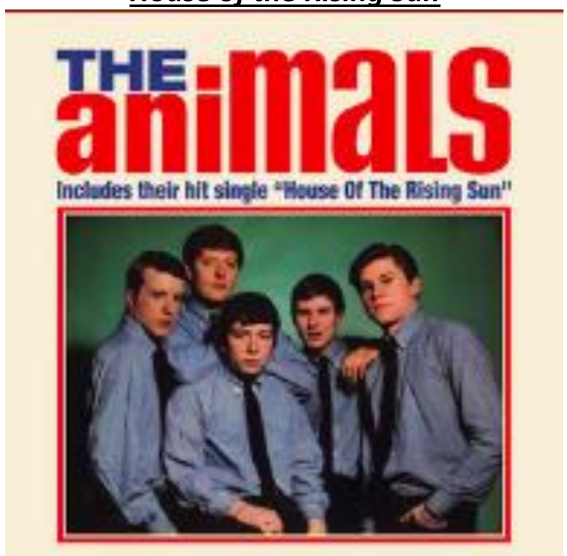
MEDALLION WEALTH MANAGEMENT

June 2023 Market Commentary

House of the Rising Sun



There is a house in New Orleans
They call the Rising Sun
And it's been the ruin of many a poor boy
And God, I know I'm one

The Animals- https://www.youtube.com/watch?v=N4bFqW_eu2I

Over 30 years ago, when I was a young analyst, I was fortunate to attend an investment conference in Las Vegas. It was my first visit to Sin City, and it made an impression on me that lasted throughout my career. Everything about Vegas is designed to impress; the blue-sky weather, the palms, the pools, the extravagant hotels, the restaurants, the shows, and of course the casinos. It's a place designed, with the express purpose of convincing you to willingly transfer a portion of your net worth to the owners of the casinos, aka the House.

The highlight of that trip wasn't the hours spent sitting in a conference room listening to company presentations, or the time spent at the blackjack tables; no, the highlight was a behind the scenes tour of the gaming operations at Mandalay Bay. It was fascinating to learn about the various house odds and watch how they monitor the betting floor. I vividly remember a presentation by a young math geek about slot machines. He said that they generally set the slot machines so the house keeps about 15% of the money played (aka, the Hold). The key though is to vary this amount so that the customer enjoys themselves enough to sit there depositing money until they don't have any more. He said, "you want them to have a good time over the course of play, not even realizing that they've lost all their money."

When two people bet each other there is a clear winner and loser, but when someone else facilitates that wager, we have a third party in the mix, the **"House."** For the privilege of facilitating the "action" the house takes a percentage of all the wagers made, this is called the **"Hold".** As stated above, the house's hold rate for slot machines is about 15%.
In sports betting the "hold" is also known as the **"Vig"** or vigorish. If you want to bet on a game, you typically bet $110 to win $100. The person on the other side of that bet also bets $110 to win $100. So, a total of $220 is bet with the house. One person loses his $110, the winner gets their $110 back plus $100. The house keeps $10 for facilitating the action, or a hold rate 4.5% ($10/$220).

With the advent of legalized online sports betting, we've all been inundated with ads and promotions from various betting houses. Most of these are promoting parlays. A parlay is simply a series of bets that all must go right for you to win. The more layers to a parlay, the higher the payout, but also the higher the odds of losing. Parlays are fun, but the house's hold rate rises from 5% on straight bets to between 15% and 25% on parlays.

Here's a quick rundown of the House's various Hold rates:

- State run lotteries 25-50%
- Racetracks 22% overall
- Casinos 18% overall, table games 14%
- Online sports betting 5% on straight bets, 15-25% on parlays

