Countdown to Chaos

John M. Gustafson – 30 June 2024

"Do not dwell in the past, do not dream of the future, concentrate the mind on the present moment." - Buddha

While the stock market continues on a steady, upward trajectory, closer examination reveals that this rally has been largely driven by a select few stocks - almost exclusively in the technology sector. This concentration of growth in a limited number of companies masks underlying concerns that warrant careful consideration.

Despite our typically optimistic outlook, we believe the market has overlooked several significant negative factors as we trundle along into the summer. I'll try to point out some continuing positives as well, but with the performance we've seen over the past few quarters, the potential downsides currently can't be ignored.

Those who have been with me for years know that I'm a "zagger" - when the consensus and public message is negative – as it has been over the past couple of years with few facts behind it - I'm looking for the light. But when everything is coming up roses as expected, I generally begin to look for signs of caution.

"One of the penalties for refusing to participate in politics is that you end up being governed by your inferiors." - Plato

Unless you've been living under the proverbial rock, the fact that the upcoming presidential election poses a significant risk of prolonged uncertainty cannot be missed. There's a strong possibility that the winner (once again) may not be definitively known in early November, as the election process becomes mired in legal challenges, recounts, and allegations of fraud.

This scenario would likely create significantly increased market volatility and investor uncertainty in the near term. Not a new experience, unfortunately, but something that can't be ignored and/or a surprise when it hits. The good news is that at least it is now a "known unknown" rather than "unknown unknown" that can cause complete chaos.

"The darkest places in hell are reserved for those who maintain their neutrality in times of moral crisis." - Dante Alighieri

Adding to the complexity is the health and cognitive fitness of the only two candidates with an actual chance of winning. Both Joe Biden and Donald Trump have faced scrutiny regarding their mental acuity, with reports from close associates suggesting neither is as sharp as they once were with ample video evidence of this fact from both. And that disastrous debate on Thursday

evening reminded me of an American political fact: lies delivered confidently with strength will beat a weakly delivered truth every time.

The truth is, the clown show probably didn't change any minds on either side. Both candidates looked and spoke exactly as the other side describes them. Biden needed to look younger than he is and he seemed to look and sound even older. And Trump delivered his usual fact-less word salad with the confidence of a child who doesn't care to answer an actual question.

The bottom line is that for the third POTUS election in a row Americans have a Hobson's choice and it will cause significant volatility in markets that can't come as a surprise.

"Ask five economists and you'll get five different answers – six if one went to Harvard." - Edward Fiedler

Some economic indicators are finally suggesting a mild softening of the labor market, after several years of historic growth and historically low unemployment. Consumer sentiment has also ticked-down slightly, leading to reduced spending across certain sectors. This pullback in consumer activity could potentially shift GDP growth from its current robust state to a more mediocre performance by autumn.

There are several factors contributing to this uncertainty, but the two most prominent have clearly been the stubborn rise of inflation and its effect on purchasing power, along with geopolitical tensions that are affecting global trade.

If these trends continue, it could easily impact corporate earnings and overall investor confidence over the next several quarters. The "recession is just around the corner" message has been in the media, especially on the right, for a couple of years now with little evidence to keep it going other than the political climate. I don't believe anything is imminent, but we are at least finally entering the "landing" phase of the interest rate / inflation cycle – and we are still on the path for a soft one. Stay tuned...

"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said." - Alan Greenspan

One yellow light on my dashboard is the Federal Reserve's steadfast commitment to achieving a 2% inflation target which may prove counterproductive along these lines. In contrast, central banks in Canada and Europe have already signaled a shift towards more accommodative monetary policies. This divergence raises questions in my mind about whether the U.S. central bank is correctly calibrating its policy to current economic conditions. If the Fed fails to pivot in time, it could exacerbate economic headwinds and lead to a more severe downturn.

This is a little less of a worry from my chair than the elections, simply because the Fed has done a fantastic job sailing through the multiple economic hurricanes of the past couple of decades and I don't believe they have simply forgotten how to do their jobs properly.

"We live in a rainbow of chaos." - Paul Cezanne

The ongoing conflicts in Ukraine and the Middle East show little sign of resolution, continuing to impact global stability and economic prospects. Not to mention consume countless minutes and column inches of the American news cycle and political discourse.

