

Where does value stand in the current scenario?

Growth chasing creates bubbles that always lead value

Unfortunately, large cap value (ergo, advisors like us) has recorded a muted performance YTD (+0.14%) compared to large cap growth (+34.01%). We believe value's underperformance may be primarily due to continuing uncertainty in the macroeconomy and investors shifting their investments to capture growth. Time and again, growth chasing has led to bubbles ultimately then leading to a market correction. We do believe AI can create value to our day-to-day lives. However, we believe the investor must remain quite cautious about all the surrounding AI hype and the macro scenario that is playing out.

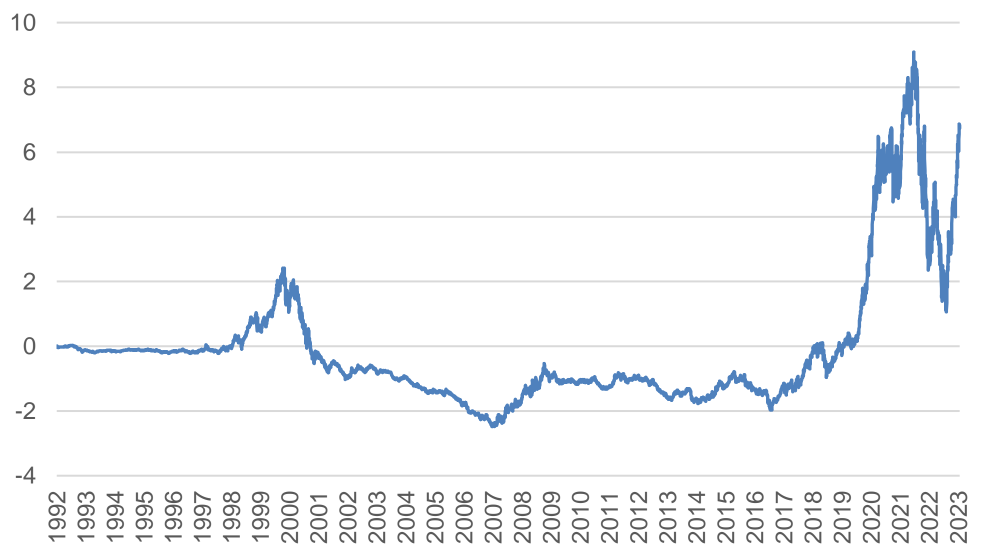
Exhibit 3: Value performance has exceeded growth in the long run



Source: MSCI Indices, Berunda Analysis

From Exhibit 3, in the long run, value always outperforms growth, except during market bubbles, which have become quite frequent *(Counterpoint to value managers: In the long run, we are all dead -Keynes and in the short run, there are SPAC and now AI billionaires!).* During the internet bubble (1998-2000), growth outperformed value, like what we are witnessing now. As the internet bubble burst (2000-2002), growth stocks were significantly discounted and traded well below value till the COVID-19 pandemic. Since the pandemic, growth stocks have started to exhibit a pattern similar to what we saw during the internet bubble.

Exhibit 4: Growth-Value relative performance starting to peak again since 2020



Source: MSCI Indices, Berunda Analysis

Our analysis also shows that the relative performance of growth and value (growth minus value) has remained around zero during 1992-1998 and well below zero from the dot-com crash to 2018. The pandemic-led bullishness around technology companies and recent AI hype were some of the major factors in the recent uptick in growth-value relative performance well above six. These charts (Exhibits 3 & 4) visibly indicate that a bubble may be forming due to the recent AI bandwagon, which clearly overlooks the macro scenario.

What story is the current US macro environment telling us?

Increasing interest rates could be more detrimental to the YTD extreme bullishness in growth stocks

Most of the tech sector stocks have rallied along with the AI hype based on the expectation that there may be a recovery in the macro economy in the second half of 2023. Further, many tech companies have also recorded that their sales cycles have elongated due to the current macro environment and inventory destocking. Some macro indicators such as the unemployment rate and inflation, may indicate consumer demand to remain moderately stable. However, a strong job market could lead to sticky inflation, thereby forcing the Fed to hike rates by another 50 basis points in the coming months. These scenarios could also test the bullishness in growth stories as interest rates continue to remain high. Even though some of the AI investments are transformational, adoption could take time or slow down, similar to what we are witnessing in cloud and cyber security, when liquidity reduces. We believe such scenarios may have a negative effect on the current rally in the market as early as the second half of 2023.

