Introduction:

We hope you are enjoying your summer. For those of us here in Florida, we had school start up again and we'll have this heat and humidity for another several months.

We are working with student interns this summer and have them conducting some very interesting FINTECH research. Once again, we are analyzing what Gen-Z thinks about four specific FINTECH topics: Banking, Brokerage, Crypto and Payments. Download the full 40-pages of research here or visit our website to read thematic FINTECH notes, stock-specific pitches or our proprietary research reports. There were some interesting takeaways and conclusions, like Gen-Z prefers traditional banks versus online banks. Who knew?

The US economy continues to motor along, and it had an excellent second quarter. US real GDP growth was +2.8%, well above the 2.0% forecast and double the first quarter. In June and July, it seemed like the equity markets were posting new highs each and every day. In August, we've experienced a bit more volatility, but the market continues to perform (up for the last 8 days).

Is everything perfect? Absolutely not, but with steady economic growth and declining inflationary pressures, it likely gives the Fed enough data to pivot. The Fed has battled inflation for roughly two years, and it is slowly trending down towards their 2% target. The market won't get its initially anticipated seven rates cuts this year, but the first should come at September's FOMC meeting. The labor market remains resilient, even if the latest jobs report somewhat disappointed versus expectations. While unemployment is slowly rising, it isn't overly concerning at 4.3%. US consumer spending continues to "chug along", as Americans do what they do best – spend!

In this newsletter, we will address the Fed, interest rates, the inverted yield curve, inflation, jobs, wage growth, and the highly concentrated stock market. We always conclude our notes with Cliff Clavin section of useless information, but we have to start with the market's biggest question mark - the US Presidential election.

The Election:

As crazy as it sounds, the 2024 US presidential election will be the first one, since 1976, that doesn't have a Bush, Clinton, or Biden on the ticket. The market continues to wrestle with the war in Israel and the Ukraine, but the biggest uncertainty is the US presidential election. The election is less than 100 days away, and the two candidates have yet to debate.

We did have a debate on June 25th, and it had a fantastic topic: golf. We would have loved to watch President Biden play golf against former President Trump (with both men carrying their own bag) in an 18-hole match. Following an assassination attempt on former President Trump and President Biden pulling out of the race, we unfortunately won't get a ***"Duel in the Sun" Part 2***. That 1977 British Open at Turnberry (now owned by Trump) featured Tom Watson and Jack Nicklaus battling for the Claret Jug on the 72nd hole. Our loss…

We attempt to *focus on the fundamentals* and not publish on controversial political issues. We won't start now and insert any political leanings in our research, but the upcoming election will absolutely impact our economy. In our opinion, it is helpful to set aside any political views and try to examine the economic landscape from an unbiased investment standpoint. While elected officials and candidates' matter, we *focus on the fundamentals*.

In an election year, the media loves to emphasize drama and controversy. In our investment process, we remove emotions from the equation. Looking at long-term returns for the US stock market, political parties tend to have a modest impact, while growth in corporate revenue, profits, cash flow drives the majority of stock returns.

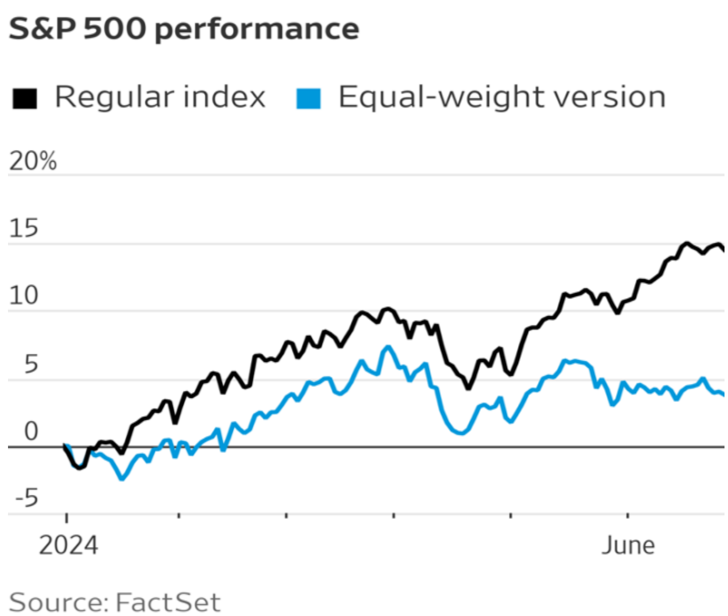
Since the 1920s, there have been 24 US presidential elections, and the market has had positive returns in 20 of them. In the four instances when the stock market fell, there were significant issues impacting the US economy (the Great Depression, the early part of World War II, the 2000 tech bubble, and the 2008 Global Financial Crisis). In fact, the last time the stock market fell in a presidential re-election year was 1940.

