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Perhaps the number one thing that makes intelligent investing so challenging is the fact that the two main drivers – momentum and mean reversion – are often in conflict. The trend is your friend is a market truism and ignoring that truism can be risky indeed. At the same time, the elastic band can only be stretched so far and trends that stray too far from the mean can be expected to correct, often unexpectedly and sometimes violently. Occasionally, trends that run too far for too long can lead to an asset bubble which in turn can lead to a mean-reverting event (i.e. a panic or crash). U.S. stock market bubbles have been relatively rare. Arguably, there have been five in the past 150 years. Unfortunately, bubbles can only be identified with certainty after the fact. With the benefit of hindsight, it's only too obvious and we ask ourselves how investors could have been so stupid not to see it. Yet, leaving aside the fact that hindsight is 20/20, there are perfectly understandable reasons why people don't "see it". First, there is what we call today FOMO, fear of missing out, which has nothing to do with intelligence. In 1720, Issac Newton, one of the smartest people of all-time, owned some shares of the South Sea Company which he sold at a profit when it became, in his mind, overvalued. As it kept rising and his friends told him how much money they were making, he bought back in and ultimately lost 1.2 million Sterling (2021 value). "I can calculate the movement of stars, but not the madness of men," he said. Then, there's the hugely successful investor, Stan Druckenmiller, a protege of George Soros, who relates, "January 2000, I go into Soros' office and say I'm selling all our tech stocks. Around March, I just had to play. I couldn't help myself. I think I missed the top by about an hour. I bought $6 billion worth of tech stocks and in six weeks I had left Soros having lost $3 billion in that one play. You ask me what I learned. I didn't learn anything. I knew I wasn't supposed to do that." For those who "see it", but don't capitulate, there's still the likelihood of public derision and career impairment. In the 1920s, Paul Warburg, a highly respected founder of the Federal Reserve Board, warned of speculation and a dangerous market bubble. For his troubles, he was dubbed, "The Cassandra of Wall Street", was mocked publicly, and booed when he entered his men's club. In breaking news, JP Morgan's top market strategist, Marko Kolanovic, is out of a job, having called for a recession that hasn't (so far) materialized and largely missed the AI boom of the last 18 months. Lastly, while there's always a heap of speculation towards the end of a momentum-driven run, there's also always a seemingly credible storyline as to why prices can go higher still. In 1929, Business Week wrote, "This is the longest period of practically uninterrupted rise in security prices in our history. The illusion upon which it is based is that the fundamental conditions and requirements of progress and prosperity have changed, that old economic principles have been abrogated, that business profits are destined to grow faster and without limit, and that the expansion of credit can have no end." Throw in a reference to Artificial Intelligence and could this not have been written today? Yet, Sir John Templeton warns us that "The four most dangerous words in investing are: This time it's different." The legendary Bob Farrell's first 3 rules of investing are: (1) Markets tend to return to the mean over time; (2) Excesses in one direction will lead to an opposite excess in the other direction; (3) There are no new eras – excesses are never permanent. Lastly, one of the most famous stock traders of all-time, Jesse Livermore, observed, "There is nothing new on Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again."

So, what about the U.S. stock market today? The Financial Times notes, "Momentum – a strategy of buying what's winning and selling what's lagging – is always a powerful force in markets, but its outperformance since ChatGPT sparked the artificial intelligence frenzy has been on a scale never

