Maximum Optimism 2.0

December 2023 **Letter No. 125**

"……Bear markets are born out of maximum optimism"

- Sir John Templeton -

"Just as the signs of the upcoming holidays are everywhere today, the signs of great optimism can be found in nearly every corner of our domestic markets too. You don't need to look very far. To veterans of the markets, here are some of the signs of excess:

- Sustained rallies with little to no pull-backs or corrections
- Record amounts of leverage

- Larger percentage of stocks with little to no current earnings; many without positive cash flows ("story stocks")
- Extremely high levels of traditional financial ratios (price/earnings; price/sales, price/book value, etc.)
- Analysts constantly upgrading future price objectives just to stay ahead of spiraling stock prices, some who may be abandoning their own financial disciplines in the process

Of course, no one knows when the top tick will arrive, thus bookending this current bull market. No bell ever rings at the exact top. The signs of great optimism above have been a hallmark of every prior late-stage bull market cycle…"

From Letter No. 101, December, 2021

The above snippet is from my **December 2021** letter. As of that moment in time, the U.S. stock market was caught up in a massive speculative fever unrivaled in recorded history. Great numbers of stocks had become so completely untethered from their underlying intrinsic value that it was nearly a certainty it was a bubble top, one that was ready to blow. The most egregiously priced stocks had become the "must-own stocks" of the moment, while a slew of others were completely caught up in the frenzy, and seemingly no price was considered too high to pay. It had become a speculator's dream. They believed they were going to get rich, and those who sat it out were chumps.

It would take just about five more weeks (and a further gain of only 2.50%) for the leading global stock barometer, the S&P 500 Index, to notch its all-time high at 4,818. The point of ***"Maximum Optimism,"*** as decreed by Sir John Templeton four decades earlier, had been reached and market de-stabilization was already setting in. In a span of just nine short months that same S&P 500 Index would give up 27% to the downside in dramatic fashion, marking the first major low at just under 3,600 in what might eventually be only a first leg of a potentially more extended bear market cycle. Historically, full bear market cycles don't usually end after the first significant decline. Time will tell.

By October of 2022, the collapsing of market prices had reached their initial panic climax, evidenced by severe "over-sold" readings. It was a point where extreme pessimism had replaced the prior maximum optimism, dragging market indexes and most stocks down too low too fast. A contra-rally followed, but now the question on everyone's mind was whether this was a new bull market or simply a "bear-market rally" of the kind not to be trusted? The bulls say that the U.S. economy never went into the previously advertised "coming recession," and now there are too many good things happening that will drive economic activity forward, faster. Not the least of these is the much-heralded age of Artificial Intelligence (AI) . On the other side are the bears who claim that the recession, which has been fomenting, is still on the way. It has been fueled by higher interest rates, which slowly eat away at the core of consumerism while creating greater budget deficits. Both of these events might further inhibit consumer spending, capital investment, and global trade, and could make any recession worse than feared. Both are good arguments.

Here is the thing about markets. There will always be bulls, and there will always be bears. Sometimes securities will trade at price levels that reflect their underlying core values, but more often than not they don't. They can trade way above perceived fair value, and they can trade way below. That is what makes a market. Further, for every buyer there has to be a seller, and vice-versa. However, what is most important in this equation is **at what price point each trade is made!** Then, there is the all-important factor of human emotion. Both investors and speculators, for whatever the reason, can often make the wrong trade at the wrong time because they let their emotions drive their

thinking. Fear Of Missing Out (FOMO) happens at market tops, pushing otherwise sensible investors to pay top dollar for assets that are potentially already fully valued, while the Fear Of Getting Wiped Out (FOGWO) happens at panic lows, as some move to sell after maximum damage has already been levied.

