Meaningless Murmurings

Weekender

January 20, 2024

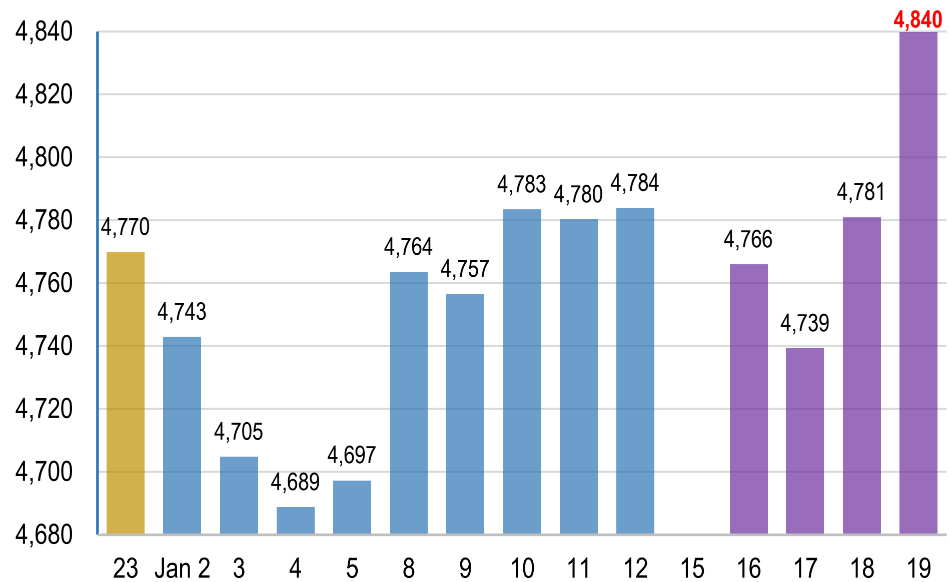
There are many roads to success, but only one sure road to failure: and that is to try and please everyone else.
Benjamin Franklin

We have to do the best we are capable of. That is our sacred responsibility.
Albert Einstein

The most important thing is this: to be ready at any moment to sacrifice what you are for what you could become.
Charles Dickens

Good morning, and welcome to the *Weekender* for Saturday, January 20, 2024. An all-time high was printed for the S&P 500 yesterday. It's the first record in approximately two years. On Friday alone, the tech-heavy Nasdaq was higher by 1.7%, the Dow by 1.1%, and the S&P 500 by 1.2%. For the week, the S&P was higher by 1.2%. Talk of lower interest rates and continued AI blather were the primary drivers of last week's gains.

S&P 500 Index Levels
(Source: Bloomberg)



Since interest rates peaked on October 19, 2023, the question of when and by how much rates will peak is no longer pertinent. Now, markets are trading the 'when and how much rates will come down.' Last year, equity markets traded peak interest rates on four separate occasions. Markets tend to jump the gun by trading a host of phenomena before they appear. The current Federal Reserve has been transparent about its data-dependent rate decisions to reduce speculation. So now, markets are trading potential economic data in advance. While the Fed has not yet determined or announced when their target rates will begin to fall, interest rate markets have begun carrying the Fed's water by pushing rates down before any official Fed decision.

A series of quick cuts, which markets expect, implies the Fed sees something problematic in the economic pathway, like a recession. A slow return to normal rates, where rates settle 0.5-1.0 percentage points above the sustainable inflation rates, would likely support long-term economic growth as long as inflation remains on a concerted path toward the Fed's target of 2.0%.

