Changes Happen Fast These Days

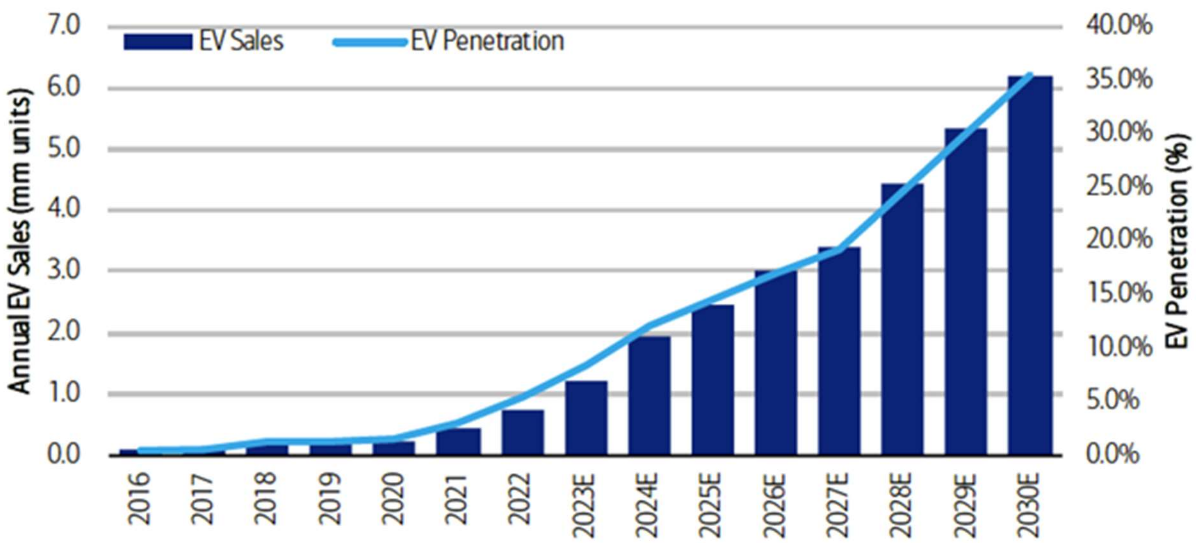
Anecdotally, it seems like things change quicker these days. Technology, medicine, recovery from bear markets, investor sentiment and so on. It is increasingly looking as though the adoption of electric vehicles (EV's) could be a major example of events occurring faster than expected.

Recently, Bank of America Global Research stated that their estimate for price parity of EV's (including incentives) with internal combustion engines (ICE) will occur in 2025, four years earlier than previous estimates. They expect new EV launches in the 2024-2027 period to exceed ICE.

Below we can see their estimates for EV sales in units and market penetration as a percentage through 2030.

Exhibit 4: US EV penetration & volume forecasts through 2030E

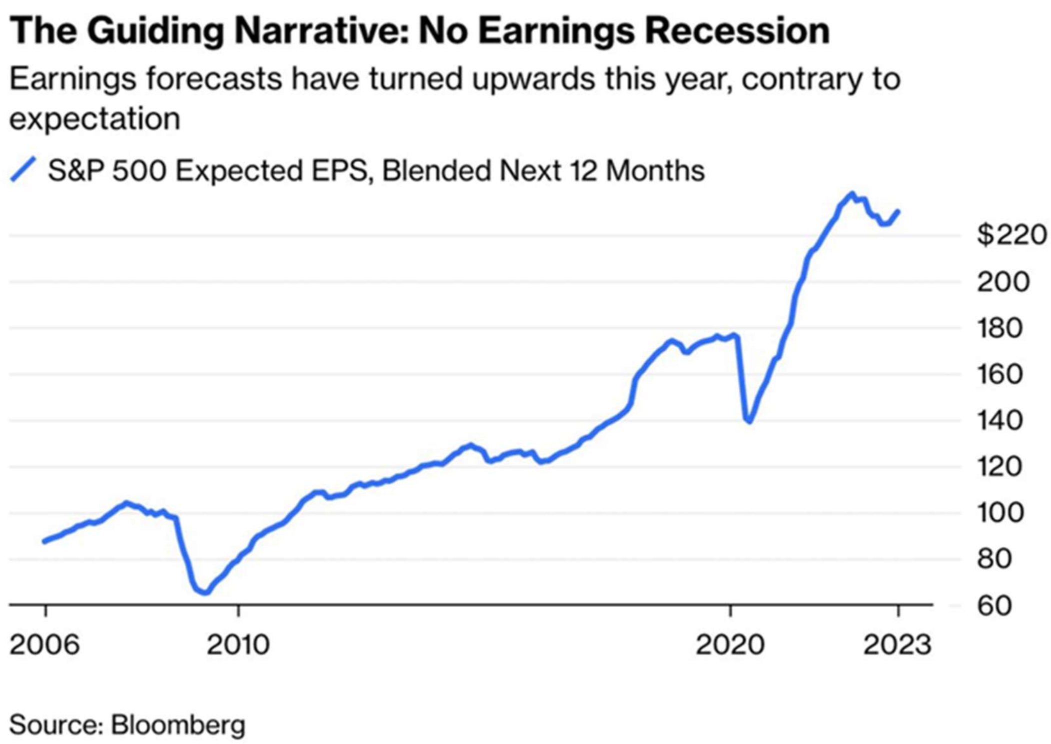
BofA forecasts ~8% EV penetration in 2023E, ~15% in 2025E, ~36% in 2030E



