JARVIS® NEWSLETTER: CAUTIOUS OPTIMISM IS THE RIGHT POSTURE

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OVERVIEW

Since we wrote the last edition of this newsletter, so much has happened. We have seen the meltdown of a number of previously well-regarded regional banks, another interest rate increase from the Fed and, most recently, a slew of earnings reports. Through it all, both the stock and bond markets have maintained solid performance, shaking off bad headlines.

The tone that we have struck throughout 2023 is that of cautious optimism, as we maintain that most of the pain investors would experience in this cycle already likely occurred in 2022. So far, we think our viewpoint has borne out, with the S&P up nearly 8% Year-to-date and the Volatility Index (VIX) down to a level we haven't seen since mid-2021. As the old adage goes, markets often climb a wall of worry to build into the next bull market cycle.

Key Takeaways

- Mega-Cap Tech: Resuming Its Leadership?
- Opportunity in the Financial Sector
- Conclusions

For the last six months, we have spoken about our observation that CEOs of the largest companies have successfully lowered the bar of expectations for revenue and earnings growth. As reinforced by this week's sluggish GDP number at 1.1% annualized growth in the 1st quarter, the economy is certainly showing signs of slowing, but that has not put a damper on stock performance of some of the world's largest companies. In today's letter, we are going to cover the earnings of two technology behemoths, **Meta Platforms (META)** and **Microsoft (MSFT)**. Both companies delivered earnings reports that were quite well-received by the investing public. Despite the challenges in the economy, so far this year, we are seeing the type of market action that leads us to our cautiously optimistic view.

At the same time, cracks forming in the banking system remain and understandably continue to express concern that additional bank failures are on the horizon. While we know that the memories of 2008 are still relatively fresh in the minds of investors, we think the extrapolation that many of the country's largest regional banks are under threat is unfounded. With that as a backdrop, we are seeing some very interesting opportunities developing in the financial sector, one of which we will examine in today's letter.

As market-linked interest rates continue to fall (the US 10-year Treasury rate is consistently below 3.5% over the past month), we think the window for locking in generous rates of return is beginning to close. If you have cash in the bank earning a below-market return, I can help. Set time directly on my calendar and I would love to help you take the first step to securing some passive streams of income for your financial future.

Head to our website and sign up for our mailing list, so you can receive our weekly updates in your inbox every Saturday morning. As always, we are back with new reports from our analyst team for subscribers to our research service again this week. Remember, subscribers receive 6-8 full length stock reports each month, the type of which we use to make our own investment decisions in-house. Head to our subscribe page to gain access to the research.

With that all being said, let's get into it! We always enjoy getting a lay of the land from the earnings season and this quarter's reports have given us a lot of interesting insights, as we consider the best ways for investors to allocate in a still-uncertain landscape.

MEGA-CAP TECH: RESUMING ITS LEADERSHIP?

Just as a quick reminder, the strongest performing stocks in 2022 were value-oriented: we saw excellent performance out of the energy, health care, and consumer staples sectors. At the same time, the market leaders of the previous decade experienced terrible performance. Industry leaders like **Meta Platforms (META), Tesla (TSLA), Nvidia (NVDA), and Netflix (NFLX)** all saw their stocks drop by 50% or more in 2022!

Take a look at the chart below from Fidelity that shows the sector performance Year-to-date. We can see fairly quickly that the sectors that dominated last year are lagging in 2023, with the underperforming sectors of 2022 experiencing significant uplift in the first four months of this year:

SECTOR | INDUSTRY

Sector Name	Last % Change 10:40 AM ET 04/28/2023	1 Day	5 Day	1 Month	3 Month	YTD	1 Year
		04/27/2023					
Communication Services (.GSPL)	-0.34%	+5.53%	+3.53%	+4.51%	+8.81%	+23.79%	-2.82%
Information Technology (.GSPT)	+0.64%	+2.17%	+0.97%	+2.73%	+10.37%	+20.70%	+6.96%
Consumer Discretionary (.GSPD)	-0.63%	+2.77%	+1.41%	+4.57%	+2.45%	+14.66%	-12.83%
Consumer Staples (.GSPS)	+0.28%	+1.04%	+1.33%	+5.51%	+5.14%	+3.10%	-1.89%
Materials (.GSPM)	+0.43%	+1.36%	-2.20%	+3.58%	-4.90%	+2.42%	-5.13%
Industrials (.GSPI)	+0.55%	+1.99%	-1.77%	+2.18%	-1.68%	+0.84%	+2.99%
Real Estate (.GSPRE)	+1.00%	+2.43%	+0.52%	+4.83%	-6.88%	+0.72%	-22.71%
Utilities (.GSPU)	-0.10%	+1.20%	-0.50%	+5.13%	+0.16%	-2.10%	-5.34%
Health Care (.GSPA)	+0.44%	+0.51%	-0.73%	+3.92%	-1.02%	-2.70%	+0.31%
Energy (.GSPE)	+0.96%	+0.44%	-1.75%	+7.97%	-9.67%	-3.97%	+15.14% +
Financials (.GSPF)	+0.56%	+1.60%	-1.73%	+5.62%	-9.58%	-4.35%	-7.15%
S&P 500 ® Index (.SPX)	+0.37%	+1.96%	+0.13%	+4.14%	+1.85%	+7.71%	-0.95%

