Bet You Didn't See It Coming – Holiday Edition

In the world of unexpected events, it is a safe bet that you didn't expect to go into the holiday season amid sightings of unidentified drones or flying objects over NJ and elsewhere. It reminds of the times from childhood when NORAD was used to track Santa Claus. Nonetheless, I can't remember a similar kick off to the holiday season. Truly an unusual event.

2024 might well go down as a year of unusual, tail events. In statistical and finance circles, tail events are highly improbable events. While they are events that certainly deserve a place as considerations, their rarity or improbability make them things that decision makers tend to dismiss. The problem, of course, arises when some of these highly improbable events carry repercussions that can be quite significant, often orders of magnitude greater than more commonly occurring events.

2024 saw a series of political events that, taken together, would suggest that it was among the most tumultuous periods in decades and even, perhaps, the last century. Recently, for example, martial law was declared in "South" Korea. This was not a pariah state, ruled by a dictator, but the country which is sometimes singled out as having developed more quickly into a modern economy than any in the world, ultimately emerging a manufacturing and exporting powerhouse to rival Germany. Germany, not to be outdone, has seen their own government collapse and is now calling for a vote of confidence which could lead to a new government as early as March. That would seem unusual if not but for France's Macron having been down the same path just prior to Germany. After calling for snap elections, the French government, too, collapsed. Canada is now on the brink, as well. Georgia had their own elections that ushered a new conservative leader, while Romania had elections so abhorrent to the establishment that the courts promptly threw out the verdict and declared a "re-do." The US, for its part, witnessed what many regard as one of the most dramatic political resurrections in the nation's history. So, from Milei in Argentina, across the US, Canada, France, Germany, Georgia, Romania, Korea, the world is experiencing a period of unprecedented, simultaneous change not seen in many, many decades. It seems that George Bush may have been prescient in reckoning that there would be a new world order. It just may not be the one he imagined.

That is just scratching the surface of the global realignment. Beyond political strife in many countries, war rages on in others, as Ukraine and Russia engage in ever more missile and drone exchanges. And, almost overnight in the imagination of many, Syria fell. Global foreign service spokespersons were breathless with excitement. They could hardly contain their excitement and surprise, accounting for this as more good fortune in their proxy wars with Russia. After decades of conflict, a layperson would be forgiven for asking why career diplomats and intelligence officers would find this a surprising outcome. Eventually, someone wins and someone loses. Yet, it was unclear at the outset and remains unclear what will become of the nation of Syria and its environs. You are free to contemplate now whether you saw it coming that Israeli tanks would be within 20kms of Damascus or Turkey massing troops at the border in 2024. This was the war that began with the US and Russia effectively agreeing to alternate bombing runs or one another's allies on the ground as you may recall. So, I will forego a guess on where or how this one ends.

Lest it seem as though we are fascinated with global politics, it is worthwhile to note that, as many clients know, we have long said that one should not become too emotional about global political events in normal times. They, however, have the potential to become tripwires in markets at valuation extremes. In financial markets today, valuations have diverged more than at any time in recent history, with US market valuations lapping those of European and other world markets. Gold, likewise, has ascended to record valuations, as has bitcoin and other risk assets. And, despite enduring a generally higher rate environment, inverted yield curves and upward trends in unemployment, US economic reports seem to have, thus far, defied recession. If this situation holds, it would be virtually without precedent. There are certainly those, like myself, who are open to the possibility that the combination of profligate government spending and hiring of recent years is very significant factor in having staved off recession in the near term. The simultaneous actions of the Treasury and Fed, while paying lip service to an inflation fight, have collectively also resulted in anything but genuinely tight money or restrictive policies.

Producer prices and prices in general, while not continuing to rise as fast as previously are still burning past the inflation rate of most of the last many years. And, it seems that consumers are not impressed by a performance that tacks *only* another meager 3%+ increase in prices on top of the 20%+ of the last few years. The combination of higher finance rates and higher prices is having a particularly powerful and early effect on sectors like outdoor recreational power equipment – a segment that is certainly discretionary spending for nearly all consumers in the US. A major athletic footwear manufacturer just warned on future sales, as well, leading me to consider development of a *JetSki and Jordan's index* as a leading indicator to be to the US consumer economy what liner board was to when the US was a manufacturing-oriented economy.

Meanwhile, interestingly, this ongoing inflation continues in the face of the Bureau of Labor Statistics ongoing best efforts to periodically and persistently attempt to *modernize and reconfigure* the metrics upon which prices, employment and the like are calculated. Anecdotally, most readers will easily see price comparisons with the late 1970s. What has largely benefitted the US consumer and economy and kept the current scenario from feeling very much like the mirror of the 1970s are benign energy prices. One could make an argument that energy prices are actually too low in dollar terms. The green transition is facing significant headwinds. Fossil fuel usage, even before the Draconian appetite of AI, is still fairly strong and growing globally. If one were gaming things out in Washington, some of the outcomes one would have to contemplate would be those wherein oil is more on the threshold of triple digits rather than flirting with $60-70bbl. The Straits of Hormuz, Iran and a host of other factors, of course, come into play, as well; so, assuming stable, low energy prices is something that even energy companies themselves never assume.