seen before and has surpassed the high set during the 2000 dot.com bubble." This was on full display in the second quarter as Joe Calhoun lays out in a manner worth reproducing: "The 2nd quarter was one of the strangest of my 33-year career. If you owned large-cap growth stocks, you had a good quarter; if you owned almost anything else, you didn't and you likely lost money. I don't know when the bear market in doing the right thing will end, but it wasn't this quarter. What do I mean by "the right thing"? Well, there are certain things that the research and history say are the prudent things to do, but the only way to (compete with the S&P 500) over the past decade has been to ignore them. Diversify, nah, just buy the S&P 500 (which isn't very diversified). Diversify internationally? Loser. Diversity into mid/small cap stocks? Loser. Buy stocks based on fundamentals like price/sales ratios. Loser. Own assets with low or negative correlation to the S&P 500. Loser. Morningstar tracks 370 asset allocation funds. Only one has beaten the S&P 500 on a risk-adjusted basis since 2009. According to Cambria funds, broadly diversified portfolios have underperformed the S&P 500 in 13 of the past 15 years, a fact matched only once in the last century." Bonds broke even in the second quarter, but are in the throes of their longest bear market in history (almost four years) during which Treasury bonds have lost about half their value. Over the past 7 years, nearly all of the gains from a 60/40 U.S. stock/bond portfolio have come from stocks. U.S. stocks have been outperforming international stocks for 16 years running and by a lot and are now 3 standard deviations above the mean historical U.S. outperformance, a record high. It's worth noting that, for the 30 years from 1980 to 2010, the return on American and European stocks was the same. Similarly, large capitalization U.S. stocks have outperformed smaller capitalization stocks for 14 years, the longest streak on record. The smaller cap Russell 2000 has never gone such a long time without recording a new high when the S&P 500 was hitting new highs. Since 2009, smaller cap stocks have underperformed dramatically, but, from 1930-1980, they outperformed dramatically. Finally, so-called "value" stocks have declined relative to the S&P 500 for more than a decade, causing some to proclaim value investing is dead. The underperformance of so many market sectors is behind Calhoun's screed regarding the seeming futility of such time-honored concepts as diversification and value investing.

However, even owning large capitalization U.S. stocks in the 2nd quarter was not enough. Bespoke Investment Group broke the Russell 1000 (big cap) Index into deciles and calculated their Q2 performance. The only decile to show a gain were the 100 largest stocks, up 0.76% compared to a gain of 4% for the capitalization-weighted index. The average stock was down 4% and the decile with the 100 smallest stocks was down by almost 10%. Dismal as was the performance of the Russell 1000; it outperformed the smaller-cap Russell 2000 by the most since data began in 1979. Similar to the "under the hood" performance of the Russell 1000, only 25% of the S&P 500 stocks have outperformed the index year-to-date, the lowest percentage in at least 50 years. Canada's TSX Index and the Dow Jones Industrial Average both fell during the quarter and are up a modest 4% or so year-to-date, about the same as the average stock in the S&P 500 (the largest underperformance of the average stock relative to the index since at least 1990).

So, what's this we keep hearing about new highs in the S&P 500 and how stocks are doing well? In a word, the Magnificent 7, which rose 17% for the quarter and 37% for the half and specifically Nvidia, which was up 37% for the quarter and a stunning 150% for the half. Five well-known names account for 60% of the S&P 500's return year-to-date and 44% of the gains since the start of 2022 come from one stock. This seems like momentum run amok. Is it a bubble? Of course, we won't know until well after the fact, but there are certainly good reasons to think that it could be. Over the past decade, the S&P 500 Tech sector has had triple the return of the S&P 500 and represents almost a third of the index, up from 6% in 1990. The Magnificent 7 have a bigger market capitalization than all the world's energy, basic materials, utilities, and transportation stocks combined. At Nvidia's peak in June, three stocks (including Apple, Microsoft) had a market value exceeding the entire Chinese stock market and

equal to the GDP of Germany, France, and the U.K. combined. They represent 20% of the S&P 500 and almost 10% of the total global stock market value. It took 20 days for Nvidia to add $1 trillion of market capitalization, greater than the total market capitalization of Berkshire Hathaway, which Warren Buffett has spent 60 years in building. Concentration risks were typical of the bubble tops of 1929, the 1960s, and 2000 and, depending on the metric, this could be the most concentrated ever. Trading in Nvidia is manic with 10 times the daily share volume compared to the rest of the Magnificent 7 and leveraged long ETFs in Nvidia pulled in $750 million in one week in June. Markets dominated by a handful of favorite stocks is typical toppy action; indeed, Bob Farrell's rule number 7 states, "Markets are strongest where they are broad and weakest when they narrow to a handful of blue-chip names." Concerning the 1920s, John Brooks writes, "The 1929 boom was, in fact, quite a narrow and selective one. It was a boom of the most actively traded stocks bearing the names of the most celebrated companies, but it was emphatically not a boom of secondary stocks." In 1977, Fortune Magazine, talking about the so-called Nifty Fifty bubble, wrote, "The two-tier market really consisted of one tier and a lot of rubble down below. What held the Nifty Fifty up? The delusion that these companies were so good that it didn't matter what you paid for them, their inexorable growth would bail you out." Also writing about the Nifty Fifty/GoGo Era, John Kenneth Galbraith noted, "The whole concept of glamour stocks is a perfect reproduction of 1929 and, to an extraordinary extent, the industries are the same. In 1929, the glamour stock was an electronic concern – RCA – although the word electronics had not been invented. Investors felt there must be magic in any industrial process they did not understand and they still feel that way." On a related note, a recent CNN article observed that most people buying Nvidia don't really know what it does.

