46 PEAKS
INVESTMENT ADVISORY GROUP

Partying like it's 1999.

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The year was 1999. You're forgiven for not knowing that Cher's "*Believe*" was the #1 song that year. Notable events included the anxious buildup to the potential "Y2K" doomsday computer glitch and the Space Shuttle Discovery becoming the first vessel to dock with the ISS (International Space Station). It also was a time when markets were abuzz with the nearly limitless potential of the internet - investors were inventing new ways to measure business success including website clicks and "eyeballs". Tech stock prices soared like rocket ships.

Cisco and America Online were two of the most prominent Large Tech stocks that year. But a lesser-known chip maker, Qualcomm, had the highest return in1999 – up 2,587%. Investors piled into Large Cap Growth stocks and diversification was a four-letter word. As you can see in this table, stock market performance was lopsided:

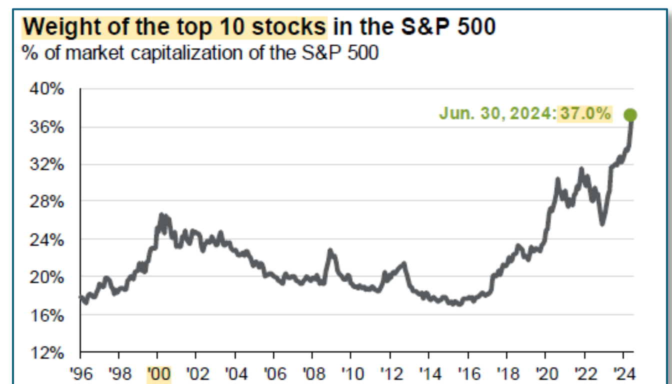
Category	Index	1998	1999	1998-1999
Large Cap Core	S&P 500	28.58%	21.04%	55.6%
Large Cap Growth	S&P 500 Growth	38.16%	37.38%	89.8%
Mid Cap Core	S&P 400	19.11%	14.72%	36.6%
Small Cap Core	S&P 600	-1.31%	12.40%	10.9%

It was the first decade of my career and like many experiences before the years all started blending together, I have a vivid memory of those times. Stocks seemingly went up every day. It was fun. Even though I was fairly early in my professional journey, I realized it was ridiculous. It couldn't last. I won't forget that feeling. In years since, I figured there was no way that could happen again. Perhaps it's part of human cycles resulting from the retirement of the more experienced, but it may be happening again today. Looking at those same four categories of stock markets over the last 18 months reveals that recent stock market performance has been remarkably similar to that of the late 1990's.

Category	Index	2023	YTD 2024	Last 18 Months
Large Cap Core	S&P 500	26.2%	15.3%	45.5%
Large Cap Growth	S&P 500 Growth	42.7%	20.7%	72.1%
Mid Cap Core	S&P 400	16.0%	4.9%	21.7%
Small Cap Core	S&P 600	16.1%	-0.8%	15.1%

In some ways, recent performance has been **even more one sided**. In the late 90's, non-U.S. stocks almost kept pace with U.S. stocks. But over the last 18 months they have returned only about 55% of the gain of the S&P 500. And if we look at Bonds, over '98-'99, Core Bonds returned 7.8%. The last 18 months? Only 4.8%.

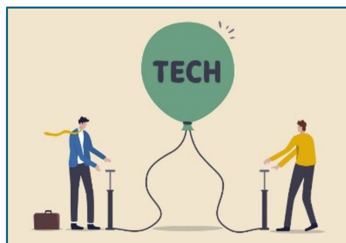
The rally in the S&P 500 index, and in particular Growth stocks, has not exactly been broad based. No, this historic recent performance has not been a rising-tide-lifts-all-boats kind of market. It's been driven by only a small number of the largest stocks. As a result, by some metrics, the U.S. stock market is more concentrated in its largest stocks than at any other time in its history. The top ten companies in the S&P 500 make up **37% of the index's total value** (market cap). You can see on this chart how today's concentration is far higher than we experienced at the height of the Tech bubble in 1999 – 2000.



