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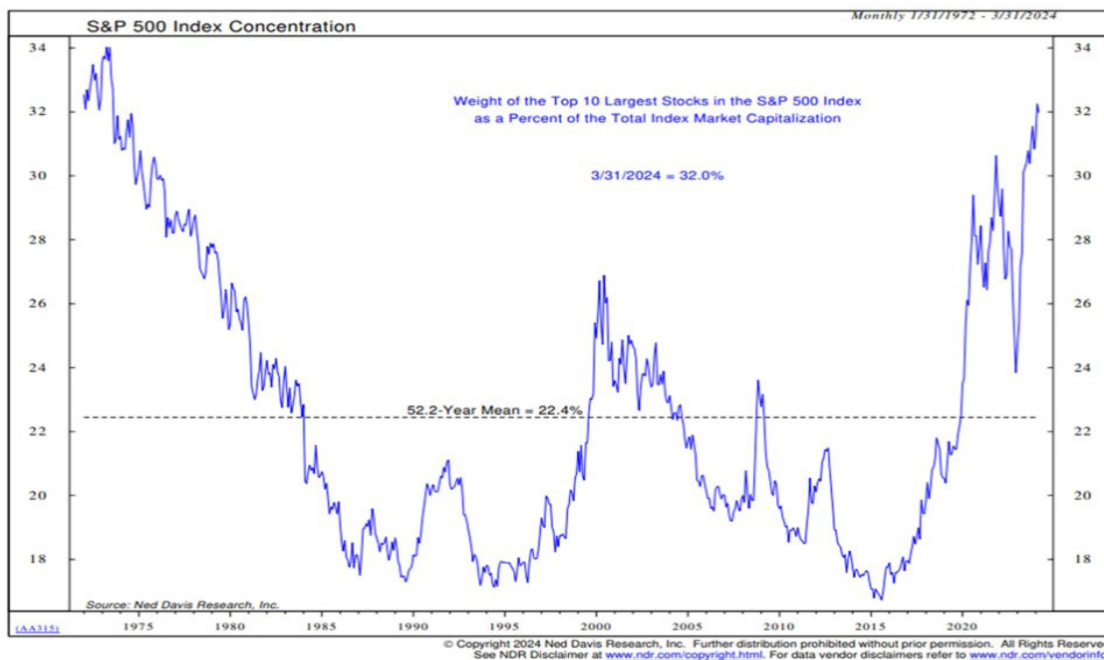
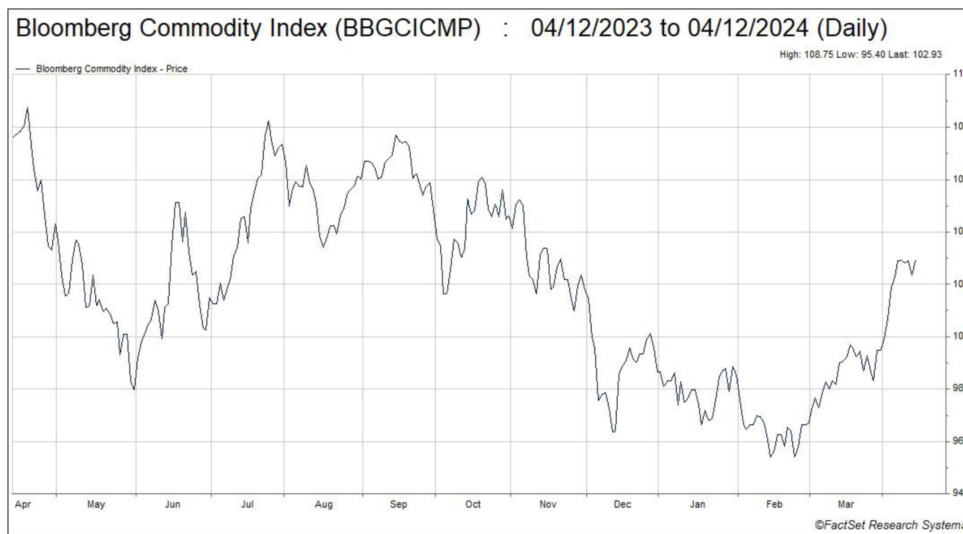
Prospector Partners Quarterly Commentary

The first quarter of 2024 was marked by a continued pushing out of expectations for when, and by how much, the Federal Reserve would cut rates, as inflation remained above the Fed's 2% target and the U.S. economy remained resilient. January's release of December's CPI (Consumer Price Index) came in at 3.4% against a 3.2% estimate, with core inflation still running at 3.9%. Later in the month, 4Q23 GDP was also reported significantly ahead of expectations - coming in at 3.3% versus the 2.0% growth expected. Adding to the "higher for longer" narrative, CPI readings in February and March would also come in above consensus expectations.

Given the stock market's ebullient response late in 2023 to perceived dovish inflation readings and Federal Reserve statements, it would have been reasonable to expect stocks to reverse course on more hawkish data. However, in this seemingly "all news is good news" market environment, the opposite proved true in the first quarter. Indeed, the S&P 500 gained over 10% with all sectors, save for real estate, rising. While market breadth improved during the first quarter, given the S&P 500 concentration, four stocks (Nvidia, Microsoft, Meta Platforms, and Amazon) contributed roughly half of the S&P 500 return for the period. As can be seen in the chart below, the Index's concentration has continued to grow and has not been this top-heavy since the 1970s.



