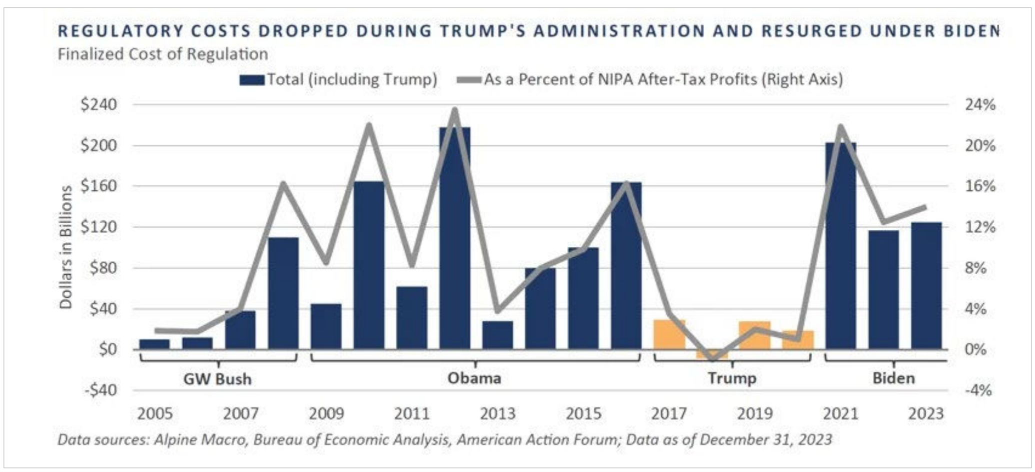
The Long & Short of It

Quarterly Newsletter
Fourth Quarter 2024

Ain't That Up Enough?

Benjamin Graham, Warren Buffett's mentor and author of the seminal work *Security Analysis*, is paraphrased by Buffett with the quote, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." In the short term, whether the Federal Reserve can engineer a soft landing is of little importance relative to the degree today's investors agree they will. Likewise, whether the Trump administration is actually business-friendly matters less for valuations today than the degree that investors believe it will be. Of course, in the long run, the success of artificial intelligence, cryptocurrencies, and the low-carbon transition will matter. But in the short run, they matter less than the degree investors expect of their success.

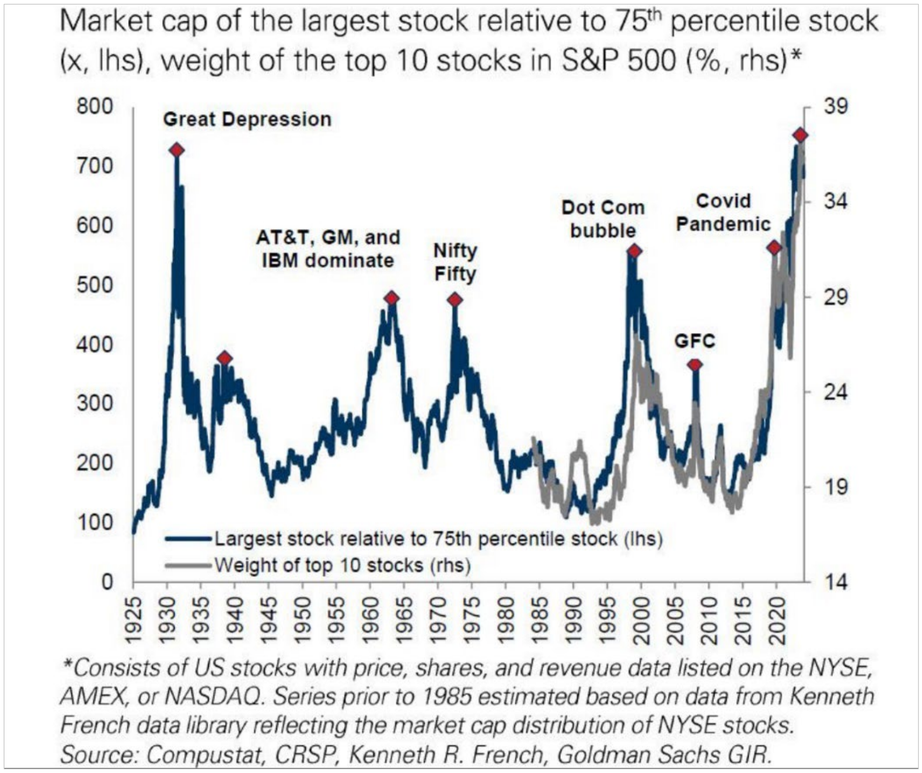
Since October 2023, we have seen a near 50% rally in the stock market as too-hot inflation moved toward the Fed's 2% target. More and more, the consensus is growing that the Fed will successfully achieve a "soft landing." This outlook is not unusual at this particular point in the business cycle, though an actual soft landing would be extremely rare. If the consumer price index (CPI) does eventually reach 2%, it could mark the bull market's top since expectations can only get worse after perfection is reached.