Schwab Research published a study about the importance of staying invested. If you started with $10,000 in 1961 and only invested in the S&P 500 only when there was a Republican in the White House, your investment would be worth $102,000 by 2023. If you did the same, but only invested when there was a Democrat in the White House, your investment would be $500,000. If you invested regardless of what party was in the White House, the value of your portfolio would be $5.1 million. This speaks to the power of compound interest and what Warren Buffett calls the "8th wonder of the world".

The media makes it seem like this election is the "most important election in our history". However, we do not believe this election will "make or break" our country, as America will continue to thrive. Politicians come and go, but our economy continues to innovate, grow, and remains the envy of the world. Instead of guessing how citizens will vote, we will focus on the real drivers of the US economy: corporate profits, small business success, the labor market, wage growth, and personal consumption. We will remain disciplined and focused on the long-term growth of our FINTECH companies. After all, who resides in 1600 Pennsylvania Avenue won't change your declining use of cash and paper checks, right?

The Market:

Through the 1st half of 2024, the S&P 500 rose nearly +15%, but the average stock in the benchmark was up just +4.1%. The Dow Jones Industrial Average is flat this year, while the Russell 2000 index (small and midsize companies) is also essentially unchanged. Performance remains concentrated in the top names in the S&P 500, as its best performing and largest ten stocks are responsible for over 70% of index return this year.



As this FactSet chart shows, the overall S&P 500 continues to perform well, but it is being propelled by a handful of mega-cap stocks. This is the largest underperformance of the average stock to the overall market since 1990 (per Dow Jones Market Data).

In 1984, Wendy's had a memorable ad campaign with the catchphrase *"Where's the beef"?* Fast forward 40 years, and we are wondering *"Where's the growth"?* Over the last eight quarters, the S&P 500 hasn't been delivering terribly strong EPS growth. Starting in the 2nd quarter of 2022, earnings growth has only been +6%, +4%, (4%), 0%, +6%, +5% and +7%. Looking forward to the 2nd half of 2024, forecasts are expecting acceleration to +8% and +17%. Then, in 2025, expectations accelerate again with FactSet consensus estimates at roughly +15%. These appear somewhat aggressive.

Over 90% of S&P 500 companies have reported 2nd quarter results and there is a large discrepancy between the winners and losers. Analysts were projecting that the S&P's Tech sector would experience +15% year-over-year EPS growth, while the "Mag 7" forecasts were expecting +50% profit growth. Amazingly, those exceptional growth rates were actually exceeded. However, examining the rest of the S&P 500, we can see a very different story. According to FactSet, the rest of the S&P 500 companies' earnings were expected to be down (9%) year-over-year. If we extend out another quarter, "Mag 7" profits are expected to jump another +30%, while the rest of the 493 stocks in the S&P 500 are expected to decline on average (yet again). Clearly, this is a "tale of two cities" or two different markets, with very different relative performance.

Even after a tough week or two of performance recently, the "Mag 7" stocks are trading at an average of 35x their forward 12-months earnings. This impacts the overall S&P 500 valuation and lifts it multiple to an elevated 22x forward earnings (per FactSet). Instead of looking at index averages, we prefer to analyze individual FINTECH companies and conduct bottoms up, fundamental research. Speaking of the "Mag 7", let's discuss how concentrated the S&P 500 has become.

"Mag 7" Concentration:

A decade ago, the market cap of the "Mag 7" was $2 trillion. Today, even after its recent decline, its market cap is a whopping $16 trillion. This is greater than every public company in China, 2x every Japanese company, 3x every India company and 6x the German market. Since December 2019, the "Mag 7" stocks have collectively delivered a whopping 33% annualized return. On May 28th, 2024, it was the first time since 2000, that the S&P 500's top three stocks were worth more than 20% of the whole index. This has been highlighted with the "Mag 7" representing 30% of the entire S&P 500's index, more than 2x its level 5 years ago.

