GCM Quarterly Report

Summer 2023

Exciting news! The biggest and perhaps most important event of the entire decade has been teased: an epic cage fight between Elon Musk and Mark Zuckerberg. Our money is on Mr. Zuckerberg, who trains and competes in Brazilian Jiu Jitsu, but perhaps Elon is hiding some kind of martial arts wizardry up his sleeve.

Edit: sad news… the fight has been called off. Perhaps some day we can see these modern-day titans of technology take to the ring. In any case, onto more important matters.

Earnings and the stock market

Sell in May and go away? We don't think so. From the beginning of May to the end of July, the S&P 500 has increased 10%. Importantly, breadth within the market has broadened out since the first quarter, with small and mid-cap stocks also performing well so far this summer; the S&P mid-cap index is up about 9% over the same time period and small-cap stocks are up over 11%. That's not to say mega-cap technology stocks like Amazon and Apple have slowed down (they're both up over 15% since May). Rather, it's merely a sign that investors are becoming optimistic on a wider range of opportunities than just the five or six biggest companies in the world. It's worth noting, though, that August and September are historically the worst months of the year for market returns, so our optimism may be premature. (Source: Raymond James *Weekly Headings* 8/4/23).

What's with the bullish sentiment? The market can often behave like a pendulum, swinging too far in one direction, overdoing it, then swinging back in the other direction. In this case, the post-COVID optimism of 2021 was likely exaggerated and precipitated a selloff in 2022. We think the relief rally we've enjoyed this year is driven, at least in part, by investors reversing course once again. Of course, the health of corporate America is also an important factor.

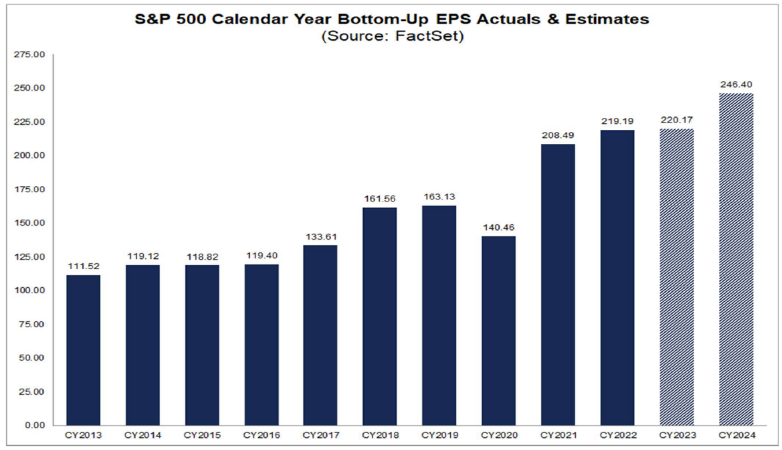
As of August 4th, earnings for the second quarter of 2023 have been reported by 84% of S&P 500 member companies. Results are better than feared, but they're not exactly *good*. On the plus side, "both the number of companies reporting positive earnings surprises and the magnitude of these earnings surprises are above their 10-year averages." (Source: Factset). On the negative side, aggregate earnings for the quarter appear to be about 5.2% lower than the same quarter last year. If this figure sticks through the end of the reporting season, it will be the worst quarterly earnings decline in three years. Interestingly, but perhaps not surprisingly, the consumer discretionary sector has reported the strongest earnings growth (+52%) of the eleven S&P sectors while the energy sector has reported the worst earnings decline (-51%).

Profit margins have fallen a little bit year-over-year, from 12.2% to 11.5%. This is likely a consequence of higher wages and consumers finally hitting their limits on price increases. Importantly, this figure is still a smidge above the 5-year average of 11.4%, indicating corporations are still, on average, producing stronger profits than in the recent past. (Data from Factset).

Market Statistics	July '23	YTD	2022	3-Year Annl.	5-Year Annl.
S&P 500	3.21%	20.65%	-18.11%	13.72%	12.20%
Dow Jones Ind. Avg.	3.29%	14.47%	-14.04%	12.93%	9.31%
Russell 2000 (Small Cap)	6.10%	14.43%	-20.76%	11.61%	4.69%
MSCI EAFE (Foreign)	3.24%	15.28%	-14.45%	9.25%	4.55%
MSCI ACWI (Global)	3.66%	18.11%	-18.36%	12.91%	10.41%
MSCI Emerging Mkts.	6.23%	11.42%	-20.09%	1.46%	1.71%
Barclay's Aggregate Bond	-0.07%	2.02%	-13.01%	-4.46%	0.75%
iShares Gold ETF (GLD)	3.02%	8.48%	-0.77%	-0.30%	9.61%

Source: Morningstar, as of 7/31/2023

As we've said many times in our newsletters, investors are primarily concerned with what's going to happen as opposed to what's already happened. To this point, calendar year earnings for 2023 are still expected to increase modestly by about 1% and calendar year earnings for 2024 are expected to increase by over 12%. While these figures may moderate over the coming months and quarters, we believe a hopeful outlook on the next ~18 months is the primary driver of the stock market's rise thus far this year. (all data in the prior paragraph from [Factset]).



S&P 500 calendar year earnings. Note that estimates for 2023 and 2024 (the gray bars on the right) are higher than prior years. (Illustration from [Factset])

The economy

Interest rates have defied all early-year prediction and are actually on the rise. The 10-year yield, a common benchmark rate off of which mortgages and many other kinds of loans are calculated, is just over 4.2%, the highest level since the Great Financial Crisis. What's the cause for this? Many analysts blame strong employment and healthy economic conditions. At the beginning of the year, analysts were predicting a recession during the second half of the year and believed the Federal Reserve could begin cutting interest rates as soon as autumn in order to soften the economic slowdown. Now, investors believe the Federal Reserve will not begin to reduce rates until 2024 and there's a chance they may even increase rates once or twice more if unemployment stays low and economic growth remains positive.