Although we were unsurprised by the more tempered estimates for Fed rate cuts in 2024, given forecasts for as many as six or seven rate cuts during the year seemed overly aggressive, the market's continued strength against this more hawkish backdrop has been remarkable. With the job market remaining strong, unemployment below 4%, and economic growth resilient, we continue to think it is too early to declare victory on the inflation front. Additionally, the recent unsettling rise in commodities has garnered investor attention during the first weeks of April.



By way of example, year to date through April 12, copper is up 9%, silver up 18%, WTI crude oil 20%, and cocoa up an astounding 150%. These increases, buoyed by increasing estimates for global

growth, geopolitical tensions and, in cocoa's case, years of under planting and diseased crops, risk finding their way into further goods inflation. To date, the U.S. consumer has been incredibly resilient in the face of persistent inflation and rising interest rates. However, as we get farther removed from pandemic-related fiscal stimulus, and as the consumer continues to grapple with higher interest rates, should inflation persist at higher levels, it could have a considerably negative impact on consumer confidence and spending.

Electric Vehicle Collateral Damage

It is important to note that despite a fairly broad-based rally year to date, the market is not a monolith – we continue to find opportunities to buy attractively valued companies which have not fully participated in the rally. For example, recent expectations for electric vehicle (EV) demand and production has been reduced due to a combination of factors including concerns over battery life and insufficient charging infrastructure, as well as overall affordability. The negativity surrounding EV's resulted in Tesla (TSLA) being the overall biggest decliner in the S&P 500 during the first quarter, dropping over 29% for the period.

While no Prospector portfolios have a position in TSLA, and we have generally viewed expectations for EV share gains to be overly aggressive, we do maintain a number of positions with exposure to long-term secular growth from electrification and automation. Objectively, we are in a time where more and more functions in our daily lives are being automated. Whether it be driver assist in our cars, ordering food at restaurants, or line assembly in a manufacturing plant, demand for technology enabling this automation is increasing. Likewise, the increased use of electricity as a power source will likely drive the need for electrical grid upgrades for years, or decades to come. As sentiment improves, investors should focus on the long-term secular growth story, providing an opportunity for these holdings to re-rate higher.

Reduced Restaurant Appetite?

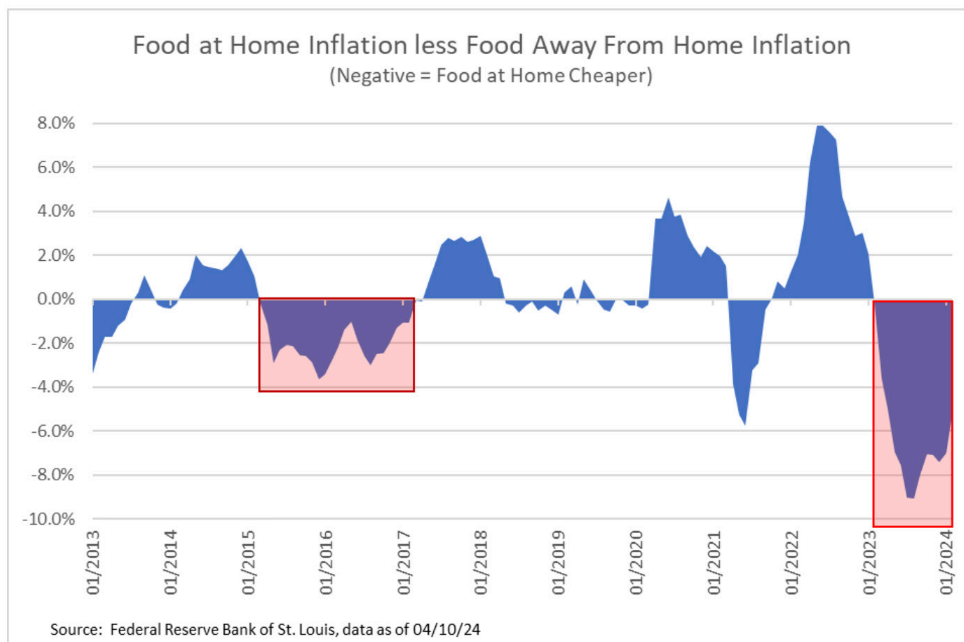
Prospector has a long history of investing in restaurants. And, while we are always discerning in our approach, we have become even more so recently. We believe the combination of weak top line growth, ongoing cost inflation, and weakening pricing power creates a difficult backdrop for near-term restaurant fundamentals.