Where are we now? Of course, no one knows what will happen next, but my observation is that December of 2023 feels a lot like December of 2021, but with one big difference. In the bear market rout that followed 2021, a lot of smaller company stocks took a much bigger hit than their larger company brethren. I've just finished looking over about 1,600 individual stock charts, and there were a lot of stocks that were smashed down more than 50% from their all-time highs of 2021. Nearly none of those have recovered in a meaningful way. Conversely, many of the largest stocks (the ones that weigh most heavily on the leading stock indexes) have not only recovered, but some have even gone on to new all-time highs. It's like FOMO on the biggest names and FOGWO on others, such as bonds, emerging markets, and small cap stocks. The NASDAQ 100 Index in particular has many hallmarks of an "echo" bubble. Déjà vu?

Just to make the point, consider the "Year-To-Date" returns of certain various indexes. What you are about to see is the relative disconnect between the biggest names and everything else. The S&P 500 Index generally, and the Communication Services Index specifically, are completely dominated by just a handful of large tech companies.

Here's the year-to-date returns through October 31*(sourced from https://personal.vanguard.com/us/funds/tools/benchmarkreturns, except DJIA)*:

Dow Jones Industrials (DJIA)	-0.28%
S&P 500 Index	+10.69%
Small Cap 600 Index	-4.97%
MSCI World Index (ex-US)	-1.38%
FTSE Emerging Index	-1.88%

The good news is that the markets had a good November *(as I write this on Nov. 24!)* and so some of those negative "year-to-date" performance numbers have turned positive. Strategically, it appears (to me) that there is a significant imbalance between the biggest names in tech and the rest, and therefore it would appear there is much more long-term value creation potential elsewhere. My view is that any index that has domination by the Top 10 names have all the hallmarks of FOMO. I'd prefer to sit this one out; go ahead, call me a chump! I'd give basic materials and energy (potential beneficiaries of inflation) more exposure than information technology. I like Emerging Markets (potential beneficiaries of a weak U.S. Dollar) more than developed markets. Since the Fed has hinted that they might be closer to the end of the current cycle of interest rate increases, and for the first time in over a decade, I would even encourage buying bonds that extend beyond just the short-term (bond prices rise when rates fall). Each of these preferred areas also have the benefit of higher dividend and interest income beyond the uncertainty of capital appreciation potential that exists for any asset, whether big or small.

In conclusion, I keep waiting for the fever to break. That would be the fever of FOMO *(fear of missing out)* on the biggest names in the market. I'll take a look at those somewhere ahead, preferably following a stretch of FOGWO, "fear of getting wiped out," a time following a potential collapsing of prices. "Big Tech" has become a very narrow and very crowded trade as we come to the end of the year. Too big and too crowded for me. Granted, that trade has worked up to now (I missed this rebound), but in my view it's become an "echo bubble" that has the potential to blow up somewhere ahead, just as so many other stocks did right after the New Year of 2022. We wished you Happy New Year then too!

David Holperin
Senior Vice President/Investments
Portfolio Manager – Solutions Program

Indices are unmanaged and are not available for direct investment. Past performance is no guarantee of future results. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The S&P 500 Communication Services comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector. The NASDAQ-100 is a modified capitalization-weighted index that is comprised of the largest non-financial companies

listed on the National Association of Securities Dealers Automated Quotation System stock market. It includes both foreign and domestic companies, and does not include any financial or investment companies. The Dow Jones Industrial Average (DJIA) is an index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The Standard and Poor's SmallCap 600 Index is a capitalization-weighted index that represents the U.S. small capitalization market, including companies with a market cap in the range of $300 million to $2 billion. This index consists of 600 domestic stocks chosen for market size, liquidity, and industry representation. The S&P index committee uses the 50th and 83rd percentile of market value of all U.S. companies as a general guideline to identify small cap. The MSCI World Index is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of developed markets. The FTSE Emerging Markets All Cap China A Inclusion (U.S. RIC) Index measures the performance of large, mid and small cap China A share constituents. U.S. RIC reflects the tax a U.S. investor would pay. It is a series of net-of-tax total return indexes which is calculated based on dividends received following the deduction of withholding tax at the rates applicable to a U.S. Regulated Investment Company (RIC) that benefits from double-taxation treaties. The index is market-capitalization weighted.

When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies.