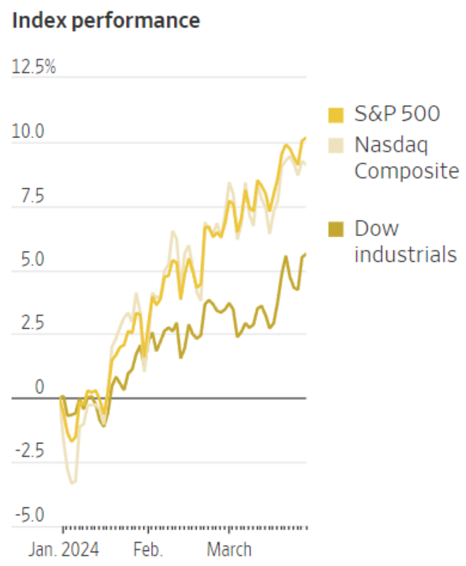
Momentum

"Over time, we anticipate that our use of AI has the potential to augment virtually every job, as well as impact our workforce composition. It may reduce certain job categories or roles, but it may create others as well." **– Jamie Dimon**

The first quarter turned out to be more of the same for markets, with stocks (S&P 500) up 10%, continuing the strong momentum of 2023. Any weakness only lasted a couple of days and investors bought the dip resulting in 22 all-time closing highs. Market leadership has shifted from just a few names to being broader based as 10 of the 11 sectors rallied.



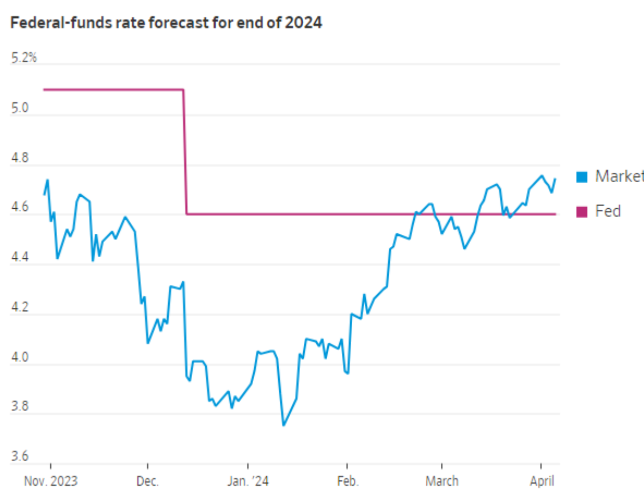
Source: FactSet

The economy continues to defy expectations, inflation worries have cooled, and recession risks have mostly subsided with only one-in-three economists seeing a recession in the next 12 months. Corporate profits remained resilient, the artificial intelligence craze continued and most importantly, hopes of interest rate cuts continue to be the main source of market optimism.

After one of the best quarters in history, bonds were negative in the first quarter. This was a result of a rising 10-year bond yield, which melted up from 3.86% to 4.20% at quarter end. Although the outlook for bonds looks better today than it has over most of the past decade, we may have already seen much of the decline in rates as Treasuries have essentially discounted the entire Fed Rate cut cycle. Below we discuss the quarterly drivers of performance and take a deeper dive into the incredible performance of Nvidia.

Q1 Recap

In our 2024 Outlook, our primary concern was the ultimate path of interest rates. At the time, the Fed was predicting three rate cuts, while the futures markets were predicting six rate cuts *(chart)*. Had you told us that the futures market would reverse course and is now only predicting two rate cuts, while the Fed maintained its outlook, we would have been more likely to say the market would be down 10% vs up 10%. This is what makes a



Note: Market forecast is based on fed-funds futures contracts. Fed forecast reflects officials' median at meetings with economic projections.
Sources: FactSet; Federal Reserve

