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Q2 2024 Review and Outlook

Executive Summary

- Q2 had two dominant themes in our opinion. The first was the haves versus the have-nots. The second was cognitive dissonance when investors hold two contradictory beliefs concurrently.
- On the first theme, Q2 was kind to companies that have the Artificial Intelligence (AI) theme. The AI have-nots largely languished. We will expound more on the second theme below.
- While it is tempting to jump on the theme of the quarter, we think investors should lean slightly against these themes and rebalance back to targets and from the haves to the have-nots.

The Economy, Interest Rates and Consumers

While the US likely avoided the most predicted recession of all-time yet again in Q2, economic data largely surprised to the downside. The economic surprise index which measures economists' estimates against actual data fell into negative territory in Q2. Both continuing jobless claims and the unemployment rate touched two-year highs, albeit from historically low levels. Pending home sales fell to twenty-year lows while new single-family homes for sale reached levels not seen since 2008.

The rate of inflation cooled globally with the US inflation index surprising to the downside falling -0.1% most recently in June. While cooling inflation led both Canada and Europe to cut rates, Jerome Powell and the US Federal Reserve continue to argue that they want to "be more confident" that inflation really is cooling before cutting rates. Despite these assertions, the market is yet again pricing in 2-3 rate cuts by year end and expecting these rate cuts to be largely positive for stocks. Most economists expect 80% of the world's central banks to be cutting rates by year end and equity investors appear to think this will be positive for stocks moving forward. There is certainly some cognitive dissonance here. The last three times we saw such high levels of coordinated global central bank easing were during the depths of the tech bubble, the Great Financial Crisis and the pandemic respectively. Coordinated central bank easing is usually associated with some pain in the markets and economy, but this time could be different.

Nevertheless, the Federal Reserve's patience left cash yields above 5% propelling "risk-free" 3 Month US Treasury bills to a smooth 1+% return in Q2 and a near 3% return for the 1H of 2024. This led to some cognitive dissonance in the bond market as well. Typically, investors demand more yield for longer-term loans to protect against inflation. For now, cash has a 5+% yield in the US, whereas 10- and 30-Year Treasurys yield just 4.2% and 4.4% respectively. Investors constantly fret about America's rising debts, interest costs and perpetual deficits, but remain willing to make longer-term 10- and 30-year loans to a profligate government at a discount to shorter-term 3-month loans. This inverted yield curve relationship, where longer-term yields are lower than short-term yields, is often associated with a fear of recession, but we are seeing more cognitive dissonance here as well. Despite rising bankruptcies and defaults, investors have pushed the excess yield on riskier corporate debt to near all-time lows. Time will tell which group is correct. For now, we don't mind holding a bit more cash at 5+% yields and being patient on longer-term Treasurys and high yield debt.

For the top 40% of income earners who generally have cash in the bank and represent 62% of all US consumption, these high cash rates augmented their income. Interest income earned from money market accounts continues to shatter historical records and is largely accruing to the wealthiest consumers. On the flip side, for the bottom 40% of earners who account for just 22% of spending and often rely on short-term debt to make ends meet, persistently high short-term rates led to near-record levels of interest paid on credit cards and auto loans and rising delinquencies and defaults on both. There is some cognitive dissonance here as well on the Fed's part. Some economists have argued that by keeping interest rates high, the Federal Reserve may in fact be stoking inflation and widening the gap between the haves and have-nots as the wealthy accrue the income from high short-term rates.

This divergence between the haves and have-nots may have something to do with the cognitive dissonance consumers are displaying as whole. According to two separate polls, over 45% of Americans rate their personal finances as excellent or good, while less than 25% rate the country's economic conditions as excellent or good. Despite low historical unemployment levels, cooling inflation and a lack of recession, a recent poll found that 49% of Americans believe unemployment is at a 50-year high, 72% think inflation is increasing, and 56% think the US is in recession. Average confidence in major institutions is roughly half of what it was in 1979. Most consumers are also quite pessimistic about their own prospects ahead, yet a near record percent expect stock prices to increase moving forward. This is odder still as 49% of the pollsters think the S&P 500 is down this year.

Public Stocks

The S&P 500 was in fact up over 15% at the end of Q2, registering one of its strongest first half performances since the tech bubble run-up in the late 1990s. Perhaps the reason why so many Americans think stocks are down for the year again ties back to the haves versus have-nots as a record 77% of stocks in the S&P 500 failed to outpace the index in the first half. In Q2 alone, S&P 500 companies that had an Artificial Intelligence (AI) theme gained 15%, while those that did not lost 1%.

Companies that have the AI theme are also becoming rarer and larger. 60% of the S&P 500's year to date gain was driven by just five large cap companies- Nvidia, Microsoft, Amazon, Meta and Apple. 90% of the S&P 500's Q2 performance came from just Nvidia, Apple and Microsoft. Nvidia alone in fact accounted for just under a third of the S&P 500's 15% 1H rally as it added $1 trillion of value to its market cap in just 30 days. For comparison, Warren Buffett's Berkshire Hathaway has yet to crack the $1 trillion market cap despite 60 years of near 20% annual returns.

