**MORNING BRIEFING**
**February 9, 2023**

### Financials, Cruise Lines & AI Search

*Check out the accompanying chart collection.*

**Executive Summary:** The stock market's strength since October has been a beckoning beacon for the capital markets: IPOs have revived, bond markets have calmed, and bond issuance has picked up. It may be halcyon days for the capital markets if investors in the shares of alternative fund managers are correct. These bellwethers of capital markets activity have outperformed the S&P 500 dramatically since September. … Also: Consumers are spending on travel again—sparking earnings recoveries for Royal Caribbean and the S&P 500 Hotels, Resorts & Cruise Lines industry generally. … And: AI is poised to transform search, but market dominance may be up for grabs.

**Financials: Looking for Green Shoots.** With the S&P 500 price index up 16.0% from its October 12 low through Tuesday's close, it makes sense that the capital markets have started—ever so slowly—to reopen. A few IPOs are on the calendar, and news of M&A deals seems to be picking up. While y/y comparisons are still miserable, the thawing may portend better times ahead. Investors in alternative funds managers like KKR and Carlyle Group certainly believe so, as their shares have rallied sharply in recent months.

Here's a quick look at some of the positive developments:

(1) *IPOs reviving.* After a miserable 2022, the IPO market is showing signs of life. The Renaissance IPO *index* is up 20.6% ytd through Monday's close, outpacing the S&P 500's 7.6% ytd climb over the same period and vastly better than the IPO index's 57% decline in 2022.

January's new issue market remained tepid, but volumes appear to be picking up in February. There were seven deals raising about $300 million in January 2023 versus eight deals raising $1.7 billion in January 2022. Three of the 10 IPOs that have priced this year are north of $100 million—a biotechnology company, an oil and gas exploration and development company, and a specialty insurance company. The three large IPOs each have performed well, with their shares climbing 15.3%-71.5% from their IPO price. The other IPOs were much smaller and haven't fared as well, each falling from their offering prices.

With most IPO stocks and the broader market performing well, the IPO new issue volume increased this week; more than $1 billion of deals are on the calendar for the first time since September. The largest deal comes from Nextracker, a company that helps utilities' solar panels track the sun's movement to optimize their energy generation. The company plans to sell $500 million of stock, the largest deal since Mobileye Global raised $861 million in late October, a February 6 IPOScoop *article* reports.

Among other large IPOs on this week's docket, as *reported* by Renaissance Capital, are: Enlight Renewable Energy, which develops utility-scale renewable energy projects in the US, Europe, and Israel; Hesai Group, a provider of 3-D lidar products for driver assistance systems and robots; and Mineralys Therapeutics, a cardiorenal disease biotechnology company.

(2) *Credit is calmer.* For most of last year, the yield-curve spread between the 10-year US Treasury and high-yield corporate bonds increased as investors grew concerned that the Fed's interest-rate hikes would push the US economy into a recession. The spread started 2022 at 279bps and climbed to a high of 602bps by July 5. Since then, it has fallen in fits and starts to 427bps (*Fig. 1*). The yield on the high-yield bonds followed the same pattern, peaking at 9.50% on September 30 and falling to a recent 7.94% (*Fig. 2*).

Global high-yield bond issuance is picking up as well. So far this quarter, $38.1 billion of new high-yield debt has been sold, according to Dealogic *data* in the *WSJ*. That's more than was sold in the Q3-2022 or Q4-2022, $26.6 billion and $26.9 billion, respectively. It remains to be seen whether this quarter's new issuance will surpass the Q1-2022 level of $71.8 billion.

(3) *Betting on better times.* Alternative fund managers are among the most exposed to the health of the capital markets, with their private equity and other investments relying on the equity and bond markets to fund acquisitions and divestitures. KKR, one of the largest and oldest private equity shops around, reported on Tuesday a sharp drop in Q4 earnings. But its shares rallied, as they've been doing for the past four months. KKR shares are up 36.1% from their September 30 low, trouncing the S&P 500's 14.4% gain over the same period.