For some added context, consider that for decades, a weight of 5% was the largest allocation that any single stock could hold in a mutual fund while still being considered "diversified". Today, there are three stocks each worth more than 6.5% of the S&P 500 index. Those top three account for about 21% of its value. That's **not diversification**. That's concentration.

While the largest stocks in the S&P 500 index are mostly household names – Microsoft, Apple, Amazon, Google – the index's performance over the last two years has been driven more so by a company that few households are familiar with. NVIDIA, which sounds more like a suggested default password for a Wi-Fi network than the name of one of the largest companies in the world, makes computer chips and hardware used in Artificial Intelligence (AI). In the first half of the year, it was up almost 150%. Without NVIDIA, instead of 15.3%, the S&P 500's first half return would have been about 10.7%. Think about that for a second. The flagship index of 500 large, established, high quality U.S. stocks would have returned 4.6% less over a six-month period if only one single stock that most people have never heard of was removed. If you removed the entire Magnificent 7 stocks, the y-t-d return would shrink from an impressive 15.3% to a more pedestrian 6.3%.

Looking back to the late 1990's something similar happened. We already mentioned that lesser-known computer chip maker Qualcomm was the #1 performing stock in 1999. Another, more well-known company, Cisco Systems was making the "plumbing" for the internet and its stock price was on fire. At its peak on 3/27/2000, Cisco's valuation was 5.5% of U.S. GDP. How does that compare to NVIDIA today? Well, NVIDIA's valuation was recently worth 11.7% of U.S. GDP. That's more than the entire U.S. oil and gas industry. **More than Amazon and Berkshire Hathaway combined**. It's hard to get your head around that.



When passionate investors talk about these high performing Tech stocks, most of the arguments start and stop with fans saying: "*It's a Great Company!*". Cisco and Qualcomm were both great companies in 2000. But after the Tech bubble burst and their stocks tanked, Qualcomm took more than two decades to recapture its 2000 share price level and Cisco still has not. Why? **Valuation**. How do today's "great companies" compare? This chart shows the Price/Sales (P/S) ratio for the S&P 500 Technology sector starting in the mid 1990's. The current P/S ratio far exceeds that of 1999-2000, and at 9.25X, is at levels normally justified by only young, small, and extremely fast-growing companies. To value a $3 Trillion company at these levels is extremely optimistic, to put it mildly.

These valuations are largely dependent on hope that AI is going to be "the next industrial revolution". Will it be? We don't know. The technology is amazing. Scary in some ways. But Goldman Sachs' Head of Global Equity Research thinks the cost / benefit outlook for AI is not favorable, mainly because it is so expensive to build and to run, and its economic benefit for many companies may not compare favorably to its cost.

Nonetheless, a few research firms that we trust think we are still in the early stages of an AI bubble that will power Tech stock prices much higher in the year ahead. Former Federal Reserve Chairman Alan Greenspan used the term "*irrational exuberance*" to describe Tech stock prices in December 1996 - more than three years before the stock market peaked – a reminder that high valuations can get higher. Yet, when they turn, they can turn quickly. We think investors without the sharpest long-term memories cannot even imagine how much and how quickly an overpriced market darling can fall. Here's a trivia question for you…What was **the largest one-day percentage drop in Apple stock during the last 25 years**? (Mind you, we're not looking all the way back to 1980 when Apple initially went public.) Think of a number in % terms. Answer to come later.

These large Tech stocks have rallied due to not just to the potential of AI, but also thanks to the economic tightrope that the U.S. has navigated the last two years. Having avoided a recession thus far, nowadays it seems everyone is on the "soft landing" train, where the economy cools perfectly to bring inflation down, without a painful recession or significant job losses. We were somewhat skeptical of the recession chorus in 2023, partly because it felt unanimous. For the same reason, we're growing skeptical of the "no-recession" majority now. But there's more to it than just our contrarian streak. Where there's smoke, there's fire, and we see smoke in several economic metrics.

