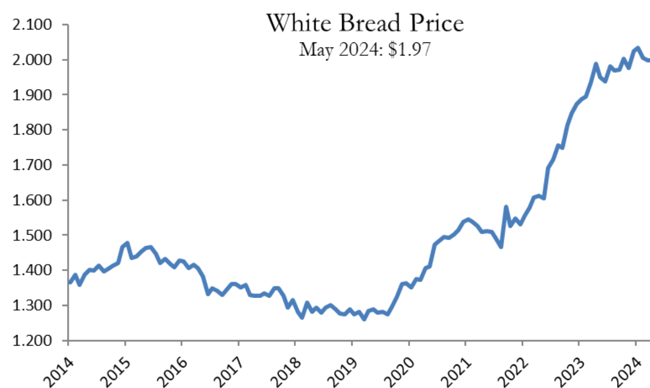
2Q2024

HOURGLASS CAPITAL

If at first you don't succeed, redefine success.
--George Carlin

I miss the days of coaching my kids. When they were young and impressionable my comments had a greater impact. They had no choice but to listen to my rants about practice and commitment. The running joke I revisited with them and their teammates time-and-again was "What do we do if something gets too difficult?" To which everyone would yell "We quit!" Of course, the comedy of the response was meant to drive home the absurdity of relinquishing the effort just because something had gotten too difficult and uncomfortable.

I wonder if anyone on the Federal Reserve board played youth sports? Maybe those distant formative memories will help with their current dilemma. The economy is slowing, yet unemployment remains low and inflation, while somewhat tamed, is far from the stated target of 2%. The S&P 500 continues to celebrate lower inflation prospects, and the potential for future interest rate cuts, despite absolute price levels for most basic goods & services being the highest in years. In the world of financial markets, economists tend to deal in theory and percentages. Rising prices are now rising less rapidly than before, but are still rising, and at this point in the inflation cycle have broadly imbedded nearly 20% higher prices than before the pandemic began. Unfortunately for working families and consumers, their budgets are based on absolutes. The purchasing power of their hard-earned dollars is declining. The U.S. Bureau of Labor Statistics provides a telling chart that tracks the most common of all purchases, a loaf of white bread. A fundamental example of the rise in costs being felt by most low-to-middle income families when paying for their basic staples. Rising prices have ebbed in the first half of 2024, but the price of a loaf of bread has risen over 50% since before the pandemic. Families are attempting to maintain their standard of living while prices are higher and the number of products in their cart at checkout are fewer. Their needs and demands ripple through the entire economy. Workers request higher wages to compensate for higher prices, product and services costs are then elevated, and the cycle continues.....until it doesn't.



The Fed's dual mandate to provide price stability and full employment is now being challenged from both sides. Are they about to change their definition of success before achieving their 2% inflation target? The main stream media and the talking heads on CNBC yearn for that first rate cut and the perceived unleashing it will have on market forces and demand. To date, the economy appears resilient as inflation is more muted (on a percentage basis!) while the labor picture remains one where unemployment figures remain near previous lows. Price stability and full employment, right? Perhaps, but the economy is slowing. First quarter GDP was an anemic 1.4% while the Atlanta Fed's estimate for 2nd quarter GDP is 1.5%. Hardly an economy in full expansion mode.

In 1958, a New Zealand economist and professor named Bill Phillips invented the Phillips curve of economics while teaching at the London School of Economics. The Phillips curve considers the dynamic between the rate of inflation and the unemployment rate. More specifically, the "curve" represents the relationship between unemployment and wage behavior over a business cycle. Phillips showed that the lower the unemployment rate, the tighter the labor market and the faster employers must raise wages to attract scarce labor. Many economists today consider the Phillips curve as an indicator of general price inflation to unemployment. The

tighter the labor market, the more pressure on hiring which drives higher wages and elevates the price of goods and service across the broader economy. Economists have been predicting the job market would lose momentum in the face of higher interest rates, as Phillips projected, yet hiring gains continue to show strength. The latest employment figures from the U.S. Labor Department show a healthy 206,000 jobs added in June equating to a low 4.1% unemployment rate.

