We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

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BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Boujdour Lighthouse, *Cape Bojador, Boujdour, Morocco*

The Boujdour lighthouse was originally constructed in 1953 and was first lite 6 years later. The tower stands at 171 feet tall and became a historical monument in Morocco in 1976.

Les Eclaireurs lighthouse, *Tierra del Fuego, Argentina*

This lighthouse is known romantically as the “Lighthouse at the end of the world” due to its location being in southern Argentina. The lighthouse was built in 1920 and has become a very popular tourist attraction.

Feel free to send us your photos of Lighthouses to be featured in our weekly market observations.

A tale of two markets

The real estate market is in an interesting spot, one that we have not seen in quite a long time. Housing prices have slowed down as rates have surged but we by no means have seen a crash. Rising rates have impacted millions of Canadians who owned variable rate mortgages the most, as many of these terms of reset and thousands of mortgages across Canada have begun to negatively amortize. Rental prices are also surging reflecting the lack of supply in various North American markets which is why home prices have remained high despite the economic backdrop across North America.

However, none of what we mentioned above is why we decided to write this piece in this week's publication. We are writing this piece because of some comments that were made by the CEO of Fannie Mae this week. Priscilla Almodovar explained that the housing market is a tale of two separate markets right now, buyers, and sellers.

Fannie Mae is a U.S. government-sponsored enterprise that operates across the mortgage market. As of March 2023, Fannie Mae was ranked number 28 on Forbes's largest U.S. companies by revenue.

Back to her comments.

Priscilla went on to explain that homeowners are in good shape as they own a lot of equity in their homes, and most have a rate in the 2-6% range. Roughly 92% of U.S. homeowners who have mortgages have a rate below 6%, according to a June analysis by Redfin. As the 30-year mortgage rate hits 8%, many Americans are deciding to stay put rather than buy a new home at an elevated mortgage rate.

On the flip side, buyers are contending with the highest mortgage rates in 23 years and are also dealing with low inventory. Homes on the market have declined by 4% year over year as of September 30th. Despite mortgage rates surging, the average sale price for an existing home has increased by 3.9% over the last year.

The CEO went on to say that her company believes mortgage rates will stay above 7% for most of next year and end 2024 close to 6.7%. If mortgage rates remain above 7% for the next year expect sales volume to continue to come in soft as they have over the last year. Consumers will continue to stay put if they can and home buyers in a pinch will be the ones stomaching these higher rates. Expect rates to remain higher for longer than many expect but do not expect that to result in a steep decline in home prices. The lack of housing supply across Canada and the U.S. will keep home prices elevated for the time being. Perhaps the underinvestment in the housing supply in both countries prevented a mortgage crisis 2.0.

Bridgewater's top dogs

The co-chief investment officers of hedge fund giant Bridgewater Associates released a note earlier this month addressing the current state of the global economy and financial markets. The statement was quite insightful, and we recommend giving it a read if you have the time. Bridgewater Associates was founded by Ray Dalio in 1975. The company currently has north of $120 billion in assets under management and Dalio's net worth is estimated to be $15.4 billion.

Here is the letter published on Bridgewater's website. Click here.

We will give a summary and our thoughts on their statements.

Bridgewater believes that two major forces will continue to put upward pressure on long-term rates and downward pressure on economic growth. 1. the need to sustain restrictive monetary policy, and 2. an emerging liquidity hole in the bond market.

Bridgewater stated that economic growth is not weak enough to justify rate cuts and inflation remains too high. They believe the correct response to these conditions is to hold or even raise short-term rates a bit further. On the side of the emerging liquidity hole in the bond market, the U.S. government is about to heavily increase their borrowing on the long end of the yield curve. This added borrowing greatly outweighs the existing demand from investors to buy bonds. The impact of this liquidity hole has been delayed by the U.S. Treasury funding its fiscal deficit via T-bills with the demand for those T-bills coming from a residual excess of liquidity left over from prior MP3 policies. Bridgewater stated that the third quarter bond market sell-off began when long-term issuance was on the rise and private investor demand was far below the future required demand.