What data in particular could keep the Federal Reserve on a more aggressive rate-hiking course? US GDP for the 2nd quarter came in at [2.4% annualized], much higher than anticipated thanks to consumer spending and corporations expanding inventories. Inflation is also getting better, with June's readings for both the [Consumer Price Index] (CPI) and [Personal Consumption Expenditures] (PCE) (two different methods for measuring more or less the same thing) falling to the lowest levels since 2021. Finally, payrolls remain strong. Although job growth in June was a little below expectations, the [unemployment rate] ticked lower yet again to 3.6%.

Politics

Acrimony in Washington has reached a new high (or low, depending on how you want to look at it). The credit rating agency Fitch downgraded United States debt on August 2nd from AAA to AA+ [blaming in part the political situation]: "We do feel like governance has deteriorated steadily over the last 20 years." While we agree with many analysts that Fitch's action is largely symbolic and will have little impact on the demand for US debt, it still feels like Sister Margaret is rapping our knuckles with a ruler. It's embarrassing to have the nation's creditworthiness called into question because some children in Washington can't get their collective act together. Most of us pay our bills on time and expect our country to do the same. The legal controversies surrounding the former president and current president's son are also unlikely to impact the economy or stock market, but are similarly embarrassing. And, just when you were getting settled in for a relaxing end to the summer, the first GOP debate is scheduled for August 23rd.

What we'll be watching

With about four months left in the year, there are a few things we'll be watching with great interest: economic growth (particularly through the holiday season), the trajectory of interest rates and the Fed's remaining opportunities to either hike rates further, leave rates unchanged, or even reduce rates (we think the latter is unlikely in 2023), and to a lesser extent the presidential campaigns that are beginning to emerge. The latter is only likely to cause interim disruptions to market behavior next year, but the two former items could potentially have a meaningful impact on stocks and bonds alike.

Ben's Corner

I'm sure many of you know that cars are something of a hobby of mine. My wife would say it's more of an obsession, but any true hobbyist of anything would say the line between "hobby" and "obsession" is a fuzzy one.

Being in the financial services industry, a guilty pleasure of mine is watching documentaries and reading stories about high-profile frauds. It's interesting to learn about the schemes these conmen come up with and, frankly, it's amazing how clever people can be when their morals and basic human decency are thrown out the window. But it's also awfully satisfying to see these people brought to justice.

Believe it or not, I'm going to connect these two things.

Let's rewind the clocks back to 2020. The COVID pandemic is in full swing. Businesses are shut down, you're not supposed to leave your house, we're all sitting around binge watching *The Great British Baking Show.* Then a big announcement crosses the headlines: in order to help businesses maintain payrolls while everything is shut down, the government is creating the Paycheck Protection Program (PPP for short). The details are pretty straightforward: any small business that can meet certain criteria related to lost income as a result of the pandemic could request a loan from the government. The best part? The loan is forgivable.

I'm sure you can see where this is going…

I have no doubt the Paycheck Protection Program was responsible for keeping a lot of businesses' doors open (particularly restaurants) and a lot of people employed, and the SBA has estimated that about 80% of PPP loans were used legitimately. Unfortunately, that means that about 20% of PPP loans were used for fraudulent purposes, what NBC News called, "The biggest fraud in a generation." The estimated amount of taxpayer money that was taken fraudulently through PPP and other COVID relief programs ranges from $80 billion to over $400 billion. A few examples:

- David Hines, a 29 year old from Florida, pled guilty to fraud of $3.9 million. In addition to buying himself a Lamborghini with taxpayer money, there was a $30,000 expense on his ledger that simply read, "mom." At least he loved his mother, I guess…
- Richard Ayvazyan, Marietta Terabelian, and Tamara Dadyan of California were convicted of stealing $18 million in COVID relief loans. They cut off their ankle bracelets and tried to run to Montenegro, but not before buying at least one Harley Davidson.
- Elias Eldabbagh of Washington, DC stole $17 million. He bought a Tesla.
- Another guy in Florida was accused of fraudulently claiming $7.2 million in COVID loans. He bought a Maserati, a Mercedes, and a Lincoln to park in the garage of a 12,000+ square foot house that was also bought with COVID funds.
- Finally, Kenneth Landers (also of Florida) collected over $900,000 in COVID loans and bought himself a vintage Jaguar E-Type roadster, a car Enzo Ferrari famously called one of the prettiest cars ever made.

Is there a moral to this story? I'm not sure. It's not exactly a surprise that a minority of people will always try to cheat the system, whatever that system may be. In hindsight, it's easy for me to say that PPP and the other COVID relief programs were flawed from the get-go. The people who drafted the legislation were in a bind: do you focus on speed of distribution and risk making the programs easy to manipulate? Or do you implement stringent application criteria to try to prevent fraud at the risk of making the programs too difficult to access by the people who need them most? I'll leave that question for you to ponder with your spouses, friends, and family members.

Interesting history fact of the quarter

The video game company Nintendo was originally founded in the late 19th century as a manufacturer of playing cards called *hanafuda*. It wasn't until the late 1960s that the company branched out into other table games like mahjong and chess, and another decade passed before they tried their hand at arcade games with hits like Donkey Kong (1981). The Nintendo Entertainment System (NES for short) home video game console was launched in 1983 and the rest, as they say, is history.

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