



First Quarter 2024 : Quarterly Letter

The first quarter saw the US economy continue to grow at a steady pace supported by a tight labor market and robust consumer spending. While headline CPI is well below its recent peak of 9.1%, it has stubbornly hovered around 3.2% since last June. Bond investors have grown cautious about whether the Fed will deliver three interest rate cuts this year as expected. In reaction, the yield on the 10-year Treasury rose by 0.3% over the past quarter to 4.2%, and the 7-10-year Treasury Bond Index posted a -0.9% quarterly loss. Equity investors were unphased by the higher rates. The stock market reached all-time highs, led by mega-cap stocks. The Russell 3000 Index posted a 10.7% return for the quarter.

Despite cause for celebration, many investors are asking “Are we in a bubble?” One market sage, Ray Dalio, founder of Bridgewater Associates, suggests there is a 53% chance we are in a stock market bubble based on his modeling. Some might say, “just 53%, not so bubbly.” Others, “53% is high, especially since a year or two ago the bubble probability was zero.”

We see the stages of a bubble as follows:

1. Paradigm Shift. This occurs when people change their thinking, often driven by new technologies and industries.
 - a. The roaring 20’s and the 29 crash: autos, phones, lax margin requirements gone awry.
 - b. The 1990’s dot.com bubble: the rise of the internet
 - c. The 2008/2009 global financial crisis: housing bubble, collateralized debt obligations, financial engineering gone awry.
 - d. The 2023/2024 rise of artificial intelligence.
2. Boom. The new paradigm assets outperform. Valuations expand. Speculators enter and drive prices even higher.
3. Euphoria. Higher prices attract more buying. Asset prices skyrocket as investors are driven more by excitement and fear of missing out (FOMO). There will always be someone willing to pay more. During the Dutch Tulipmania of the 1600s, people got swept up in a speculative fever, some spent a year’s salary on rare bulbs in hopes of reselling them for someone willing to pay more.
4. Profit Taking. Extremely high prices attract sellers. The bubble peaks and the stage is set for it to burst.
5. Panic/Crash. Many investors hang on, hoping prices will continue to rise, but are disappointed. Euphoric buying is replaced by panic selling and prices crash.

No, we are not in a bubble, but we are on a bubble path. We are in the latter part of the boom stage, roughly consistent with Dalio’s 53% bubble probability. It doesn’t have to go euphoric.

Whether we follow the bubble trajectory or not, right now, U.S. equities are not cheap. A widely followed measure, the Shiller cyclically adjusted price-to-earnings ratio, referred to as the CAPE 10 because it averages the last 10 years’ earnings and adjusts them for inflation, is a metric used by many to determine whether the market is undervalued, fairly valued, or overvalued. Currently, the CAPE ratio is high at 34. The historical average is 17.5. So, the market is expensive. However, at the peak of the dotcom bubble, it reached 44.2, suggesting room to rise if this market moves to the euphoric stage of a bubble. More importantly, what do high valuations mean for long-term returns?

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Each year, many investment firms use current valuations to estimate returns over the next decade. Estimates vary, but an average of JP Morgan, BlackRock and Callan Associates (an institutional consultant) suggest large capitalization stocks will return just 6.8% over the next decade, which is below the historical average of about 10%. Of course, these estimates change with changes in valuation. As valuations rise, expected future returns fall and vice versa. We build valuation-based expected returns into our modeling of your financial plan to better assess risk on your behalf. We will be updating your plan to capture our valuation-based expected returns for our next plan review. In the meantime, please reach out to me if you have any questions.

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