The main drivers of revenue growth for a typical restaurant are: 1) organic same-store sales growth, 2) new unit growth, and 3) M&A (i.e. acquiring competitors). Of those, many consider same-store-sales growth (guest count growth + growth in average ticket per guest) as the key indicator of a brand's underlying health. In recent quarters, the primary driver of same-store sales growth for the industry has been elevated levels of average ticket growth (pricing), while guest count growth (volume) has been muted or negative. This pricing dynamic was fueled by restaurants working to offset outsized increases in labor and commodity costs, along with guests splurging on extra drinks and appetizers following a period of COVID-driven pent up demand. Given the pent up demand, improved consumer balance sheets exiting COVID, and the broad nature of inflation across the economy, these pricing actions were generally tolerated by consumers.

In addition to driving sales growth, the ability to increase prices is critical to maintaining profit margins amidst elevated labor costs and increased food/ingredient costs. While those inflationary pressures have eased off their peaks, restaurants are not out of the woods yet. On the hiring front, labor

shortages have eased but competent workers are still in demand. In the broader U.S. economy, wage growth has moderated but remains elevated. And for restaurants with exposure to California, they'll have to deal with the additional headwind of new legislation that pushes the state's minimum wage for fast food workers to $20/hr. On the food procurement side of the business, many items of the shopping basket are lower year-over-year but some of that relief has reversed following recent month-over-month increases. It's also worth noting that menu composition and commodity exposures vary by restaurant. For example, those who primarily serve beef continue to experience elevated costs and the prospect of relief remains uncertain.

While 2023 saw the American consumer's resilience on full display, their appetite for continued price increases is showing signs of moderation. In communications with investors on recent earnings calls and at recent conferences, management teams have flagged softness in demand from the lower income consumer demographic. Lamb Weston, supplier to many large fast food chains, sees french fry demand "at or below" the category's historical growth rate. On a recent conference call, one of their largest customers described a challenging consumer environment in which customers are seeking affordable options after years of cumulative inflation across their personal budgets. Who can blame them? According to Restaurantbusinessonline.com, the price of a cheeseburger at that franchise has increased 55% since 2021. Earlier in this inflation cycle, restaurants could justify their price increases by pointing out similar price hikes at their fellow food peers – both restaurant competitors and grocery stores – but more affordable alternatives are starting to emerge. Recent economic data shows that



CPI: Food Away From Home (the cost of dining out/getting takeout) is rising faster than CPI: Food At Home, or to put it more plainly, prices are rising faster at restaurants than at the grocery store.

The last time a similar gap in the data emerged was in 2016-2018, a period which some industry observers named "The Value Wars," where restaurant chains relied on more frequent discounts and

value-oriented promotions in order to stand out to value-seeking consumers. It might be too early to call it a war, but the generals are rounding up their troops. In recent weeks, discussion from industry players such as Wendy's and Jack in the Box underscore a renewed emphasis on providing value, evidenced by Wendy's $5 Biggie Bag, or Jack's Munchie Meal platform.

In this environment, we're keeping a close eye on the health of the consumer and how their spending behaviors change. We look to avoid companies who have seen their relative value proposition erode after taking excessive menu pricing, or those who continue to face outsized cost pressures in food and labor. At the same time, we prefer those who have run their business in a more prudent manner in which the brand maintains their value-proposition for customers without sacrificing profitability.

Outlook

Since early 2022, the Federal Reserve has aggressively raised interest rates in an effort to lower inflation, causing significant uncertainty within stock and bond markets. While the rate of inflation has subsided, and the consensus appears to be we have reached an end to the Fed hiking cycle, declaring victory would be premature. The U.S. and rest of the world continue to manage the impacts of inflation, higher interest rates, and geopolitical events. In our assessment, there remains a possibility of Federal Reserve policy error and / or recession, though barring extraneous events, we still lean towards slowdown and not recession per se.

The biggest risk right now would seem to be from a "shock to the system" while we continue transitioning from the pandemic economy to a more normalized economy. Certainly, the traumatic events in Israel, and the risk of potential systemic shock that might spread from the Middle East, keep us up at night as we are sure they do you as well. As always, with our bias towards quality, we strive to mitigate any downside, while also participating in the upside.

Meanwhile, employment remains strong. Heavy fiscal stimulus from already passed U.S. legislation for defense, infrastructure, semiconductors, and energy investment are only now beginning to be awarded. The spending will not peak until later in the decade. Relatively high energy costs in Europe, and Germany in particular, makes manufacturing here relatively more attractive. Political risk in China makes that country less attractive to do business in. All told, U.S. manufacturing is being called upon to step up. Barring a major crisis, Ronald Reagan's termed "willing workers" should be able to find jobs…and pay their bills. Furthermore, supply / demand imbalances in the labor market suggest further wage gains to come which will partially mitigate the impact of inflation on the consumer. We expect continued housing market pressures as a result of higher interest rates and affordability concerns. However, the shortage of housing after over a decade of under-investment following the Great Financial Crisis should prevent a disastrous decline in home prices. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans, and consumer credit quality remains strong at the moment.

While what we see argues for a more inflationary and higher interest rate environment than seen in the past ten years, it also does not argue for a recession. Nonetheless, the unexpected can occur. Should a recession happen in the near term, the factors highlighted above suggest it could be less significant than the previous two recessionary periods. We are also mindful that 2024 is an election year, the result of which could have implications on companies, sectors and the overall economy.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. We continue to find opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals.

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