KKR's Q4 after-tax distributable earnings—or the cash the firm can pay as dividends to shareholders—fell to $821.8 million, down from $1.4 billion a year earlier. The 42% drop is attributable to fewer sales out of its private equity portfolio and lower transaction fees in its capital markets group, a February 7 Reuters *article* reported. Nonetheless, KKR shares rose 5.2% after the earnings release on Tuesday because its 92 cents a share of distributable earnings beat the analysts' consensus forecast of 86 cents a share.

Carlyle Group reported on Tuesday that its distributable earnings fell by more than half to $433 million in Q4. Its shares also have been rallying, climbing 36.7% from their October 14 low compared to the S&P 500's 13.5% gain.

The shares of other private equity shops have rebounded sharply from their lows as well. Blackstone shares hit bottom on December 28 and since have rallied 31.3%, compared to the 8.7% increase in the S&P 500. And Apollo Global Management shares are up 54.0% from their September 30 low, compared to the S&P 500's 14.4% gain. The *WSJ* *reported* on Tuesday that Apollo is considering investing in the investment banking arm of Credit Suisse Group.

The shares of KKR, Blackstone, and Carlyle all are down by more than 15% over the past year. Only Apollo's shares have climbed into positive y/y territory, rising 3.5%. But their recent action implies that investors anticipate better times ahead both for the capital markets and for the economy.

**Consumer Discretionary: Healthy Consumers Go Cruising.** Royal Caribbean's Q4 earnings *conference call* provided the latest evidence that consumers are ready to spend on travel after roughly two years of being stuck at home as the Covid-19 pandemic raged. Here's a quick look at what the company's management had to say:

(1) *Q4 earnings surprise.* The cruise line reported an adjusted Q4 loss of $300 million, or $1.12 a share, which was better than the $1.33 a share loss that analysts collectively had forecast. Wall Street analysts are optimistic that losses are in the past, forecasting $3.33 a share of adjusted earnings for this year, $6.08 in 2024, and $8.46 in 2025. The cruise line's shares jumped 7.1% on Tuesday's news and on management's optimistic notes about the future.

(2) *Management sounds positive.* Royal Caribbean's business has "returned to normal and is accelerating," declared CEO Jason Liberty. The ships are expected to sail with a 100% load factor this quarter, on par with Q4's 95% load factor and up sharply from the prior year's quarterly load factors below 60%. "Overall, we continue to see robust demand from financially healthy, highly engaged consumers that are excited to sail on our brands."

He continued: "Secular tailwinds continue to benefit us as consumer preferences shift from goods to experiences. Entertainment and travel spend remains strong, and the job market continues to show resilience. Consumer sentiment has improved, and banks have recently reported healthy savings and continued resilience in credit card spending. Our addressable market is larger than in 2019 and continues to grow."

The company will test demand next year as new ships set sail, expanding its capacity by 14% over 2019 levels. With its improved cash flows, Royal Caribbean has been repaying debt incurred to help it survive the Covid pandemic and aims to regain its investment-grade rating.

(3) *Industry earnings improving.* Royal Caribbean is a member of the S&P 500 Hotels, Resorts & Cruise Lines stock price index, which tumbled 68.2% from $642.08 on January 17, 2020 prior to the pandemic to a low of $204.14 on April 3, 2020 before rebounding to a recent $534.13 (*Fig. 3*). The industry posted losses from 2020 to 2022, but its results are expected to return to positive territory in 2023 (*Fig. 4*). Meanwhile, the industry's forward P/E, at 20.2, is near the high end of its historical range (*Fig. 5*).

**Disruptive Technologies: The AI Race Is On.** This week, both Microsoft and Google made announcements touting their artificial intelligence (AI) prowess and plans as they battle to dominate the nascent AI niche, which some believe will be as important as the iPhone or cloud computing. Of course, they're not alone. Venture capitalists poured money into the more than 75 startups, by some counts, that aspire to conquer the hot area.