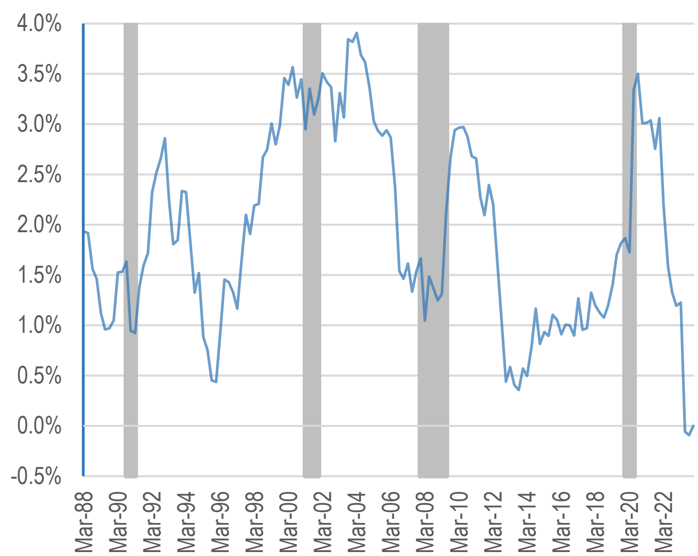
We do not believe financial market expectations of quick-and-many interest rate moves by the Fed is the likely outcome. To that end, it's very likely that equity markets, driven by large technology stocks, have gotten a little over their skis. We have reduced some exposure to the expensive tech names and redeployed it to areas with strong fundamentals and low valuations.

Now, a little shibboleth on artificial intelligence (AI). The promise of artificial intelligence is vast. It could precipitate the most dramatic change in human existence since the discovery of fire. This is a remarkable claim that is both awe-inspiring and impossible to quantify. Here is something we can quantify. The three-year cumulative change in US nonfarm productivity is negative for the first time since the 1980s. Computer-related investment pulled the world out of the 1980s productivity slump. A similar outcome may come from AI-related investment.

US Economic Productivity

1Q 1988 - 3Q 2023

(Source: Bloomberg)



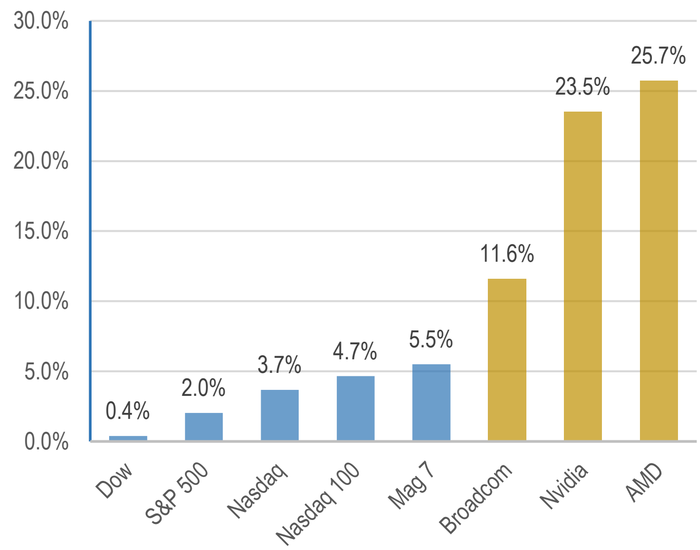
We believe the long-term prospects of artificial intelligence will eclipse almost every previous transformation in history. Many firms will be negatively affected, while others will experience logarithmic growth. In most areas, chasing potential AI leaders is neither prudent nor necessary. Investing in the picks and shovels of the AI gold rush continues to be our preferred strategy. In addition, AI-directed investment through profitable market leaders is also an attractive way to facilitate exposure in these early innings.

The S&P 500 was the last of the three major indices to reach a fresh high. It did so this week. Even so, it was the usual suspects that propelled the index higher. The continued hubbub about the potential for artificial intelligence also played a role in the records. Chip stocks with a tight relationship with the development of artificial intelligence have been dramatic outperformers.

Year-to-Date Performance

Indices (Blue) and Stocks (Gold)

(Source: Bloomberg)

