July 9, 2024

Dear Client,

Re: **July Conference Call on Wednesday, July 24, 2024 at 6:30 PM**

As we enter the second half of the year, we are experiencing something of what Albert Einstein proposed, a parallel universe. What differs from Einstein's version is that the stock market and the economy are not aligning in parallel, in fact, they are starting to move in opposite directions.

As I wrote in BFSG's quarterly newsletter, *Perspectives,* which you will receive soon, there is no doubt that artificial intelligence is real but has gotten ahead of itself. In the information technology boom of the late 1980's to the early 2000's, economic productivity increased about 2%. If you think about how that information technology productivity impacted the world, you would be amazed, but still only impacted growth by 2% or so. Therefore, as hyped up as AI is, it is unlikely to add much more than 2% by 2035. If I am correct in my assumption, then the AI hype in the markets is overblown and could be susceptible to a correction.

The economic indicators that I use to gauge the economy and the portfolios are flashing red. Could I be early and too conservative like I was last year? Of course, that is a possibility. However, the facts are the facts, and the stock market appears to be overvalued. According to Validea's valuation gauge, the U.S. mega-cap stocks are overvalued by 30% and can be bought cheaper 90% of the time (See Image 1), while the broad U.S. stock market is fairly valued and can be bought cheaper 54% of the time (See Image 2).[1] I don't believe the soft-landing scenario, simply because it has rarely happened before. In previous newsletters, I have talked about hard landing or no landing because to perfectly land a complex economy such as ours is more than difficult. We can see that interest rates are biting and the consumer is running out of money. Credit card delinquencies are up, and it costs more to buy a hamburger and fries at McDonald's. Commercial real estate is tottering, and banks' balance sheets are full of less-than-market-value mortgages. Wage pressures have eased, and it is taking workers much more time to find a job. According to Indeed, the online job posting website, job openings have declined by at least 4% (See Chart 3). I could go on and on, but this is the parallel universe, an economy that is deteriorating and a high-flying stock market due to the hype of AI. The question lies in why the AI stocks have outperformed everything else. One is human behavior and the other is easy money supplied by the Federal Government.

<u>Image 1</u>: U.S. Mega-Cap Stocks

Current Mega-Cap TTM PE Ratio: **25.14**
Average Mega-Cap TTM PE Ratio: **19.27**
Over (Under) Valuation: **30.5%**
Historical High Mega-Cap TTM PE Ratio: **31.84 - 4/9/2021**
Historical Low Mega-Cap TTM PE Ratio: **10.73 - 11/20/2008**
Percentage of Time Mega-Cap Stocks Have Been Cheaper: **90.8%**

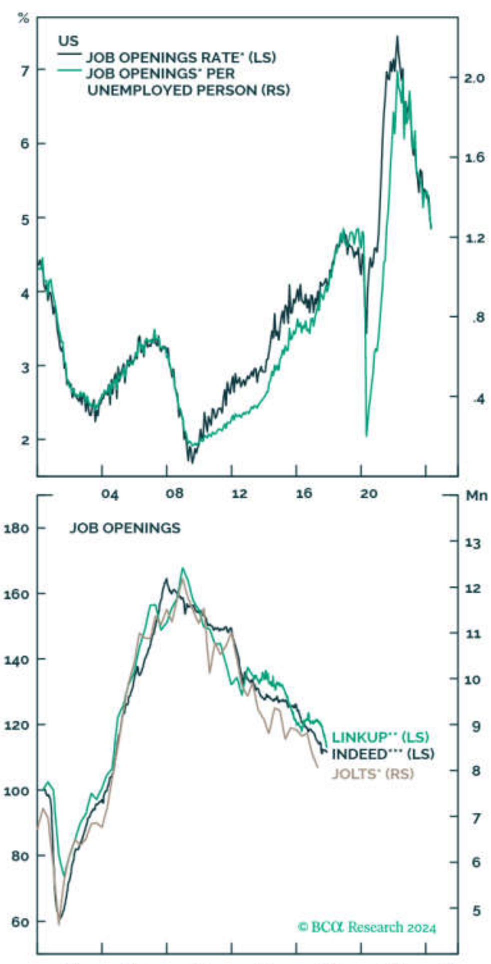
Source: Validea.com

<u>Image 2</u>: The Broad U.S. Stock Market

Current US TTM PE Ratio: **20.92**
Average US TTM PE Ratio: **20.48**
Over (Under) Valuation: **2.2%**
Historical High US TTM PE Ratio: **28.84 - 1/12/2021**
Historical Low US TTM PE Ratio: **10.49 - 11/20/2008**
Percentage of Time US Stocks Have Been Cheaper: **54.9%**

Source: Validea.com

<u>Chart 3</u>: Number of Job Openings Are Declining



* SOURCE: JOB OPENINGS AND LABOR TURNOVER SURVEY (JOLTS), BUREAU OF LABOR STATISTICS (BLS).
** SERIES INDEXED TO FEB. 1, 2020 = 100. SOURCE: LINKUP.
*** SERIES INDEXED TO FEB. 1, 2020 = 100. SOURCE: INDEED.