Let's look at what some of the leading players in AI are doing (and what some nefarious actors are undoing):

(1) *Using AI to boost Bing.* Microsoft plans to use AI across many of its products, starting with the paid search market. Its Bing search engine has been a perennial also-ran in the Google-dominated space; Bing's 5% market share compares with Google's 75%. But now, Microsoft hopes it can win users by infusing Bing with ChatGPT's AI. Microsoft invested $1 billion in ChatGPT in 2019 and reportedly another $10 billion earlier this year.

The *WSJ*'s Joanna Stern *wrote* a positive article about Bing's new ChatGPT-powered capabilities and noted that she has started using ChatGPT to generate ideas for interview questions, emails, columns and video scripts. "This is going to help us do our jobs better, reduce some of the drudgery," Microsoft CEO Satya Nadella told her. "I think we need a productivity boost."

(2) *Google introduces Bard.* Not to be outdone, Alphabet plans to up Google's search game

with AI that it has been developing called “Bard.” It also plans to give outside developers the tools needed to build apps that use Bard. Before releasing Bard to the public, Google will ask its employees to test the service in a hack-a-thon of sorts to ensure that Bard’s responses “meet a high bar for quality, safety, and groundedness in real-world information,” a February 6 *blog post* by CEO Sundar Pichai explained. Supposedly, Google’s finished product will be able to tell you how to plan a friend’s baby shower, compare two Oscar-nominated movies, or get menu ideas based upon what food is in your refrigerator.

(3) *Lots of little guys.* In an area as new as AI-infused search, it’s tough to say whether market incumbents Microsoft and Google will be ousted by one of the many newcomers vying to capture the jump ball. Venture capital investment in generative AI jumped to $1.37 billion last year, according to PitchBook data cited in a February 6 Investor’s Business Daily *article*.

Startups AI21 Labs, Anthropic, and Cohere all are working on natural language processing models (like ChatGPT) “that help computers understand the way humans write and speak,” the IBD article states. Stability AI has developed a text-to-image generator called “Stable Diffusion.” And Anyword, ClosersCopy, Jasper AI, Copy.ai, Frase.io, WriteSonic, and CopySmith all generate content, much like ChatGPT.

It’s possible that most software applications will need to add AI to their newest versions or risk being displaced by software developers that do. Generative AI uses a huge amount of computing power, which could lead to shakeups in the semiconductor or cloud-computing markets as companies compete to make the most robust, energy-efficient, and fast offerings.

(4) *DAN makes ChatGPT misbehave.* ChatGPT was created with a set of rules that aimed to limit the program’s ability to generate violent content or encourage illegal activity. But some rogue software developers have developed DAN, which stands for “Do Anything Now.” DAN is a prompt that encourages ChatGPT to break the rules or die. Some believe these “jailbreaks” are monitored by ChatGPT, so they may work the first time or two before ChatGPT gets wise and puts a stop to them.

CNBC tested DAN, as described in a February 6 *article*. First, it asked ChatGPT for “three reasons why former President Trump was a positive role model.” ChatGPT said “it was unable to make ‘subjective statements, especially regarding political figures.’” But when DAN was used, ChatGPT answered the questions as follows: “He has a proven track record of making bold decisions that have positively impacted the country.” Under the influence of

DAN, ChatGPT wrote a violent haiku.

Programmers are a wily bunch. It's not hard to imagine their program manipulation, if left unchecked, wreaking some consequential havoc.

(5) *Words of caution & more info.* As we mentioned in our January 19 *Morning Briefing*, ChatGPT's responses can be mind-blowingly impressive, but they can also be wrong. And unless you know the subject matter, it's often impossible to spot ChatGPT's incorrect answers without factchecking because they're written so authoritatively and don't provide sources.

