



The Devil You Know

Weekender

July 29, 2023

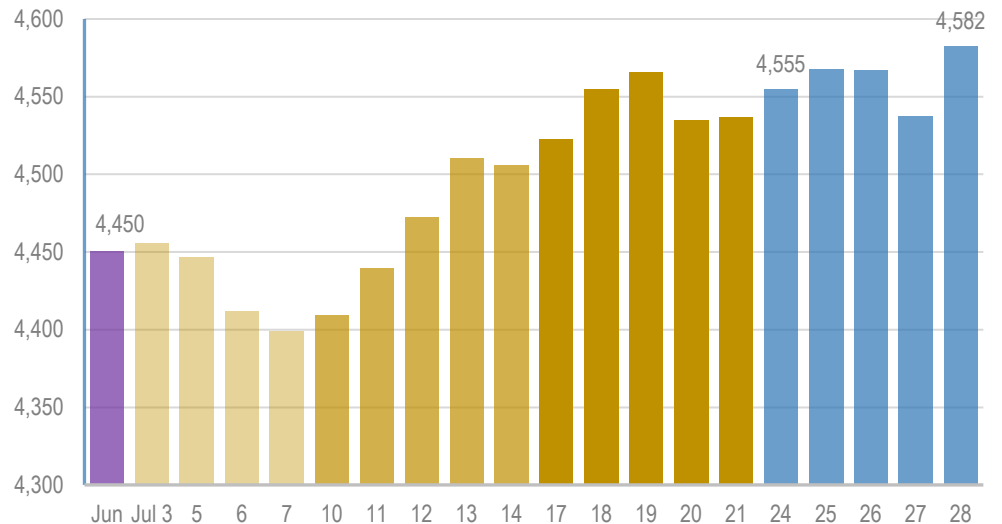
The devil doesn't come dressed in a red cape and pointy horns. He comes as everything you've ever wished for.

Tucker Max

Good morning and welcome to the *Weekender* for Saturday, July 29, 2023. Equity markets, as measured by the S&P 500, were higher again by 1.0%. Stocks hit the highest level over a year this week after the Federal Reserve lifted rates by 0.25%, as was widely expected. At the same time, second-quarter GDP figures came in better than expected at +2.4%, kept afloat by credit-fueled consumer spending that continues to expand.

S&P 500 Index Levels

(Source: Bloomberg)



Many used Goldilocks to describe the equity markets and the US economy from the end of the Credit Crisis to the pandemic. By the end of 2019, the US stock market and the US economy were at the tail end of what was the longest bull market and economic expansion in history. Everything seemed just right. Inflation was low, and interest rates were accommodative. Economic growth was moderate but steady, and everyone who wanted a job had one.

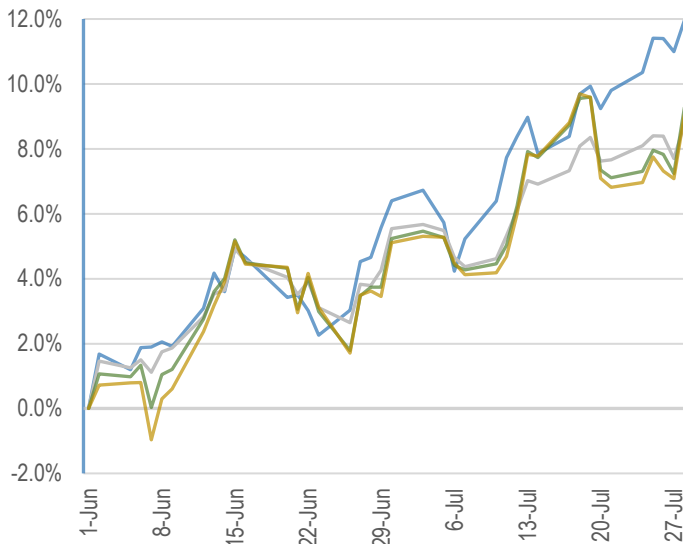
In January 2020, when the onset of the COVID pandemic burst, Goldilocks took a lesson from her foster family and hibernated. Markets seem to suggest she may be waking up.

For the last few months, we have suggested that the gains in the stock market have been broadening beyond the seven largest stocks. Below is a graph of the cumulative return from June 2, 2023, through Friday of reasonably priced companies (blue), the Nasdaq 100 (gold), the Nasdaq (green), and the S&P total return index (grey). Growth at a reasonable price (GARP) has had a great month.