Which brings us to comparisons between today and the dot.com boom, specifically the last five years of Cisco's run to its March 2000 peak as against Nvidia today. Incredibly, Nvidia's return of 3,440% has taken its price-to-sales ratio from 9 to 42 as it passed Microsoft to become the world's largest company (by market capitalization). Cisco's return of 3,590% took its price-to-sales ratio from 7 to 39 as it passed Microsoft to become the world's largest company. Worth noting is that Cisco's stock fell roughly 80% during the dot.com bust, but, in 2003, its earnings were higher than in 2000 and, in 2010, with the stock still down 70%, sales and earnings were hitting new highs. This highlights the comment made by one analyst recently, "There's a magnificent difference between a magnificent company and a magnificent stock – the difference lies in magnificent valuation." Over the past 50 years, the only time the S&P 500 outperformed the equal-weighted S&P by more than the past two years was 1998-99. The outperformance of large capitalization stocks (S&P 500) over smaller caps (Russell 2000) is at its most extreme since 1999. The outcome then was reversion to the mean as over the next seven years the Russell gained 90% against 10% for the S&P. The outperformance of Growth versus Value stocks is at its highest level since 2000. The outcome then was again reversion to the mean as Growth fell by 27% and Value rose by 84%. In 1999, Barron's Magazine wrote, "What's Wrong, Warren?" saying Buffett was losing his magic touch with Berkshire Hathaway down 40% from its peak as "the market" was hitting record highs. What happened next? The S&P 500 dropped 40% and Berkshire rose by 50%. Investors seem comfortable with a price-to-sales ratio of roughly 8 for the Magnificent 7 like it is nothing, up from 3 ten years ago. In 2002, Scott McNealy, CEO of Sun Microsystems, one of the hot stocks of the era, went on a famous rant about how crazy it had been for investors to pay ten times revenues. Over and above the excesses surrounding artificial intelligence, investor sentiment in general is at or near record bullishness, allocation to equities is at or near record highs, valuations are at or near record highs, cash levels are at or near record lows, and, last but not least, short sellers, people betting that stock prices will fall, have been almost driven out of existence (indeed, one of the foremost, Jim Chanos, has shut down his funds). The giant fund company, Vanguard, hardly known for its bearishness, is forecasting a lot of mean reversion over the next decade with international equities,

U.S. small-cap equities, U.S. value stocks, and bonds outperforming U.S. growth stocks, large-cap stocks, and U.S. equities in general. They expect U.S. growth stocks to deliver negative real returns.

Mean reversion over the next decade? History suggests they'll be right, but what about shorter time frames? Here, the true believers in the power and potential of A.I. think there's more to go. Mustafa Suleyman, the CEO of Microsoft AI, for example, thinks we are in the early innings of a "transformative experience". Another fan, who compares the A.I. boom to the introduction of the Netscape browser, says, "Look at what happened between 1995 and 2000. Inflation went down, profit margins went up. We're in a comparable situation now, probably similar to 1996 - 1997." "A third analyst, in an article entitled, "Tech looks Bullet Proof Despite High Valuations and Narrow Markets" opines, "I expect higher prices by year-end and into 2025 as the high valuations are justified by incredible corporate earnings growth and the promise of continued growth due to tremendous improvements in productivity." Of course, when we look at previous eras of significant technological advancements - from the telegraph and the railroad to the smartphone and internet – we note that the associated stock market momentum booms have been, in inflation-adjusted terms, not so dissimilar and have always been followed by a multi-year period of regression to the mean. To suggest that something radically different is going to happen this time is to suggest that Templeton, Farrell, and Livermore are going to be wrong. As always, we won't know until after the fact, but, even if it turns out there is no "new era", it doesn't mean the current momentum-driven run-up has to peak in July 2024.

