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Wealth Management
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May 2024 Crescent Commentary

“Put me in the cautious side on this one.”

Over the past few months, we’ve seen a strange dichotomy develop between the economy and financial markets. With financial markets, we’ve seen a return to speculative fever and exuberance that rivals what we saw in 2021. Junk bonds – or bonds of highly indebted and risky companies – have moved up to levels not seen in three years. “Meme stocks”, which were popularized by online chat rooms during covid, have again drawn a lot of interest. Recent headlines in The Wall Street Journal include “Market Froth is Getting Extreme” and “Bullish Investors are Piling into Stock and Bond Funds”. These activities imply expectations of a flawless path for our economy.[1]

Yet when we look at the economic data, we don’t see the flawless path implied by financial market exuberance. The economic data released for the first quarter revealed that GDP growth is slowing in the U.S. We also saw that inflation remains stubbornly high and has not fallen as much as the Federal Reserve had hoped in recent months. A few weeks ago, a Wall Street Journal article reported that one of the world’s largest private REITs – The Starwood Real Estate Income Trust – is “bleeding cash and running out of options.” While speculation continues to pervade different segments of financial markets, news like this makes you aware of potential challenges under the surface.[1][2]

If there are challenges beneath the surface, the current climate of speculation and exuberance would suggest that many people don’t know it. As we’ve discussed in past commentaries, we’ve seen investor speculation and enthusiasm taken to a new level over the past year with hope and hype for AI, or artificial intelligence. While the technology certainly has the potential to make businesses more efficient, the profit dynamics of firms providing AI hardware and applications are far from sorted out. Recent Wall Street Journal articles support these facts: one outlined how the AI craze “is riding on questionable AI assumptions”, and another described how “the AI revolution is already losing steam.”[1]

At the same time that certain segments of financial markets are riding on exuberance, many mundane and boring investments remain neglected. This dynamic reminds us of the late 1990s, when investors snapped up all things dot com and neglected boring but sound investments. Eventually the bubble burst, and the tide turned. From 1999 to 2009, mundane industries realized a gain, while dot com stocks crashed and U.S. stocks as a whole experienced a loss for the decade. A recent interview with Jamie Dimon, Chairman and CEO of JP Morgan, summarizes our current viewpoint: “put me in the cautious side on this one.”[2][3]

In our view, the current divergence between exciting and boring investments creates opportunity. At some point, investors will look back and realize that boring is beautiful. We’ve seen this following historical periods of exuberance and speculation. We can point to “lost decades” where the U.S. stock market was flat for more than ten years and mundane investments carried the load. For example, consider the 17-year period from 1964 to 1981 when the Dow stock index was flat.[4]

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Or the nearly 14 years 1999 to 2013 when the U.S. stock market was flat. Dividend reinvestment generated gains for investors in the 1970s despite the flat stock market. And boring investments such as consumer staples, healthcare, and industrials generated gains for the period 1999 to 2009, while U.S. stocks as a whole fell over those ten years.(3)(5)(6)

Another unknown to add to the current mix of circumstances is the ultimate impact of higher interest rates on our economy. Again, the current intensity of speculation and exuberance imply the expectation of a "soft landing", where our economy continues to grow despite the higher interest rates. But we know that there's always a time lag between when interest rates increase and the ultimate impact to an economy. It can take several years for higher interest rates to filter through the economy. For example, prior to the 2008 Financial Crisis, the Fed stopped raising rates in June 2006. We didn't see the full impact of the rate increases until over two years later in September of 2008. We may have to wait until late 2025 or early 2026 before we know how our economy responds in full to the current higher interest rates.(7)(8)

Given the several economic unknowns we have described, we find it difficult to understand the current mentality of speculation and exuberance that we see in different segments of financial markets. But then again, that's always the case with speculation and exuberance. Why on earth did people bid up the prices of tulip bulbs in the 1600s, only to lose everything when prices came crashing down? It's simply part of human nature.

We continue to recommend that investors own a balanced and diversified mix of assets in the current environment. It's fine to own diversified amounts of investments currently perceived as having high growth prospects. These will likely continue to do well as long as our economy does. But it's also important to own them in diversified amounts so that if the economy does hit a bump, you're protected. To balance that, we continue to recommend stable, dividend paying investments. Because these types of investments are largely neglected in the current mood of speculation, we believe this is where opportunity lies for long-term gains. As we discussed above, dividend-paying investments have a demonstrated track record of resilience during more challenged times, and they have been shown to do the best over the long term when including both booms and busts.(9)

On a final note, we want to add that an end to financial market speculation, even a bursting of a bubble, does not necessarily spell large problems for our economy. If you look at the bursting of the dot com bubble in 2000, our economy continued to do fine and experienced only a minor recession. In fact, that time period was called "the recession that wasn't". While inflated portions of financial markets crashed, sound investments neglected during the late 1990s euphoria did well. For example, when the dot com bubble burst, U.S. stocks fell 15% for the five-year period 2000 to 2005 (with a peak decline of more than 40% in 2002). Stable, boring, neglected industries showed double-digit gains over those five years, including healthcare, industrials, and consumer staples companies. This is why we continue to advocate for a balanced investment allocation with a strong weighting of stable, dividend-paying investments.(3)(10)

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Forbes Best-In-State Wealth Management Team 2024

Sources:
(1) The Wall Street Journal
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