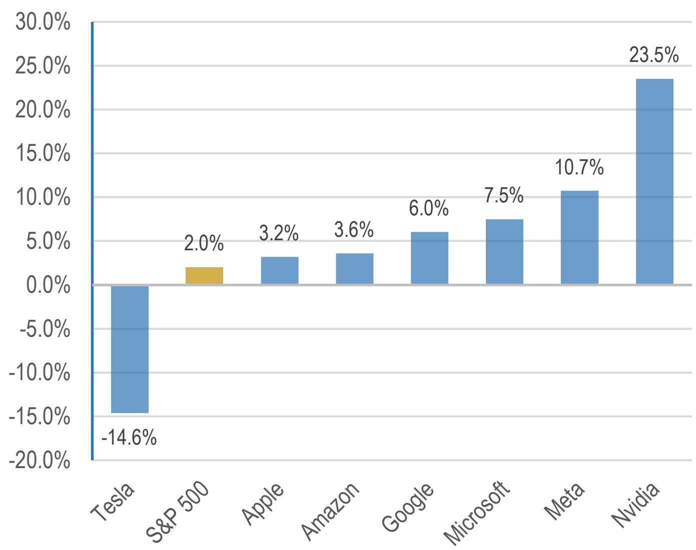


On a year-to-date basis, most members of the Magnificent Seven, except Tesla, continue to exert leadership outperformance on equity markets and indices. Still, ideological excess is beginning to yield to the hard facts of tactile expectations. We expect this to continue, although it's likely that, except for the picks and shovels manifest through sophisticated chip companies, significant measurable profits generated from artificial intelligence are still some distance away.

Forty-one members of the S&P 500 closed on Friday at an all-time high, including Microsoft, Meta, and Nvidia, which were driven by rising artificial intelligence sentiment. Lower technology punters like Marriott, McDonalds, and Costco also hit records. Meta Platforms shares have been recovering from a 76% selloff in 2022.

Year-to-Date Performance

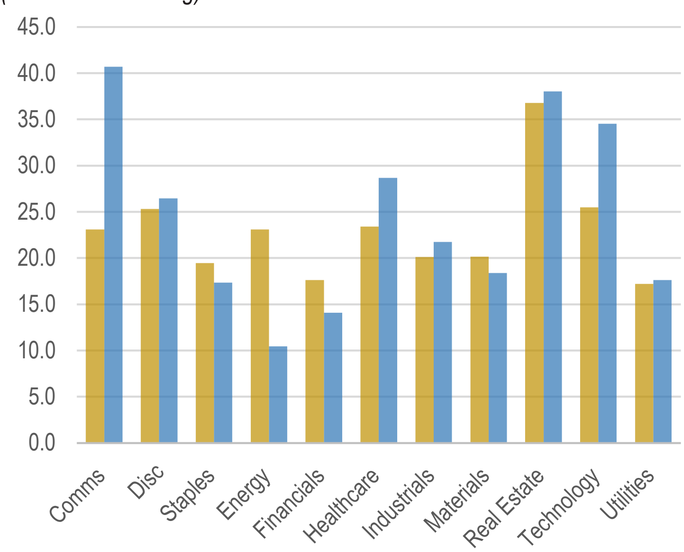
Indices (Gold) and Stocks (Blue)
(Source: Bloomberg)



Meanwhile, on the valuation front, things are getting dear. Based upon price-to-earnings ratios, every sector is more expensive than its pre-pandemic levels, except staples, energy, financials, and materials.

PE Ratios

January 1 2020 (Gold) and January 19, 2024 (Blue)
(Source: Bloomberg)



Geopolitical Tension

It's possible to pay too much attention to financial markets. Around the world, there is much to be concerned about. From a geopolitical perspective, the wars in Gaza and Ukraine are harbingers of what seems to be an increasingly expanding conflict. Several European countries have taken the lead in increasing support for Ukraine's fight to defend itself and expel Russia from its sovereign boundaries. Germany, Finland, and the United Kingdom increasingly suggest they must move one step deeper by preparing for war.

Russia is engaged in a fantasy war of nostalgia. President / Dictator Putin wants to relive the former "glory" of the Soviet Union without possessing the economic or military strength required for the endeavor. Being deterred from his goal the past year, Putin now commits to devote 30-40 percent of Russia's economic output in 2024 to weapon restocking and beefing up its military. The Kremlin is leveraging its relatively new and convenient coalition members, China, Iran, North Korea, and once British Commonwealth members South Africa and India, as its inherent capabilities show their limitations.

The United States finds itself increasingly impotent in the tense geopolitical environment, needing to keep its eyes looking westward and contain China. For the first time in a couple of generations, Europe is no longer waiting for US leadership. Eastern European countries like Poland, once firmly in the orbit of communism, are voraciously building up their military for what they expect to be Russia's next move. Among the rest, sides are drawn in what will likely start as a conventional excursion. But once the first nuclear weapon is used, all bets are off.