The Ukrainians may succeed in halting further Russian advances this summer, however a decisive breakthrough by Ukrainian forces seems unlikely. Putin is clearly a fan of the Russian WWII strategy of simply throwing bodies at the problem until it's solved. This protracted conflict continues to disrupt global energy markets and supply chains, with far-reaching economic consequences.

Further south on that side of the globe, the situation in Gaza remains volatile, with Hamas showing little interest in pursuing peace talks. The potential for a prolonged guerrilla war in the region threatens to further destabilize the Middle East's global trade routes.

The term "quagmire" seems to have been invented for both conflicts. It is nice to not have American soldiers in direct combat in either theater, but we certainly are involved with not much end in sight.

"To know what you know and what you do not know, that is true knowledge." Confucius

As most of us have noticed over the past decade plus, the world is experiencing unprecedented levels of heat, surpassing all recorded history. This extreme weather is not just an environmental concern but poses significant economic risks as well.

The scorching temperatures could fuel the development of more powerful and frequent hurricanes this fall, potentially causing billions in damage to coastal regions and disrupting major economic centers. Just ask anyone in Florida who has struggled to acquire homeowner's insurance, let alone be able to afford the current premiums.

Also because of the rising costs of natural disasters, property insurance has risen across the country, not simply in the areas directly affected. *The Wall Street Journal* recently posted an article discussing the fact that the annual number of "billion-dollar disasters" continues to rise with not much end in sight. The issue may or may not be solvable by humans, but it still must be added to economic calculations going forward.

"Millions saw the apple fall, but Newton was the one who asked why." - Bernard Baruch

Piggybacking off an asset class removed from our portfolios late last year, the commercial real estate sector continues to face a significant downturn, presenting a major economic wild card. The shift to remote work, accelerated by the pandemic, has left many office buildings in major cities largely vacant. This trend shows no signs of reversing, leading to a glut of empty commercial spaces in urban centers.

Surprise, surprise – once workers were given the freedom to work "anywhere" - and with the significant improvement in video conference technology – who is surprised most don't want to return to set hours in a set environment? That won't work for everyone, but there is an awful lot of empty office space piling up in medium to large cities across the country and around the globe.

This is the opposite situation to residential housing, which continues to face shortages in most areas with good economic growth. There is bound to be some sort of pricing adjustment downward in the commercial sectors. That sort of adjustment, depending on the speed and depth, could affect banks, income tax bases in cities as well as the ancillary services that rely on the sheer number of bodies that flow in and out each day and spend money.

The remote employee migration has seemed to significantly slow after the pandemic. This could help urban planners, corporations and commercial real estate owners to better asses their actual needs now that things have stabilized. It doesn't eliminate the issue, but it may help to curb the short-term impact.

"I am always ready to learn although I do not always like being taught." - Winston Churchill

Despite all the potential problems outlined above, the U.S. Economy has always done an amazing job chugging forward no matter the current crisis – in the long term. I'm highlighting specific items this quarter because the short term is becoming significantly cloudier.

As I mentioned at the beginning of this missive, a significant portion of any upside return over the past year or two has come almost exclusively from a handful of tech companies. A situation not unlike the late 1990's. The issue isn't necessarily because it's tech, the issue is how the market indices calculate their returns and how it is skewed by company size and the weight in each the given index.

Currently, the technology group accounts for roughly 31% of the entire S&P. That is staggeringly high. My experience has been that any time any of the industry sectors approach 30% of the overall index, they are highly overvalued in the near term.

A couple of historic examples of this valuation reality outside of tech are Financials and Energy. Fianncials made up close to 30% in 2007 – and we all know what happened in 2008. The Energy sector grew to those lofty levels in the mid 90's before oil completely flopped. Something that seems to occur in that industry each decade.

Again, nothing is an imminent danger – companies and sectors can remain over-valued for a while – but it's also why when we rebalance the portfolios or add new individual names we will not be increasing the current allocation to technology. We've been fortunate to have enough of the big names to benefit and grow the portfolios, but as the old market saw reminds us, "Bulls make money and bears make money, but hogs get slaughtered."

Thank you as always for your business & friendship. Please reach out with any questions.