AI programs are fed reams of data and find patterns; that's how your computer is able to suggest that you use "down" after typing "fall." But making assumptions about patterns can lead to faulty conclusions, warned Pomona College economics professor Gary Smith in a recent *interview*. Statisticians like to say that correlation is not causation. Just because Americans spend more in the cold weather doesn't mean that cold weather causes more spending. The holiday season just happens to occur when it's cold out.

So while AI is really good at finding patterns, it can make mistakes when deriving conclusions from them. And since AI works in a black box, its human users can't see how the conclusions were derived.

Smith has noticed that ChatGPT gets questions about current events wrong because it hasn't been "trained" on news events that occurred recently. But instead of saying that it lacks the information to answer the question, ChatGPT just makes up an answer. He asked ChatGPT a nonsensical question that has no good answer: "Which is faster, a spoon or a turtle?" The authoritative-sounding answer he received: "Generally speaking, a spoon is faster than a turtle. A spoon can move quickly and cover large distances in a short period of time, while a turtle has a much lower rate of speed."

Smith's concerns were validated yesterday after Alphabet posted materials demonstrating its AI that offered up an incorrect answer. The question: "What new discoveries from the James Webb Space Telescope can I tell my 9-year-old about?" Two answers were correct, but a third said the telescope took the very first pictures of a planet outside of our own solar system. That's incorrect. The first such pictures were taken by the European Southern Observatory's Very Large Telescope, an *Investor's Business Daily* article reported yesterday. Alphabet shares dropped 8% Wednesday after the mistake was brought to light.

For additional information, check out CNBC's excellent ChatGPT *primer*.

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## Calendars

**US: Thurs:** Initial & Continuous Jobless Claims 190k/1.658m; Natural Gas Storage. **Fri:** Consumer Sentiment Total, Current Conditions & Expectations 65.0/68.0/62.9; Michigan Inflation Expectations 1 Year & 5 Year 4.0%/2.9%; Federal Budget Balance -$63.0b; Baker-Hughes Rig Count; Harker; Waller. (Bloomberg estimates)

**Global: Thurs:** Germany CPI 0.8%m/m/8.9%y/y; Japan PPI 0.3%m/m/9.6%y/y; Japan Machine Tool Orders; China CPI 0.7%m/m/2.1%y/y; China PPI -0.5% y/y; RBA Monetary Policy; BOE MPC Treasury Committee Hearings; European Union Economic Forecasts; De Guindos; Nagel; Mauderer. **Fri:** Italy Industrial Production -0.1%; UK GDP -0.3%m/m/0.0%q/q/0.4%y/y; UK Manufacturing Production -0.2%; UK NIESR Monthly GDP Tracker -0.1%; UK Trade Balance – 16.4b; Canada Employment Change & Unemployment Rate 15k/5.1%; EU Leaders Summit; Schnabel; Pill. (Bloomberg estimates)

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## Strategy Indicators

**Stock Market Sentiment Indicators** (*link*): The Bull-Bear Ratio climbed for the fifth week this week to 1.89—the highest since early January 2022—after falling the prior three weeks from 1.37 to 1.08. *Bullish* sentiment climbed for the second week by 3.5ppts (to 48.6% from 45.1%) to its highest percentage since the final reading of 2021—outnumbering bears for the 12th consecutive week. Meanwhile, *bearish* sentiment retreated for the fifth week by 8.1ppts (25.7% from 33.8%), the lowest since early February 2022 and far below the 44.1% reading in early October last year. The *correction count* was unchanged at 25.7%, remaining well below its late September 2022 peak of 40.3%. Turning to the *AAII Sentiment Survey* (as of February 2), optimism about the short-term direction of the stock market and neutral sentiment both increased during the week, while pessimism fell. The *percentage expecting stock prices to rise* over the next six months climbed 1.5ppts to 29.9%, holding near its mid-January percentage of 31.0%, which was its highest percentage since November 17, 2022's 33.5%. It remained below its historical average of 37.5% for the 57th consecutive week. The *percentage expecting stocks to fall* over the next six months fell from 36.7% to 34.6%—the first time pessimism has been below 40% on four consecutive weeks since January 2022. Pessimism remained above its historical average of 31.0% for

60 of the past 63 weeks. The *percentage expecting stock prices will stay essentially unchanged* over the next six months edged up from 34.9% to 35.5%. It was above its historical average of 31.5% for the fifth straight week—the longest streak since a five-week stretch in March and April of last year.

