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THE VIEW FROM PRINCETON

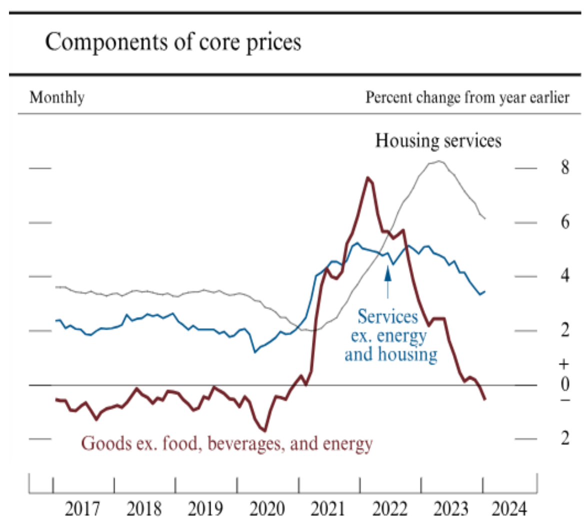
Market Commentary ⬩ May 2024

Something for (Nearly) Everyone; A Good Start

The Financial Times published an article a couple of weeks back week titled "The US economy is normal again."[1] We could not have said it more simply, and we read others who have come around to the same general conclusion.[2] This is not to argue that conditions are perfect, nor that we have resolved all lingering doubts or uncertainties about the economy and financial markets. In fact, there are unknowns aplenty, but the point is that these are normal unknowns. Markets are functioning well, and investor enthusiasm seems not irrational in the current environment. There is no reason to feel apologetic over enjoying the gains in stocks and portfolios to start off the year.

The premise of the article was straightforward: "goods-to-services spending…found an equilibrium", manufacturing activity has improved of late, and "excess savings" from the pandemic have been largely consumed. Tack on a strong jobs report and an encouraging outlook for Q1 2024 real GDP (and probably Q2 as well) and it is little wonder we enter this earnings season with financial markets offering something for everyone.

Equities are higher, interest rates are higher, gold is higher, commodities are higher, bitcoin is higher – it does, indeed, seem like an environment of higher for longer. If this is the proverbial Goldilocks economy and stock market, then every bed feels comfortable and every bowl of porridge is just the right temperature. EXCEPT for that one bowl of inflation, where the temperature remains too hot for policy makers and traders alike and threatens to send us back to places for interest rates none of us would care to revisit.



Source: Board of Governors of the Federal Reserve, March 2024

Overall, however, after the dismal 2022 bear market which is thankfully ever further in the rearview mirror, investors and savers have been rewarded with higher markets and higher CD rates for their investments and savings. As long as your money has been in large banks ("too big to fail") and large growth stocks ("too big to be beaten"), monthly account statements appear as normal as they have in quite some time.

[1] Financial Times. "The US economy is normal again" April 4, 2024. Robert Armstrong.
[2] As another example, JP Morgan Wealth Management. "Zooming out to see the 3 largest trends of Q1". April 5, 2024.

The question is the same as ever: how long can this last? Perma bears serve their role reminding us fervently of all that can go wrong, and they are not wrong. Many things can change the tenor of markets, ranging from sticky inflation and higher rates, to the well-covered risk in reliance on a narrow group of high-performing stocks with very high expectations to meet, to geopolitical conflicts around the world. And then there is the approaching US election season and all the machinations ahead of November. The calendar is crowded with events like data releases, trial scheduling, SCOTUS hearings, and the all-important quarterly earnings confessionals.

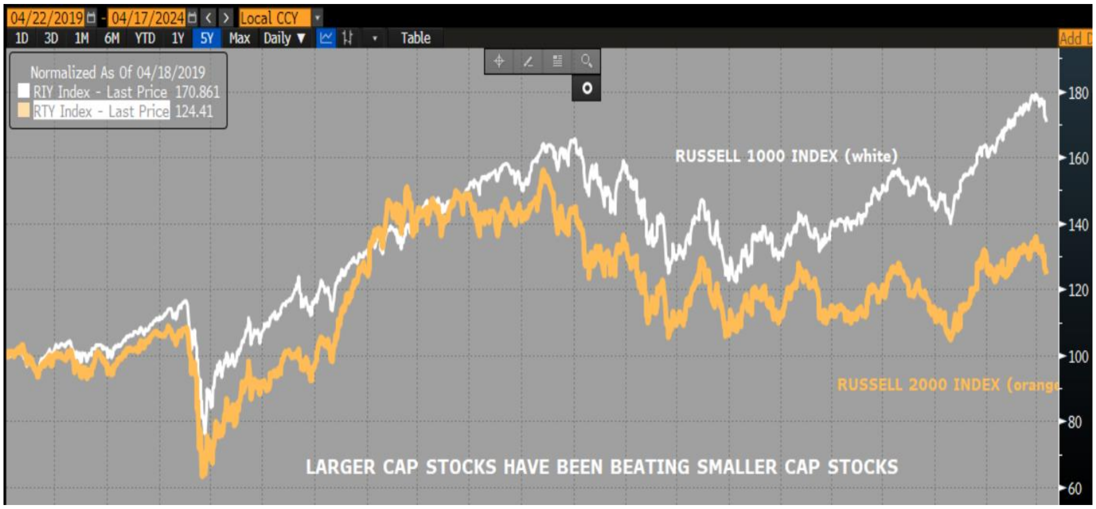
At the same time, markets have a way of sorting through the plusses and the minuses to arrive at their place of agreement, which in this cycle recognizes the current manageability of the business cycle (inflation, employment, and GDP growth) joined to dramatic secular change as we potentially retool nearly all the global computing ecosystem. For the moment, "artificial" intelligence is translating to genuine gains.