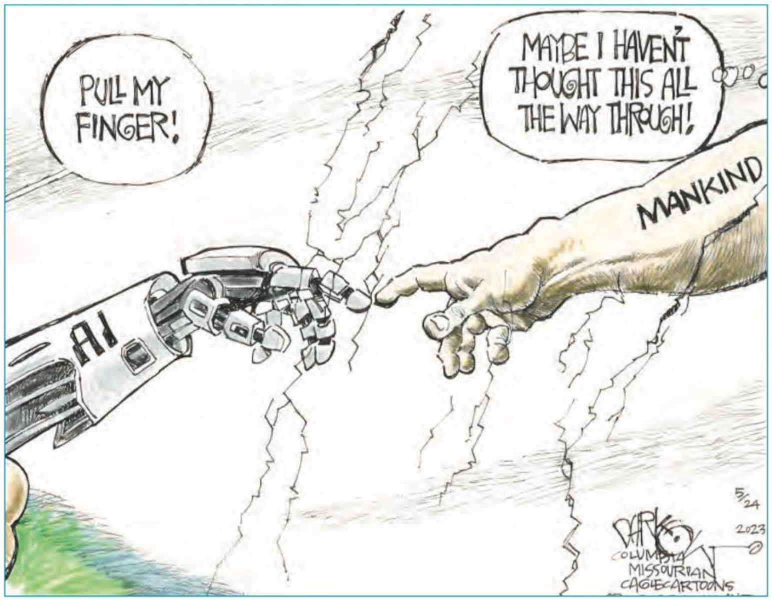
In my view, it's totally okay to place bets for entertainment purposes. Just remember to know your odds, and that you are paying to be entertained not to make money. If you're not being entertained, don't bet. Sometimes you win, sometimes you lose, but the House always wins.

Investing has many similarities to gambling; you have a buyer and a seller on every side of the trade, and you have the house in the middle facilitating the action. One of my rules when buying a stock is to try and think like the seller; asking myself what they know that I don't, what is their motivation to sell?

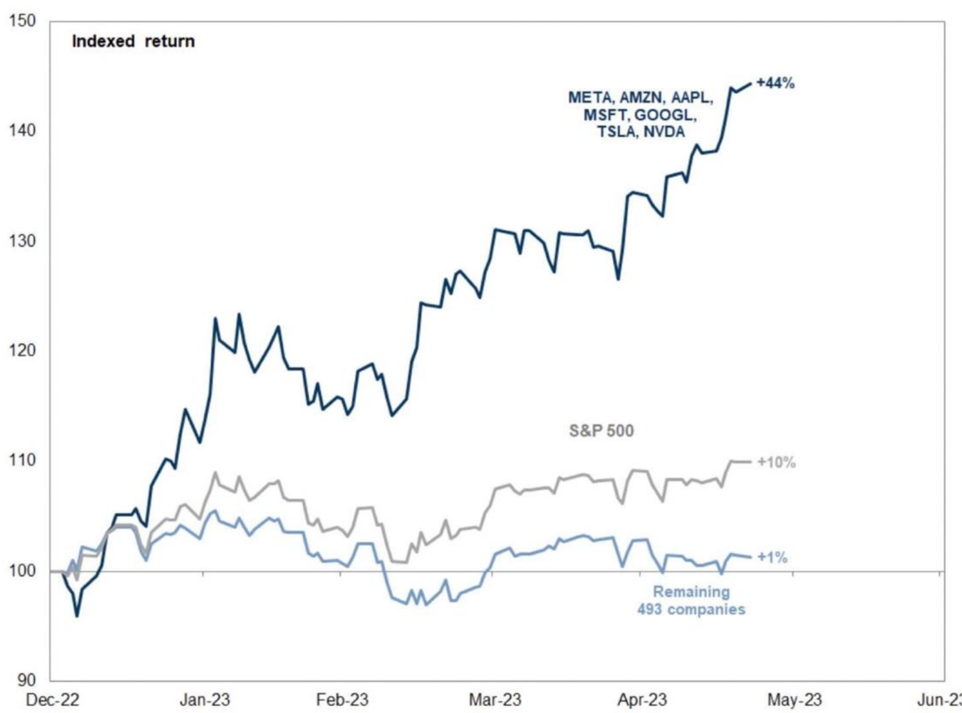
While investing may have similarities to gambling it also has a significant difference; a true investor can become more like the "House" over time. If we think of investing as purchasing a share of a company's long-term earnings stream, instead of simply a short-term transaction between buyer and seller, then we are starting to act more like an owner instead of a gambler.

Knowing your odds is imperative, but also knowing that your odds improve when you bet on the right company and you extend your time horizon. Become the house.