These implications would produce grinding pressures on economic growth impacting the equity market and the U.S. dollar. Bridgewater believes there is limited upside in the U.S. dollar moving forward. They also believe the outlook for equity markets is not advantageous due to the risk premium levels of different asset classes. They believe earnings will be a contributing drag to the equity market and restoring risk premiums in equities relative to bonds will require higher yields and lower prices, something that is not currently happening and that they believe will not happen for quite some time.

Nvidia's tough few days

Unless you have been completely ignoring the business news in 2023, we are sure you have heard of Nvidia. Nvidia is a semiconductor producer which has been the biggest winner in the artificial intelligence (AI) revolution. The company's stock price is up 197% year to date (even with a recent pullback). The company has risen meteorically and now boasts a market capitalization of $1.05 trillion. The company has the sixth-largest market capitalization globally. Even with its competitive advantage in the AI semiconductor space, we believed Nvidia was due for a pullback purely based on fundamental analysis, Nvidia trades extremely expensive relative to earnings, cash flows, and book value. However,

the biggest risk for Nvidia was not fundamental, it was geopolitical risk. As an American company, Nvidia operates under the rules of the U.S. government which at any moment could cut them off to China, citing national security issues.

Earlier this week, it was announced that the Commerce Department was updating its restrictions that were announced in 2022 that target China's access to advanced American technology. The updated restrictions ban the export of U.S. high-tech chips without a license to China. Exports of semiconductors just below the set threshold will require government notification that could be followed by a ban.

After these new restrictions were announced, Nvidia immediately came out to say global demand for its products will remain strong and these restrictions will not impact their near-term financial results. However, Wall Street disagreed, numerous analysts put out notes to clients that this will have a large impact on Nvidia in the long term as China currently accounts for approximately 20% of Nvidia's revenue from its data center business which encompasses most of its dominance in artificial intelligence. Citi's analyst covering Nvidia slashed his price target by $55 after this announcement but continued his buy recommendation.

Investors seemed to agree with Wall Street analysts this week as Nvidia shares dropped close to 10% wiping out $100 billion in market capitalization in just a few days.

Analysts believe that Nvidia needs Chinese revenue to grow earnings at the rate investors have come to expect recently with Nvidia.

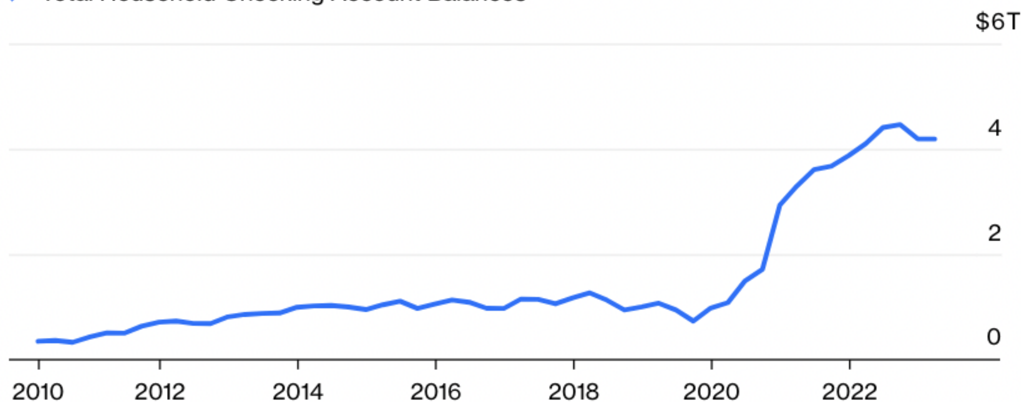
The tighter export controls are expected to crimp Nvidia's ability to sell its H800 and A800 chips to China. In the short term, Nvidia should be fine as the global supply of AI chips greatly trails robust global demand.

KeyBanc Capital Markets said Tuesday that the new restrictions are a negative for Nvidia, arguing "it will ultimately be difficult to backfill China's demand."

The latest export controls go into effect in 30 days and are a new low point in Chinese-American relations. The trade war that many believed the Trump administration initiated has continued throughout the first 3 years of the Biden administration as the East and West continue to decouple.

