The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

SECOND QUARTER 2024
MARKET OUTLOOK

MARKET OVERVIEW [1]

A quick scan of the most read articles on Bloomberg this quarter revealed these headlines:

"US Yields Spike" "Big Tech Surges" "Big Tech Selloff" "'Mag Seven' Get Crushed" "Tech Giants Roar…" "Tech Giants Hit…" "S&P 500® Hits 30th Record of 2024" "GameStop Soars"

It's not hard to discern that the world was very focused on the so-called Magnificent Seven – the daily oscillations of these stocks were some of the most important stories. These mega cap tech stocks continued their run throughout the quarter, causing large cap indexes to dramatically outperform their small and mid cap counterparts. However, more recently it seems as if investors are looking for ways to rotate out of these very popular stocks.

Economic data was generally softer. Employment figures worsened, and inflation continued to slow, although it's still above the Fed's long term targets. Recently, policy makers have been indicating that risks to the labor market are coming into balance with risks of price stability – indicating that rate cuts may be on the table.

Geopolitical concerns were ever-present this period. There are big issues here at home, too. President Biden had what nearly everyone described as a disastrous performance in the first debate, leading to many in his own party to ask him to bow out of the race, setting the stage for more volatility and uncertainty for the upcoming election.

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As you may have discerned from the usual cadence of publishing our quarter-end commentaries, I almost always finish writing these right after the quarter has ended. As a result, sometimes our outlook is informed by events and news that have transpired after the quarter end. As I was putting the finishing touches on this edition, we have had some surprising and disruptive political developments. Coincidentally, I had already written on the subject of our domestic political situation. I even emailed a friend and client of ours, asking, "When and how will this wild political situation impact the market?" His thoughtful response confirmed my suspicion that this is indeed an unusual time and there are real impacts to consider.

It is at some risk that I wade into the dangerous waters of commenting on politics, but I feel like it's simply too important of a topic to take the easy way out and avoid the subject altogether. My goal is to be as unbiased as possible, simply focus on the observable facts in front of us, and apply our behavioral analysis framework.

[1] *The S&P 500® Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.* *See additional information regarding S&P ratings at https://www.stephensimg.com/terms-and-conditions/. You cannot invest directly in an index.*

OUTLOOK

Over twenty years ago, doctor, author, filmmaker Michael Crichton said this in a speech:

> *Briefly stated, the Gell-Mann Amnesia effect is as follows. You open the newspaper to an article on some subject you know well. In Murray's case, physics. In mine, show business. You read the article and see the journalist has absolutely no understanding of either the facts or the issues. Often, the article is so wrong it actually presents the story backward—reversing cause and effect. I call these the "wet streets cause rain" stories. Paper's full of them.*
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> *In any case, you read with exasperation or amusement the multiple errors in a story, and then turn the page to national or international affairs, and read as if the rest of the newspaper was somehow more accurate about Palestine than the baloney you just read. You turn the page, and forget what you know.*
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> *That is the Gell-Mann Amnesia effect. I'd point out it does not operate in other arenas of life. In ordinary life, if somebody consistently exaggerates or lies to you, you soon discount everything they say. In court, there is the legal doctrine of falsus in uno, falsus in omnibus, which means untruthful in one part, untruthful in all. But when it comes to the media, we believe against evidence that it is probably worth our time to read other parts of the paper. When, in fact, it almost certainly isn't. The only possible explanation for our behavior is amnesia.*

I don't know about you, but I've personally experienced this many times. I can go a step further, when I've had articles published about me, and I've even spoon-fed the writer the answers and facts they want, only to find them butchered and misquoted in the final publication. I don't think Crichton is implying any ill will or malice, it's just that journalists can't be experts in every subject, and oftentimes their work is at least inaccurate, and at worst just flat out wrong. For whatever reason, it's part of the human condition to forget or ignore these imperfections and inaccuracies when consuming news.

Crichton gave this speech in 2002, back when there was some semblance of unbiased media reporting. In case you haven't noticed, those days are long gone. It's difficult, darn near impossible, to find reliable news sources that aren't obviously biased and aligned with one political agenda or another.

The Gell-Mann problem was bad enough. Now it seems as if the media is engaged in outright misrepresentation of the facts, either because they believe their end justifies the means, or maybe simple economics – sensationalized and dramatic affirmation of people's beliefs garners viewership. Confirmation bias makes this problem even worse, as team red and team blue have created isolated social media realms where the only information consumed is sometimes factually flawed, often out of context, but also explicitly and unabashedly biased.

The Society of Professional Journalists publishes a Code of Ethics. In my amateur opinion, it seems well thought out and thorough. But reading it also depresses me, because it seems to me that none of the major media outlets come even remotely close to adhering to these principles.

I've been worried for a long time that the combination of confirmation bias, social media, and a legacy media which has abandoned journalistic principles would eventually lead to a condition that so divides the population that it eventually tears the fabric of society, creating irreconcilable differences. Are we there yet? I don't know, but I am genuinely concerned.

Why does this matter for our purposes? I'm applying the same philosophy I used when we saw the COVID situation coming, when we worried about inflation, and when we had evidence of the inflection point in Artificial Intelligence. It's the very same philosophy that drives our investment process – **behavioral biases cause people to chronically underestimate the magnitude and duration of change**. Once we find change, then we try to free ourselves of the status quo bias, and imagine where that change might lead us.