As one analyst noted, "it's Nvidia's world and everyone else is paying rent." Broadening this out to AI, AI-related stocks in the S&P 500 now trade at nearly 30X forward earnings while the rest of the market trades near 18X. The top 10 stocks in the S&P now account for over 35% of the index's weight, but just under 25% of its earnings. This level of concentration in a handful of stocks at relatively rich valuations is a phenomenon we have not seen since the late 1990s just ahead of the tech bubble. While we aren't calling this AI run up a bubble, we do think slowly rotating some capital from these relatively large, rich AI haves and toward the relatively smaller, cheaper AI have-nots makes sense. Small and mid-cap stocks delivered positive results when the tech bubble eventually popped and remain a good diversifier. Reversal can also occur quickly. Just recently on July 11th when the cooler inflation data noted above was released, we saw the small-cap Russell 2000 index outperform the large-cap Russell 1000 index by over 4%. This was the fourth largest daily outperformance for small caps since data began in 1978.

International markets also experienced these two major themes in Q2. International stocks largely lacked the AI theme delivering a small but positive 1% return in Q2. International stocks also struggled with a stronger US dollar with the Fed maintaining its 5+% target rate while both Europe and Canada began cutting their rates. In terms of cognitive dissonance, the Japanese Yen weakened considerably against the dollar and traded at its 30-year lows despite the Bank of Japan hiking rates for the first time since 2007 and ending eight years of negative rates. Higher relative interest rates typically attract more capital, but the opposite occurred. In June, we saw a record level of foreign demand for US Treasurys. Perhaps this phenomenon also ties into the haves versus have-nots theme and rising discontent globally. In Q2 and more recently, we saw some surprising elections. In Mexico, voters arguably chose populism over democracy with the Mexican peso off 4% and the Mexican stock market off 6% post-election. France also saw surprising elections with both far right and far left parties gaining seats over centrists. French stocks and bonds also sold off post-election. More recently in the UK, the Labour Party swept into power replacing a rocky fourteen-year reign by the Conservative Party.

For now, the US remains a destination for capital, but we too are facing a historic and contentious election. The assassination attempt of Donald Trump just this past weekend marks a disturbing upward trend in political violence

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and polarization. Since the 2011 shooting of Representative Gabby Giffords, we've seen the 2017 shooting at a Congressional Republicans softball practice, the 2018 mailing of over a dozen bombs to prominent Donald Trump critics, the foiled 2020 plot to kidnap Michigan Governor Gretchen Whitmer, the January 6th, 2021, United States Capitol attack, and the assault of Paul Pelosi and plot to assassinate Supreme Court Justice Kavanaugh in 2022. According to polls, more Democrats and Republicans view the opposing party as "very unfavorable", "close-minded", "dishonest", "immoral" and intent on "destroying America" than ever before. Despite this rising tension domestically and globally, volatility remains historically low and suggests more dissonance.

Alternative Assets

Turning finally to alternative assets, we see more of the same themes here. The AI haves versus have-nots is on full display in private markets. While fundraising and IPOs remain at historically low levels, the private market is wide open to AI-related firms. Paris-based Mistral AI, for one, raised a massive $640mm Series B round just one year after a massive $112mm seed round. AI-related private firms like Mistral trade at nearly 40X revenues compared to 8-20X revenues for all other private tech sectors.

While we continue to make selective investments in early-stage AI, we think it is prudent to look outside of the obvious AI plays for other potential winners. Given the insatiable demand for AI companies and Nvidia's chips, we are seeing a near doubling of demand for power from data centers in just the last five years. We are investigating not only private data center investments that have access to abundant power, but also investments in assets that we think will supply the power required to fuel this AI boom.

On the real estate side, the market appears bifurcated between funds that have cash and those that do not. Blackstone Real Estate for example has stemmed the outflows from their fund and now are on a buying spree, most recently agreeing to purchase upscale apartment firm AIR Communities for $10B. On the flip side, Starwood Capital moved to severely restrict redemptions from its fund noting that selling their assets "would negatively impact all investors". Given this dichotomy, we think now is a good time to put capital to work in real estate as we see more sellers needing cash than buyers with cash.

Conclusion

So, what is an investor to do in a world dominated by a handful of AI haves and in the face of rising cognitive dissonance? As noted earlier, we think it will pay to lean slightly against these themes. On the bond side, we don't mind owning a bit more cash at 5+% yields. We are leaning against the urge to make longer loans to a profligate government at lower yields and the dissonant desire to lend to high yield corporates at record low premiums while defaults mount. In public equities, we are not abandoning the concentrated AI-heavy index, but we do expect to rebalance and lean slightly more toward smaller firms and international stocks with cheaper valuations. In private markets, we are resisting the urge to chase AI-related companies higher and instead are focusing on other opportunities in data centers, energy and beaten down real estate. As always, we think making short-term predictions and chasing the theme du jour is generally futile. We believe in sticking close to our long-term targets, which now calls for some rebalancing away from the haves and to the have-nots.

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