Source: BCA Research

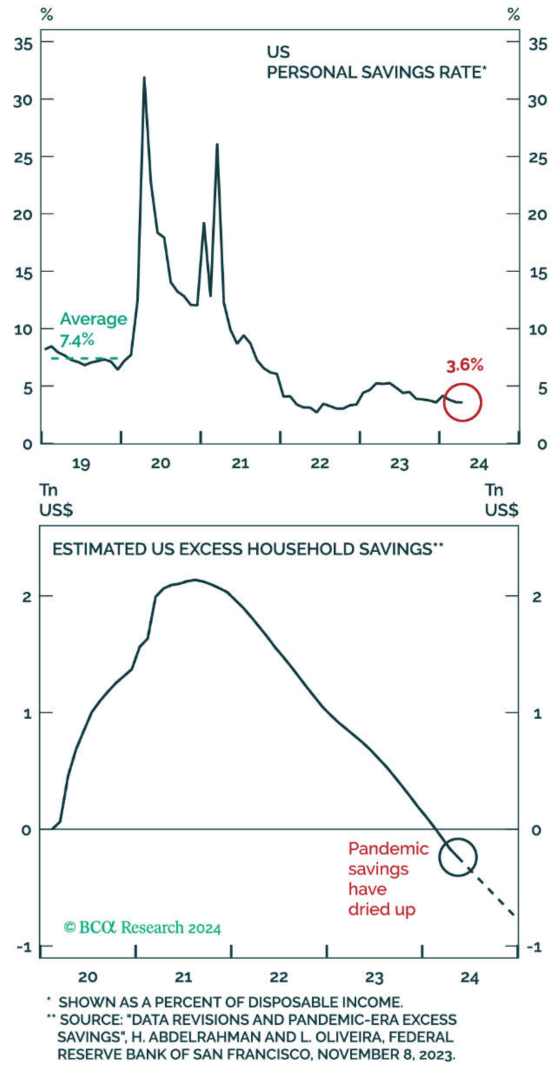
Behavioral finance tells us that humans want to be part of the crowd when an event occurs. Essentially, people loath the fear of missing out. If your neighbor is making a killing on Nvidia and you are not, you feel inadequate and want to participate. But what your neighbor never tells you is how much he or she has lost because of this gambling behavior. For example, if you had bought one of the market darlings, like Cisco, during the dot.com runup from 1999 to 2003, you would still have less money in 2024, even though Cisco has higher earnings and revenues now (See Chart 4). This is the price you pay when you overpay for stocks and bonds.

Chart 4: Cisco (CSCO)

Source: BigCharts.com

The second reason why some but not all high-flying tech stocks went ballistic even though, in my opinion, economic value does not justify their high prices, is because the government flooded the economy with cheap and easy money (See Chart 5). However, all that money is now spent, and consumers could be forced to spend more than they have due to a lack of savings, higher than normal inflation, and a rising unemployment rate. This reduced spending and higher unemployment is what could cause a recession as consumers have less to spend, find credit availability limited, and as unemployment continues to creep up. Companies are bound to cut production, which increases unemployment, and therefore we have a negative feedback loop.

Chart 5: US Households Will Need to Spend Less Now That They Have Run Out of Excess Savings (next page)



Source: BCA Research

Although I don't expect a recession like the Great Financial Crisis of 2008, there appears to be a series of negative feedback loops that will weaken the economy in the latter part of this year or the early part of next year. High interest rates are starting to bite, and the Federal Reserve likely won't lower interest rates until it is too late. Inflation, although coming down dramatically from over 10%, is still rising at about 3.5%. The Federal Reserve knows if they lower interest rates too soon or by too much, they could reignite inflation. That's the last thing they want to do. The cure for high inflation is higher unemployment and lower demand.

At some point, the Federal Reserve and the U.S. Government will have to deal with the $35 trillion dollar debt overhang. If the Federal Reserve monetizes the debt by keeping interest rates artificially low, then inflation could reignite higher, bond yields could spike and housing could fall off. If the government goes on an austerity diet, then aggregate demand will drop, but that may be politically challenging.

If this all comes together as I suspect, then a recession may occur late in the year or early next year. Although I am cautiously optimistic for the next 4 months, we are watching for any signs of deterioration and are defensive in nature. While a recession would be bad for stocks, it would be good for bonds. This is why we have always had a sizable bond component to cushion the downside of any market downturn. We constantly are balancing risk and reward in our decision-making process.

Peter Berezin of BCA estimates that the fair value of the S&P 500 is 3750. As of July 3, 2024, it traded at 5537, which could represent a 33% decline, which would not be surprising as this has happened before. If the S&P 500 dropped by that magnitude, it would wipe out approximately three years of gains.

We will be discussing this in our next conference call on **Wednesday, July 24th at 6:30 PM**. We look forward to a lively conversation. Also, please join us for Live at BFSG every Thursday at 9:00 AM.

Please click here to join the Conference Call.

Or Telephone: 1 (720) 707-2699
Webinar ID: 955 8799 7509
Passcode: 388235

International numbers available: click here

Best regards,

Steve Yamshon, PhD
Managing Principal

1. Source: Validea. Mega-cap stocks are stocks with a market capitalization greater than $50 billion. The broad U.S. stock market is reflective of the Dow Jones U.S. Broad Stock Market Index, which is designed to measure the performance of large-, mid- and small-cap U.S. equity securities.
2. Source: BCA Research.
3. Source: BigCharts.com.