As of this publication, Nvidia is up roughly 150% year-to-date. Nvidia was the largest gainer in the S&P 500 last year and has more than tripled in value over the last year. It hit an eye-opening market capitalization of $3 trillion in June, less than four months after it eclipsed the $2 trillion mark. Enthusiasm for everything AI-related, especially for the primary chip maker whose products are essential to powering AI technology, continues to fuel the market. Last quarter, and for the fifth consecutive quarter, Nvidia reported sales and profits that blew past Wall Street expectations. The stock rose +37% in the second quarter alone.

In prior newsletters, we have addressed our problem with how the S&P 500 is weighted. The largest stocks have their gains amplified. As a market cap structured benchmark, it rewards success. Is this market concentration (in so few stocks) justified? Is it healthy? As we write this newsletter, roughly 40% of stocks in the S&P 500 are at least 10% below their all-time highs, and dozens of stocks still in negative territory this year. When three companies represent so much of the benchmark's weight, it becomes harder and harder to make the case that the S&P 500 represents a fully diversified portfolio.

Jobs & Spending:

We do not believe that the US economy is declining or headed towards a recession. 2nd quarter 2024 GDP proves our point, and the Atlanta Fed's GDP Now forecasting tool is now projecting +2.0% GDP growth in the 3rd quarter. The July jobs report did modestly disappoint, with employers only adding 114,000 new jobs (lower than the 175,000 expectation). While this was below Street estimates, it is simply declining from its torrid pace last year. The US economy is still experiencing solid growth and seems to be normalizing. The labor market remains tight, with the unemployment rate hovering just over 4%. There are still roughly two million more open jobs in the US than unemployed individuals.

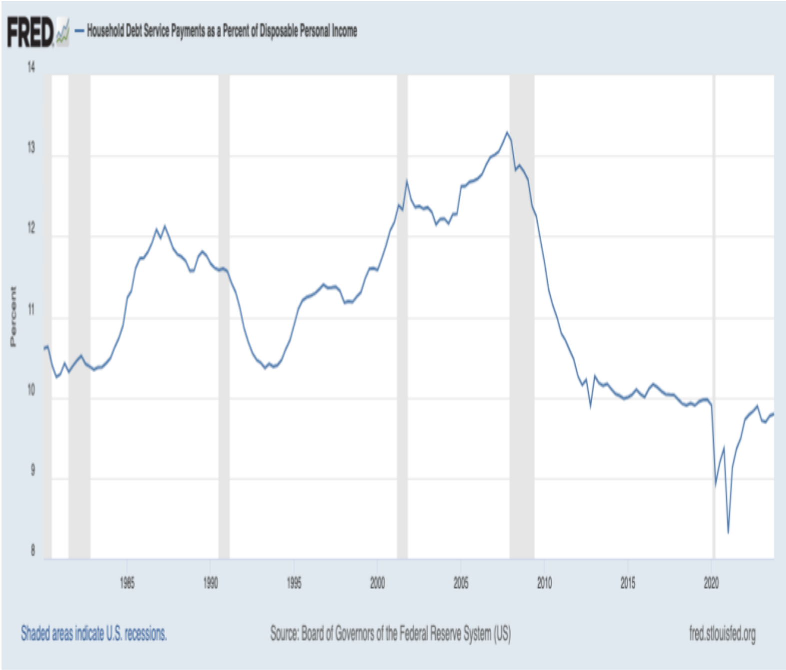
We continuously mention how our economy is powered by the US consumer and their ability to steadily spend. Shopping is a key component driving growth, and PCE (personal consumption expenditures) accounts for roughly 2/3rds of our GDP. What fuels this spending? We like to keep things simple (KISS). We believe that plentiful jobs and higher wages drives consumer spending and helps account for our economic strength.

Households:

If one examines the New York Fed's *Quarterly Report on Household Debt and Credit*, it shows that consumers are borrowing more and more money. Last quarter, total household debt rose by $184 billion and is now at $17.69 trillion. One of the largest contributors to this growth is +9% higher credit card balances, coupled with rising delinquency rates.