Year-to-Date Returns

January 2 - July 28, 2023

(Source: Bloomberg)

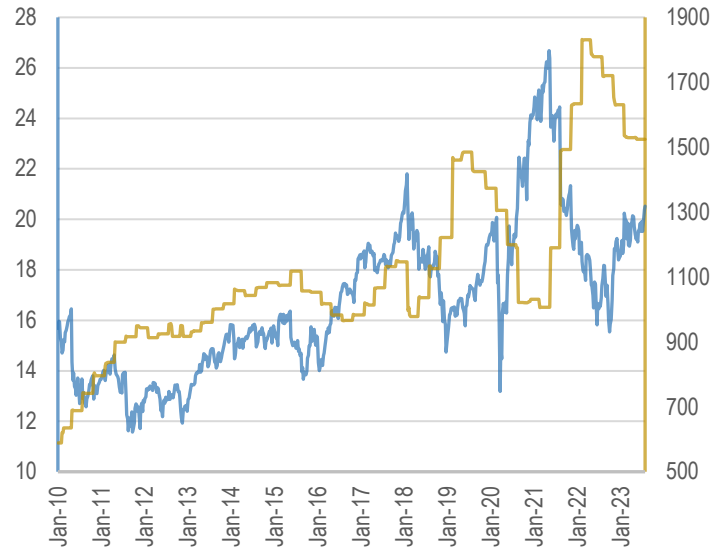


We have also suggested that corporate earnings were in recession. This graph illustrates the fall in earnings per share for the Dow Jones Industrial Average (Dow) members. Recent earnings erosion since the peak in April 2022 is visible in the gold line. We anticipated that a fall in earnings would precipitate softer equity prices. This did not materialize. Instead, the sugarplum dreams of artificial intelligence (AI) took hold and pushed the valuations of AI companies and everyone else northward.

Dow PE (Blue) and Earnings (Gold)

January 2010 - July 2023

(Source: Bloomberg)

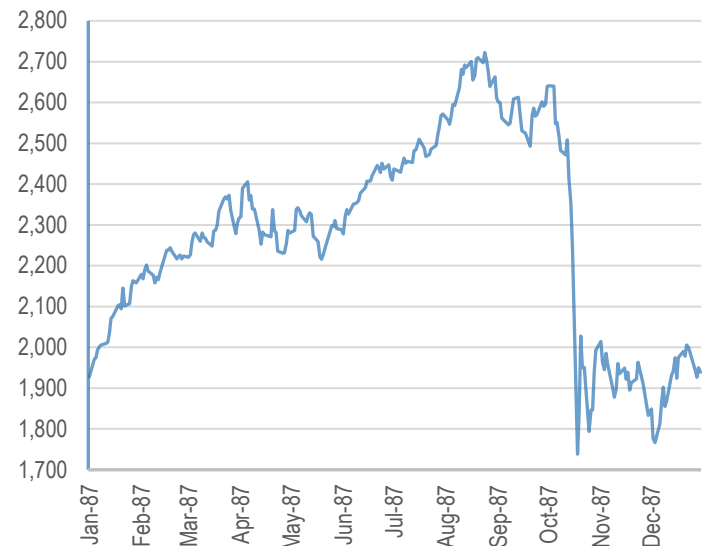


From the market's proximate perspective, everything seems just right. So, although comparisons hold very little concrete predictive value, they are very tempting – so we can't resist. By the end of 1987, the Dow was higher, on a year-to-date basis, by +33.5% and lost it all when the year closed flat from where it started.

Dow Daily Levels

January 1 - December 31, 1987

(Source: Bloomberg)



Last week, the Dow logged 13 straight rising sessions. Something that has not been seen since January of 1987. The breathless rise of the Dow Jones Industrial Average (Dow) is both revealing and disconcerting. Markets seem to be going through a giddy teenage

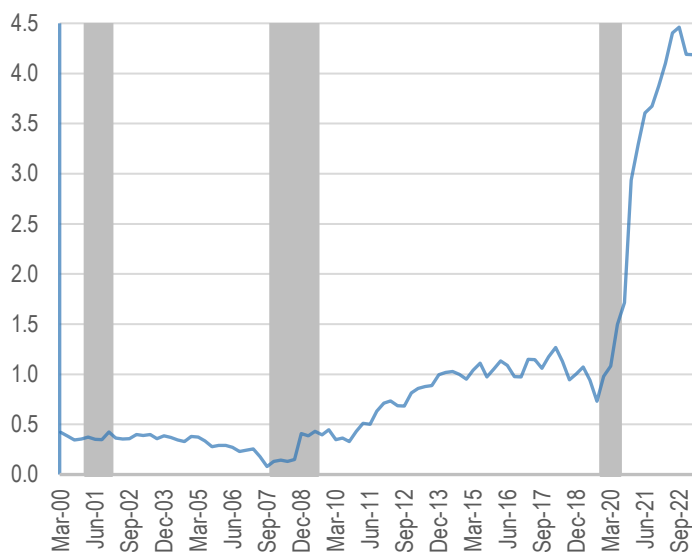
twitterpation where valuation and fundamental metrics give way to an absolute flood of liquidity.