Source: BofA Global Research estimates

Earnings Strength

In the short-term, there are a long list of factors that can influence stock prices, including of course investor emotions. However, as you move towards longer timeframes the list of factors gets much shorter, with earnings being at the top of the list. For at least the past year, many have predicted a steep decline in earnings in conjunction with a recession. Both seem to have either been wrong, or delayed, as we have seen higher earnings guidance.



Look closely at the chart above and compare the rate of increase between 2010 to 2020 to the couple of years just after the pandemic arrived. Earnings spiked higher in recent years for a variety of factors. Do they need to decline rapidly back to the former trend rate? It is possible, but just like with stocks, our base case is more of a sideways to slow uptrend to digest the previous gains, while frustrating bears at the same time.

AI: A Bubble?

While the debt ceiling, the Fed and inflation are among the big topics so far this year, undoubtedly from an investment perspective the biggest market mover has been Artificial Intelligence (AI). While AI has been around in some form for many years, it took a notable leap forward in a public way late last year with ChatGPT. Since then, anything potentially tied to the future growth of AI has surged higher in stock price despite many areas of the broader market remaining weak. Inevitably, with such a significant move higher in such a short period many investors are convinced an AI bubble has already occurred. In fact, our first chart below shows that the technology sector is the most extended above its 50-day moving average as measured by standard deviation since 2004.