Worried consumers

Consumers are currently parking (a lot) more money in checking accounts than they were before Covid-19. In fact, the amount of cash sitting in household and non-profit checking accounts has more than doubled over the last 3.5 years.



Is this trend coincidental or is it proof that consumers and investors are more worried than ever? Are consumers parking more and more of their money in accessible accounts to pay for expenses or plan for emergencies? We think that this is proof that consumers continue to be worried and are planning for the worst by loading up their checking accounts. The other way to look at on this chart, is when economic uncertainty and inflation are defeated will these consumers pile this extra money into equities and go on a buying frenzy?

Rising interest rates, multi-decade high inflation, and major geopolitical risks are spooking some consumers who are as worried as they have been in years. These consumers are passing on large purchases, passing on buying investment assets, and holding cash as they attempt to brave the storm.

The other driver of this chart jumping over the last 3 years is the amount of money that was created by the U.S. government in response to Covid-19 (stimulus resulted in trillions of dollars being printed by the government to support the U.S. economy while it dealt with pandemic lockdowns).

Returns for the S&P 500

The S&P 500 is up 13.5% this year, a great rebound after a brutal 2022. However, our long-time readers know this year's S&P 500 return is completely due to the returns of 7 technology companies known as the Magnificent 7. The big technology companies that we know as the S&P 7 are up over 50% year to date (as of October 10th), while the S&P 493 is slightly down over the same period. That's right the positive returns realized by the S&P 500 this year are completely due to 7 mega capitalized companies.

Before you ask why that is, let us show you a chart.

The P/E ratio for S&P7 has in 2023 gone from 29 to close to 45

Source: Bloomberg, Apollo Chief Economist. Note: 12-month trailing P/E ratio used.

The P/E ratio for the S&P 7 has expanded from 29x to 45x this year, while the S&P 493 has a P/E ratio that is close to a third of that and it is flat this year. Our point of this exercise is to say that the S&P 7 has not risen rapidly due to an expansion of company earnings but because of investor optimism – price chasers. P/E ratios of 45x are extremely expensive and make us very cautious when we look at these companies. Although these are high growth companies who historically trade more expensively than other companies. In today's environment they are extremely expensive and are trading at a huge premium. Diving deeper into the S&P 7's P/E ratio, the two companies whose P/E ratios have soared this year the most have been Meta and Nvidia. Nvidia is trading at 106 times earnings (57x a year ago), and Meta is trading at 37 times earnings (11x a year ago). If the outlook for these technology giants gets

worse and tech bulls hit their sell buttons, will they take the rest of the market with them? It seems more and more likely that they will as the market is being dragged on by a small number of companies and anything that goes wrong with those select companies could topple the rest of the market.

Oil's geopolitical risk(s)

As tension rises in the Middle East and countries threaten Israel, the geopolitical risks associated with the oil market come front and center in the news. Oil prices surged on Russia's invasion of Ukraine last year just like they had done in previous conflicts involving large oil producers. Even though Israel and Palestine are not large oil-producing nations, they have allies who are threatening to decrease their production (even more) or even call for an embargo. Iran who is rumored to have helped Hamas plan their attack on Israel is calling for an oil embargo on Israel. The already tight oil market jumped 2% on Wednesday with this news.

Many believe the conflict in Israel and Gaza could accelerate in the coming weeks which could further increase energy prices. As a major oil-producing region across the world, the Middle East's instability could further accelerate oil prices and continue to boost the earnings of energy producers moving forward. We are not betting on conflict and hope a proper resolution can occur but believe this conflict will get much worse before it gets better. Many believe that the region is on the brink of a widespread conflict that could involve groups from numerous countries. Some believe there is a high probability that Hezbollah from Lebanon or various Syrian groups could join Hamas in their attack on Israel which would certainly escalate tension in the region.

Iran has even called on its allies to stop exporting oil from Israel and to kick Israeli diplomats out of their country.

These geopolitical risks that have large impacts on the global price of oil cannot be overlooked as there is a high probability that the price of oil will surge and reignite energy inflation across the world.

Until the West and the rest of the world find a way to increase their investment in oil production, their oil prices will come at the whims of OPEC and their member nations' actions.

MacNicol & Associates Asset Management
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