We do not usually weigh in deeply on non-financial matters like this. However, the stakes have increased such that once potentially catastrophic outcomes seem increasingly more likely, potential systemic impacts cannot be ignored. As a free nation, and at least for the moment, still the leader of the free world, we need to be careful and wise but decisive and bold.

Market Narrative

The primary catalysts for this short year's equity moves are similar to those that drove last year's stellar returns—artificial intelligence and lower interest rates. We generate more clarity with each new data point released than the previous year's faith and hope. Markets are coalescing around the probability of an economic black swan—a soft landing—a condition where inflation comes down to a benign level without demand destruction, usually created by a destructive recession.

Financial markets are increasingly convinced that the Federal Reserve will lower its target interest rate from 5.5%, where it is at present, to something closer to 4.0% over the year. It's worth pointing out that equity and fixed-income markets regularly traded the prospect of lower rates four times last year to no avail—the point. Just because markets want and expect a particular outcome does not make it inevitable.

Recent data continues to paint a picture of economic resilience due to the degree of remaining pandemic stimulus, moderating inflation, and lower interest rates. At present, the labor market is strong. Job openings exceed the number of unemployed, and despite a few high-profile layoff announcements, unemployment claims are shallow because product and service demand continues to defy expectations for erosion.

We are skeptical that the Federal Reserve will be compelled to reduce interest rates in the face of such strength. Lowering interest rates is one of the Federal Reserve's most potent monetary tools to stimulate demand during periods of emerging weakness. However, the economy does not appear to be weakening. At their current level, rates have softened demand for housing without imposing any related weakness on the economy. At the same time, pent-up demand continues to be a characteristic of the automobile market despite higher loan rates. We remain convinced that a significant recession is likely with a fractured labor market, which, at this point, seems remote.

Inflation

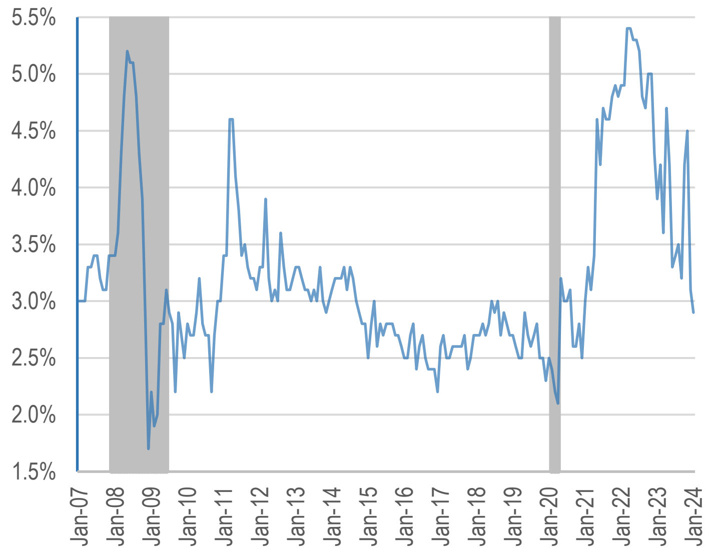
Inflation is trending in the right direction to support the market's rate scenario. The consumer price index for December came in at 3.4%. PCE, the Federal Reserve's favored inflation metric, currently stands at 3.2% (November). Producer prices are deflated at -0.2% for December, and export and import prices are registering deflation. A few sticky things like shelter, the most significant component of consumer inflation indices, refuse to yield its upward trek.

Providing some support to the backward-looking data mentioned above, the University of Michigan's inflation expectations data show that consumers expect inflation to fall to 2.9% over the next year.

One-Year Inflation Expectations

January 2007 - January 2024

(Source: Bloomberg)



Many economists argue that primarily, the easy inflation-taming gains have been accomplished. Getting from here to the Fed's target could be a lot harder. Others suggested that the Fed's target of 2.0% inflation should be adjusted to, perhaps, 3.0% in a well-known game of achieving success through moving the goalposts. Both points are interesting but not necessary. The critical question is whether inflation at its current level is sufficiently disruptive to consumers to push the economy into a recession or the financial market into a correction. We do not believe inflation at its current level will cause either.

