It's been a few of months since I last shared an update on the strategies I manage. I hope to provide timely updates when there are important issues to share!

<u>Executive Summary</u>:

- Towards the end of April, one of the three main risk charts flipped negative,[1] which resulted in my raising cash levels in the different strategies between 13% and 15%. A commensurate amount reduced equity levels and, therefore, the portfolio's risk level.
- The semi-annual rebalance is due the first week of July. Once the rebalance is completed, I will email you detailing the changes.
- As I write this in the middle of June, the stock market is reminiscent of last year regarding leadership. Once again, the leadership in 2024 is very narrow as the top ten stocks are responsible for 76% of the S&P 500 gains year to date.[2] We saw roughly the same thing last year, with the Magnificent 7 stocks responsible for much of the market's gains.[2] This situation causes a concern for market participants that the breadth, or number of stocks participating to the upside, is much less than desired.[3]
- The blackout period for corporate stock buybacks begins now and will continue for the next month or so until corporations release their Q2 earnings.[4] With narrow leadership and corporations who are large buyers of stocks out of the markets for the next few weeks, we could see a pullback in the stock market.[67] In my opinion, any pullback in the stock market would be beneficial and healthy.
- The upward and rapid spike in interest rates that we saw in April[5] caused one of the risk charts to flip negative.[6] This has abated, benefiting both the stock and bond markets[7], which in turn has benefitted the portfolio. However, that one risk chart still remains negative.[8]
- Overall, the first half of 2024 has been a good one for the portfolio, and from my current vantage point, the second half of 2024 should also be good.[68] However, I am watching several issues that could pose a problem in the second half of the year. Those include an unexpected slowdown in the economy, the wars in the Middle East and Ukraine, banking issues related to March 2023 that haven't been fully addressed[9], inflation possibly reigniting from higher oil prices,[69] etc.

The first place I should start is why I raised cash levels in April. One of the risk charts that pertains to interest rates flipped "negative," causing me to reduce equity levels, and hence the risk, in the portfolio.[10] This particular chart is my most accurate chart and, historically, has been a harbinger of potential market action to the downside anywhere from 2-8 months out.[11] This particular chart is the same chart that flipped "negative" in March of 2021,[12] which, in hindsight, foreshadowed the market downside that we saw with the tech bubble popping in the fall of 2021,[13] followed by the challenging financial markets in 2022.[14] I am not suggesting that a repeat of that action is on the horizon. However, given the very narrow leadership we are witnessing in the markets today,[15] it seems to be prudent to reduce the risk levels in the portfolio since narrow market leadership can be a precursor to a market pullback,[16] and a pullback of at least 10%-20% isn't unfathomable in my opinion. While this particular chart is my most accurate,[17] it has a track record of less than 100%,[18] and hopefully this chart change in April amounts to nothing more than a head fake. As for the other two risk charts, they solidly suggest continuing with exposure to equities, and they are nowhere near flipping negative as of this writing.[19]

As I mentioned in the Executive Summary above, this year is reminiscent of 2023,[20] which can be seen in the year-to-date performance of various indices. As of this writing, the NASDAQ is up 19%, and the S&P 500 is up 15%.[21] However, the DJIA is up only 3%, the S&P Midcap is up 5.3%, and the Russell 2000 (small caps) is down .1% ytd.[22] There appears to be a clear bifurcation in the stock market! Approximately 75% of the gains seen in the NASDAQ and S&P 500 are from ten stocks,[23] with Nvidia, Apple, Meta, and Microsoft responsible for 50% of the gains in the S&P 500.[24] The market capitalization of Nvidia, Microsoft, and Apple is rapidly approaching $10 trillion![25] So, the fantastic gains seen in the first half of 2024 for the NASDAQ and S&P 500 need to be taken into context. This market advancement has been led by just a handful of tech stocks, which are closely tied to artificial intelligence with very elevated valuations compared to the rest of the market. The ten largest S&P 500 stocks currently carry a 30X P/E multiple, whereas the remaining 490 stocks carry a more reasonable valuation with an 18X P/E multiple.[26] This narrow leadership is also evident when looking at the market-cap-weighted S&P 500, up 15% year to date,[27] and the equal-weighted S&P 500, up only 5.17%.[28]

I am going through a 165-page document written by a former Open AI engineer named Leopold Aschenbrenner titled "Situational Awareness, " which was penned in June 2024.[29] It's a slow read but well worth the effort because it gives a very informative insight into the supposed future of Artificial General Intelligence (AGI). If you prefer not to read it, here is my synopsis from the article. By 2027, Aschenbrenner feels that computer AGI "can outperform PhDs and the best experts in a field,"[30] and he means *any* field. Very shortly, computers could be more intelligent than humans,[31] which will take a tremendous amount of investment (trillions).[32] So, it may not be so implausible that the market has given very high stock valuations for companies at AGI's vanguard. In my opinion, the advent of AGI and computers that are much more intelligent than humans will be as transformational for humanity as fire and the wheel, and therein lies the investment opportunity. Where it makes sense, I will be focusing on the portfolio's composition to include AGI-oriented investments in the future.