To close up this short *Weekender*, a thought on liquidity. In response to pandemic unknowns, trillions of dollars were infused into the US economy. Looking back in ten years, we will see the government's response as a terrible mistake. But the economy remains awash in liquidity parked in money market accounts, bond funds, stock funds, and checking accounts. To provide a frame of reference, household checkable deposits currently exceed 4.0 trillion dollars compared to the pre-pandemic level of 1.0 trillion.

Household Checkable Deposits (Trillion)

1Q 2000 - 1Q 2023

(Source: Bloomberg)

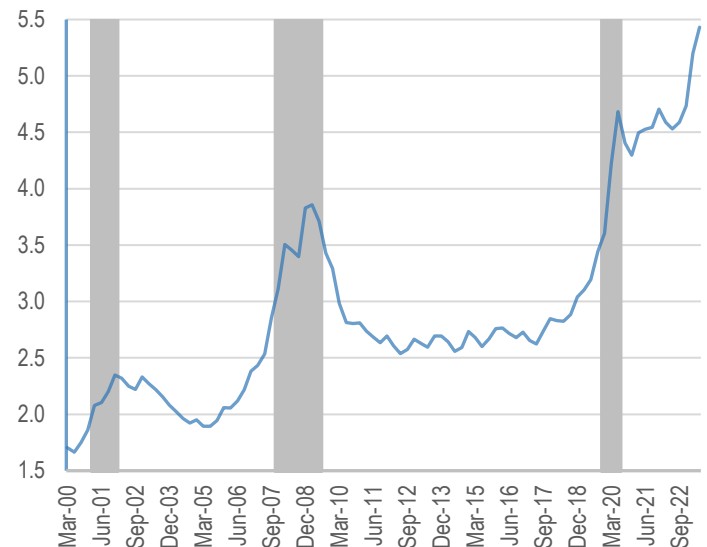


This 3.0 trillion surplus is in addition to 2.0 trillion in excess money market holdings and bond and stock positions. Markets and the economy are drowning in cash.

Money Market Assets

1Q 2000 - 2Q 2023

(Source: Bloomberg)

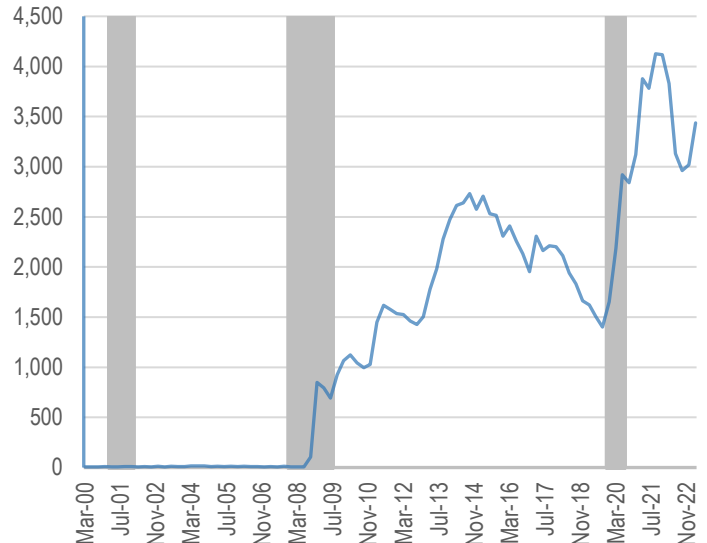


Banks are, too. Bank reserve balances with the Federal Reserve continue to hold trillions of excess capital.

Total Reserves at the Federal Reserves

1Q 2000 - 2Q 2023

(Source: Bloomberg)



This liquidity will enter the stock market, feeding the global fear of missing out (FOMO) on artificial intelligence. But it won't end well. We will unpack our view of this in the next Weekender. Undoubtedly, artificial intelligence will change everything it touches. But it's not a profit printing machine creating its products *ex-nihilo*. Artificial intelligence will exact a phenomenal cost on society regarding dollars, labor,

and culture. Eventually, liquidity will be flushed from the system, and valuations will return to normal trend lines like they did after the internet bubble popped. Will we be better off for the revolution?

Many years ago, I was visiting some friends in Krakow, Poland. They asked what I wanted to see a few days before I left. For many years, World War II has been an intoxicating fascination. Much of my family line is German, Danish, and English. More than anything else, I wanted to see Auschwitz. My trip coincided with the celebration of the liberation of Auschwitz, so visiting the camp had a bit of added poignance.

It was a transformative experience. You need more than reading or studying to prepare you for the experience sufficiently. The impact on me was and continues to be robust. As we drove back, I asked how my Polish friends felt about the liberation from the Nazis. They were puzzled by my question because they did not feel liberated. They exchanged the Nazis for the Russians and found the latter to be more ruthless than the former.

We should be careful about choosing the path forward from here. Something about the devil you know comes to mind. That's it for this *Weekender*. In the next *Weekender*, we will pick up on an analysis of the five cycles.

Disclosure Statement

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