46 PEAKS
INVESTMENT ADVISORY GROUP

Bang, Zoom. To the Moon.

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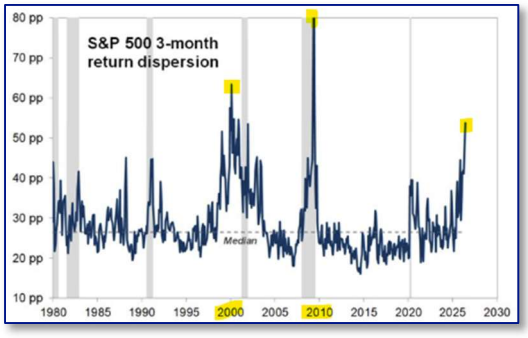
What a time to be an investor. As America celebrates its 250th birthday, the U.S. has dominated global stock markets for the past 15 years and, outside of 2000 – 2007, much of the last 35 years. Many stock market categories in the U.S. and around the world are forging all-time highs. And two historic, life-changing innovation cycles are seemingly just getting started. On top of that, fixed income yields now provide real returns, while arguments grow stronger that private investments and hedge-fund-like alternative strategies are becoming less "alternative" and more essential to improving the risk/return experience.

Only three months ago, the environment was unsettling. Facing uncertainty over the war with Iran and the effect of higher oil and shipping prices on the global economy, the S&P 500 had just experienced its worst quarter in four years (down 4.4%). But with "peace" a growing possibility, the index rebounded in the 2nd quarter, rising 14.9% - its best quarterly gain in six years. Talk about a quick turnaround. In fact, April and May were the **fourth best two-month returns for the S&P 500 in the last 75+ years**!

The rally has not been without some chop under the surface. Rotation has been a defining feature of the market this year. Multiple sectors - Utilities, Health Care, and Consumer Discretionary - moved between top and bottom performers throughout the year. While eight sectors saw declines over 10%, the S&P 500 index as a whole avoided a double-digit drop in the first half.

This chart shows the extreme level of dispersion in the stock market – currently at levels only seen twice before since 1980. The two previous spikes preceded major bear markets, although we'd caution that two signals do not a rule make.



Dispersion and reversals were not limited to stock sectors. Five months ago, there was seemingly unanimous agreement that the U.S. Dollar was in a downward spiral and if you recall, Gold and Silver were running up like hot meme stocks. Since then? Over the last five months, the U.S. Dollar has rallied 7% while **Gold has dropped 26%** and Silver has plunged 50%! While all of this intra-market volatility can create short-term opportunities, it's also easy to get burned chasing fads. Be careful out there.

Importantly, **Emerging Markets led in the 2nd quarter**, gaining 23.4%, and are up 25.6% year to date, driven largely by semiconductor stock strength in South Korea and Taiwan. U.S. investors should be aware that today, three of the most important Tech stocks in the world are in Taiwan and South Korea, (while another is in the Netherlands).

The economy continues to exhibit **resilience and adaptability**. Much like the stock market, we see frequent handoffs and rolling periods of strength from one economic sector to another. When one sector stumbles, another takes the baton. This dynamic has kept the U.S. economy out of a recession since Covid, and we think the odds of a recession in the next twelve months remain low.

Consumer sentiment, however, remains challenging. Part of the reason is politics – Democratic consumers sentiment is very low, while Republican consumers are much more optimistic. And then there's the dynamics of the K-shaped economy, where lower end consumers are struggling more with inflation and slowing wage growth than more wealthy consumers, who are enjoying their rising property and portfolio values.

In spite of these sentiment

divergences, **overall spending continues to hold up** – it's simply very hard to get Americans to cut down on their spending. And while our "peace" with Iran has been disrupted again in July, it still seems likely that this war will not grind on indefinitely like the one between Russia and Ukraine. At some point, trade through the Strait of Hormuz should return closer to normal and oil prices will find their economically comfortable equilibrium level. (Although recent events are certainly making this look less certain.)

Due in large part to the war, inflation this year is not going as planned. The U.S. economy in Q2 was defined by a shift toward **more persistent inflation**, with headline PCE inflation reaching 4.1% in May and Core (excluding more volatile food and energy) rising to 3.4%, both the highest levels since 2023. This increase was driven by elevated energy prices. June's inflation numbers just came in and they were lower than expected, thanks of course, to the recent decline in the price of oil.

Notably, a new Federal Reserve Chairman (Kevin Warsh) took the reins in the 2nd quarter. Even though he came out of the gates charging with enthusiasm, a plan to change a few protocols at the Fed, and a commitment to reduce inflation, markets took it in stride.

We can't cover the 2nd quarter of 2026 without mentioning SpaceX. In short, we think it's safe to say that **SpaceX is potentially one of the most important companies, and IPO's, in the history of the world**.

