MID-CONTINENT CAPITAL
A Connectus Partner

CONSILIUM*

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*advice; judgment; resolution; wisdom

Resistance is Futile

"A body in motion remains in motion… unless acted on by an unbalanced force."
– Newton's first law of motion

The S&P 500 index, propelled by its largest technology and communications sector components, registered a total return of 10.4% in the first three months of the year, one of the strongest first quarter performances ever. But more impressively, the index has produced a 28.4% return since its lows on October 27, and 34.3% over the last year. In isolation, these results are clearly very powerful and at least somewhat unexpected.

But if we widen our aperture for additional context, the market's performance is less astonishing – normal, even. In the postwar era, the S&P has returned an average of 91% over any random six-calendar-year period (including overlaps).[1] In the six years ending 12/31/2023, the market returned 98%; better than average, to be sure, but barely in the upper half of all such observations. For perspective, in the six years ending 12/31/1999, the market returned an all-time best 255%.

And what did investors have to withstand to "enjoy" these recent results? A 20% peak-to-trough decline in late 2018, a 35% plunge early in the 2020 Covid crisis, and a 27% washout in 2022. Historically, a 20% or greater "bear market" decline[2] occurs once every four years or so. To experience three bear markets in six years is extremely unusual and does not square with the narrative of a consistent and powerful uptrend in stocks—it has been anything but easy.

The story of the markets since last fall *has* been easy, however: five consecutive months of higher prices; a gain of nearly 26%; a surge in speculative assets such as Bitcoin and gold; and increasing global participation, with European and Japanese stocks reaching all-time highs. It would be tempting to describe the rally as "too much of a good thing", and it might be—but that does not mean it cannot continue. Momentum is every bit as real a phenomenon in the stock market as it is in nature, and it would be very rare for stocks to simply reverse course suddenly and give back these gains. Indeed, an array of studies has demonstrated that higher prices typically beget higher prices. Further, performance such as we've seen recently tends to occur early in bull markets, and nearly always presages further gains in the year ahead.

As noted in the last few issues of *Consilium*, we have been cautious, as we believed a recession was likely following the Federal Reserve's aggressive efforts to fight inflation. But "likely" was never "guaranteed". We have not been negative, nor have we made any major adjustments to client portfolios, waiting instead to "see the whites of their eyes": harder evidence that a recession was imminent, rather than relying solely on traditional predictors of a downturn. Being open to the possibility of a picture-perfect outcome—higher corporate earnings, easier monetary policy, and uninterrupted economic growth—has kept us on the right side of the market recently.

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[1] Arithmetic average total return, with dividends reinvested; data since 12/31/1947

[2] Using the commonly accepted definition for simplicity

This does not mean that our concerns were or are unfounded. None of the risks noted in recent issues of *Consilium* have dissipated. In fact, the market's toughest obstacle—elevated valuation—has only worsened. As noted, the S&P 500 index is up 26% over the last five months, but actual reported earnings have risen only 1%, and estimated earnings have risen just 4%, while long-term interest rates have declined slightly. Looking back even further, since the onset of the Covid pandemic in February 2020, the S&P 500 is up 63%, actual earnings have risen 36%, estimated earnings have risen 42%, and long-term interest rates have nearly tripled. According to Goldman Sachs, this places today's equity market valuation in the highest 5% of all observations over the last 30 years.

A lofty valuation carries little near-term predictive value, history shows. But as an investor's time horizon lengthens (and we certainly support long-term thinking), the starting point of valuation becomes increasingly critical to investment results. Even if future earnings and dividend growth matches historical performance, it is likely that index returns from current levels over the next decade, while positive, will not meaningfully exceed those available from high-quality fixed income instruments.

It is fair to ask: what could we be missing? Is there a *deus ex machina* that will reward today's investors for assuming elevated risks? We recognize that AI has the potential to boost productivity across the economy and lift profit margins even further. We acknowledge that GLP-1 drugs could work miracles and substantially reduce the costs of treating chronic medical conditions, to the benefit of the broader economy and society. These and other positive developments could happen—but they haven't happened yet, and investors are being asked to pay a high price for what is still a speculative outcome.

With an eye on these larger concerns, and until and unless circumstances demand otherwise, we will continue to "proceed, with caution", and focus on identifying and holding strong, high-quality companies that can grow and outperform for years at a time. This has been, and will remain, the right course for our clients no matter the market or economic setting.

Sources: nasa.gov, FactSet, Robert Shiller/yale.edu, Goldman Sachs

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