The most important indicator of weakness may be that **the job market is clearly weakening**. Unemployment has risen from a low of 3.4% to 4.1%. Layoffs are rising. A key metric – those who are unemployed for an extended period – is drifting higher. While it hasn't rung the "recession is definitely coming" bell yet, the job market has its hand on the rope.

Other, non-labor-market metrics are telling. **Construction permits and starts have plummeted**. In June, construction layoffs spiked to their highest levels since the dawn of the Great Financial Crisis in September 2007.

Looking at **consumer credit**, we also see a lot of smoke. Credit card delinquencies are spiking and have risen for ten straight quarters. Auto loan delinquencies are rising as well. Small businesses are hurting too – U.S. Corporate bankruptcies are at their highest levels since 2010.

On the other hand, metrics that reflect the economic health of wealthier people look good. The $15.7 Trillion gain in the U.S. stock and bond market since 11/1/23 likely has a lot to do with it. Home price gains too. To wit, restaurant traffic is strong. TSA Travel volumes are high and more Americans plan to take a vacation to a foreign country this summer than ever before. It seems that there are two economies right now. If you own your home and have a stock portfolio - your net worth is up sharply and you're feeling good. But those in the lower half of the income spectrum are feeling the pain of inflation and a tighter job market.

There's also smoke coming from broad economic indicators and metrics. When analyzing markets, metaphorically, it's not just important to know if the tide is high or low, it's also important to know if the tide is coming in or going out. Recent trends are ugly – The Bloomberg **US Economic Surprise Index** has plunged from broadly positive last year to sharply negative in May. The current level of negative surprises is at a <u>9-year low</u>.

Some good news - Progress has been made on the inflation front and there's reason for optimism that it will continue. Headline CPI inflation figures, down to 3.3%, have been bolstered by two factors that should ease in the months ahead - housing (rent) and car insurance. Many analysts think inflation very well could get under 3.0% by early 2025. We're inclined to agree.

Perhaps the best news for investors is that the weakness in the economy and the labor market can open the door for the Federal Reserve to lower interest rates. The Fed itself is predicting slightly lower rates by the end of the year. Other countries' Central Banks have already started, and it appears that we are in the early days of a regime change to looser policy and lower rates. All else being equal, that should help the economy and is bullish for stock and bond markets. But when the Fed starts cutting rates, **all else is usually not equal** – historically, the Fed has often been "too late", and the damage has already been done to businesses and consumers. If that's the case this time, we may still be heading toward a meaningful economic slowdown or recession.

Looking forward, while we remain more open-minded than most to the possibility of a recession in the next 6-12 months, we continue to think that the economic picture is murky. As we've discussed many times over the last few years, historical models have proven virtually useless in the current environment. As a result, in the markets, we remain neither overly pessimistic nor optimistic. Considering how calm things have been lately, it's easy to think volatility "must" go up soon. But there are a couple of old sayings pertinent to the current environment - "*it's a bull market until proven otherwise*" and "*never short a dull market*". These quips remind investors that **momentum is a powerful factor**. When volatility does return, and it always does, as long as we avoid a recession, downside risks are likely limited to a typical 8-10% correction.

From a portfolio design perspective, we think there are opportunities for investments other than Large Tech stocks to contribute to portfolio performance and for diversification to reward patient investors once again. As the kids would say "*it's been a minute*" since that was the case - For **the last three years** through June, while Large Cap U.S. stocks have gained an average of 10% per year, Small Cap stocks have <u>declined</u> 2.6% annually. Emerging Market stocks are <u>down</u> 3.9% per year. The Equal Weight S&P 500 index has trailed the Cap-Weight version by over 15% in total. International stocks are up a paltry 1.5%. And Core Bonds have <u>lost about 10%</u> in aggregate over the last 3 years. Many asset categories are trailing U.S. Large Caps by record amounts over the last three years. We're not the biggest fans of the "reversion to the mean" argument, but we are keenly aware that the law of cycles and valuation has not been repealed.