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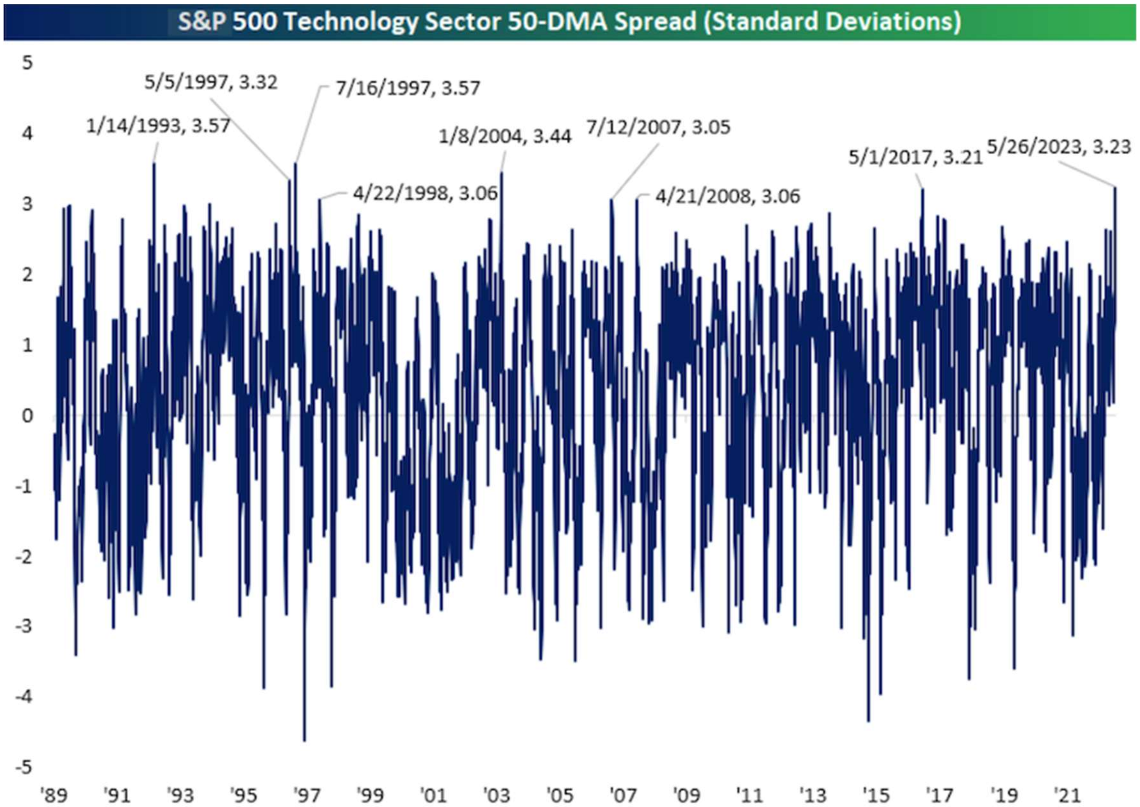
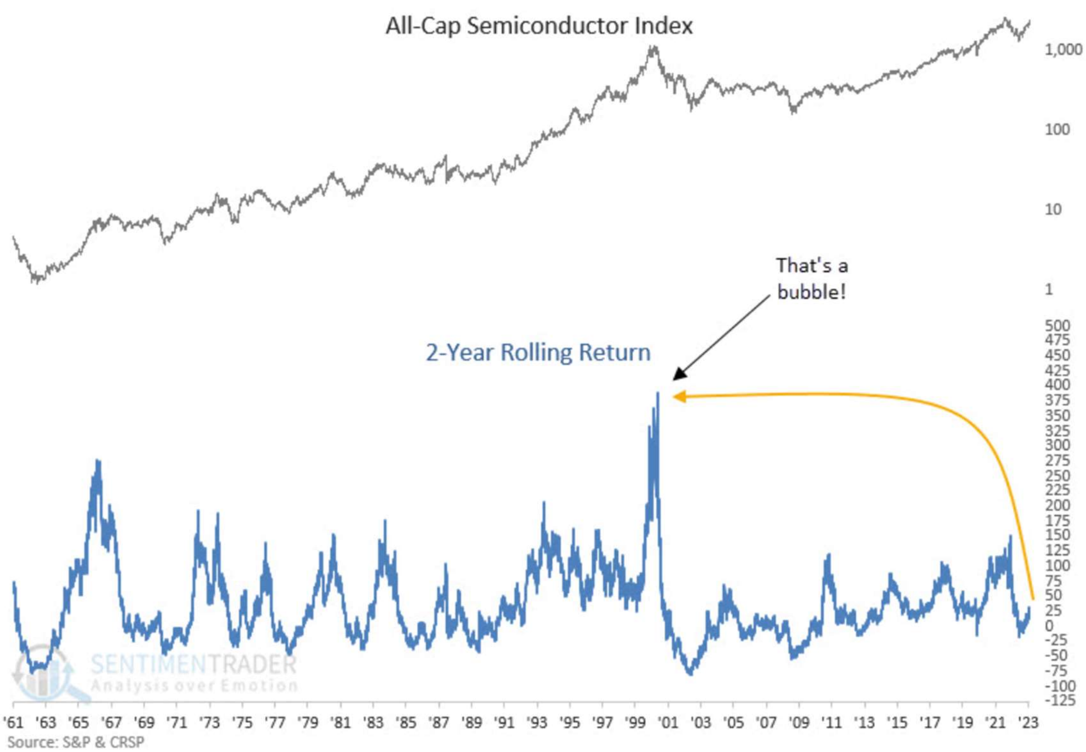


Source: Bespoke Investment Group

However, our next chart shows that the semiconductor index (a critical part of the AI industry), is still at a depressed levels on a rolling 2-year return basis.