Economic Slowdown

It seems fair to characterize the current economic landscape as schizophrenic. Based on historical tells, myriad data points suggest that the economy is slowing. But the consumer, which accounts for more than seventy percent of economic output, seems increasingly happy and expects a better world over the next year. They continue to buy, buy, buy, and spend, spend, spend. A refrain in constant use in the Wasden household growing up.

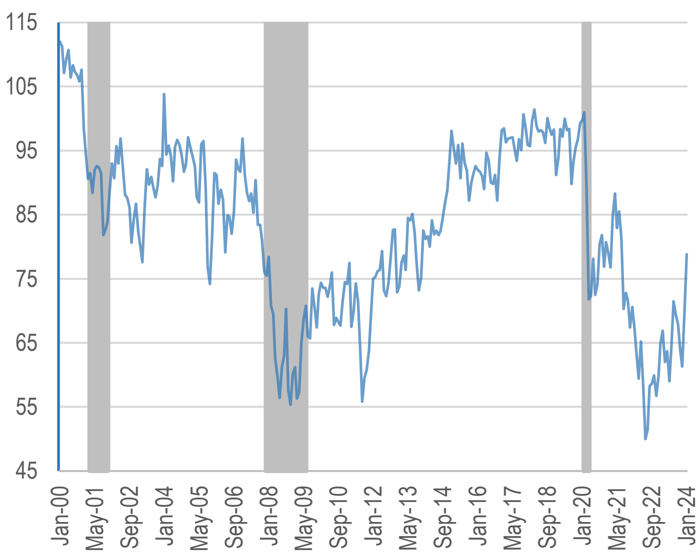
Consumer Sentiment

US consumer sentiment soared in early January, driven primarily by the view that short-term inflation expectations continue to fall. The University of Michigan's sentiment indicator jumped 9.1 points, the most significant monthly lift since 2005. The release was much higher than all economists' estimates. However, it comports well with retail sales data, showing the consumer is "all in" on the economy. The sentiment is now 57.6% higher than its all-time low in June of 2022, which, not surprisingly, was also a period of peak inflation.

US Consumer Sentiment

January 2000 - January 2024

(Source: Bloomberg)



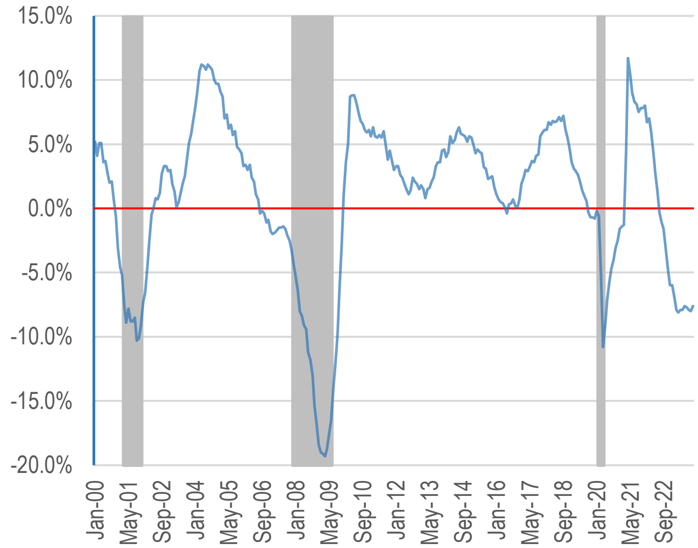
Leading Indicators

The index of leading economic indicators are designed to look into the future and divine the likely spot the economy will hit over the next year or so. From their perspective, a recession is looming. However, these historically accurate numbers may not be as predictive as they were because pandemic-related monetary and fiscal stimulus continues to put a false floor in economic performance.