For those frustrated with diversification or tempted to embrace the "*why invest in anything other than U.S. Tech stocks*" philosophy, let's get in our time capsule, return to 2003, and review what happened in the four years following 1999.

Category	Index	1998-1999	2000-2002	2003	2000-2003	1998-2003
Large Cap Core	S&P 500	55.6%	-37.6%	28.7%	-19.7%	25.0%
Large Cap Core EW	S&P 500 Equal Weight	25.7%	-10.6%	39.6%	24.8%	56.8%
Large Cap Growth	S&P 500 Growth	**89.8%**	-51.2%	27.1%	-38.0%	**17.6%**
Mid Cap Core	S&P 400	36.6%	-0.1%	35.6%	35.4%	85.0%
Small Cap Core	S&P 600	10.9%	1.7%	38.8%	41.1%	56.6%
Core Bonds	Bloomberg AGG	7.8%	33.5%	4.1%	38.9%	49.7%

After enjoying gains of nearly 90% over a two-year period of '98-'99, Large Growth stocks lost more than half their value over the three-year period 2000-2002. While they bounced back in 2003, Mid-Caps and Small Caps bounced back even more. As you can see in the far-right column, for the full six-year period '98-'03, Large Growth stocks, and even **the broad S&P 500, severely underperformed all other major U.S. equity categories, and Core Bonds**. We are not predicting a repeat of this. But with each passing month where U.S. Large Growth stocks trounce everything else, and as their valuations get richer and richer, we think it's important for investors to be open minded to a variety of outcomes and to tilt portfolios toward both diversifiers and risk mitigators. After all, to answer the earlier trivia question, on September 29th, 2000, Apple stock dropped…**51.9%. In one day**. While investors in NVIDIA or Apple likely think that would be impossible today, I'm sure it felt impossible on September 28, 2000, as well.

We have high conviction that one area that might help investors in the years ahead is the rest of the S&P 500, outside of the top stocks. You can see in the table above that the "equal-weighted" S&P 500 index, which trailed the standard S&P 500 index miserably from 1998-99, performed relatively spectacularly from 2000-2003. We have an equal-weight S&P 500 based strategy in many of our portfolios.

Another area of potential portfolio support could come from International Stocks. I know that nobody wants to hear about International Stock investing, but since we're talking about individual stocks in this note, let's discuss a couple. The largest producer of computer chips in the world is not in the U.S. It's Taiwan Semiconductor. Turning to Healthcare, do you know anybody taking Ozempic? It's made by a company called Novo Nordisk from the lovely country of Denmark. It's not just an individual stock story – non-U.S. stock benchmarks current trade at a whopping 36% discount to U.S. Large Cap stocks. With more Tech and Healthcare stocks around the world now than in the past, non-U.S. investing may have a chance at better performance than when those markets were dominated by long-tenured financial and energy companies.

Clearly, this is a challenging environment for investors - the seductive powers of U.S. Tech stocks are strong. But the scars of history from 1999 have not gone away and neither should their lessons. The period of 2000-2002 should serve as a reminder of what can go wrong. On top of it, there is still a lot of uncertainty about whether the Fed and the economy can successfully "stick" the usually elusive soft landing or if we'll slip into a recession now that most analysts think we won't. To us, there's an increasing likelihood that markets experience a change of tone. While the bull market in Large U.S. Tech stocks can certainly last much longer, it also **may be ending right now**. Market action in July has significantly favored Small-Caps, Mid-Caps, Non-U.S. Stocks and Core Bonds. Thus, now more than ever, it is important for investors to remember that unless you're considerably aggressive with a high tolerance for portfolio declines and a long time horizon, it's critical to "believe" in the importance of diversification, patience, and risk management.

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