The sheer $1.25 Trillion size of the SpaceX IPO speaks to the size and importance of the Space economy in general. This is not about headline grabbing colonization of Mars or the Moon. There are things that **can be done in zero gravity that are impossible on Earth**, including drug development, electronic component manufacturing, and even human organ farming. Need a new kidney? An upstart biotech company will grow one for you in space, SpaceX will transport it back to Earth, and then a robot will swap your old one for a new one. Another example - Elon Musk predicts that the earthbound data centers necessary to support A.I. will become obsolete because they can be replicated in space where solar energy is free and abundant, and the data centers do not need complex cooling systems.

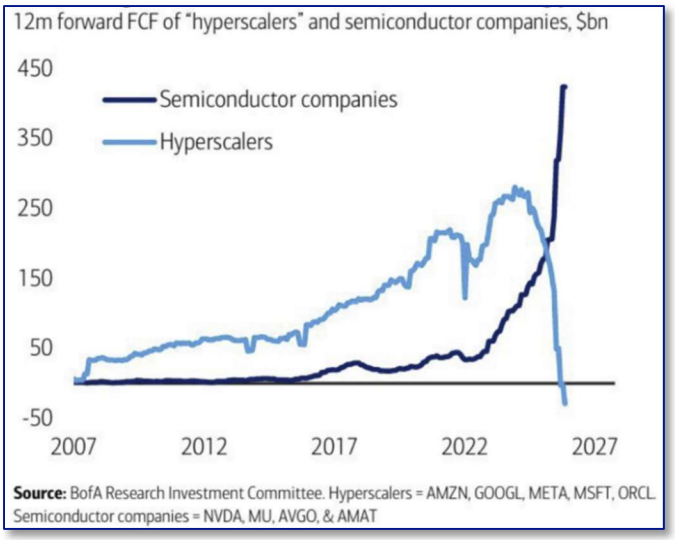
What about SpaceX's $1.25 Trillion IPO valuation? Is it warranted? It depends on how much you prefer to think about "*what can go right*" instead of "*what can go wrong*". Famous and visionary growth stock investor Ron Baron predicts SpaceX will be worth $10-$30 trillion in 10-20 years as it dominates the extension of the earthbound economy into space. The more "grounded" Morningstar Research, on the other hand, argues that SpaceX is currently worth only $780 billion. To us, since we are talking about entirely new business models and opportunities that may not even exist yet, it's simply impossible to confidently handicap the future of the space economy and the value of SpaceX.

Unrelated to the Space economy, but similarly important to investors, the Space X IPO highlights significant changes in the venture capital, IPO, and innovation company timeline. The typical IPO from 1999-2005 occurred when a company was a little over 3 years old and at about a 4x return on investment. At the time of their initial public offerings (IPOs), Amazon was 2 years old, Apple was 4 years old, Facebook was 8 years old. **SpaceX is a 24-year-old company**. Nowadays, to participate in the growth of the most significant and dynamic companies in the economy, investors need to invest in private, illiquid companies. Of course, the risk and illiquidity of these investments mean they are only suitable for more aggressive and patient investors with long-term horizons.

As we've mentioned previously, Artificial Intelligence (A.I.) is now THE key driver of the U.S. and global economy. And will be for years. It's hard to understate the potential. It's also easy to make bold, and likely wrong predictions. For one, we think the "*A.I. will kill all the jobs*" narrative is likely wrong. A theory called The Jevon's Paradox argues that **increasing the efficiency of a resource lowers its cost, which drastically increases demand, ultimately requiring *more* total resources** (and labor) than before. In other words, instead of destroying a field, extreme efficiency makes the field explode in size since demand skyrockets when costs per unit go down. There are countless examples of this occurring over the past 10-20, even 100 years - the original concept dates to 1865.

For investors, figuring out how and when A.I. will affect different industries and stocks, and to what extent, is not so easy. These riddles, uncertainties, and related handoffs may fuel volatility for a long time. The current state of A.I. is that the largest firms known as "Hyperscalers" (Google, Amazon, Facebook, Microsoft, and Oracle)

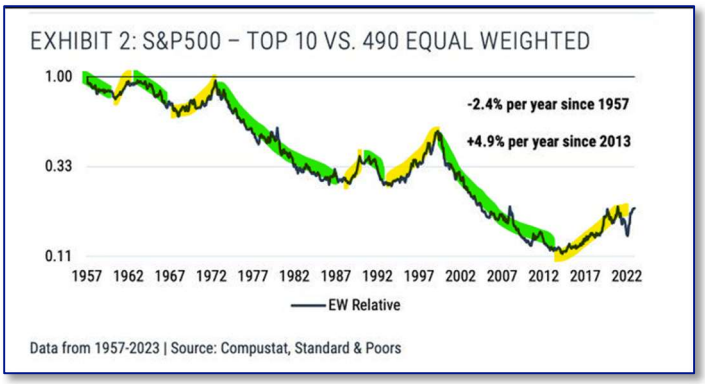
are spending enormous sums of money investing in A.I., much of it on semiconductors. This striking chart shows the net free cash flow over time for these two categories.



