R Thoughts

Morgan Stanley

The Diamond Peak Group
at
Morgan Stanley

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> "It's unbelievable how much you don't know about the game you've been playing all your life."
>
> New York Yankees Hall of Fame Baseball Player Mickey Mantle

We feel ya Mick, we really do.

Given the data we constantly review and drawing from our many years of experience in the financial markets, we continue to be confounded by the relentless advance of the U.S. major market indexes like the S&P 500 and NASDAQ.

More on this in a bit.

The Stock Markets

Quickly reviewing the first quarter of 2024 we found that despite sticky inflation which cast doubt on the pace of anticipated interest rate cuts, the rally in U.S. stocks that began in the final three months of 2023 extended though the first three months of this year. The S&P 500 advanced more than 10%, hitting several record highs and crossed above 5,000 for the first time. This marks the first time the S&P has posted double-digit gains in consecutive quarters since 2012.

This rally broadened out as nearly every sector of the S&P 500 except real estate, finished the quarter in positive territory. Not surprisingly, technology stocks, especially those in the artificial intelligence (AI) space, outperformed. Energy stocks, buoyed by rising oil prices, also performed well.

Interest rates rose throughout the quarter with uncertainty regarding the prospects for rate cuts pushing longer-term U.S. Treasury yields higher and bond prices lower. The 10-year US Treasury yield rose from around 3.8% to 4.4%.[1]

Commodity prices perked up after slumping late in 2023 as the S&P GSCI Commodity Index gained more than 8.5%. Energy advanced as crude oil and gasoline gained more than 15% and 20% respectively.[1] Gold gained just over 7.5% and currently trades at $2365/oz.—a record high.[2] Although a welcome respite for commodity investors—these increases—which affect almost each and every raw material produced—are inconsistent with the current popular mantra of controlled inflation and lower interest rates.

The current market premise—the popular view—is the outlook for the U.S. economy is moving from a "soft landing" or a minor recession to one of a "no-landing" scenario—no recession, above expected economic growth and lower interest rates engineered by the Federal Reserve. This "Goldilocks" view of the markets and the economy anticipates higher corporate profits and lower interest rates allowing the potential for even more upward momentum in stock prices.

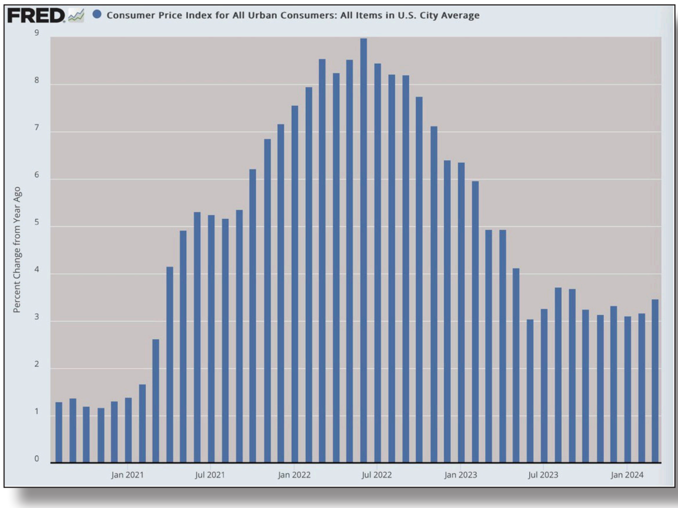
We remain skeptical of this outlook and defensive in our current investment allocations.

As the well-known investor and author Peter L. Bernstein is quoted as saying about managing money, "being wrong on occasion is unescapable," we have adhered to our long-held disciplines and not given into the current popular market trends and momentum. We have missed out on some opportunities in the short run, choosing to preserve capital and manage risk until more margin for error is evident in U.S. stock indexes.

Here is a few data points why we believe the current consensus of a renewed "Goldilocks" economy may be flawed.

First, as seen in Chart 1 below, Core Consumer Price Inflation (CPI) although down from levels 2 years ago, remains well above the Federal Reserve stated target of 2%.

Chart 1[i]



We question the current belief that the Federal Reserve will aggressively lower interest rates as they have stated, and as the market currently believes.

We believe the inflation story is still very much unresolved and with it the premise that rates must decline "because Jay[3] said so."

This entire market advance the past 6 months—in our view—is based on the expectations of lower interest rates engineered by the Federal Reserve and centered on the belief that inflation is tamed and is yesterday's news.

To quote Coach Lee Corso from ESPN's College GameDay fame, "not so fast, my friend."

As market observers we allocate capital based on what we call, "the weight of evidence."

Currently gold is trading at all-time highs around $2365/oz. while oil is up, trading close to $90 barrel. These are not historically consistent with the prospect of lower inflation and lower interest rates, in our view.

Again, our opinion, but if oil remains in the $90 range we find it difficult to believe that inflation can decline materially and no way it would not have an impact on consumer's purchasing power and buying habits. This would have the potential to bleed over into the economy with negative consequences.

