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January 2025 Crescent Commentary

Has the Fed started checking IDs?

In 1955, Federal Reserve Chair William McChesney Martin used a metaphor that concisely explains the Fed's role in maintaining a stable economy: "The Federal Reserve…is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up." He went on to discuss how the Fed's job involves taking precautionary action to prevent too much inflation, and that the precautionary action could burden the economy. He likened the Fed to an adult in the room, who must take prudent action, even if it upsets businesses and consumers.(7)

In last month's Commentary, we talked about the euphoria currently pervading multiple asset classes. Certain segments of the stock market, private investments, crypto currency, and real estate have shown signs of exuberance over the past several years. The only market that has actually fallen and not recovered is the bond market. Recent comments by high level financial figures appear to support this view. According to CNBC, JP Morgan CEO Jamie Dimon "called the U.S. stock market inflated and said he felt more cautious than others in the business world." During his press conference at the end of January, Fed Chair Jerome Powell said asset prices appear "elevated by many metrics right now," driven partly by exuberance for "this thing around tech and AI." And then we have prominent hedge fund manager David Einhorn, who said we've reached the "Fartcoin" stage of the economic cycle – a reference to some investors' willingness to throw money at any new crypto currency that comes along.(1)(2)

Given the level of exuberance we simultaneously see for multiple asset classes, it would seem to us that it's too late for the Fed to take away the punch bowl before "the party was really warming up". We will experience economic consequences from this, just as we always do after periods of exuberance. No one can know exactly when or how it will unfold. And although the Fed may not be taking away the punch bowl, we do think they've at least started checking IDs at the party. In last December's meeting, the Fed announced that it would move slowly to cut rates as a result of uncertainty around the path of inflation and the impact of tariffs. Markets were expecting more and faster rate cuts, and the Fed's announcement does seem to have taken some of the edge off of the speculation we've seen. Time will tell whether this is a speed bump, or the beginning of a longer term deflation of speculative assets.(1)

In addition to the Fed checking IDs, another recent development took some of the edge off of speculation, and that's the announcement of a new artificial intelligence model by the Chinese company DeepSeek. One of the biggest challenges of trying to invest in a new industry is the potential for rapid shifts in that industry, which can make entire businesses obsolete. If you look back at the dominant companies 25 years ago, most of them are either irrelevant or highly challenged today. Several have stock prices lower than they were 25 years ago. This is part of the reason why we think investors should tread carefully with artificial intelligence. The stock market's violent reaction to DeepSeek's announcement demonstrates the fragility of investing in this industry.(6)

As the Fed mentioned in the quote above, asset prices appear "elevated by many metrics right now," driven partly by exuberance for "this thing around tech and AI.” These assets are priced for a perfect future, and we know the future won’t be perfect. Depending on the assumptions reflected in their stock prices, they may even be priced for an impossible future. That leaves these investments susceptible to major drawdowns as an imperfect future takes shape. Several of the major U.S. companies involved with AI appear to dominate their markets, and they certainly should have a place in a long-term investor’s portfolio. However, we think the fragility of the situation requires a high degree of diversification.

History supports our recommendation of enhanced diversification. The U.S. stock market is currently the most concentrated on record, with the top five largest companies making up the largest ever percentage of the stock market. As the Fed pointed out, this concentration is driven by investor exuberance for artificial intelligence, which has pushed stock prices for these large companies far ahead of their actual business performance. The last two times we saw such a gap between stock prices and reality were the Nifty Fifty bubble 50 years ago and the dot-com bubble 25 years ago. The aftermath of these two time periods saw large drawdowns for the largest companies, with increased volatility. And although the aftermath was a messy time period for the stock market, stocks outside of the top companies did relatively well. For example, while the U.S. stock market declined over the ten-year period 1999 to 2009, Several industries bucked the trend of decline and actually experienced a gain over that decade. These consist of mundane industries that were neglected during the exuberance, including Energy, Consumer Staples Products, Utilities, Materials, Healthcare, and Industrials. Similarly, we believe that diversifying today beyond the top ten largest companies will yield positive results in the future. It’s basically a matter of the tortoise versus the hare.(3)(4)(5)

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Forbes Best-In-State Wealth Management Team 2024 and 2025

Sources:
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