Having said all of that, we highlight a couple of important outliers in this new normal: small cap stocks' underperformance at a time of considerable innovation that usually feeds their relative returns, and the steady hum of government money printing that is unprecedented for a country not directly fighting a world war. More mature large cap companies out-innovating small caps is a fascinating shift in the leadership of disruption, while a rampaging federal debt points to a future reckoning only an economist named Houdini may be able to escape.

First, the superiority of large cap stocks over their smaller, usually feistier, brethren (and sisters) is something to behold. We think it speaks to the nature of innovation and disruption in the foundations of computing. Advances in artificial intelligence, wholesale migration of applications and other IT processes to a cloud environment, and all the related activities require capital expenditures in the billions and workforces in the thousands. The founders' garage as the Petri dish of all that will be new and wonderful seems relegated to university history classes much like the fax machine and the pager.

The HP Garage, Palo Alto, CA, in 2020

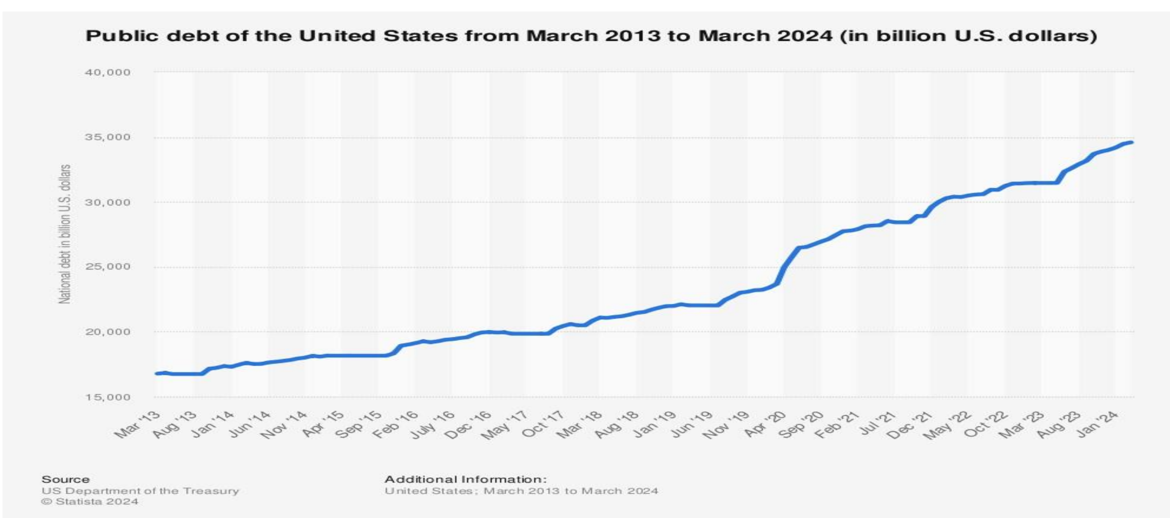
NVIDIA Headquarters, Santa Clara, CA



Source: Bloomberg

All these images together depict an economy and society in transition, each time rhyming but not repeating, to use that worn out description. There may still be a couple of pals somewhere in "the Valley" or now in Texas or Upstate New York or elsewhere around the world working from their proverbial garage, but who wants that when you have billions of dollars at your beck and call within the gleaming edifices of the new technology bourgeoisie. We need clean rooms, buildings that won't shake, tools for design and production, and all the people power to turn ideas into commerce. When the new plumbing and electrical is in place, that may be the time for the artisans to return with applications and use cases piggybacking on all the heavy lifting now underway.

Now about all that debt. We would be remiss not to touch on this touchy subject. The reality is we are running up the bills as we all enjoy the investment performance of the day (or generation). We may sleep easier on the soft pillow of an S&P 500 Index up 10% year-to-date after advancing nearly 30% last year, but these gains could reflect the pull forward of growth that can one day present an unpleasant invoice for immediate payment.



Source: US Department of the Treasury © Statista 2024

There are limited paths that deal with all this money-printing. Austerity is one approach to the problem (ask the Greeks how they felt about tax increases, spending cuts, and other reforms). Another option is productive growth (now there's a thought: the economy grows faster than the underlying debt in a "cake-and-eat-it-too" symbiosis). It is not a political statement to observe that growing our way out of the runaway government debt may be the preferred course of action, but it does get political very quickly. Like it or not, there may be a link between this sticky inflation we are hearing about and burgeoning deficits. If growth and productivity improvement are antidotes to a fiscal what-ails-us, then it just may be all this secular technology innovation that brings the measure of relief. Fascinating how all these things tie together, or don't. Time will tell.

For now, we are optimistic about business conditions and their underpinnings, but we are realistic as ever about our surroundings. Recently, an unusual Northeast US earthquake shook us in our seats for a few seconds that made for days of conversation. Financial markets have a way of rattling as well.

Quarterly results can shake the stocks now and again, as can commentary about the direction of interest rates, and other headline grabbers. However, as investors with a longer view, we believe the benefits of innovation, such as advances in computing, are accelerating and can reach into many areas of the economy and into our lives. This is why we have always had a bias toward investing where the world is going and growing and a belief that there is a basis for most, if not all, investors to have exposure to innovation to varying degrees.

As ever, we encourage you to call with questions, concerns, or insights. We always benefit from exchanges of ideas and observations.

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