Post COVID, US household balance sheets have grown by an astounding $50 trillion. As an indicator of household strength or weakness, we like to look at household debt service payments, as a percent of disposable personal income.

This chart, from the Federal Reserve, illustrates how much it is costing consumers to service their debt. Despite higher interest rates, this shows that household pressure isn't dire, when compared to the last 50 years.



While Americans are taking on more debt, incomes have been rising to help offset how much goes towards paying off debt.

This is the third year of America's fight with inflation, and it is unfortunately widening a split in our economy. The stock market is up, household wealth is at record levels, and investment income has never been greater. However, at the same time, some US households have spent their pandemic-era savings, and credit card loans and auto-loan delinquencies are rising.

We view this division as troubling, as too many low-and-middle income Americans are struggling to survive. While some gain from higher interest rates on their savings and portfolios, others are stressed by inflation and must deal with elevated borrowing costs.

A recent study by TransUnion found that many households view inflation simply as higher prices, and not the rate of change of rising prices for goods and services. Overall consumer sentiment remains relatively low, and this subtle misunderstanding of inflation is another reason why certain households are expressing displeasure over our economy. Legendary investor John Templeton once said, "bull markets are born on pessimism, grow on skepticism, mature of optimism and die on euphoria." From our vantage point, we continuously hear about a fairly pessimistic or skeptical American household, and do not see a terribly optimistic or euphoric investor.

The Fed, Interest Rates, Inflation, but more importantly - FUNDAMENTALS:

Inflation is still above the Fed's 2% annual target, but it is slowly moving towards it. The Fed already has stated it doesn't need to see CPI at 2% before it will begin to cut rates. For additional proof that rates are headed lower soon, on July 31st, Fed Chairman Powel said, "if we see inflation moving down (more or less) in line with expectations, growth remains reasonably strong, and the labor market remains consistent with current conditions, then I think a rate cut could be on the table at the September meeting."

Our favorite tool for gauging Street interest rate expectations is the CME's FedNow tool (click here). It is now pricing in a 77% chance of a 25-basis point cut and a 23% chance of a 50-basis point decrease. Everybody is expecting the Fed to lower interest rates on September 18th. The only question is whether or not it will be a 25 or 50-basis point cut.

Economic growth remains healthy, 2nd quarter results were solid, and companies appear confident in their business fundamentals. We like to view stock buybacks as a company's confidence in their forward outlook, and we have noticed significant purchases and announcements. In the 1st quarter, 443 companies in the S&P 500 announced nearly $200 billion in share buybacks, which was up +16% year-over-year. According to a Goldman Sachs research note, it is estimating that S&P 500 share buybacks could exceed $1 trillion this year (despite a penalizing tax).

Instead of obsessing over monthly inflation data points and its potential impact on Fed policy, we believe it is much more important to understand the bigger picture. The US economy continues to advance and generate steady growth. We believe that stock prices reflect underlying business fundamentals. For example, if Nvidia continues to dominate its market for AI chips and revenue and profits continue to soar higher, its stock price should reflect those positive results. Vice versa, if a business is struggling and its market positioning is weakening, its stock price should fall.

We spend all of our time focused on our FINTECH securities, trying to understand the positive and negative trends each company faces. We weight our positions to reflect these prospects. For us, we believe conducting bottoms up, fundamental research – on specific securities – is much more valuable than generalized macro commentary. From our perspective, we closely watch consumer spending, as that materially impacts our large, payments exposure. In the past three years, we have had a global pandemic, a banking crisis, supply-chain headwinds, and multiple geopolitical predicaments. However, the consumer brands that are still standing appear stronger than ever. They are better operators in a better position to execute the challenges they face. And let's not forget that some of these companies have much stronger balance sheets now too.

Signals & Indicators:

New jobs are created every month, consumer spending remains strong, wages are rising, corporate earnings are healthy, and inflation is headed towards 2.5% to 3.0%. Some believe that a recession is still coming, but it is taking longer to materialize in this specific business cycle (with significant stimulus following the global pandemic).

Walmart, the nation's largest retailer recently reported a revenue and earnings beat, with same-store-sales (a critical consumer spending metric) up +4.2% and online revenue +22% year-over-year. Doug McMillon is Walmart's CEO, and he said, "we aren't experiencing a weaker consumer overall", which is great news for our economy.

