Nvidia Takes the Spotlight

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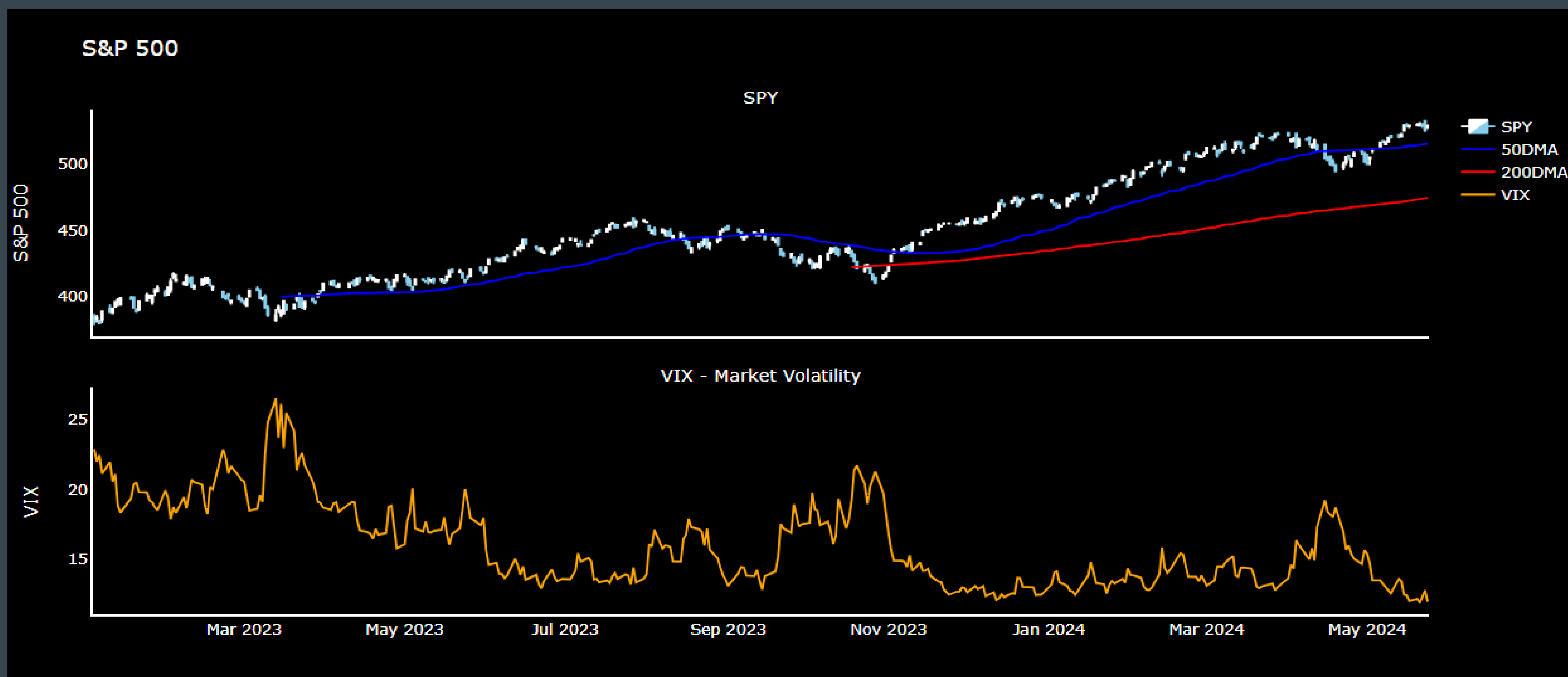
Last week, the tech sector had its best performance since November, with a gain of over 3%, driven by Nvidia's strong earnings report. The market was quiet until Wednesday, due to minimal economic data. Nvidia's stock surged to a record high, exceeding $1,000, which positively influenced the broader market. Volatility has diminished significantly, with the VIX dropping below 12 after a brief rise towards 20 last month. Historically, the VIX averages around 20, but in the past two years, it has rarely surpassed 18. The S&P 500 sits at all-time highs, guided by Nvidia.



The FOMC minutes from April's meeting were released, providing insights into the Fed's monetary policy considerations. While the information is somewhat dated, it still offers valuable context for investors to understand the Fed's decision-making process and the data influencing their policies. Some highlights from the minutes are below:

They noted the lack of progress over the past 2 months which has been pointed out across the media as inflation has stalled out. They specifically pointed out services and Core Goods inflation.