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I don't want to spend too much time enumerating the things that have changed (for the worse). I'm sure you won't have a hard time coming up with a short list yourself. The punchline is that the political landscape has changed, the way Americans are informed (or misinformed) has changed, and America itself is changing. I don't think we realize just how much we've changed, and exactly what the trajectory is. My suspicion is that there is risk that things get worse before they get better. I worry that no matter who is elected President in November, neither party will accept the result. **This is relevant because political unrest is not conducive to growth, a healthy economy, or a stable market.** That being said, I confess that I don't know where precisely these risks might manifest in equity markets, but it is something I'm worried about through the end of this year and beyond. For now, I'm betting on more surprises and more volatility. As you watch these events unfold, some of them truly historic, remember to apply our philosophy – people will tend to underestimate how durable and impactful real change is. And on a personal note, as you digest news and information, I hope you remember to consider the bias and Dr. Crichton's clever advice.

On to the economy! There was change here too. We have seen a material deterioration with the consumer. I don't think it's entirely obvious from looking at macroeconomic data, but we are seeing it in granular, company -specific data. This should come as no surprise. Inflation and lagging wage growth have been cutting into real disposable income. At the same time, higher interest rates have crowded out other forms of spending. In theory, this is the natural and intended result of the Fed's policies, as higher rates should lead to a reduction in aggregate demand.

There is now some evidence that slowing demand is contributing to slower growth in prices. CPI just recently came in below 3%. While we're not back to the official 2% target, policy makers are celebrating the progress, and Fed Chairman Powell indicated that risks are becoming more balanced between the dual mandate of price stability and employment. Almost instantaneously, investors interpreted the data and commentary as setting the stage for a rate cut in the next few months.

We have been told, "Don't fight the Fed." So, the natural response is to get bullish if you believe the Fed is about to cut. The Fed's policies have become such important drivers in the economy and the market there's a popular belief that they supersede the importance of fundamentals themselves. This has been summed up with another popular expression: "bad news is good news." The logic goes that deteriorating fundamentals (bad news) will lead to an accommodative response from the Fed (good news).

I don't think it's quite that simple. Sometimes bad news is just that, bad news. My guess is that like many things that involve complicated systems and human psychology, there is a non-linear function that describes the relationship. Incrementally and initially, it can work in a way where a little "bad news" results in a cascade of events and logic that result in a higher market and positive sentiment. Beyond some threshold however, if enough bad news accumulates, it will be difficult for policy makers to respond in time. The Fed has a long history of being slow to respond and then overshooting. It's how we got here in the first place. I don't know where we are in the economic cycle – I don't think anyone does. But as I sit here today, it feels as if the market is underestimating the deterioration we are seeing.

One of the reasons some investors get excited about impending rate cuts is their profound impact on the housing market, and the housing market itself is a large component of our economy. By now, you've probably heard about the surprising and paradoxical impact higher rates have had on home builders in the last couple years. With so many homeowners having locked in mortgages at unprecedentedly low rates, even making a lateral move is prohibitively expensive. The level of existing homes for sale plummeted, leaving only new construction to meet incremental housing demand.

Normally, one would expect higher rates to dampen aggregate demand through the channel of housing. This has historically been the case. It didn't happen this time at all. In fact, one could reasonably argue that higher rates had the net result of *helping* homebuilders. I don't think there's much controversy around this idea. My question is, **will this new dynamic also work in reverse if and when mortgage rates fall?** Will lower rates enable those who have been wanting to move, freeing up new supply, thus crowding out new construction? If that's the case, how much impact will a slowdown in homebuilding have on the economy at large?

In summary, what I'm saying is that the market today feels a little like what we saw in December of last year. Back then, investors were feverishly forecasting rate cuts and pricing them into equity markets. And I guess that's why I'm essentially repeating what I said then – **be careful getting too excited about a rate cut cycle. There's a reason they would be cutting rates.**

Politics are depressing. Incremental economic news isn't great either. Let's move on to something more uplifting. Artificial Intelligence continues to stand out as a potential game changer and an important growth theme across all of our strategies. Spending on AI infrastructure is still happening at a breakneck pace. Bottlenecks to incremental AI buildout are showing up in permitting and access to electricity.

Lately skeptics have complained that we haven't seen significant tangible benefits from AI. I say it's way too early. I will continue to draw on lessons learned from investing in Internet-related companies from the first days of the World Wide Web until today. In the late 90s, even after Web browsers had been available for some time, there wasn't much remarkable on the internet itself. It's hard to remember back then, but there wasn't much functionality behind most websites. There was a mad scramble to secure URLs (believe it or not, many businesses lacked the foresight to register their own business names or brands followed by ".com"). And then once everyone had secured their URLs, no one really knew what to do with it. I was a member of the "Internet Committee" at my former employer at that time, and those meetings consisted of us brainstorming about what to put on the web, and then coming to terms with what was technologically possible at the time – which was not very much.

It took years to develop better front-ends with HTML, Flash, and Java. Similarly, it took quite some time to create better back end access to the systems and data which were fueling the websites with the content itself. Security protocols were also being created along the way as the complexity and sensitivity of content grew. Remember, YouTube wasn't even launched until December 2005, years after the so-called dotcom bubble. Some of the most powerful internet business models weren't even created until a decade after the World Wide Web was enabled by browsers like Netscape's Navigator. There will be short-term noise and volatile sentiment on generative AI. There will likely be noise and uncertainty on the political front. The same goes for economic conditions and interest rate policy. We will do our best to use all that volatility to our advantage, trading around core positions and staying focused on long-term opportunities. It took nine years to go from Netscape Navigator to YouTube, and then another five until Instagram was launched. What will the next five, ten, and fifteen years hold for generative AI? I have some wild ideas, but I'm sure they're not wild enough.