Valuing banks at end game but not tech: *What you don't know won't hurt you (but actually may make you richer)?*

Investors continue to write down bank balance sheets today (which is perhaps valid), even though banking stress is yet to exacerbate. However, we hear of several trillion of AI market potential in the decades to come and buy tech stocks right away. The negative ramifications of AI and the impact to traditional software and hardware products are largely ignored by investors. If AI can write and maintain computer code, do we need traditional software products, jobs or cloud services? If AI chips are the future, shouldn't investment in traditional hardware be reduced?

Despite the technology sector rallying in the first quarter of 2023, the high interest rate environment created a sense of concern over Silicon Valley Bank's (SVB) speculative lending practices to Silicon Valley start-ups. As a reminder, SVB was heavily concentrated in technology sector deposits. We note that vaporizing Venture Capital (VC) funding acted as one of the major catalysts that ultimately led to the meltdown of

the bank. However, this has created a highly skeptical view towards the entire banking sector, including large banks, despite growing deposits and possibly earning higher future returns from current interest rates. However, the market who has discounted the financial sector (down 2.98% YTD), has particularly high hopes when the media mentions “AI”.

Why does all this make the current market rally so concerning?

S&P 500’s Trillion-Dollar Club trades at an inflated 43x P/E valuation against S&P 500’s P/E of 23.5x

As we have explained earlier, the top 8 stocks of the seven companies, Apple (Market Cap: $2.91T), Microsoft (Market Cap: $2.51T), Alphabet (Market Cap: $1.57T), Amazon (Market Cap: $1.29T), Nvidia (Market Cap: $1.08T), Tesla (Market Cap: $869.87B) and Meta Platforms (Market Cap: $728.66B), constitute the “Trillion-Dollar Club” (see source: Fortune article below). This club accounts for about 30% of the S&P 500’s $36.609T (as of June 20, 2023) market capitalization. YTD the club’s market cap has inflated from $7.22T at the beginning of the year to $11T, a lofty 50+% jump. In addition, the club’s P/E valuation increased from 28.3x to 43x, which is nearly double the S&P 500’s P/E of 23.5x.

What threat does this bloated valuation of the Trillion-Dollar Club pose?

The Federal Reserve’s determination to fight inflation is highlighted by recent testimony and the Fed minutes. Investors must consider the possibility of a further increase to the Fed funds rate as a possible scenario. In that scenario, the market’s euphoria over AI could quickly turn more rational. Even if the market intends to reassess the club’s valuation to 28.3x approximately $3.5T of the S&P 500’s market cap could be wiped out. This translates to a correction of 9.5%, erasing nearly two-thirds of the current gain in the market. However, such a correction may not stop with the Trillion-Dollar Club. Rather, the contagion may spread to other sectors.

Finally, for full disclosure, we are a small value-based investment advisor, who has under-performed the market indices year-to-date in 2023, but beat the market indices in 2022.

Sources

- Why Amazon, Nvidia, and Tesla shares could tumble | Fortune
- MSCI
- SectorSPDRs

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Sri Nagarajan is the Managing Partner of Berunda Capital Partners. He is also the Principal of ValAn Global Solutions, a research support services firm. Prior to founding Berunda Capital and ValAn Global Solutions, Sri Nagarajan served as a Senior Research Analyst and Managing Director at Cantor Fitzgerald. Sri Nagarajan has also served as a senior analyst at various sell-side firms such as FBR Capital Markets & Co., RBC Capital Markets and UBS from 2002-12. Mr. Nagarajan has also worked as a senior investment analyst at Cohen & Steers Capital Management, a global asset management firm from 2007-9. From 1993-2000, Sri Nagarajan was a senior manager at Sabre, Inc., managing a team researching efficient scheduling optimization algorithms and macroeconomic forecasting models for the transportation industry. Mr. Nagarajan received his B.E. from Anna University, India, an M.S. in industrial engineering from Louisiana State University, M.S. in systems engineering from The University of Arizona, and an MBA in Finance and Strategic Management from The Wharton School of Business.

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