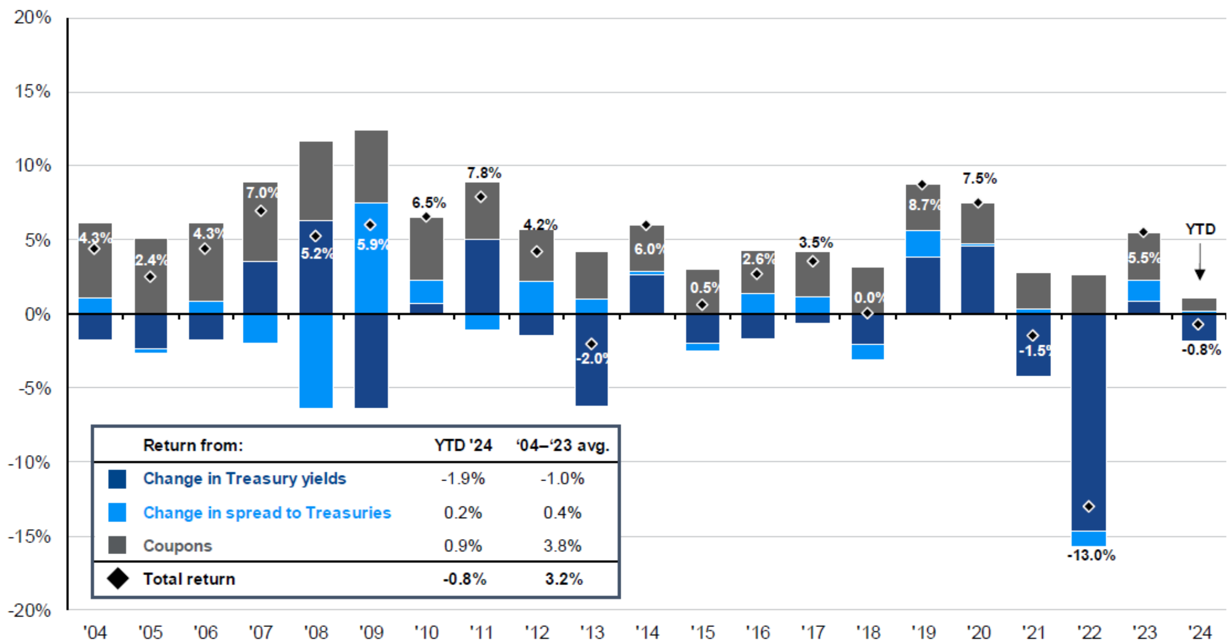
market and makes forecasting very difficult.

The other surprise for the quarter was the disbanding of the Magnificent 7, and yet another Wall Street acronym may now be in the history books. We wrote about the Magnificent 7 several times last year and those 7 stocks carried markets to all-time highs. However, for the quarter Tesla was down nearly 30% and Apple was down 11%. Nevertheless, Nvidia gained another 82% for the quarter and continued to post impressive earnings numbers and guidance. Nvidia accounted for 24% of the market's returns for the quarter and that performance allowed those seven stocks to outpace the overall market again, but the margin of victory was much narrower. We view this as a good thing, as other stocks and sectors are now starting to perform, which provides breadth to the overall market.

Bonds were slightly negative in the quarter and all the losses were the result of Treasury yields increasing. This is not uncommon and has been the norm for the last few years as there have been such large swings in rates. In October, yields reached 5% before experiencing one of the largest drops in history to get back to 3.8%. Today, yields sit around 4.35%. If we study history and the historical average spreads between the Fed Funds rate and today's 10-Year rates, it suggests that the 10-Year has already discounted all of the coming rate cuts for this cycle. We believe bonds are mildly attractive at these levels and provide a much higher level of current income compared to the past 10 years. In addition, if rates were to suddenly decline, as in something bad has happened, bonds would perform well and act as a good diversifier to stocks, which hasn't necessarily been the case over the last few years.