Leading Economic Indicators

January 2000 - November 2023

(Source: Bloomberg)



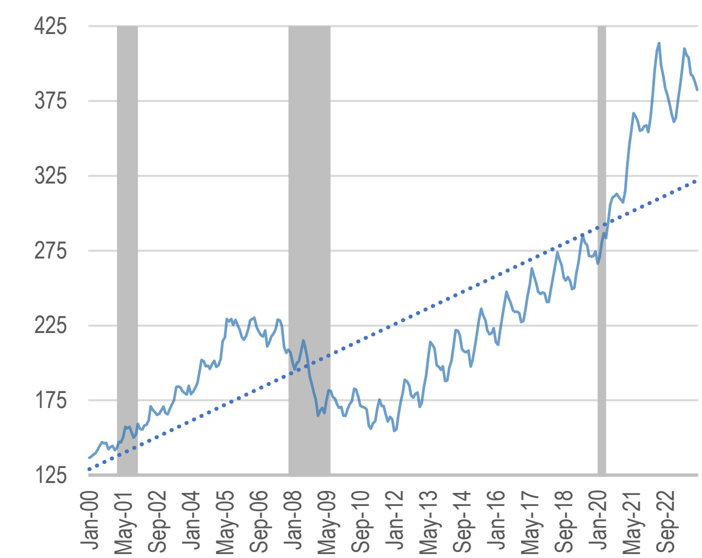
Housing

Interest rates, higher than their pre-pandemic levels, certainly impact real estate demand on the margin. But the total sales of existing homes, which accounts for the bulk of the single-family market, are still well above their trend line due to pandemic-related purchases.

US Existing Home Sales

January 2000 - December 2023

(Source: Bloomberg)



One More Thing

As a second-year graduate student, while studying for my master degree, I was allowed to work as a research assistant to a notable ethics professor, David K. Hart. It was one of the most fascinating times of my life. Part of my daily duties involved collecting the Professor's mail from the university mail room and taking it to his office, encamped in the basement floor of his home, which leaned precariously far over the edge of a foothill offering panoramic views of the valley below.

After parking in his driveway, I walked down the steep side yard to the glass doors of his study. Inside, every wall was overflowing, stem to stern, with the most eclectic assortment of books. Together, we spent hours talking about the lives of the great men and women of the world. He sat on an old leather desk chair, previously owned and passed down by his father, while I perched on a ratty old couch pushed up against the only wall without a bookcase. Unbeknown to me, each of our daily talks served an essential purpose in this extracurricular education. For all of them, I sat in rapt attention. Such special moments were precious to me then and priceless to me now.

Professor Hart and I published a paper based on some of the work done by philosopher David L. Norton, who wrote a wonderful, seldom-read book, now out of print, entitled *Personal Destinies: A Theory of Ethical Individualism.* It's a stunningly well-written book but one you must be awake to read and understand. Insomnia's payoff is worth it.

One of Norton's fundamental tenets is that every human form possesses an oracle within them. An authoritative source from which active inquiry may ask and receive guidance on everyday issues of importance. It is more than an internal Google, more like an interactive map that may be accessed for advice and lead an individual to a life of fulfillment and happiness. Greeks called it the daimon.

Our Founding Fathers called it the moral sense. Reliance on it was foundational to the principles Thomas Jefferson enshrined in the Declaration of Independence. Although different in name, it served the same general function as the daimon. Possession of such a gift gave the founders some confidence that democracy would work in such an "enlightened" citizenry guided by their moral sense.

Norton's book stoked fears that we may have lost connection with our oracle, daimon, or moral sense - that we are no longer confident in its authenticity. Norton said, "We are apprehensive that an ear turned toward our inwardness will detect, at most, meaningless murmurings, that a resort to the inner self will be a dizzying tumble into a bottomless pit. Fearing this, we anchor ourselves upon external things; we cast our lot with the fortunes of objects."

An inability to KNOW who we are lies at the crux of almost every social ill and family squabble. The increasing sense of "unknowing" continues to expand throughout the Western World. Social media serves a constant barrage of crises, and we follow them for the distracted ambulance chase they provide. Meanwhile, an increasing number of our kind remain entirely disconnected from the gift of fluid consciousness, which makes us uniquely human.

Conclusion

That's it for this *Weekender.* Have a wonderful week.

The stock indexes mentioned are unmanaged groups of securities considered to be representative of the stock markets in general. You cannot invest directly in these indices.