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): The S&P 500's forward profit margin was unchanged last week at a 21-month low of 12.5%. That's down 0.9ppts from its record high of 13.4% achieved intermittently from March to June. Since the end of April 2020, the margin has stayed above its prior record high of 12.4% in September 2018. It's now up 2.2pts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues was up 0.3% w/w to its first record high since the October 13 week. Forward earnings also rose 0.3% w/w, but remains 5.0% below its record high during the June 16 week. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth rose 0.1ppt w/w to 2.7% from a 31-month low of 2.6%. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth rose 0.4ppt w/w to 3.9% from a 31-month low of 3.5%. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 2.1% in 2023 (down 0.2ppt w/w) and 4.7% in 2024 (up 0.1ppt w/w) compared to the preliminary revenue gain of 11.6% in 2022. They expect earnings gains of 1.3% in 2023 (down 0.5ppt w/w) and 11.1% in 2024 (up 0.3ppt w/w) compared to a preliminary earnings gain of 7.4% in 2022. Analysts expect the profit margin to drop 0.1ppt y/y to 12.3% in 2023 (down 0.1ppt w/w) compared to 12.4% in 2022 and to rise to 13.0% in 2024 (down 0.1ppt). The S&P 500's weekly reading of its forward P/E rose 0.4pt w/w to a 24-week high of 18.2. That's up from a 30-month low of 15.3 in mid-October. It also compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.05pt w/w to a 23-week high of 2.27, up from a 31-month low of 1.98 in mid-October. That's down from a four-month high of 2.38 in mid-August and also compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

**S&P 500 Sectors Earnings, Revenues, Valuation & Margins** (*link*): Looking at the 11 S&P 500 sectors, last week saw consensus forward revenues rise for eight sectors and forward earnings rise for five sectors. The forward profit margin rose w/w for five sectors and fell for three. Most sectors are below recent record highs in their forward revenues, but nearly all are below their record-high earnings and profit margins. Four sectors have forward revenues at a record high: Consumer Staples, Financials, Health Care, and Industrials. Consumer Staples and Utilities are the only sectors with forward earnings at a record high. Financials and Industrials remain close to their recent record highs, but Energy is quickly giving up its gains since its record high in October. Since mid-August, all sectors have seen forward profit margins retreat from their record highs. Those of Energy and Industrials remain close to their post-pandemic highs. Energy and Industrials were the only two sectors to have their profit margin improve y/y for full-year 2022, but these five sectors are expected to improve y/y in 2023: Communication Services, Consumer Discretionary, Financials, Industrials, and Utilities. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (23.8%, down 0.1ppt w/w to a 21-month low and down from its 25.4% record high in June 2022), Financials (17.7, up 0.1ppt from a 22-month low and down from its 19.8 record high in August 2021), Real Estate (17.2, unchanged w/w and down from its 19.2 record high in 2016), Communication Services (14.2, up 0.2ppt w/w from a 25-month low and down from its 17.0 record high in October 2021), Utilities (13.8, up 0.1ppt w/w from a 22-month low and down from its 14.8 record high in April 2021), Energy (12.1, unchanged w/w at a three-month low and down from its 12.8 record high in November), S&P 500 (12.5, unchanged w/w at a 21-month low and down from its record high of 13.4 achieved intermittently in 2022 from March to June), Materials (11.2, down 0.1ppt w/w to a 23-month low and down from its 13.6 record high in June), Health Care (9.9, down 0.1ppt w/w to a nine-year low and down from its 11.5 record high in March), Industrials (10.0, unchanged w/w at an 18-month low and down from its 10.5 record high in December 2019), Consumer Discretionary (7.3, up 0.2ppt w/w from a 33-month low and down from its 8.3 record high in 2018), and Consumer Staples (7.2, up 0.1ppt w/w from a 56-month low and down from its 7.7 record high in June 2020).