"Participants observed that while inflation had eased over the past year, in recent months there had been a lack of further progress toward the Committee's 2 percent objective. The recent monthly data had showed significant increases in components of both goods and services price inflation. In particular, inflation for core services excluding housing had moved up in the first quarter compared with the fourth quarter of last year, and prices of core goods posted their first three-month increase in several months. In addition, housing services inflation had slowed less than had been anticipated based on the smaller increases in measures of market rents over the past year."

The Employment Cost Index was brought up and is a popular measure they have looked at when gauging wage inflation.

"Even so, a number of participants noted that some measures of labor cost growth, including the ECI, had not eased in recent months, and a couple of participants remarked that negotiated compensation agreements had added to wage pressures in their Districts."

The part of the minutes that the market responded to were comments about keeping rates higher for longer and contrary to what Jerome Powell said in his April speech, participants are willing to tighten policy further.

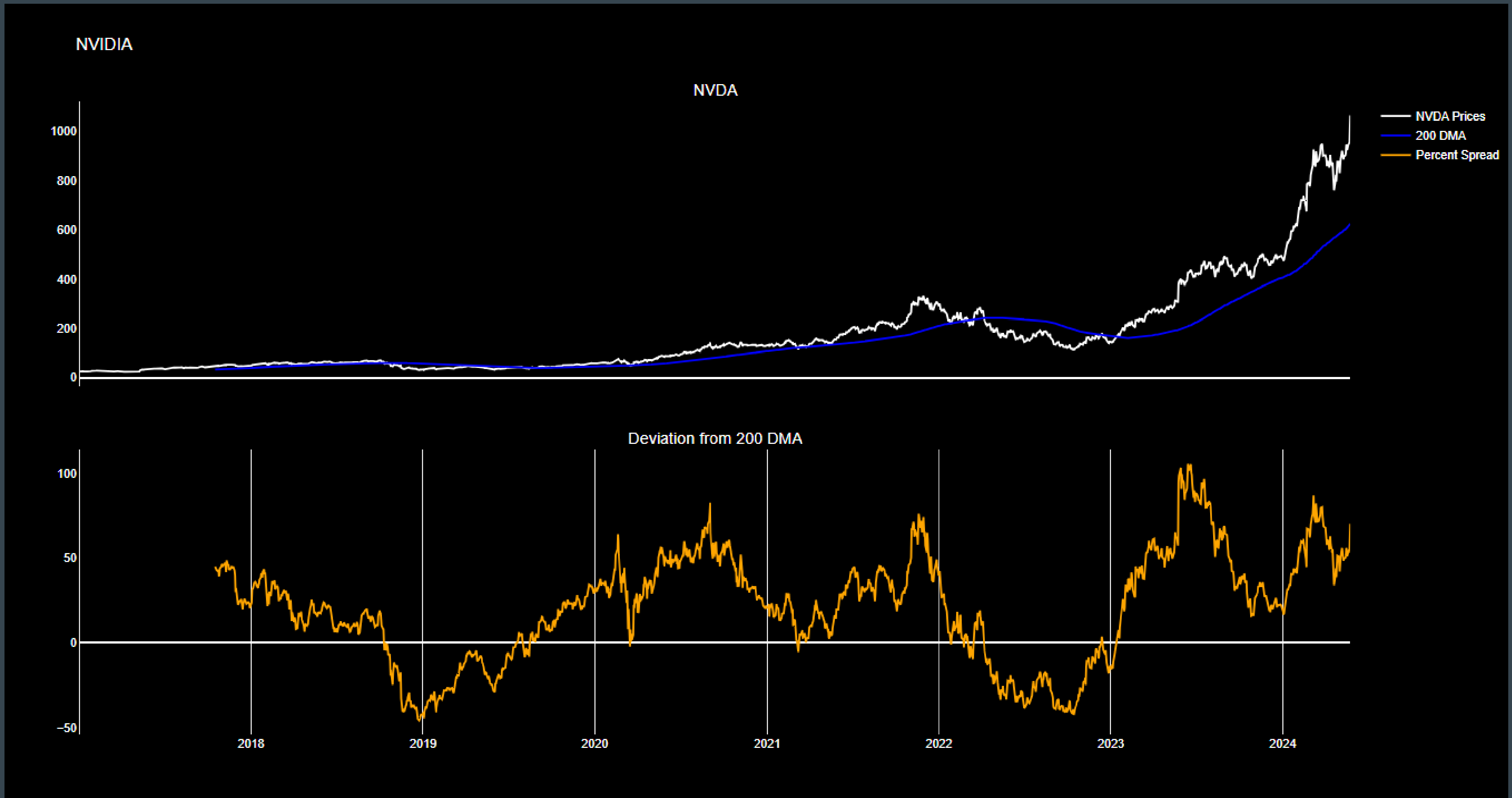
“Participants discussed maintaining the current restrictive policy stance for longer should inflation not show signs of moving sustainably toward 2 percent or reducing policy restraint in the event of an unexpected weakening in labor market conditions. Various participants mentioned a willingness to tighten policy further should risks to inflation materialize in a way that such an action became appropriate.”