The point of mentioning the Phillips curve is to illustrate a concern the Federal Reserve has with cutting interest rates prematurely. At the end of 2023 the market anticipated 6 rate cuts in 2024. By the end of March 2024 that figure had declined to 3 rate cuts. Now, at the end of the first half of 2024, the smartest minds in economics foresee one, possibly zero, rate cuts in the current year. How have so many been so wrong? The picture would be clearer if the labor market were falling in-line with the recent inflation data. The administration's own policies may be clouding the picture. Unrestrained immigration at our southern border along with increased hiring within the government has propped up the labor figures as low-income, low-skilled hires and bigger government makes the path forward for the Fed less clear. Their concern is that cutting rates to soon may unleash added demand within the economy at a time when the labor market is just starting to shrink. Immigration has been curtailed for re-election reasons, and the future path of governmental hiring may decline if policies change during an election year.

At the market level the picture remains positive although evermore concentrated. According to the strategy team at JPMorgan, the market currently sits at multi-decade extremes in terms of momentum crowding and stock concentration. The largest 20 stocks in the S&P 500 represent 75% of the index's gain YTD and 65% over the last year. Valuation and investor positioning are also near record extremes. In order to maintain these stretched characteristics, earnings revisions and future estimates will need to exceed the current expectation of 12-14% EPS growth over the next 6-18 months while also beating higher year-over-year EPS comparisons. This current rate of growth normally occurs in early cycle recoveries, not in a late-stage cycle similar to today. All this must happen in an environment where most other sectors are struggling to grow. Over the past 12 months, the largest 20 names in the S&P showed an 18% gain in earnings estimates while the other 480 companies had downward revisions equaling -6.0%. Of course, none of the 20 performers meet the requirements necessary to be labeled as even reasonable value investments in our portfolio.

Company	Ticker	Price	P/E	Price-to-FCF	Price-to-Sales	EV-to-Sales
NVIDIA Corp	NVDA	124.26	72.3	77.9	38.4	26.9
Broadcom Inc	AVGO	1601.61	60.8	37.7	16.5	15.5
Microsoft Corp	MSFT	452.62	39.2	47.7	14.2	13.3
Meta Platforms Inc	META	512.92	26.6	26.5	9.2	8.5
Apple Inc	AAPL	213.22	33.2	32.5	8.7	6.7
Alphabet Inc	GOOGL	184.07	27.8	33.4	7.3	5.6
Amazon.com Inc	AMZN	194.55	53.0	44.0	3.4	3.3
Hewlett Packard Enterprise Co	HPE	21.12	13.5	9.2	1.0	1.1

The chart above is a comparison of some of the most favored names within the market at the end of this quarter relative to our only holding in the technology sector, Hewlett Packard Enterprises (HPE). By nearly every metric we consider as value investors, the top companies are at historic extremes. Nearly all are significant players in the rush to build out platforms to support artificial intelligence. It's difficult to argue against the popularity of this expansion, but as always, the multiple paid and the make-up of the incremental buyer is concerning. Passive funds must maintain similar weighting exposures to these securities and any incremental positive news begets more buying despite the cost. If sentiment or the growth targets for these high-fliers were to change, the potential for significant multiple contraction is far greater than we've witnessed is quite some time. The over-sized weighting within the indices will also have a far greater impact on broader market performance as well. Markets just don't go up, let's remember, and the last daily market decline greater than -2% hasn't happened since February 21st of 2023!! We may be long overdue for some market volatility.

While every earnings season is important, the figures for the 2nd quarter of this year will provide some valuable insight into the continued growth performance of the artificial intelligence mavens. Earnings targets and expectations remain extremely elevated, providing for a high bar that must be cleared to appease the momentum crowd. Every earnings report begins to feel like a typical day in Vegas where your outcome becomes very binary and the price paid will either reap big returns or sharp losses. As a value investor, I prefer the world to be much more mundane and based on fundamental figures rather than the promise of steep returns. For this reason, we continue to be defensively positioned and wary of the hottest portions of the market.

At the portfolio level, we gave back a small percentage of our first quarter gains in the Strategic Value strategy returning 8.8% at the composite level relative to the Russell 1000 Value returning 6.6% YTD. We continue to be overweight larger businesses in the Energy, Utility, and Healthcare sectors where, in my view, investors have yet to recognize the full value of each enterprise. We are positioned in a manner where we have exposure to commodity markets where any devaluation in the USD will be supportive to prices while also maintaining exposure to less volatile healthcare businesses. Hopefully these firms will prove more resilient in an economic scenario where consumers become much more selective with their spending decisions.

I appreciate your friendship and confidence. Please feel free to reach out if I can be helpful with any investing needs you, a family member, or a friend might have.

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