



Market Commentary
February 23rd, 2024

English Version

Insigneo Weekly Dispatch

The Nvidia Phenomenon

Thoughts on Nvidia after its historical earnings report.

Guidance on investments and the major structural
factors behind your clients' portfolios.

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The Nvidia Phenomenon

Nvidia, Nvidia, Nvidia. It is astounding how much we have been hearing about this company over the last couple of days, and to be honest, rightly so. After reporting a blowout quarter on Thursday, the stock closed 16% higher for the day, adding \$277 billion in market value in one day, the most in market history. To give you some context, that is more than the market capitalizations of IBM, Ford, and General Motors combined...created in a single day. This move drove Nvidia's market capitalization to \$1.9 trillion, making it the fourth-largest company in the world based on this metric, behind only Microsoft, Apple, and Saudi Aramco, having already blown past Alphabet and Meta. In fact, Goldman Sachs recently called Nvidia "The most important stock on planet Earth". Nvidia's clout was certainly in full effect this week, after the stock's move lower early in the week dragged the Nasdaq Composite and ICE Semiconductor Indexes lower, then boosted them nearly 3% and 5% higher on Thursday. Nvidia has actually propelled all major US markets to record highs. Two logical questions that come to mind are: Why was Nvidia up so much yesterday? What to do with the stock now?

Why was Nvidia up so much yesterday? The company reported fourth-quarter earnings on Thursday, shattering Wall Street's expectations for the quarter and providing a much better than expected outlook. Over the past few quarters, Nvidia has reported better earnings than expected and subsequently raised the bar for the following quarter. The bar was set quite high coming into the fourth quarter, and although Wall Street expected the company to report good numbers, it was not expected to clear the high bar, let alone give a

better-than-expected outlook for the following quarter. Well, it did. Nvidia reported revenue growth of \$22 billion for the quarter, over 20% more than the previous quarter and more than 250% higher than the previous year. Analysts expected revenue growth in the \$20 billion range. Along the same lines, Earnings Per Share, which were expected to come in at \$4.60/share, came in at \$5.16/share, 12% higher than expected. Gross profit margins were reported at 76%, and management indicated that it expects these to grow to 77% next quarter. These are astounding numbers. Even better was the company's outlook for the next couple of years, with management stating that "Artificial Intelligence was at a turning point" and "conditions are excellent for continued growth" for 2024, 2025, and subsequent years. Better than expected demand from datacenters is driving this growth, as enterprise spending for artificial intelligence is boosting demand from cloud-service providers and hyper-scalers. Demand for gaming chips also appears healthy, but sustainable growth is expected to come from its datacenter business, which accounts for over 80% of the company's expected revenues. This is important because in previous quarters, questions revolved around the sustainability of strong datacenter growth numbers. This quarter, management appeared to allay Wall Street's fears and instill confidence on the sustainability of this growth rate in the foreseeable future, as demand is greatly outstripping supply. To this point, when asked about problems supplying chips to China due to various restrictions, Nvidia's CEO alluded to the fact that this did not pose an issue for the company, as chips that they cannot sell in China are being quickly sold in other markets.

This brings us to the next question: What do we do with Nvidia stock right now? The prospect of more

sustainable earnings lends credibility to the rise in the stock's price. Looking at Nvidia's valuation, based on the past twelve months of earnings, or trailing earnings, the stock is trading at an astronomical Price/Earnings ratio of 80x. However, if we base our valuation on earnings expected over the next twelve months, or forward earnings, Nvidia is trading at a more reasonable 35x earnings. The difference between a P/E of 80x and 35x earnings is massive. What does this mean? It means that where we stand in that range is highly dependent on the "E" side of the P/E equation, or earnings. If earnings growth is sustainable, as management appeared to convey this week, then a valuation of 35x earnings does not appear to be unreasonable. However, if earnings expectations are too optimistic and prove unattainable, then the stock's current valuation would sway higher, towards the 80x extreme. We do not believe that earnings are going to revert meaningfully lower back to where they were a year ago, so we are likely closer to the 35x end of the valuation range than 80x. However, we do believe that the loftier the expectations become for the stock, the more room for error that is created. This leaves the stock open for downside risk if the company fails to meet expectations that keep moving higher and higher. For example, datacenter revenues are expected to grow from about \$45 billion in 2024 to over \$90 billion next year. This could very well happen, given the trajectory of growth that we are seeing in the Artificial Intelligence industry. However, if for some reason Nvidia encounters an unforeseen issue throughout the year that could impede this growth, even temporarily, the stock would likely see a move meaningfully lower.

We saw such an example of this in another great tech company this week, Palo Alto Networks. This large cap company is one of the premier

cybersecurity companies in the world. Having seen its stock rise meaningfully over the past six months, expectations going into the quarter were high. On Wednesday, the company reported earnings and an outlook that did not meet the market's expectations, sending the stock almost 30% lower in one day. In fact, going into its own quarterly earnings report, Nvidia's implied volatility stemming from the report was expected to be 11%, up or down. The market was not too far off with its expectation of Nvidia's move for the day, which makes us think, what if the company had not been able to meet expectations, like Palo Alto Networks the day before? To be fair, we think that Nvidia is a great company and one that is at the forefront of the AI revolution, much like Amazon was at the forefront of the ecommerce boom. However, Amazon did have many bumps along the way, and it would be unrealistic to believe that Nvidia will not experience the same.

The Magnificent 7 (Nvidia, Microsoft, Amazon, Alphabet, Apple, Meta, and Tesla) appear to be dwindling down to the Magnificent 5 after Apple and Tesla underwhelmed in their quarterly reports. With over 15% of the S&P 500 now concentrated in three stocks: Microsoft 7.2%, Nvidia 4.5%, and Amazon 3.7%, there is even talk of the Magnificent 3. The current overconcentration of the market in a shrinking handful of momentum stocks is alarming. Do not get us wrong, we believe that these are great companies and leaders in their own industries. Moreover, we believe that these stocks will likely continue to move higher over time. However, we must keep things in perspective and

remember that we are currently in a market that is highly concentrated in a handful of momentum stocks, with stretched valuations, with an uncertain macroeconomic environment as backdrop.

History is not on our side. The S&P 500 is currently trading at 23x earnings, 20% above its 10-year average and in the top decile of its historical valuation range. In the past, when the market has traded at these levels, it has almost always seen a reversion down to the mean. As a result, even though we believe that Nvidia will continue to be a leader in the AI revolution, we would not chase the stock higher at this time. Investors with a large concentration in the stock could consider protecting some gains. Investors that do not own the stock could instead focus on building a list of attractive companies, like Nvidia, that could be beneficiaries from the AI boom, which could be potential investments at more attractive entry points. If you would like to discuss potential companies in more detail, please do not hesitate to contact your financial advisor, as well as the Insigneo Research Team. ■



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