Even with Jerome Powell suggesting that further hikes might not be needed, many Fed members have been advocating for no cuts or even additional hikes if necessary. This indicates a lack of consensus within the Fed and the rhetoric from Powell about hikes might have been to keep the stock market from overreacting. Topics such as delinquencies, credit card usage, and "buy now, pay later" was also discussed, and they highlighted that financial conditions are more favorable for the wealthy, who benefit from rising asset prices and higher interest income from large cash holdings. The labor market came under scrutiny, with members noting an improving supply/demand balance. They mentioned a readiness to adjust rates if the labor market significantly weakens, making it a key policy consideration. If preemptive rate cuts trigger another asset rally, inflation could persist, exacerbating the problem. Conversely, if rates are kept high for too long or increased further, leading to a delayed rate cut, a recession could ensue, following historical patterns. The critical watch point remains how the labor market evolves and the Fed's response to any weakening.

Nvidia gapped higher on earnings after the close Wednesday and was the main contributor to the overall market heading higher into the end of the week. Nvidia’s market cap is now $2.6 trillion making it the 3rd largest company in the world. It is up 270,000% since going public.

Nvidia was tracking its long-term trend going back to 2014 at the start of the year. After returning over 100% in the first 5 months of 2024 it now sits over 1 standard deviation above trend.

From a technical perspective, stocks don't tend to stay overly deviated from their 200 DMA for very long. We define overly deviated as 10-15%. Nvidia is over 70% from its 200 DMA and has been for a large portion of the last year.



Year-over-year the company has returned almost 250%. It has been here before 2 times in the past. Below is shown in rate of change terms and tells you that the rate at which the stock has gone up will slow looking forward.

To give some stats about the current market cap of the company to corroborate the fact that the rate at which the price has gone up cannot continue, the market cap is currently:

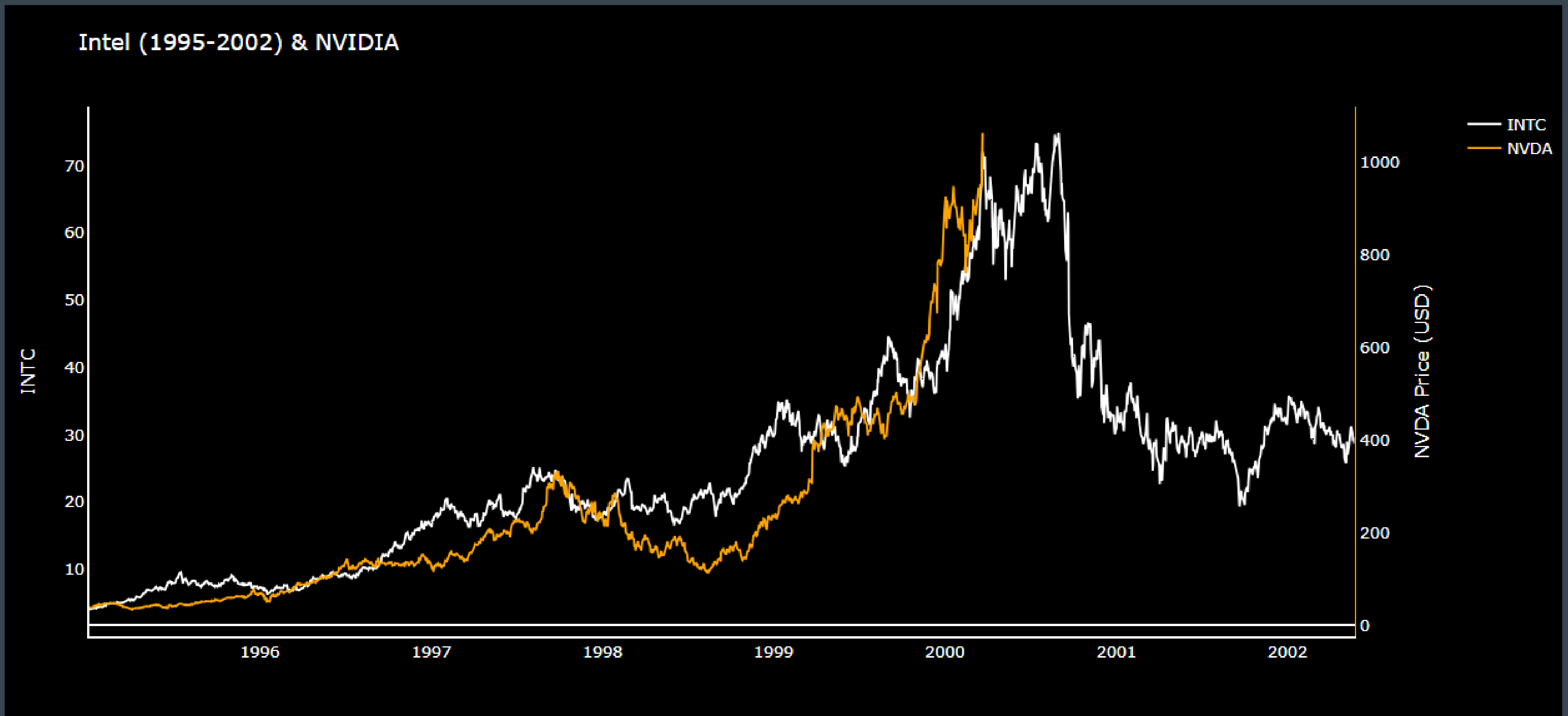
- Larger than the size of the German stock market
- 5 times the size of Visa, Exxon, and Walmart
- Larger than the GDP of every state except for Texas and California