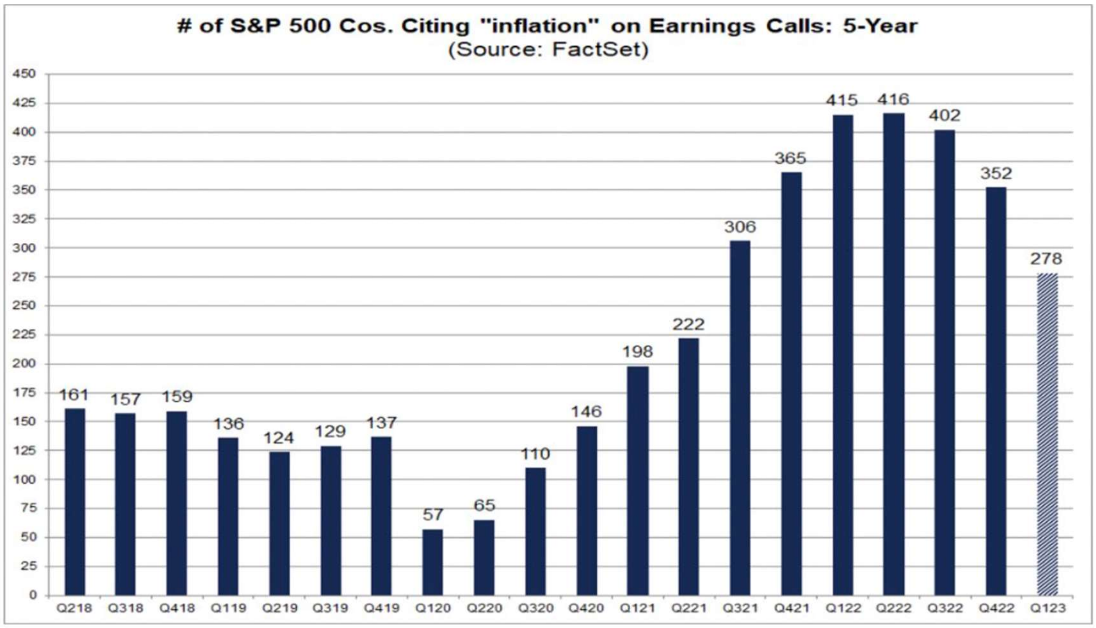


Some are referring to this era of AI similarly as the onset of the internet that created the huge bubble in 2000 (refer to chart above). That was the largest investment bubble in U.S. stock market history. Certainly, a lofty period to compare anything against.

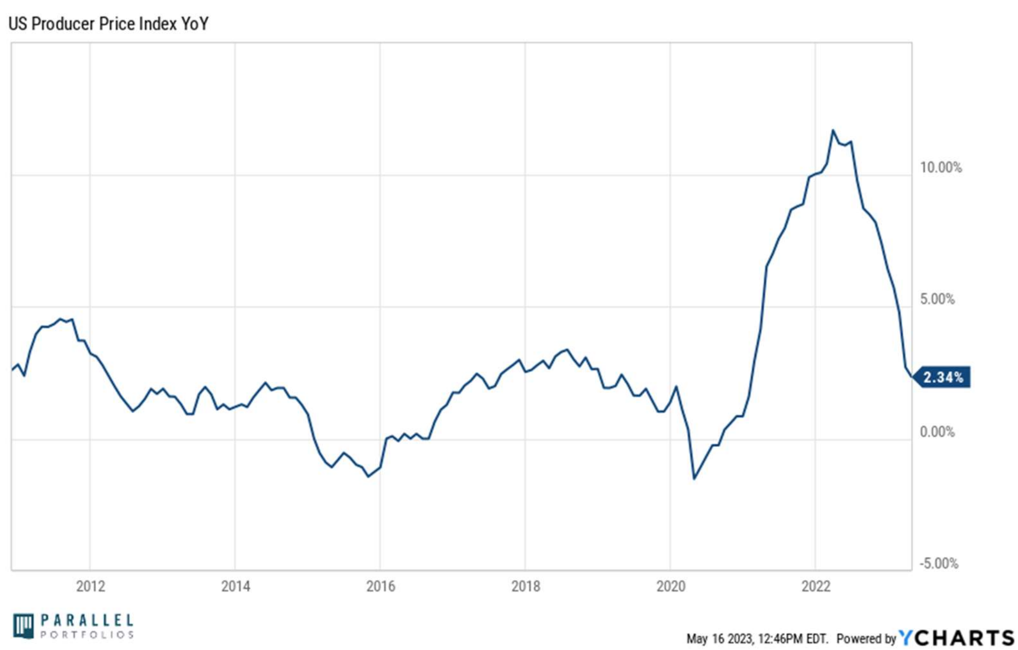
Another Look at Inflation

After many months of inflation as a headliner, it has been pushed aside by the debt ceiling talks.

