

State of the Markets

From the desk of Darrell L. Cronk



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Spring in our step

“Bull markets go to people’s heads. If you’re a duck on a pond, and it’s rising due to a downpour, you start going up in the world. But you think it’s you, not the pond.”

— Charlie Munger

The calendar says winter, but with the warm glow of outsized gains from vibrant markets from November through February, spring has come early for investors.

On February 8, the S&P 500 Index closed above 5,000 for the first time ever, after climbing 15 of the past 17 weeks, a sustained move unseen since the early 1970s. On February 23, a company that makes graphic processing units and has been the proxy for the artificial intelligence revolution surpassed \$2 trillion dollars in market capitalization, doubling its market cap since 2023. Incredibly, that single company now boasts a market cap higher than the entire Energy sector.

The Information Technology sector remains the darling of Wall Street, now trading at 30 times earnings, a 57% premium to its 10-year median valuation. The top 20 tech stocks now account for 35% of the market value of the S&P 500 Index, propelling its price-to-earnings multiple to 22 times the 2024 earnings estimates, placing it in the 90th percentile of valuations over the past 30 years.

One of the unique features about this cycle is that every single balance sheet — government, household, and corporate — has expanded significantly since the start of the pandemic. This is extremely rare and has magnified the amount of liquidity present in the economic engine. Excess capital has been searching for a home, pushing prices to levels that can be difficult to justify. This begs the question for long-term investors — do I continue to ride the market’s momentum, or do I read today’s historically high valuations as a warning signal and consider shifting direction?

Five assumptions driving the market’s momentum

One of the tried-and-true lessons we’ve learned about Wall Street is that historically, the consensus has rarely been correct and has also rarely been profitable since it is often already priced into markets. Last year, the vast majority of economists, upwards of 85%, ourselves included, were predicting a recession, and markets were

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forecasting three interest rate cuts in the back half of 2023. Neither of those came to fruition — they were just outright wrong.

If we survey today's consensus for the remainder of 2024, we find that prevailing opinion is buoyed by five assumptions:

- The economy soft landing
- The Federal Reserve cutting interest rates multiple times
- S&P 500 earnings growth of double digits
- The tightest labor market in 50-plus years remaining historically resilient, and
- The recent problem of inflation fully behind us.

If we spin the clock forward to this time next year, it is highly likely that several of today's consensus items will have failed to deliver. The best market returns have almost always been made without the benefit of clarity, certainty, or the comfortable company of consensus.

So, what does a soft landing for the economy really look like? In our view, it is simply a balance of supply and demand within the economy, the inflation rate back at or close to target, and interest rates at a neutral level — neither too high nor too low. Markets have given the affirmative nod on the first two already, even if we have not reached the finish line quite yet. However, we still view today's monetary policy and interest rates as too restrictive. Said another way, we believe interest rates remain too high to declare victory for a soft landing.

We know who brought us back to new all-time highs on the major market indexes. The pond has risen beneath us thanks to a narrow collection of mega players within the Information Technology, Consumer Discretionary, and Communication Services sectors. In fact, 2023 proved to be the second narrowest market breadth the S&P 500 Index has seen in more than 30 years, with the top 10 stocks contributing 68.4% of the total S&P 500 Index gain of 24.2%. That near-record narrowness is second only to 2007 and just ahead of 2020, 1999, and 2021 — three of those four years were followed by double-digit negative returns.

Eventually, narrow market breadth has almost always gotten resolved the same way. Narrow rallies often have led to sizable drawdowns, as the handful of market leaders ultimately are unable to generate enough earnings strength to justify lofty valuations and crowded sentiment positioning. For markets to advance from here, in our view, we need to see three things: breadth of participation must expand; earnings growth must broadly improve — and not just multiple expansion, as we have seen recently; and interest rates must steady or decline from today's levels. If any of these three elements fail to materialize, we would expect markets to reprice expectations lower.

We do find good value in areas of the market that have not had parabolic moves and where the risk and reward tradeoff remains more favorable, in our opinion — specifically, Industrials, Energy, Health Care, and Materials. We suggest investors consider these sectors.

A call for disciplined investing

In the fullness of time, the calendar will reset to a new season and markets will reprice to a new paradigm. I am reminded of a quote from Benjamin Graham, revered as the father of modern financial analysis, stating, “My experience teaches me that by far the largest losses have been sustained by investors through buying securities of inferior quality under favorable general conditions.”

It would be nice to believe that markets are always steadily efficient, acting appropriately as a discounting mechanism. The purpose of markets, after all, is to allow prices to be discovered, and that requires a large pool of buyers and sellers to participate. At various stages of an economic cycle, different shifts in human behavior occur, which can lead to prices fluctuating well above and below their fair value.

The prudent investor takes care not to lose focus and not to abandon the discipline to stick to fundamentals and principles when others around them march to the momentum of the moment. Investing without the perspective of history and without the due diligence of research can ultimately lead to regrettable investment decisions. In times like this, when pushing against the force of popular opinion can feel like a futile exercise, we would be wise to heed the words of Charlie Munger, whom we lost in November at age 99 and who earned the respect of his investors with his wit and wisdom: “Mimicking the herd invites regression to the mean.”

When investing, we believe the enduring principles of time, prudence, and discipline are keys to long-term success and a winning investment strategy.

Risk considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Equity securities** are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market. The **Energy** sector may be adversely affected by changes in worldwide energy prices, exploration, production spending, government regulation, and changes in exchange rates, depletion of natural resources, and risks that arise from extreme weather conditions. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance. Some of the risks associated with investment in the **Health Care** sector include competition on branded products, sales erosion due to cheaper alternatives, research and development risk, government regulations and government approval of products anticipated to enter the market. **Materials** industries can be significantly affected by the volatility of commodity prices, the exchange rate between foreign currency and the dollar, export/import concerns, worldwide competition, procurement and manufacturing and cost containment issues.

Definitions

An index is unmanaged and not available for direct investment.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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