Bloomberg U.S. Aggregate annual total return

Total return broken into change in Treasury yields, change in bond spreads over Treasuries and coupon

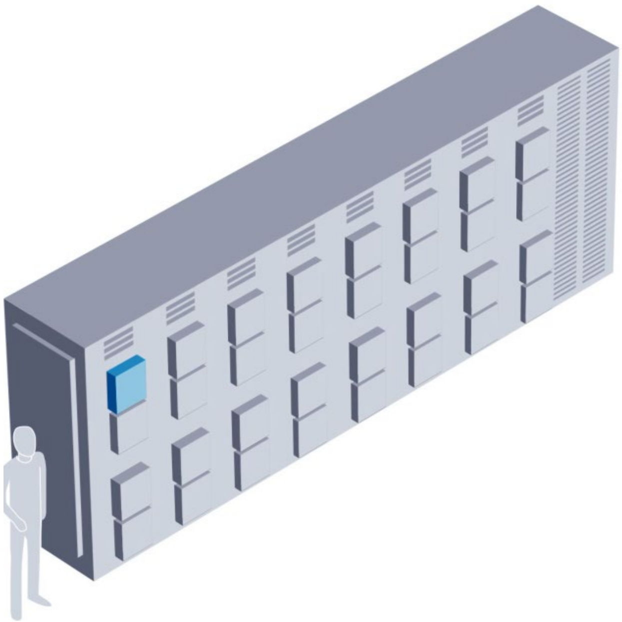


Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of March 31, 2024.

9 SOUTH 5th STREET RICHMOND, VIRGINIA 23219 | www.canalcapitalmanagement.com | T +1 804.325.1450 | F +1 866.381.5362

Nvidia (A Deeper Dive)

Since the market bottom in October 2022, Nvidia's stock price has gone up 750%, one of the largest returns in history. Today, the market capitalization of Nvidia is over $2 trillion making it the 3rd largest US company behind Apple and Microsoft, yet most people know very little about Nvidia. Nvidia was started in the early 90s and helped to solve the problem of 3D graphics for personal computers. Over the last 30 years, NVDA has been the preferred graphic card (GPU) of gamers looking for optimal performance. It turns out that these GPUs also have another use and today they have become the backbone to the Artificial Intelligence (AI) boom that is taking place across the technology sector. These chips are extremely fast and integral to the machine learning models that are being produced. Chat GPT became a household name last year and initially worked with Microsoft to develop a super computing infrastructure to train AI models using tens of thousands of NVDIA's GPUs. In the example to the left, there are 32 boxes, each box contains 8 GPUs and each box weighs 300 pounds. Each chip costs $25,000, so this configuration would run $6.4 million and weigh 9,600 pounds. These chips are typically delivered in an armored car and this illustration is a tiny amount of the square footage in a typical data warehouse run by Google, Amazon, Meta, or Microsoft.



So why is there such a mad rush to buy these chips and build these data centers? It's all about worker productivity, which can increase by working more hours or by producing more output per hour worked. AI should help many workers be more efficient and thus increase the output per hour, which is really important in a country where the skilled labor work force is aging. Productivity is the key factor in economic growth.

