3 September 2024

Markets in a Minute

Guy Foster, Chief Strategist, discusses Nvidia's highly anticipated earnings results. Plus, Janet Mui, Head of Market Analysis, analyses fresh U.S. economic data.

To view the latest Markets in a Minute video click here.

Last week was supposed to be all about Nvidia's earnings results, which took place just after the U.S. market closed on Wednesday.

Many analysts described the release as one of the most important corporate results in history, even perceived by some as more influential than last week's speech by Federal Reserve (the "Fed") Chair Jay Powell at the Jackson Hole Economic Symposium.

In the end, was it worth the hype? Yes and no.

Unpicking the poster child

Nvidia is the poster child of the artificial intelligence (AI) revolution and a direct beneficiary of the billions of dollars of investment into AI infrastructure. Its stock has added nearly $3trn in market value over the two years since ChatGPT captured the imagination of the public. At one point, it surpassed Apple and Microsoft to be the stock with the biggest market capitalisation in the U.S. equity market.

Given Nvidia's weight of almost 7% in the S&P 500 index, big moves either way directly impact the index, and it has the potential to make or break the current market rally.

Nvidia's outlook guidance will also offer a read-across for other semiconductor companies on AI spending, and act as a barometer for the AI investment theme that's lifted the share prices of mega-cap technology companies. It was indeed a very consequential earnings report.

In the end, Nvidia continued its string of positive earnings surprises compared to analysts' average estimates:

- Second quarter revenue was a record $26.3bn, up 16% from the previous quarter and up 154% from a year ago.
- Third quarter revenue is projected to be $32.5bn, plus or minus 2%.
- Gross margin came in at 75.1%, though this was a decrease from the 78.4% seen in the previous quarter.
- Nvidia also announced a $50bn share buyback.

These results are hard to fault and continue to demonstrate the insatiable demand for Nvidia's cutting-edge chips, systems and services.

Everything's rosy, right?

Well, Nvidia's stock price fell over 6% on the next trading day. The problem is that its investors have grown accustomed to blowout earnings in the previous quarters. For instance, in the period ending July 2023, Nvidia's reported revenue was a whopping 22% above estimates. In contrast, the latest quarter saw a much less impressive 4% earnings beat (earnings surpassing expectations), and a declining trend in the size of the earnings beat.

There are also concerns about supply chain and delay issues with the latest chip system (Blackwell), though Nvidia CEO Jensen Huang offered reassurances that supply will be abundant.

There tends to be lot of noise around quarterly earnings, but the longer-term AI investment thesis remains intact in our view. Nvidia's CUDA software has led to a critical mass of developers within its ecosystem, which makes switching supplier difficult. This, combined with a short product innovation cycle, helps it stay well ahead of competitors (hence defending its 75%+ gross margin). Its forward price/earnings ratio of 35x is not out of whack for such a strong, unique quality-growth compounder.

However, there are concerns around hyper-scalers (Nvidia's key customers) developing their own chips. While Nvidia is likely to lose some market share in the AI chips space, the key thing is that the entire market is growing.

We acknowledge this is a very volatile stock and markets are quick to anticipate and price in any changes in outlook. So, how do you play it?

We think having diversified exposure via a basket of selected top semiconductor names (chip foundries, equipment makers, designers and software companies) across the supply chain is a good approach to access the semiconductor investment thesis.

How much impact do Nvidia's earnings have on markets?

The answer to this trillion-dollar question is... not as much as people would've thought.

On the day Nvidia's share prices slumped, five out of seven of the so called 'Magnificent Seven' stocks (Apple, Microsoft, Nvidia, Meta, Alphabet, Amazon and Tesla) were up. The S&P 500 index was flat, meaning the rest of the market ex-Nvidia rose on the day. The S&P 500 equal-weighted index and the Dow Jones Industrial Average index made new record highs.

Why is that?

As discussed above, Nvidia's results were actually very strong. Perhaps not strong enough to support another leap up for Nvidia, but certainly strong enough to remove the uncertainty clouding AI-related investments and draw the curtain on another healthy corporate earnings season.

With Nvidia's results out of the way, markets can firmly focus on the economic fundamentals and look forward to upcoming interest rate cuts by the Fed. Economic data out last week was music to the ears of investors and as goldilocks (not too hot, not too cold) as one can hope for.

U.S. consumers remain resilient

The upward revisions to the second quarter U.S. gross domestic product (GDP) data probably did heavy lifting in supporting the market post Nvidia's earnings results. Usually, these GDP revisions data don't spur much market attention or reaction, but as we know, traders are now in a phase of (unhealthy) obsession with any data related to U.S. consumers.

Second quarter U.S. GDP growth was revised up from 2.8% to 3.0% (quarter-on-quarter, annualised), and it was driven by a meaningful upward revision to personal spending from 2.3% to 2.9%. This suggests U.S. consumers remained resilient, and helped ease recession concerns.

Now, the usual argument is that GDP data is lagging given that second quarter results cover up to June. But the latest weekly initial jobless claims offered support to the soft-landing thesis, as first-time unemployment claims have trended lower in the past few weeks. Additionally, personal consumption and income data continued to expand in July.

It's hard to square the recent data with a narrative of a U.S. economy about to fall off a cliff. The goldilocks element is that U.S. inflation is moving in the right direction. July's core personal consumption expenditure price index, the Fed's preferred measure of underlying inflation, came below estimates on a year-on-year basis, while the 0.2% monthly advance is consistent with the Fed's 2% inflation target. These economic fundamentals have supported a sharp rebound in global equities, a retreat in bond yields and a deprecation in the U.S. dollar index.

It seems that, finally, we have confidently reached the point where inflation is no longer the biggest concern to markets and central bankers. Aside from the U.S., there's good news on the inflation front in key major economies such as the UK and the Eurozone.

UK and Eurozone inflation is normalising

In the UK, the British Retail Consortium shop price index fell 0.3% year-on-year, its first contraction since October 2021. Inflation has come a long way to normalise from the Covid supply chain squeeze and the energy price surge of the past three years. While this is a data point the Bank of England will appreciate, it's not enough for another rate cut in September.

In the Eurozone, inflation slowed from 2.6% to 2.2% in August. Inflation in Germany, the largest economy in the area, has reached the 2% milestone. Markets cheered as the normalisation back to 2% inflation is finally in sight after a long battle by the European Central Bank (ECB) to fight inflation that was as high as 10.7% around two years ago.

With the normalisation of inflation, there is a strong case for monetary policy to return to less restrictive levels. For the Eurozone, the icing on the cake is that wage growth has slowed markedly in the second quarter. This is an indicator the ECB focuses on, so this further builds the case for another rate cut in September, which markets have now fully priced in.

All in all, the backdrop of easing monetary policy, ongoing economic expansion, and healthy corporate earnings are reasons for optimism for risk assets going forward.

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy. Information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness. Forecasts are not a reliable indicator of future performance. We or a connected person may have positions in or options on the securities mentioned herein or may buy, sell or offer to make a purchase or sale of such securities from time to time. For further information, please refer to our conflicts policy which is available on request or can be accessed via our website at www.brewin.co.uk.

RBCBDM1809_2409