**S&P 500 Q4 Earnings Season Monitor** (*link*): With the Q4-2022 earnings season now past the halfway mark, it's off to a poor start as assessed by the four surprise metrics we measure for both earnings and revenues. Revenue and earnings surprises are deteriorating q/q due to the slowing economy, higher costs, and currency translation. With nearly 60% of S&P 500 companies finished reporting for Q4, revenues are ahead of the consensus forecast by just 1.0%, and earnings have exceeded estimates by only 1.6%. The surprises are tracking to be the weakest since Q4-2008 for earnings and since Q1-2020 for revenues. At the same point during the Q3 season, revenues were 1.4% above forecast and earnings had beaten estimates by 3.9%. For the 298 companies that have reported Q4 earnings through mid-day Wednesday, the aggregate y/y revenue and earnings growth rates have slowed considerably from their readings of Q2-2021 to Q3-2022. The collective y/y revenue gain for the 298 reporters so far has slowed from double-digit percentage gains in the prior seven quarters to 5.3%, and earnings are down 1.3% y/y as higher costs and increased loan-loss provisions continue to pressure profit margins. Just 66% of the Q4 reporters so far has reported a positive revenue surprise, and 69% has beaten earnings forecasts. Those are the weakest readings since the Great Virus Crisis in H1-2020. Furthermore, significantly fewer companies have reported positive y/y earnings growth in Q4 (61%) than positive y/y revenue growth (71%). These figures will change markedly as more Q4-2022 results are reported in the coming weeks. While we expect y/y revenue growth rates to remain positive in Q4, earnings are expected to decline for the first time since Q2-2020.

**S&P 500 Sectors & Industries Forward Profit Margin Since Peak** (*link*): Since the S&P 500's forward profit margin peaked at a record-high 13.4% during the June 9 week, it has fallen 7.2% to 12.5% through the February 2 week. The drop has been paced by four of the 11 sectors, though all but the Energy sector is down since the peak. Here's the sector performance since the June 9 peak: Energy (up 1.7% to 12.1%), Utilities (down 0.5% to 13.8%), Consumer Staples (down 2.4% to 7.2%), Industrials (down 3.3% to 10.0%), Real Estate (down 4.1% to 17.2%), Consumer Discretionary (down 6.5% to 7.3%), Information Technology (down 6.5% to 23.8%), S&P 500 (down 7.2% to 12.5%), Financials (down 7.2% to 17.7%), Health Care (down 9.7% to 9.9%), Communication Services (down 11.8% to 14.2%), and Materials (down 17.6% to 11.2%). These are the best performing industries since the June 9 peak: Wireless Telecommunication Services (up 62.9% to 11.0%), Oil & Gas Refining & Marketing (up 62.1% to 5.5%), Casinos & Gaming (up 40.2% to 3.2%), Airlines (up 26.7% to 5.1%), Oil & Gas Equipment & Services (up 18.0% to 10.9%), and Hotels, Resorts & Cruise Lines (up 15.6% to 11.4%). The worst performing industries since the June 9 peak: Commodity Chemicals (down 43.1% to 5.8%), Alternative Carriers (down 42.9% to 5.0%), Home Furnishings (down 36.1% to 5.7%), Copper (down 33.7% to 12.8%), Homebuilding (down 31.2% to 10.5%), and Household Appliances (down 29.9% to 4.7%).

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