Figure 1: S&P Sector Performance Data -- Source: Fidelity

Because large tech companies make up such a disproportionate segment of market indexes, 2022 was marred by major underperformance in the overall market. But with falling prices often comes opportunity, which we have been starting to see over the last few months. But beyond just the simple idea of opportunistic investors snapping up quality stocks at discounts, we are also seeing significant improvement in underlying business conditions that makes us excited to be investing in our economy's biggest engines of growth: Information Technology and Communications Services. We took a closer look at two of the largest players' earnings reports from the month of April, **Meta Platforms (META)** and **Microsoft (MSFT)** and we are excited to share what we've learned straight from the mouths of management.

Microsoft (MSFT)

As you can see in the below chart showing **MSFT** stock price since the beginning of 2022, the company's shares had dropped more than 30% from peak to trough, which is an astounding move for a company of this size:

Figure 2: Stock Chart MSFT 2022-Present -- Source: TradingView

The snapback has been almost equally violent in 2023, with the stock regaining most of that ground in just a six-month period. Sentiment for mega-cap tech has certainly shifted, as investors cleared the decks with tax-loss selling late in 2022.

This week, we heard from the company's CEO, Satya Nadella on the company's 3rd quarter earnings call. Considering that this is a company with more than a $2 trillion market cap, the amount of revenue growth we are seeing there is quite staggering. There are two major catalysts for this company that are driving a renewed acceleration in results: (1) cloud computing and (2) artificial intelligence (AI). We have heard these themes from many other companies, but Microsoft is clearly asserting dominance in both of these cutting-edge technologies.

In the most recent quarter, Microsoft delivered $28 billion in cloud computing revenue, representing a 22% year-over-year increase. CEO Nadella mentioned that Microsoft's cloud business, Azure, is not only taking advantage

of a growing addressable market, but also taking market share from competitors. This point is bolstered by the fact that Amazon's cloud business, Amazon Web Services experienced a deceleration in results over the past quarter.

We have all read the headlines over the past few months about AI, ChatGPT, and other artificial intelligence projects that are at the forefront of the world's largest tech businesses. It is evident that Microsoft has taken a leadership role in the AI space. Nadella reported that Microsoft's AI infrastructure is being used by OpenAI, Nvidia, and ChatGPT to power these revolutionary new technologies. The company already boasts 2,500 Azure OpenAI customers and the segment is growing rapidly. As many as 36,000 organizations are already using the existing AI-powered platform that Microsoft provides.

Looking deeper into the numbers, we see some very interesting developments. First, even though other large tech firms like **META, Alphabet (GOOG),** and others are relentlessly reducing headcount in their organizations, Microsoft continues to grow, adding 9% to their employee rolls over the past year. This suggests that Microsoft's growth opportunities are exceeding those of its peers. Despite the increase in labor expense, the company's gross margins are up 9%, in the same time frame. The explosion in cloud and AI, along with other business segments, has allowed the company to grow quarterly earnings by 10%, which we think is impressive in a time when the company's customers are finding any way possible to reduce costs.

In short, we would call the latest quarter from Microsoft stellar and the share price rise certainly seems to reflect that.

Meta Platforms (META)

META was one of the worst performing stocks on the board in 2022, as you can see below:

Figure 3: Stock Chart META 2022-Present; Source -- TradingView

The general sense was that Meta had taken its collective eye off the ball, an organization with too large and disparate a work force, and a CEO in Mark Zuckerberg that was more interested in developing his avatar in the ethereal metaverse than delivering results for shareholders.

In reading the most recent earnings call transcript from **META,** it seems obvious to us that Zuckerberg has taken that criticism on board and seems to have developed a strategy to deliver the company from its recent malaise. In recent months, **META** has embarked on a clear strategy to become more efficient and this is evident in the company's latest results.

Zuckerberg reported that the company has been able to decrease overall headcount by 11% over the past year. They have accomplished this goal by slowing hiring and flattening management to increase the proportion of technical workers. In his estimation, this has empowered the company to improve both the speed and quality of its work. Additionally, META has pulled back on Capital Expenditures, as its buildout of the AI capabilities and the metaverse catches up to those of the company's competitors. We saw just $6.8B in CapEx last quarter, which compares quite favorably to the figure of over $9B in each of the previous two quarters. The brutal efficiency of META is beginning to take hold.

Of course, a company cannot only cut costs on its way to prosperity. It must also deliver revenue growth. Artificial intelligence is helping META reaccelerate growth by increasing the engagement of the company's 3 billion daily active users. AI is crucial to META in two major respects, according to Zuckerberg: (1) by powering the platforms' recommendations system to increase engagement and (2) the company's generative AI technology helping to enable brand new products. At this point, 20% of content on Facebook and Instagram is delivered using AI, which should only grow in the future.