For a shorter-term perspective, it is perhaps useful to look at the state of the U.S. and world economy. Here, as with A.I. and the stock market, investors are tempted to believe that it's different this time. In 2022, as central banks around the world started raising interest rates and stock prices fell, economists in the U.S. started penciling in a recession and still lower stock prices in 2023. However, as 2023 came and went with no U.S. recession and stock prices rising, the majority of investors and economists began to believe that the Federal Reserve Board had achieved the fabled 'soft landing" (i.e., bringing inflation into line without the necessity of a recession). Many plausible reasons have been put forward for the resilience of the American economy. On the one hand, the cyclical sectors – residential construction, manufacturing, and durable goods – that are especially sensitive to tighter credit conditions, represent a smaller share of the economy than used to be the case. For example, manufacturing represented 66% of the S&P 500's market capitalization in 1980 compared to 18% today. Secondly, in the current cycle, only 11% of U.S. household debt has an adjustable interest rate and the weighted-average interest rate for S&P 500 firms has scarcely budged, so the impact of higher rates has been muted. Finally, fiscal stimulation has been massive and unprecedented in a non-wartime setting. While these factors have caused the U.S. economy to be stronger for longer than it otherwise would have been, history still suggests a recession has probably been delayed, not avoided.

The scale of interest rate increases has been greater and has driven the real Fed Funds rate further above the so-called natural rate of interest than in any cycle of the past 35 years at least. Every recession in the past 50 years – and some claim in the past 150 years – has been preceded by an inverted yield curve (short rates higher than long-term rates) brought on by tightening monetary conditions. The yield curve in this cycle has been inverted for a record length of time and the current curve dynamics point to odds of a recession being in excess of 95%. The only periods of yield curve inversion in the post-WWII era remotely comparable to today led to the three big recessions of the past 80 years.

Meanwhile, signs of weakness in the U.S. economy refuse to dissipate and, if anything, to grow. The Conference Board's Index of Leading Economic Indicators, a fail-free forecaster of recessions over the past 65 years, has not seen an increase in a record 27 months. As with the yield curve, the only other

prolonged periods of weakness were prior to the two deepest recessions of the post-WWII era. Small businesses are more pessimistic than at any time in the past 40 years, except for the Global Financial Crisis. The ISM Report on Business showed that the U.S. manufacturing sector contracted in June for the 19th time in the past 20 months. The percentage of Americans planning to buy a home is lower than the trough levels of all of the eleven past recessions and the percentage planning to buy a car is below the trough levels in ten of them. Economic concerns are not confined to the United States. China, Japan, Europe, and the U.K., representing 42% of global GDP, are all struggling. Of course, the one big bell that has not rung is unemployment, but, even here, things are starting to deteriorate. The unemployment rate in the U.S. has risen from a low of 3.4% to 4.1%, in Canada, from 5.0% to 6.4%, in Sweden, from 7.1% to 8.3%, and the unemployment rate of 6.0% in Germany is at its highest in two years.

Of course, when it comes to economic weakness, many in the investment community say, “Bring it on!” because it means some serious monetary ease. The share of the world’s central banks in easing cycles has already climbed to its highest since March 2022 and that number is expected to double by the 4th quarter of this year. But while monetary ease is undoubtedly good news for bonds and certain areas of the stock market, the positive impact of the lower interest rates on the economy and on equities generally may take a while to unfold. In the case of the last six U.S. recessions, GDP did not bottom out on average until more than two years after the final rate hike and the economic effect of an inverted curve has historically been felt for a period of 15 or more months after the curve disinverts (short rates fall below longer rates), something that has yet to happen in this cycle. In addition, since WWII, 13 of the 14 rising interest rate cycles led to a recession in earnings and the one that didn’t was a very different beast (e.g., the yield curve never inverted). This is important because a decline in stock prices has been - not surprisingly - correlated with a decline in earnings and analysts today are currently expecting a big bump in earnings in the year ahead.

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