We don't know if there's ever been a transfer of spending this dramatic - maybe when the automobile or locomotive were invented? **Extremes like this don't last forever.** This creates some important questions that investors and markets will face over the next 12-24 months:

- Can the largest firms convert their massive A.I. investments into profits?
- If they can't convert this spending to profits, how much of a hit will their stocks take?
- When the investment cycle slows, how sharply will semiconductor stocks drop? (Could be more than 50%)
- Can a slowing of the A.I. buildout trigger a larger bear market in stocks, which might even spark a recession?
- How and when, if ever, will the rest of the global economy benefit from AI?

These questions create a framework for a **potentially substantial change in market dynamics** going forward. This chart, going all the way back to 1957, shows the relative performance of the top 10 largest stocks in the stock market vs. the performance of the remaining 490. Highlighted in yellow are periods when the 10 largest stocks outperform. Periods highlighted in green are when the "next 490" outperform.



While most readers would be unsurprised to learn that a basket of the ten largest stocks outperformed the "next 490" by a significant 4.9% annualized from 2013 through 2023, you might be surprised to learn that the "next 490" **outperformed the top ten by 2.4%/yr since 1957**. As the green highlights illustrate, periods of outperformance by the "next 490" can last a long time. If the top 10 stocks fail to realize profits proportionate to their A.I. investment, and if the rest of the economy ultimately realizes profitability and productivity benefits from A.I., the next cycle could see a new cycle of outperformance from stocks outside the ten largest.

While the SpaceX IPO, the enthusiasm around A.I., and strong 2Q returns have many excited about the markets, an honest evaluation of the current landscape has us saying…"***Houston, we may have a problem."*** Consider:

- Stock market valuations and concentration are high. Rich valuations leave little margin for error if earnings disappoint. The A.I. euphoria has created a stock market valuation/concentration profile not seen since the top of the Tech bubble in 2000.
- The Fed's target for inflation is 2.0%. It's been **over 2.0% for over five years** now. Inflation is the enemy of stocks and bonds (consumers and savers too).
- The new boss in town at the Federal Reserve, like any new CEO, **has only one chance to make a first impression** and the first 6-12 months may be more drastic than the market anticipates. A surprise Fed rate hike could spell big trouble for both stocks and bonds.
- To us, even more worrisome than the level of rates and a potential minor 0.25% hike is the **disconnect between bond interest rates and inflation over the past few months**. This chart shows how the price of oil (green line) and the 2 years U.S. Treasury yield (orange line) have been dancing partners for most of the last

few years – until the last six weeks, when they have diverged sharply.

- There are a few conclusions one could draw from this sudden divergence, **none of them are good**. First, in the short-term, the supply of debt is overwhelming investors – there's simply too much debt (Government and Corporate) to be absorbed. Secondly, more long-term, the market may be increasingly concerned about the U.S. fiscal position. Apollo's Chief Economist, Torsten Stork posited that – "*The oil shock may be over, but the interest rate shock may be just beginning*."
- **Speculation in the global stock markets is rampant** – the use of leverage, and derivatives are high. Compounding risks, investor sentiment is dangerously complacent and unanimously bullish. These conditions often precede violent reversals.

In spite of these concerns, as we look toward the rest of the year, we find some strong arguments for continued gains (but with some short-term turbulence likely).

For one, **strong momentum in the markets often continues**. Historically, quarterly gains above 12% (like we had in the 2nd quarter) have often been followed by further upside, with the S&P 500 rising over the next six months about 75% of the time with a median gain near 10%. Looking 12 months out following the previous 14 strongest two-month rallies, the S&P 500 was higher 13 of those 14 times, with an average return of 23.5%!

Tempering that intermediate term optimism - seasonality for August and September is traditionally weak. Further, **the run up to mid-term elections is historically challenging** - on average, markets trend lower for 3-4 months up until about a month prior to the mid-term.

So, while we would not be surprised to see an 8-12% stock market decline between now and early October, as long as the Iran war cools down, we **expect the economy and markets to remain resilient**. Investors should brace for some sharp, short-term volatility – that seems to be a key attribute of markets nowadays - especially as we head into the mid-term election.

While we won't make any predictions about the next 250 years, as an American and an investor, it's **exciting that the U.S. is the clear global leader on today's two historically disruptive mega-trends** – A.I. and the Space Economy. But that doesn't mean there are not significant opportunities overseas either. Those opportunities, the increased importance of private markets, and a potential handoff from the top ten stocks to the "next 490", means we may very well be in the early days on a transfer of leadership from what worked the past 15 years to what will drive returns going forward. But as we outlined earlier, there are risks aplenty. Much like planning a summer trip with an unpredictable chance of severe thunderstorms (or even smokey haze), investors will need to be well prepared for a variety of outcomes, keep their options open, and monitor the skies and winds closely.

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