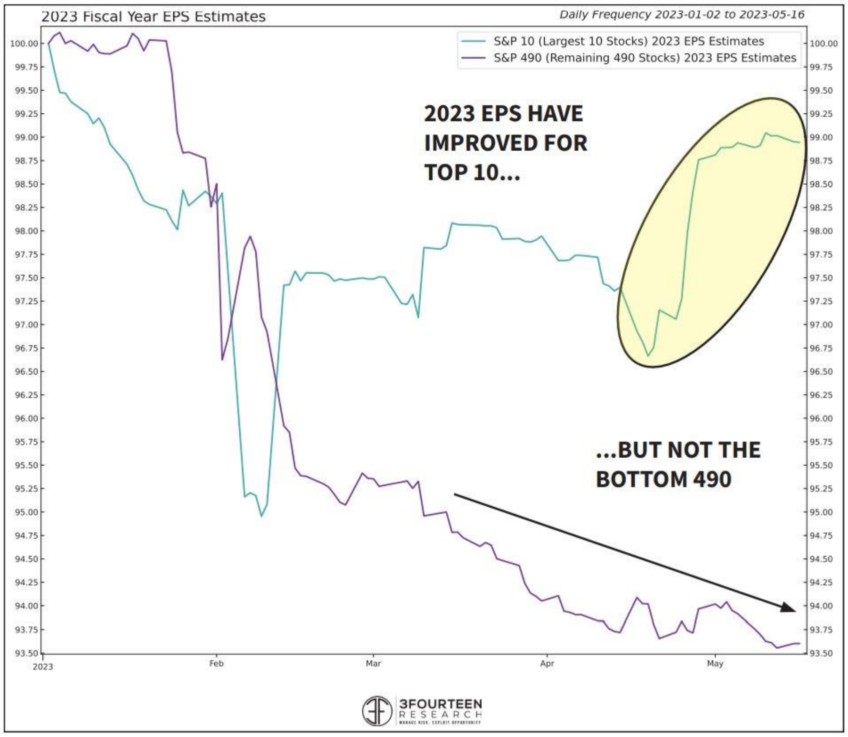
Market Commentary:



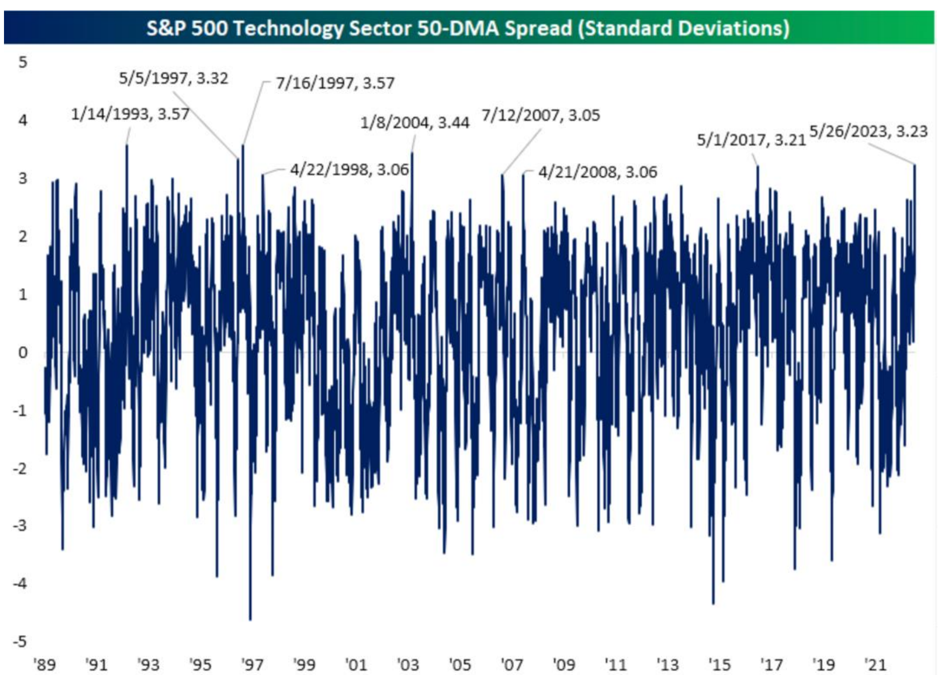
There's a lot going on in the market's these days, but there is probably nothing more important than Artificial Intelligence. A handful of very large tech stocks are at the forefront of this revolution and they account for nearly all of the markets gain so far this year.



They are also accounting for nearly all of the market's earnings growth.