Congress recently passed an additional $1.2 TRILLION spending bill with a deficit close to $1.6 Trillion dollars, and the Fed announced that it was likely to cut rates three times in 2024.[4] At some point, higher government deficits and bond supply may become problematic requiring higher levels of interest paid on Treasury issued debt. When will supply swamp demand?

With the U.S. 10–year Treasury bond yield at 4.5%,[8] it begins to provide competition to equity investments and now bonds are much more fairly valued compared to levels observed in 2020 through 2022 when rates were much lower.

So, when we look at the current weight of evidence, we see interest rates up, the U.S. deficit increasing at an unsustainable pace, Commodity and Oil prices up, Gold at historic highs. None of this argues rationally for a lower inflationary environment allowing for the Fed to lower interest rates in the near term. And, over the past six months, lower interest rates is the linchpin in which higher stock prices have been built.

Fact. Inflation remains stubbornly above the Federal Reserve's target of 2%.

Currently, we find it hard to believe that rates decline significantly into this environment unless the economy slows dramatically. We also question whether the move in gold prices might be reflecting something more sinister than higher inflation—perhaps a Federal Reserve policy mistake leading back to a late 1970's stagflation era.

Either way, we still believe that the market capitalization weighted S&P 500 index reflects the most optimal outlook with little or no margin of safety at today's current price.

Based on Morgan Stanley's published estimates for year end **2025** S&P 500 earnings and 2024 year-end target prices (stocks usually discount earnings one year in advance), current valuations on the S&P 500 Index are priced for perfection. The MS base estimate is for a year-end 2024 target price on the index of 4500, down 13% from the current level of 5200. The pessimistic (bear) target with lower earnings and P/E multiples, is 3850 down 25%. Even the most optimist (bull) outlook for earnings and P/E's by MS reflect a fully valued market with the target year end price of 5050 or down 2% from today's pricing.

In our way of thinking these do not represent attractive risk return tradeoffs in the near term.

As we discussed in the Winter edition of *RThoughts*—Wall Street Strategists estimates can be inaccurate and, at times, wildly so. But again, adding this all together into our weight of evidence scale, we find it prudent to remain very cautious on the passive/cap weighted S&P 500 Index.

In our way of thinking, if interest rates remain at current levels, stocks have little room to increase and are vulnerable to earnings and multiple (P/E) contractions. If rates come down it is likely because the economy is slowing—the potential soft landing - which traditionally leads to, you guessed it—lower earnings and multiples and with it lower stock prices.

We continue with our strategies of keeping ample liquidity in accounts in an effort to capitalize on an anticipated increase in volatility in the financial markets over the next several months.

Optimism and Opportunities

In the past couple of years Artificial Intelligence (AI) or GenAI has become one of the most publicized and hyped new technology developments in history. Its' applications are limitless, the investment potential is profound.

Jamie Dimon, the CEO of JPMorgan Chase Bank and respected business leader, stated in their latest annual report regarding the impact of AI, "While we do not know the full effect or the precise rate at which AI will change our business—or how it will affect society at large—we are completely convinced the consequences will be extraordinary and possibly as transformational as some of the major technological inventions of the past several hundred years: Think the printing press, the steam engine, electricity, computing and the Internet, among others.[5]

But as John Mauldin recently stated, "Investors often get overexcited about new technologies because they don't consider the inevitable implementation problems."[6]

And as was true in the heyday of the development of the Internet in the late 1990's and early 2000's, choosing the ultimate long-term winners and survivors in GenAI space will prove to be difficult. There will be spectacular winners but also many, many companies which do not survive. Capitalistic Darwinism in practice.

Throughout our careers we have never been early adopters or investors on any new technology—especially when we have a difficult time understanding that technology at even the most basic of levels.

What we do feel comfortable in doing, however, is to find the "second derivative"—the potential beneficiaries of this new technology and look to invest in those opportunities at appropriate prices.

Artificial Intelligence requires immense amounts of power in order to operate and run computations. These are housed in what are called Data Centers.

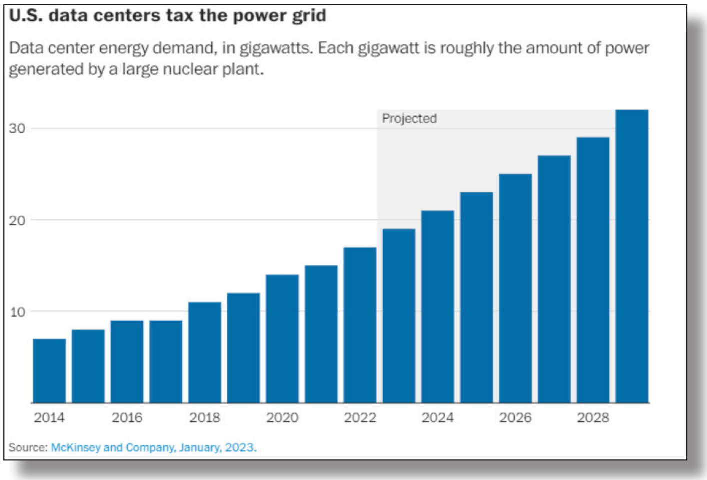
AI systems read documents then calculate, letter by letter, word by word, how bits of information usually go together. This requires many millions of computations.

