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First Quarter Review
The AI, Crypto, Weed, Weight-Loss Market

Through the first quarter, the stock market continued to advance even as the Federal Reserve Board (the "Fed") kept interest rates at recent highs. The S&P 500 rose 10%, the Nasdaq Index climbed 9%, and the Dow Jones Industrial Average rose over 5%. Bonds continued to decline in price, and the 20 Year US Treasury Bond ETF lost 4% of its value during the first 3 months of the year. Stock investors largely ignored the headwinds of higher interest rates, persistent inflation, and increasing geopolitical risks. The US economic data remained mostly positive with employment numbers remaining strong. The much-anticipated recession did not arrive as most economists predicted last year. The market rally was remarkable in that it was so smooth, lacking the gut-wrenching drops that happen regularly in the stock market. This may have contributed to the "FOMO" (fear of missing out) and investor complacency which seems to have prevailed as prices rose and stocks in general grew more expensive.

Several investment themes dominated recent headlines. These included AI (artificial intelligence), Bitcoin ETFs, weight-loss drugs (GLP-1), and the rise in the prices of oil and precious metals. The AI frenzy continued through the end of March as companies peppered their earnings conference calls with as many mentions of "AI" as they could possibly squeeze in, presumably to help their stocks participate in the "FOMO" AI-fueled rally.

However, things began to change just after the end of the first quarter. The "Magnificent 7" stocks (which alone accounted for 62% of the S&P 500 index's return last year) had been reduced to the "Fab Four" as some popular tech stocks began to stall and decline. Major stock indexes have given back as much as half of the first quarter's gains in the first few weeks of April. The S&P 500 Index is currently down over 5% from its recent high, and the Nasdaq Index has fallen almost 6% in a little over a week. It is instructive to point out that the median intra-year decline in stocks ("drawdown") since 1928 has been 13%. A "median drawdown" from this level would take the market down an additional 8% or so. That would be a "garden variety" pullback, but it might feel more painful since we have had such a smooth market advance recently. Bearing that in mind, we should not be shocked by increased volatility to the downside and a return to more normal market swings.

Markets usually move for a combination of reasons. In this case, the weakness began as the much vaunted "Fed Pivot" (from raising to cutting interest rates) has been postponed due to recent economic data releases. Inflation has remained higher than the Fed's target of 2%, and recent numbers came in well above that. With employment numbers remaining robust, the fear is that inflation can resurge quickly if the Fed reduces rates too soon. Consequently, the Fed will probably keep short-term rates elevated until at least July. That assumes that the economy doesn't experience recessionary or credit default problems until then. The mantra of "higher for longer" (interest rates, that is) is not particularly good for stocks since it increases borrowing rates and attracts investment into lower-risk assets such as money market funds yielding over 5%. Just as the glow was starting to fade from the most speculative technology stocks, the conflict in the Middle East escalated to a new level.

The stock market seems to have ignored geopolitical risks until recently. Now we have escalating conflict in the Middle East as well as the Russians advancing in Ukraine and China eyeing Tiawan. All are potentially disruptive to the world order. For obvious reasons, the oil markets are very sensitive to rising tensions in the Middle East. The price of West Texas Intermediate crude (WTI) has risen this year from $70 to about $86 per barrel. Escalation of the conflict would probably not only take a greater human toll but could be disruptive to economic growth and inflation control as well. Consequently, there is anxiety in the air as the world waits to see Israel’s response to the recent attack by Iran. Perhaps because of this and additional inflation pressures, gold has recently made a new all-time high. The fact that this has happened without much fanfare may be a sign that the move has further to go.

We often talk about the pendulum swings in markets and in the popularity of investments. As Warren Buffet observed, “In the short-term, the market is a popularity contest. In the long term, the market is a weighing machine.” As an illustration of the swings in the investing pendulum, the once-hot sector of electric vehicles has seen sales cool off and stocks drop considerably. As a prime example, Tesla stock is now down more than 60% from its all-time high reached in late 2021. The lesson we take is that, even with exciting new innovations, we should not disregard the price we are paying for them. As legendary investor Seth Klarman writes, “Risk is not inherent in an investment; it is always relative to the price paid.”

There are two unconventional investment areas that you will likely hear more about: bitcoin and marijuana. As we mentioned last quarter, bitcoin ETFs (exchange-traded funds) became a reality during the first quarter of this year. Financial giants Blackrock and Fidelity, as well as others, now offer their own bitcoin ETF which tracks the price of the cryptocurrency. In addition, marijuana is likely to be decriminalized in several more states and possibly changed at the federal level from a “Schedule I” to a “Schedule III" substance. This may give a boost to companies in that business as well as to ETFs that hold those stocks. Because of the unconventional nature of these assets and as a matter of policy (partly due to regulatory scrutiny), we do not recommend these and will not invest your money in them in the normal course of our portfolio management. However, if these are of interest to you, feel free to give us a call if you’d like to discuss how to invest in these in your brokerage account.

Technologies and the economy continue to evolve and present new and exciting opportunities including those trends mentioned above. Consequently, we are identifying opportunities in the next phase of artificial intelligence development, emerging pharmaceuticals, robotics, energy, and precious metals while we continue to invest in more stable industries such as insurance, healthcare, communications, and utilities when the price is attractive.

Please give us a call if you would like to discuss any aspect of your investment portfolio.
I hope tax time was not too painful, and we look forward to navigating these markets appropriately and successfully.

Best regards,

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