This has led the S&P 500 Technology sector to one of its most overbought levels ever. The key question now is if this is another bubble in tech, or is it something different? The chart below shows some similar overbought tech rallies. What all these dates have in common is that they eventually presaged a market selloff, the key is when. The 1997 and 1998 peaks led to years of very good returns until the 2000 bubble burst. Other dates like 2008, were reversed rather quickly.

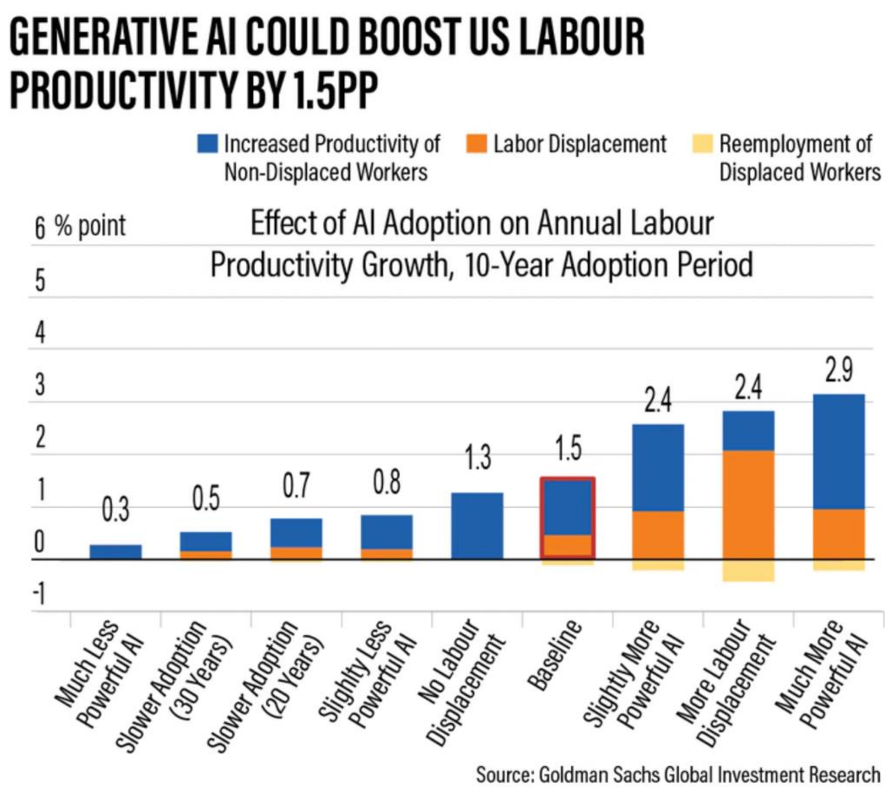


Bespoke Investment Group

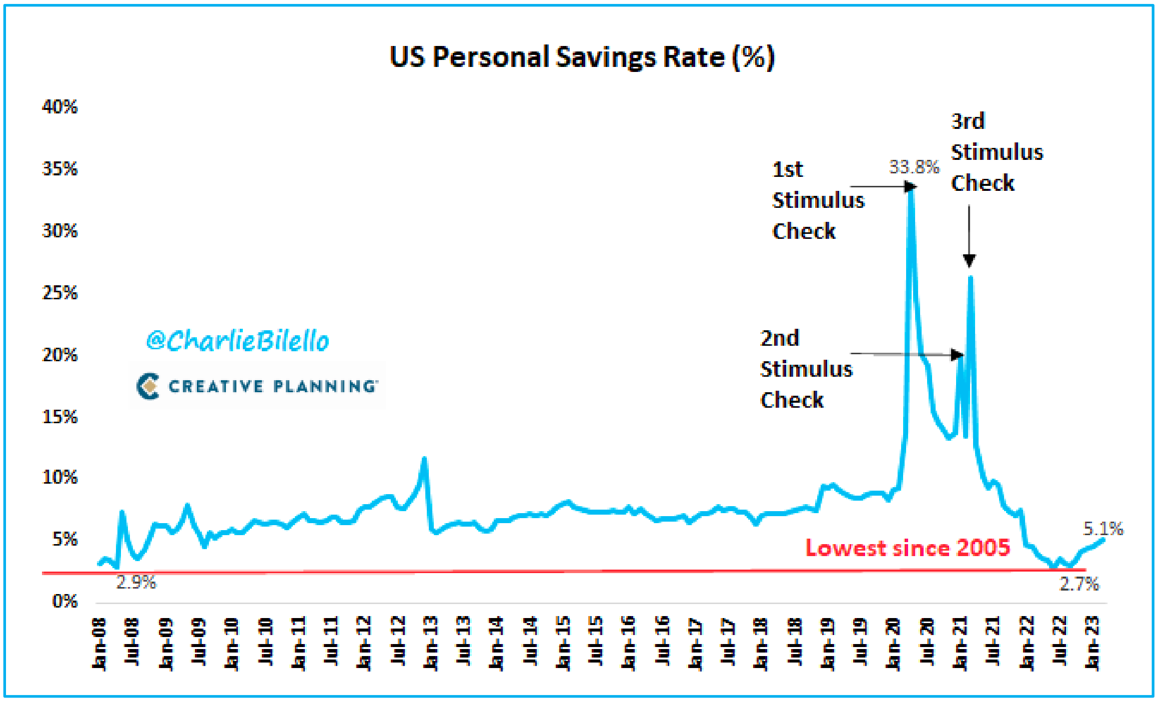
Of course, nobody knows when this rally in AI related stocks will end, but one thing we can be pretty excited about is that generative AI will lead to a boom in productivity. Goldman Sachs believes that generative AI will add at least 1.5% to overall productivity growth, and while 1.5% doesn't sound like a lot, consider that in the last decade productivity growth was only 0.8%. This added productivity would lead to an increase in S&P 500 profits of 30% over the next decade. This could also translate into wage growth of 4%-4.5%, without a lot of inflation.

It's clear that the near-term benefactors are going to be the AI tech enablers, but over the long-term the winners will be all those companies who embrace this technology to enhance productivity. Remember the Dot.com revolution of the late nineties, when companies in every industry slapped dot.com, even though they had little to nothing to do with the internet. Well, the AI revolution will probably see even more charlatans, and our job will be to identify those truly embracing the technology versus those just paying it lip service.

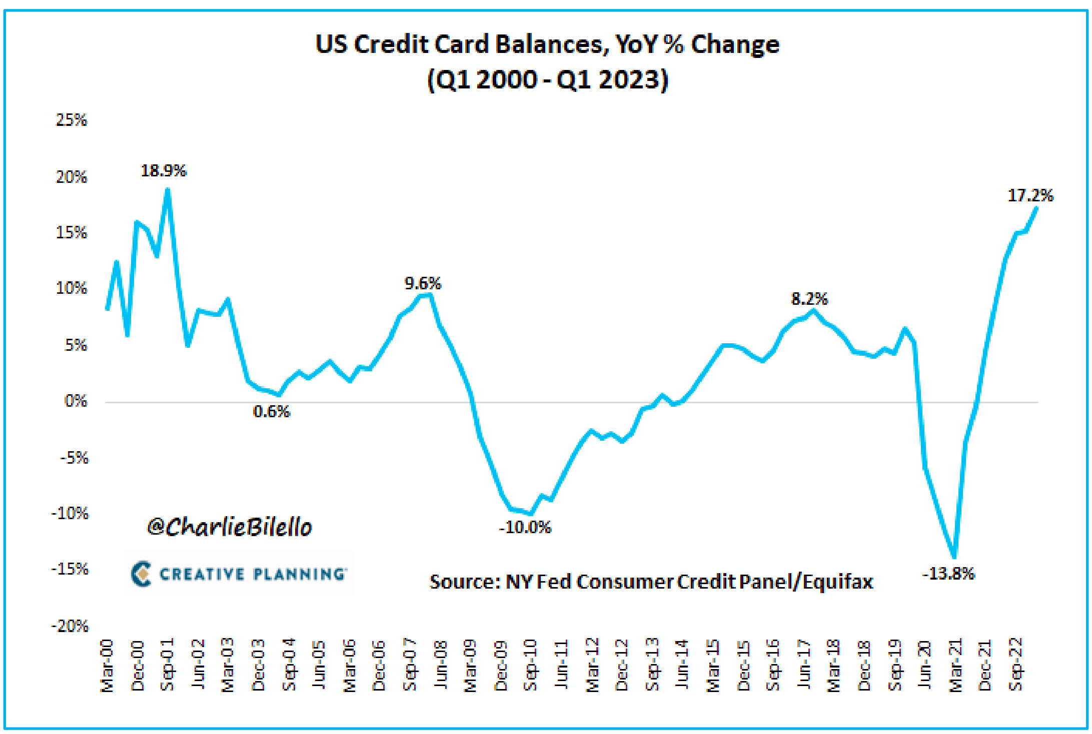
I believe that artificial intelligence is very bullish for economic growth, and for mankind as a whole. Yes, it has the potential to be very disruptive and downright scary too, but overall, I believe that it will do more good than harm. That said, I do worry about Skynet warnings from the inventors of AI, namely this succinct 22-word statement from the founder of OpenAI, the head of Google's DeepMind, and numerous other AI leaders; ***"Mitigating the risk of extinction from AI should be a global priority alongside other societal-scale risks such as pandemics and nuclear war."***



Outside of AI things are not looking as rosy. The U.S. consumer has spent down all their stimulus check savings and are now starting to rebuild their saving level.

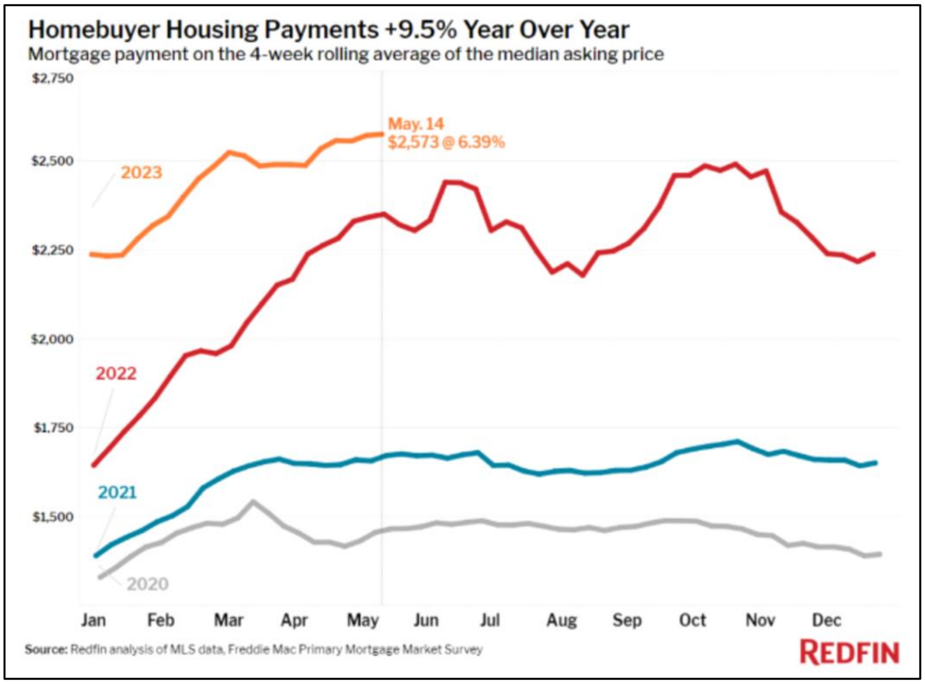


As savings are being rebuilt, consumers are relying more heavily on their credit cards. For the first time ever consumer debt has gone over $17 trillion, and for the first time in 20-years of data collection the 1st quarter didn't go down. Usually, consumers take on debt during the end-of-year holidays and then pay it down in the 1st quarter, which didn't happen this year. And credit card interest rates are now over 20%.



Not only is debt rising, but serious delinquencies (those more than 90 days delinquent) are also rising. For those aged 18-29 serious delinquencies are 8.3%. And this is after they haven't had to make any student loan payments in nearly three years. What happens when student loan payments are set to resume September 1?

Lastly, the fate of new homeowners isn't very attractive either. The average home mortgage payment is now over $2,500 per month, this is up from $1,300 in 2020.



So, we really have an interesting market here. A handful of stocks are benefiting from the inflation of the AI bubble, while most other companies are stagnating under the weight of a consumer trying to keep their heads above water. Buckle up, it's going to be an interesting summer, but as always we stand ready to see you through it.

Oh mother, tell your children
Not to do what I have done
Spend your lives in sin and misery
In the House of the Rising Sun

As always, be careful out there.

Chris Wiles, CFA

Where trust is Earned