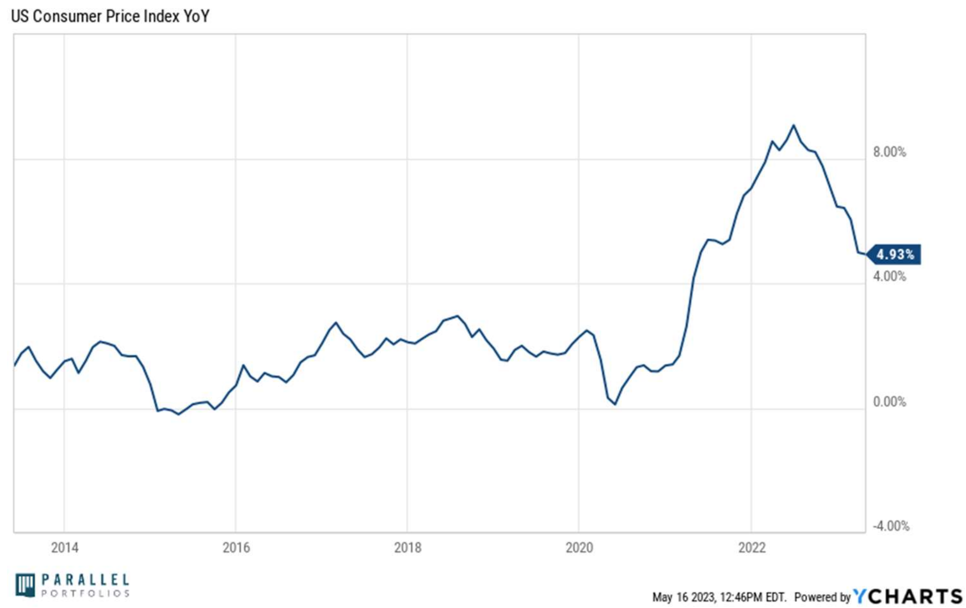
The mentioning of inflation in earnings calls, has declined significantly, but still remains above 2019 trends.



Meanwhile the Consumer Price Index (CPI) continues to decline.



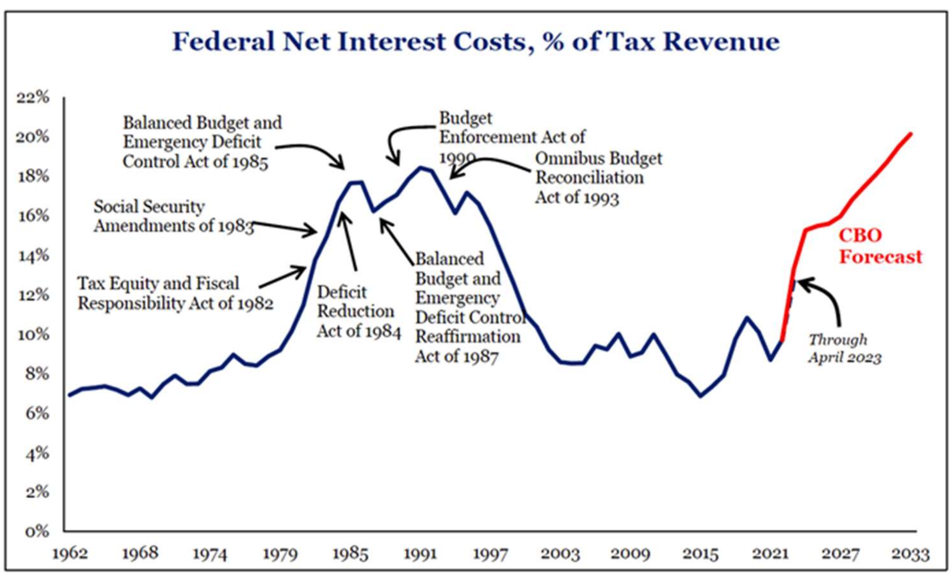
The Producer Price Index (PPI) has declined even faster, allowing for higher corporate margins to remain as companies have been slow to pass along cost savings to the consumer.



We continue to believe that inflation has further to decline, but will likely stall out at a rate higher than we have enjoyed for the past 10-15 years. If the Fed is satisfied with potentially that outcome, it could be one of the most important stories over the next one to two years.

<u>Interest Costs Spiking</u>

The past few decades of mostly declining interest rates has allowed for lower tax rates and increased government spending, without much concern over the interest cost on that debt. As we see below, that has changed over the past few years, with government interest expense projected to spike.

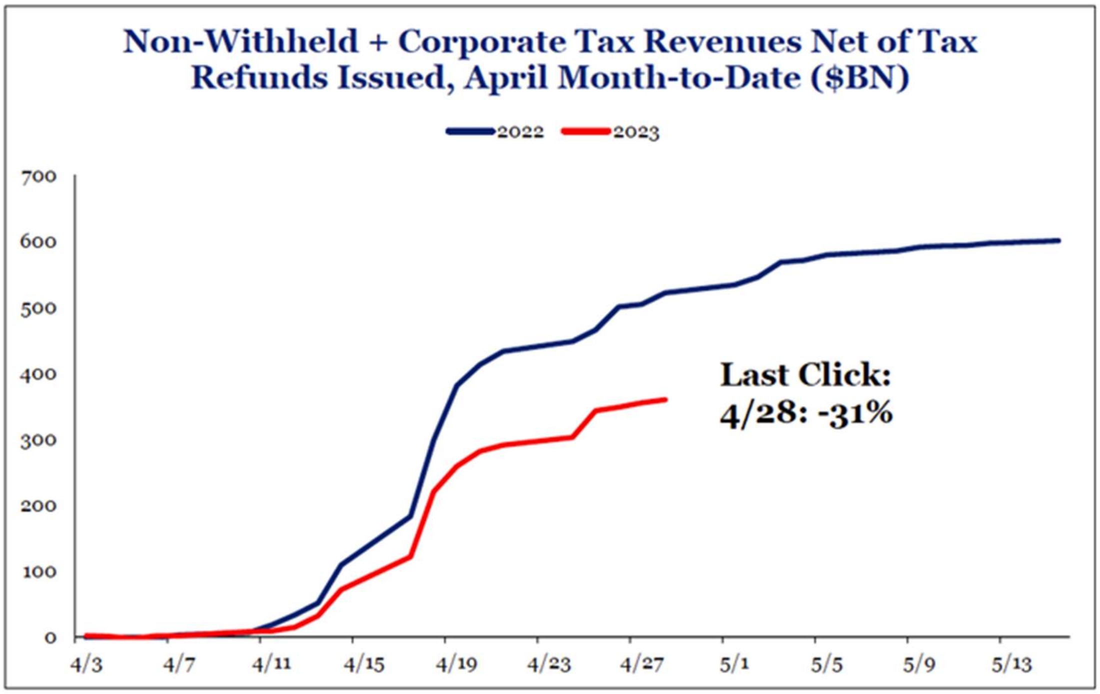


Source: Strategas Research

Assuming those projections are somewhat correct, it can be easy to think of all of the worst-case scenarios. However, we always encourage investors to keep an open mind and consider various potential outcomes. Notice the spike and eventual plateau in the chart above starting about 1980. It turns out that period was one of the greatest bull markets for stocks in history. That is not what we are predicting, but investors should be careful to assume that the only outcome is negative.

The Debt Ceiling Arrives Early

Stock markets have experienced several weeks of very low volatility as earnings season has performed better than expected. However, the Treasury has reported that tax receipts this month (chart below) have come in lower than last year, and expectations have moved the debt ceiling deadline forward. Instead of July or even August, it is now estimated to be early June.



Source: Strategas Research

This is certainly not the first time the debt ceiling has grabbed investor attention. It has created investor angst numerous times over the years. Of course, we cannot rule out a worst-case scenario of no agreement being reached and some type of default headlines roiling the markets. More likely, politicians on both sides will be debating, arguing, and posturing before a last minute agreement, perhaps temporary in nature.

Even experienced investors would be hard pressed to remember exactly when the past debt ceiling volatility occurred or to be able to locate on a chart. The volatility that ensues tends to increase fear among investors, which ultimately creates investment opportunities. We don't know how this will play out, but we do know that investors would be best served by focusing on their long-term investment process and not short-term noise.

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