As I discussed in my last email, AGI could contribute considerably to corporations' profitability,[33] and much of that profitability will come through headcount reductions[34]. When I was working in corporate finance at a previous employer, I saw firsthand how much employees can cost a company. In the business division I was responsible for, labor was roughly 40% of the cost when factoring in salaries and benefits. Imagine the increase in profitability if AGI can replace humans, and when coupled with potential interest rate decreases, it is plausible to see why earnings could continue to increase in the near future, which would be supportive of higher valuation multiples for stocks. Also, factor in a resilient consumer who seems to continue spending unabated,[35] and most of the ingredients ingredients for a further rally in the stock market are in place. When looking at the chart pattern for the S&P 500 on different point scales, I see price targets anywhere from 6,000 up to 6,930,[36] and for the NASDAQ, anywhere between 17,300 and 24,200.[37] As I have mentioned many times previously, there is no time component on the charts, so I have no idea when that may occur. It is only suggestive that the markets may have much further upside.

With that said, we do need to be realistic. We had a pullback in the markets in April,[38] and it has been a good run for May[39] and June[40], but at some point, we should expect another pullback of anywhere between 5%-10%, which is perfectly normal market action.[41] It wouldn't be out of the realm of possibility to see a 10%+ correction occur as well.[42] If any pullbacks metastasize into something bigger, I will likely reduce risk levels by raising cash in the portfolio. What could lead to a more significant sell-off than the garden variety 5%-10% pullback? Well, several things could cause such a sell-off.

One such possibility is if corporate earnings are at risk due to a pronounced economic slowdown. However, with the latest Atlanta Fed GPDNow estimate still at 3.1%,[43] the likelihood of a recession seems far off. What is of more concern to me is the two wars that are going on right now. Both the Ukrainian and Israeli conflicts are not moving in the right direction. On the contrary, both are seemingly moving towards a spread of the conflict beyond the current boundaries, which could result in more countries getting involved, i.e., the United States, NATO, Lebanon, and Iran.[44,45] My concern there, besides the human toll involved first and foremost, is that it could result in higher U.S. deficit spending to fund a broader involvement in those wars,[46] which, in turn, would result in higher levels of interest payments. The CBO just came out with their latest budget deficit projections for 2024, which came in at a staggering $1.9 trillion for 2024,[47] which is happening in a good economic environment! [48] Higher deficits could cause higher taxes down the road, which could cause lower consumer spending, resulting in slower economic growth, which would then eventually be reflected in stock valuations. Additionally, higher deficit spending could result in higher interest rates,[49]and by now, I think we all know that higher interest rates can pose problems for the financial markets, as we saw in April of 2024[50] and throughout all of 2022.[51]

And speaking of higher interest rates, something else recently popped up on my radar, and that is the recent announcement by a Japanese bank concerning their losses on their government bond holdings as a result of the global rise in interest rates.[53] Norinchukin Bank (5th largest in Japan) recently announced that they plan on selling nearly $63 billion of U.S. Treasuries and European government bonds between now and March 2025 to plug a hole in their balance sheet due to losses from rising interest rates.[54] Remember the U.S. banking crisis last March 2023 when four banks went under?[55] Norinchukin Bank is essentially in the same situation as Silicon Valley Bank and the three others that went under last year.[56] I won't go into great detail here on what is happening with the Japanese bank, but suffice it to say that selling $63 billion of securities is not good for them. It is a good reminder that U.S. banks are still sitting on nearly $500 billion in unrealized losses on their balance sheets due to rising interest rates.[58] If the Fed continues with a higher for longer viewpoint on interest rates,[59] then more stress could continue for U.S. banks until the Fed starts to lower rates. Couple that with potential commercial real estate losses for banks,[60] and one should be vigilant about the risks emanating from this sector of the economy.

To wrap this up, I have generally been pleased with the performance of the portfolio year to date. The strategy is producing nice gains even while the portfolio holds elevated cash levels. Fortunately, the cash invested in a money market yields around 5.2%-5.4% annually,[61] which is pretty attractive. With inflation hovering around the 3%-4% range,[62] the cash in the money market is getting a positive real yield. Real yield is nothing more than a stated interest rate minus inflation.[63] For much of the last decade, real yields were negative due to the ZIRP (Zero Interest Rate Policy) being promulgated by the Federal Reserve.[64] In retrospect, it was an excellent move to add Amazon (AMZN) and Google (GOOGL) into the portfolio last summer as both of those stocks have been materially accretive to the portfolio's performance, as has been the addition of Advance Micro Devices (AMD). I am keeping an eye on AMD because it has struggled since it peaked at around $224/shr in March of this year.[65] If AMD continues to breakdown technically,[66] it may have to come out of the portfolio during the next rebalance. Time will tell.

Once I complete the semi-annual portfolio rebalance in the first week of July, I will send another email updating you on what changes were made and why. Until then, I hope you are enjoying the longer days of summer!

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