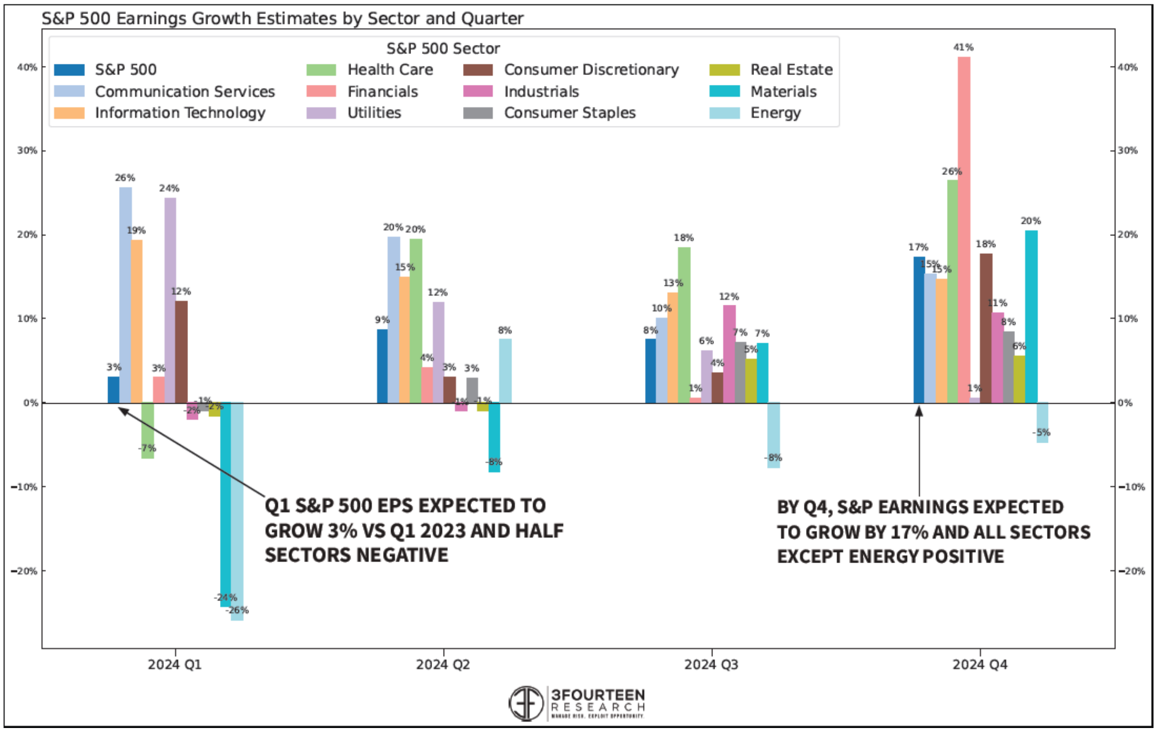
From an accounting standpoint, generative AI is also a good investment for mega-Tech companies. As an example, Google has $120 billion in cash. If they buy $20 billion worth of chips from Nvidia this year, they still have a massive amount of cash and because the cash is on its balance sheet, the investment has no effect on its earnings. The large technology companies see no better place to invest their cash. Although no one knows the ultimate return on this investment, it could be asymmetrical and provide the future growth these companies need to keep performing.

It will not always be smooth sailing for Nvidia, once you reach the top of the mountain, the risks increase and competition becomes intense, below are the biggest risks we see for the stock.

1. *Customer Concentration* – Although they don't fully disclose their customers, it is widely believed most of their revenue comes from the large technology companies mentioned above. Will they be able to sell these chips to smaller players at reasonable costs?
2. *Cash* – Nvidia is generating tons of profits. Will they be able to reinvest those profits to achieve the same levels of growth? For many companies this proves to be a very big challenge.
3. *Competition* – Although they have a strong competitive advantage today, many companies are trying to replicate these chips and the big companies are trying to produce them in house. Current profit margins are around 55% and ripe for competition.
4. *Regulation* – Uncle Sam is already worried about AIs impact on society and increased regulatory burdens are almost certain.

Moving Forward?

With recession risks subdued, a strong economy and an election year, we should see more of the same. It would be quite normal for the market to take a breather after such a large move from the fall and any correction should be contained. Our focus remains on inflation, which will drive interest rates and corporate earnings. As of today, the inflation numbers continue to be stubbornly high, and it will be a challenge to get the 2% number the Fed has targeted. Energy prices have increased this year and could be a headwind in the short term. Nevertheless, the longer-term inflation trend continues downward. Earnings are expected to be volatile for the first quarter, with half of the sectors forecasting negative earnings growth (*chart below*). However, when we look out to 4th quarter earnings, the picture gets pretty rosy as all sectors, except energy, are positive with expected annual growth of 17%. This anticipated growth is sure to drive markets one way or another over the coming quarters and although it is a lofty growth path, it's certainly achievable.



Resources

We have added a new section this quarter for those that enjoy further research and good financial reading. Below are the links to some of the better literature we have read over the quarter.

AI tools to try yourself:

Open AI: https://chat.openai.com/
Google's Gemini - https://gemini.google.com/app

What We Are Reading:

Artificial Intelligence: Long time technology analyst Ben Evans gives an annual presentation on trends within the tech industry. This year he focused on Artificial Intelligence: https://www.ben-evans.com/presentations

Jamie Dimon's Annual Letter: A must read every year that has great investing, economic and business insight from JP Morgan and Chase's long time CEO: https://reports.jpmorganchase.com/investor-relations/2023/ar-ceo-letters.htm

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management