The yield curve measures the difference in yield between short and long duration Treasuries. Historically, an inverted yield curve has been a reliable recession indicator. Since 1968, a recession has occurred anywhere from 9 to 24 months *after* the yield curve inverts.

This chart from the Federal Reserve Bank of St. Louis shows 3-month versus 10-year US Treasury yields since 1980. The highlighted red circles show yield curve inversions, while the gray bars show recessions. The correlation between the two is quite obvious.

If this indicator is always right… why haven't we hit a recession? The yield curve has been inverted for well over 2 years and yet our economy still shows no sign of slowing down.

History does tend to repeat itself, but relying on one signal to predict our $22 trillion economy might not be wise. Our economy is enormously complex, and it cannot be explained by just one indicator.

Conclusion:

We are constantly striving to generate performance for our clients, but we will not chase performance by investing in businesses outside of our area of expertise. We remain diligent on managing risk and continue to expect the unexpected. Our portfolio tends to perform relatively well in higher volatility environments, and we expect more volatility as we approach this important election.

On the fundamental front, we are pleased with our portfolio positioning. M&A is picking up for our payment companies, which all generate significant free cash flow. In addition, with significant geopolitical and macro uncertainties, our exchanges are experiencing elevated volumes. These sub-sectors remain our two largest areas of exposure, and we're excited about their forward prospects.

On the macro front, we are modeling that interest rates will stay elevated, for a little while longer. The Fed's fight against inflation is working but is has required patience. When the Fed claimed that "inflation was transitory", many didn't appreciate that it would last this ***L-oooo-nnn-ggg***. Inflation is moving in the right direction and the Fed has done an admirable job, despite all of the negative commentary expert economists hurl at them.

We hope you are having a great summer. We are always available to chat and hope to speak with you soon. Feel free to call us to discuss the overall market or anything in our FINTECH industry.

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Cliff Clavin's "Useless" Information:

In the 1980s, one of our favorite TV shows was ***Cheers.*** The know-it-all postal worker was named Cliff Clavin and played by actor John Ratzenberger. This recurring segment of our newsletter highlights some "useless" information that Cliff would be proud of.

Cliff Stats:

- Over the last century, there were only 13 quarters when US consumer spending on services shrank.
- US Money Market Funds hit an all-time high of $6.12 trillion.
- Ned Davis highlights that US Households have the highest stock allocation in history.
- Americans between 18 to 29 had the highest delinquency rate on credit cards at 9.5%.
- By 2027, mobile payments should eclipse $1 trillion in US point-of-sale transactions.
- Apple Pay is the #1 mobile payment platform in the US; the #2 mobile platform is the Starbucks app.
- According to the Commerce Department, Americans earned $3.7 trillion in interest + dividends in the 1q'24.

Air Conditioning:

As we enter the hottest part of the summer, we wanted to provide some thoughts on one of our absolute favorite inventions – the air conditioner. Can you imagine living in Tampa during the summer without it? Air conditioning has become an absolute necessity for living and working comfortably, especially as the temperatures rise (global warming?).

The AC unit was invented by Willis Carrier in 1902, to help fix a problem in his Buffalo, NY factory. Sackett-Wilhelms Lithographing & Publishing Company was having issues with their paper and ink quality, with high humidity levels inside their plant. Carrier's device was called an ***Apparatus for Treating Air***, and it consisted of steam coils, an industrial fan and cold water in the coils. These coils produced excess condensation to lower humidity and cool the air. While others experimented with cooling technology before Carrier, we are comfortable giving him credit.

Intuit (ticker INTU) announced layoffs in July, which involved the advancement of AI. It stated that 10% of the company's workforce, or around 1,800 employees, were being let go because of advancements in AI. This is the first company in our FINTECH space that has quantified the impact to its workforce specifically because of AI. More to come?

Golf:

Here's a picture of the legendary Claret Jug, which the winner of The Open gets to keep for 1 year. It dates back to 1872, when Young Tom Morris won his fourth straight championship. The trophy replaced the Challenge Belt (presented by Prestwick Golf Course).

Could you imagine Trump and Biden "hugging it out" like Watson and Nicklaus did after their epic "Duel in The Sun"?

How about those trousers on Tom Watson?!?

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