Unlike many of the tech names of the Dot-Com bubble however, there is a fundamental story driving the returns of the stock. Revenue was reported at $26 Billion; this is up 260% year-over-year and 17% quarter-over-quarter. Data center revenue was reported at $22.6 Billion, which makes up over 80% of Nvidia's total revenue. Over the past year their gross margins expanded from 66% to 78.9% and Profit margins went from 33.7% up to 58.5%. I don't think you can find in any recent history a company that has had this type of fundamental growth that was also as large of a company as Nvidia is. With the stock up 250% over the past year and the market cap where it is, however, how much of that growth is priced in? From this point forward there may be more possible downside than there is upside left in the move. Along with earnings they also announced a 10 for 1 stock split which will make their shares ~$100. This essentially does nothing to the actual company but makes their shares more accessible to those with smaller accounts.

Nvidia's largest buyers, which account for 40% of revenues, are Amazon, Meta, Microsoft, and Google. All of these companies have already begun working on semiconductor chips of their own, so they don't have to go through Nvidia to purchase them. A few of them have been successful in creating their own chips for some of their products. The chip industry, in general, has always been a cyclical industry because of how quickly chips can be manufactured once the company creates the IP to apply to the physical chip. This often leads to overordering, resulting in a supply glut. When there is oversupply, companies tend to write down inventory, shrinking margins and thus profits. Nvidia has not had that problem as they currently have the best semiconductor chip for the build-out of datacenters, which are needed to power AI technology and software systems. As a result, their margins are almost 80% gross and 58.5% net—figures that are unheard of and typically unsustainable. Jeremy Grantham is famous for saying, "Profit margins are probably the most mean-reverting series in finance." Massive margins attract new competitors. If 50% of their revenue is hitting the bottom line, there is plenty of room for a competitor to enter the market, sell the product at a lower price, and still achieve 40% margins, for example. On top of this, a factor not currently priced into the stock is geopolitical risk. Taiwan produces 60% of the world's chips and 90% of the specialized chips. There is a continuing threat of a Chinese invasion of Taiwan, which would have large negative impacts on Nvidia's ability to even get their products made. Since 2023, Nvidia has returned over 500% more than Taiwan Semiconductor. While TSMC should not necessarily have the same returns as Nvidia, part of that delta likely reflects the pricing in of geopolitical risk to TSMC that is not reflected in Nvidia's price.

China also accounts for 22% of Nvidia's revenue. Huawei has just released its own chips in four of the five categories that Nvidia competes in. The Chinese Communist Party (CCP) will likely influence corporations in China when deciding which chips to use, making it improbable that they will allow their companies to use American competitors' technology. There a lot is priced into Nvidia, mainly because there is currently no competitor on the market for their chip. However, competition is coming as everyone in the industry is looking to whittle away their market share. A comparable time in terms of market hype around new technology is the Dot-Com bubble, which drove the Nasdaq up by 500% over a five-year period. During that time, nobody thought stocks could fall because those companies were seen as the future. However, competition came in, and most of those companies are not around

anymore. Nvidia is much larger and has a better moat than those companies, but stocks can be bid up to valuations that don't make sense even relative to positive fundamentals. Nvidia currently trades at a 60 P/E ratio, which could be cut in half and still reflect the valuation of a growth stock. Intel had $33 Billion in revenue and was a growing company back in 2000 and that did not stop it from falling 75% inside of a year.



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