Contributing to last year's rally were rising expectations for a business-friendly presidential administration. Trump's first election was a surprise, followed by a solid stock market rally in late 2018 through 2019 as investors figured out his approach would be pro-business and light on regulation. This time, Trump's policies will be no surprise. In fact, there is a growing consensus that he will move even faster in 2025. As with the soft landing, the stock market now largely reflects these business-friendly expectations.

Artificial intelligence (AI) is expected to rapidly transform productivity, earnings, and our lives, for the better. Combined with low-carbon data centers and massive green energy production, it will transform the future into a big warm fuzzy happy place. While we agree that an unimaginable amount of good may proceed from it, the degree of consensus (seen in the accompanying chart with data from The Conference Board) gives us cause for concern. This is not your average optimism. In addition, most people are aware of the narrowing leadership, but many measures of that have now reached levels rarely seen, which in itself is a cause for concern. On the next page is a chart from the fine people at the Kobeissi Letter (@KobeissiLetter). Very few names are leading this charge higher. In fact, while the NASDAQ Composite Index (heavily driven by mega-tech) was up 0.6% in December, the S&P 500 Equal Weight Index declined 6.3%.

Our favorite indication so far is a headline in *MarketWatch* on December 5, 2024, summarizing Blackrock's *"2025 Global Outlook"* with: "World Economy has exited the 'boom and bust' cycle, Blackrock says." No more business cycle, huh? Got it. Of course. It seems safe to say that a significant shift in investor expectations has played a large role in the market's approximate 50% upward move since October 2023. Similar optimism existed in 2008 and 1999 before major bear markets. For example, on December 27, 1999, the optimism for technology's impact became so widespread that Barron's ran an article declaring "Warren Buffett may be losing his magic touch," due to his avoidance of most technology names and his large cash hoard at the time. The market topped in March 2000. Oops!



One Man's Opinion

We could not help noticing, then, that the very same Warren Buffett has moved significantly toward cash again. On November 4, 2024, Forbes reported that at the end of September, Berkshire Hathaway's cash hoard was up to $352.2B from $167.6B just nine months prior, representing 28% of the company's asset value. Mr. Buffett cites two reasons for raising so much cash: Stocks are overpriced and capital gains taxes must rise. Mr. Buffett expects the US government will tackle bigger fiscal deficits by raising taxes rather than by reducing spending. "I think higher taxes are likely," he said on May 4 at Berkshire Hathaway's annual shareholder meeting in Omaha, Reuters reported. "They may decide that someday they don't want the fiscal deficit to be this large because that has some important consequences. So, they may not want to decrease spending and they may decide they'll take a larger percentage of what we own, and we'll pay it," he said. In light of the current post-election expectation for reductions in the growth of government spending today, this would be a bit of a shock, but we would not put it past Congress. Mr. Buffett went largely to cash from late 1986 into 1987 before the crash in October 1987. Again in 1999 and in 2008, he raised cash before the subsequent crashes.

What Could Go Wrong?

The rising stock market coincided with the largest non-recession peacetime deficit spending in US history, so where do stocks go if the new administration succeeds in its promise to cut spending by trillions of dollars?

In addition, roughly $8 trillion in existing US debt will mature in 2025, which the US Treasury must roll over and refinance. Another $2 trillion more must be borrowed to finance the 2025 budget deficit. The Treasury's $10 trillion in new debt will dwarf all other issuers in the debt market. How long will bond buyers trust that the dollar is safe? Is the Treasury prepared for the mess coming in 2025?

Changing the way Washington governs may be more difficult than previously imagined. Historically, the "swamp" does not change but instead absorbs anyone who wades into the muck. On the other hand, if large changes are pushed through, might there be some unintended side effects and uncertainties that the stock market might find unpleasant? Either way, the uncertainties embedded in the trial balloons could scare investors. Once again, the Federal Reserve may struggle to gain control. As a whole, these efforts may shake up the current status quo of stable growth with declining inflation.

Furthermore, some impediment may come along that slows the implementation of AI, there could be limited and/or more expensive electric power, or perhaps there will be an extensive regulatory intervention to preserve the current socioeconomic order. All these risks exist but expectations are ever-optimistic beforehand: the soft landing, the new administration, the AI integration into every company (tech or non-tech), and the low-carbon transformation. Our money will be on great things coming in the long run and expectations encountering disappointment—or at least rising uncertainty—in the short run.

While we continue to employ traditional risk-aware, bottom-up fundamental security analysis for our stock and bond portfolios, we also analyze macro-level behavioral responses, especially those resulting from cyclical events and government policy-making and execution. We do this in an effort to balance equity risk in ways more effective than large allocations to intermediate bonds. We believe that investors should be positioned to survive, if not thrive, in the face of the risks and volatility that result from our oversized government's large footprints and unfettered access to capital markets. If you would like to have a discussion about risk-aware investing and seeking to benefit from the activities of government, please call or email us.

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