One aspect of META that really excites us is "Reels". Reels is META's answer to TikTok's short form video format that has begun to dominate the social media landscape. It is clear that management sees growing Reels as a crucial component to a winning strategy going forward. Reels now has some 2 billion pieces of content shared daily, which represents a 100% increase over the last 6 months. Since the Reels launch, AI is driving a 24% increase in average user time spent on Instagram. In addition, Reels monetization is up 30% on Instagram and 40% on Facebook in just one quarter's time. There is a clear acceleration underway here and it has us excited as investors. Reels also offers an interesting optionality: should TikTok be banned in the US or other Western countries, we expect META to be the direct beneficiary of this change.

We have been bullish on META for the last 6 months, but the latest earnings call only reinforces our view.

OPPORTUNITY IN THE FINANCIAL SECTOR

In the wake of the **Silicon Valley Bank (SIVB)** and **First Republic (FRC)** bank collapses, investors are understandably worried about the safety of individual banks in the US financial system. Without getting too detailed into the reasons why these banks failed, simply put, rising interest rates and the rapid loss of deposits doomed these institutions into failure and the Federal Reserve and other government agencies have had to step in to avoid contagion to other areas of the financial sector.

Upon the failure of **SIVB**, the **SPDR S&P Regional Banking ETF (KRE)** dropped more than 30% in value during the month of March. Investors have decided to sell the securities related to regional banks and other financial institutions first and ask questions later. Again, we understand the impulse here, but we think that some very quality companies are being painted with a broad brush unfairly. We do happen to like some of the bonds of regional banks, many of which carry 'A' ratings (or higher), but that now boast annual yields of 6% or more! Of course, please do contact us directly if you would like to hear more about these opportunities and how they might be a fit for your portfolio.

However, one company in particular stands out for us as a potential opportunity in the face of indiscriminate selling: **The Charles Schwab Corporation (SCHW)**. **SCHW** is one of the world's largest brokerage houses and that business has been strong. But Schwab also owns the 8th largest bank in the US by assets, similar in size to mega-regional banks **US Bancorp (USB)** and **PNC Financial Services Group, Inc. (PNC)**. For this reason, SCHW shares also plummeted in the face of the mini-banking crisis, down more than 35% since early March.

We think this represents an interesting opportunity for investors. And our argument is supported by what we learned in the most recent earnings release from Schwab. The company was able to deliver 14% earnings growth even in a difficult environment where funding costs have risen dramatically, surprisingly beating analyst estimates against all odds.

The major worry for financial institutions in this environment is the possibility that investors could pull their funds, out of a concern for solvency. Certainly, a number of banks in the US have experienced a loss of deposits over the past two months. But that problem does not appear to be in evidence at Schwab: in the first quarter, investors opened 1 million new accounts at Schwab, bringing over $132 billion in core net new assets, including $53 billion just in March. Based on those numbers, one could surmise that the funds fleeing other institutions are actually flowing toward Schwab. If that is the case, investors should feel more confident in Schwab given the conditions in the financial space, not less.

Granted, cost of funding is going to be a challenge for Schwab, and the company was up front in saying that revenues and profits for the next quarter could fall. The company also suspended its stock buyback temporarily, in an effort to be cautious in an uncertain time for the financial industry. In the end, we think these are prudent measures. Given that the stock trades at roughly 17x forward earnings at its current price based on a projection of $3 earnings per share, we think the opportunity here is quite interesting. Time will tell, but we do believe that the market's reaction to the banking crisis was overdone in the case of Schwab.

(In full disclosure, we do custody client funds at TD Ameritrade, recently purchased by Schwab).

TAKEAWAYS

There have been plenty of scary headlines in the first four months of 2023. But all things considered, investors are taking things well in stride. Markets have moved slowly higher this year, climbing the proverbial wall of worry. We are encouraged especially by the reduced volatility of markets.

We think the positive momentum in the markets is more than just a reaction to lower prices. Through recent earnings reports, we are beginning to see an acceleration of business results, especially in the technology space. Rapid development of artificial intelligence (AI) technology seems to be an important catalyst for mega-cap tech, as we learned in the earnings reports from **Microsoft (MSFT)** and **Meta Platforms (META)**.

Finally, we see developing opportunities in the financial sector in the face of the mini-banking crisis of 2023. We think the risks ultimately are contained and that investors should be considering securities that have been unreasonably punished like **Charles Schwab (SCHW).**

We hope the newsletter helps you make sense of a difficult time in markets! This month's newsletter is just a small subset of our thoughts on the current market. We would love to share more with you in a 1-on-1 meeting and see if our process can be a fit to help you achieve your financial dreams. We know that finding suitable investment opportunities in individual bonds and in growth stocks can be daunting for the individual investor. Please contact me directly at (630) 547-3316 or briand@leftbrainwm.com, or schedule time directly on my calendar if you want to engage a professional money manager like Left Brain to figure out to do with cash in the bank.

Thanks again for your continued support of the Jarvis Newsletter.

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