But this can only be accomplished with a sufficient power source.

Running so many calculations so quickly generates heat. So, it also requires cooling systems to dispose of that heat which consumes even more power and massive amounts of water.[6]

Demand for Power is projected to increase 67% between now and 2029.

Chart 2[ii]



Semiconductor manufacturer Arm Holdings CEO, Rene Haas recently stated, " . . . AI energy needs are not sustainable. By the end of the decade, AI data centers could consume as much as 20–25% of US power requirements. Today its' 4%."[7]

If GenAI—like the Internet was in the late 1990's, early 2000—is a revolutionary and disruptive technological development—then it will require huge amounts of energy to support it.

Most certainly, Gen AI is revolutionary but where are we going to get all the power to enable it?

Who will provide that support?

Hard to tell who the ultimate winners in the AI race will be—many AI chip manufactures trade at prices we can only describe as "enthusiastic." That doesn't mean that they might not be great companies. Their current share pricing on the other hand gives us pause.

We can, however, participate with the theory of—"let's look at the companies which feed the hay to the horses"—the power generators themselves.

We see significant value creation for companies that can enable this rapid growth in GenAI power consumption.

We are looking for specific characteristics in these companies while being cognizant of the prices in which we are paying, but when those line up, we will look to materially increase our exposure in these securities.

In Summary

We fully realize that our conservative portfolio positioning the last year or so has led to short term underperformance when measured against the popular U.S. Index Averages like the S&P 500. We do, however, appreciate that potential risk is elevated and return expectations at these market levels are underwhelming over the near-term horizon based on our fundamental research.

If we were to experience a market correction of 10 to 20%, we would certainly be more enthusiastic buyers of selected securities which are on our watch lists. It is said, "Patience is a Virtue" and we continue to believe that our patience will be rewarded with much more attractive entry points, improved risk-return relationships and enhanced risk adjusted returns.

Please feel free to reach out to any of us individually with any questions or concerns. As always, we appreciate your trust and confidence. Be well.

The Diamond Peak Group at Morgan Stanley

Written April 5th to April 12th 2024

Here is a link to our Team's recent recognition in Forbes, **Best In State Wealth Management Teams 2024** (forbes.com)

Source: Forbes.com (Awarded Jan 2024) Data compiled by SHOOK Research LLC based for the period from 3/31/22 – 3/31/23.

https://www.morganstanley.com/disclosures/awards-disclosure.html

Sources and Footnotes

1. Thomsen One Market Monitor—April 4, 2024
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3. Federal Reserve Chairman, Jay Powell
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7. X post – April 9, 2024
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Charts

i. FRED—Federal Reserve Economic Data—St. Louis Federal Reserve, April 9, 2024
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ii. Washington Post, *Amid Explosive Demand, America is Running Out of Power*, Evan Halper, March 7, 2024
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R Thoughts—Winter 2024
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Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

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International investing may not be appropriate for every investor and is subject to additional risks, including currency fluctuations, political factors, withholding, lack of liquidity, the absence of adequate financial information, and exchange control restrictions impacting foreign issuers. These risks may be magnified in emerging markets. Investing in commodities entails significant risks.

Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies,(iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

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Technical analysis is the study of past price and volume trends of a security in an attempt to predict the security's future price and volume trends. Its limitations include but are not limited to the lack of fundamental analysis of a security's financial condition, lack of analysis of macro-economic trend forecasts, the bias of the technician's view and the possibilitythat past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

Asset allocation and diversification does not guarantee a profit or protect against loss in a declining financial market.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. The Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. An investment cannot be made directly in a market index.

The NASDAQ Composite Index is a broad-based capitalization weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market. Investment cannot be made directly in a market index.

2024 Forbes Best-In-State Wealth Management Teams

Source: Forbes.com (Jan 2024) 2024 Forbes Best-In-State Wealth Management Teams ranking awarded in 2024. This ranking was determined based on an evaluation process conducted by SHOOK

Research LLC (the research company) in partnership with Forbes (the publisher) for the period from 3/31/22–3/31/23. Neither

Morgan Stanley Smith Barney LLC nor its Financial Advisors or Private Wealth Advisors paid a fee to SHOOK Research LLC, for placement on its rankings. This ranking is based on in-person and telephone due diligence meetings to evaluate each Financial

Advisor qualitatively, a major component of a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria, including assets under management and revenue generated for their firms. Investment performance is not a criterion. Rankings are based on the opinions of SHOOK Research LLC and may not be representative of any one client's experience; investors must carefully choose the right Financial Advisor or team for their own situation and perform their own due diligence. This ranking is not indicative of the Financial Advisor's future performance. Morgan Stanley Smith Barney LLC is not affiliated with SHOOK Research

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