It is certainly possible that a little too much is being made of Trump's rearranging of the deck chairs in Washington. While there is zero doubt that the motivation is there, things take time. In government, things are apt to take way too much time. Certain obligations will be contractual and will have to run off. Others will require substantive Congressional involvement. As intimated previously, it is likely underappreciated by many that government spending underpins much of the US economy at present.

Kill meaningful amounts of government spending and GDP will take a hit. While it goes without saying that fiscal prudence is necessary, it will indeed be bitter medicine for many. The games have begun even before Trump takes office as he and Elon Musk discover that even the Republicans may rebuff their calls for frugality. It is also widely expected that Trump will lead with tariffs. Those in favor, say they are long overdue. Those opposed say that they will result in higher prices and retaliation. The possible surprise will be that things, again, do not happen as quickly nor exactly as one might expect. Further, it is entirely possible that tariffs are a leverage point in negotiations on a range of topics extending well beyond trade. So, the tariff advocates may find implementation soft while opponents may never see their worst fears materialize. Still a further possibility is that the implementation and reaction will be very different across regions and economies such that their will be an idiosyncratic effect of tariff policy unique to respective trade partners. That will come as a surprise to those who dogmatically suggest that sweeping tariffs change the macro game en toto.

Leaning into the winds of inflation and a rather cautious global macro situation, US profits have exceeded those of Europe and US tech growth continues to outpace that of most of the developed world. In fact, the US and US tech has provided a significant proportion of all developed markets profits and growth in recent years. India continues to trudge on despite most of the world, including China, the EU and many developing countries languishing in recession or near-there-to. All taken together, these things have positioned the US as the what has been considered the best house in a generally bad neighborhood.

A surprise inside the box of the obvious: leverage may well emerge as something no one saw coming. Like a grizzly bear trying to hide behind the sofa, it should be fairly obvious to all our guests. The consumer, corporate and government debt loads are nearly limited out globally. Interestingly, too, leverage in financial markets and its cost are quite high by all historic levels. That is to say that derivatives and options are being aggressively used to leverage financial exposure in a myriad of markets from precious metals to equities to crypto. With absolute rates somewhat higher than in recent years and entities still benefitting from excess liquidity created by Central Bank actions of the Covid era, one might ask if the possibility of a credit and/or liquidity event could have outsized and, therefore, quite unexpected results in the year forward. The table is set and the guests have arrived, but there is still a hairy beast behind the sofa. And, as many now know, you don't have to see the hurricane to feel its effects. Many things having nothing to do with debt in the eyes of most are profoundly affected by leverage and liquidity in general terms.

It is at the intersection of leverage, debt and technology that we could begin to see Europe play a significant role in US tech. If you are scratching your head as to where these things converge, you are likely not alone and a great many might be surprised by what emerges in the not-too-distant future. Europe, in its struggle with low- to no-growth, a lackluster tech sector and burgeoning debt, could find motivation to assail US tech. The saber rattling has been going on for quite a long time. There is little doubt, frankly, that US tech companies do exhibit monopolistic characteristics. It is not a stretch to imagine that European Union leaders will feed upon them in months and years to come. So, we can anticipate trade officials clutching pearls and feigning surprise as EU regulators begin trying to take bites out of the big, juicy US tech apple.

Lastly, it is worth taking a stab at the AI craze in general terms not because I do not believe in AI, but because it is necessary always to evaluate Return on Investment (ROI). The best that can be said at present for AI is that 'it can do things.' Like one of the gyroscopes which spins your wrist around, it is interesting and it is obvious that it is doing something unique. Yet, a top spinning in your hand does not do much until you can figure out the good use to which it can put, like a gyroscope being found useful in in aircraft or the Hubble telescope. Then and thereafter, you must determine how much you must charge and how much you can make. With the energy consumption being estimated so high, AI could sow the seeds of its own slow adoption until that issue can be addressed. It is fair to say that a lot of current AI experimentation is free now. When you are charged, you will have to assess that the value-add is worth the cost. In some instances, it definitely will be. In other, perhaps, not. It is a real thing, albeit not perfect. It will be with us, if for no other reason other than it is really just a necessary and logical progression of computation and communication associated with computers more generally. The question will be whether it is a truly game changing application deserving of nearly unlimited valuations. Optical networking was a similarly promising technology, widely adopted. But, all instances of optical networking did not sustain unlimited valuations indefinitely. Further, like network security and semiconductors in general, this is a game running at warp speed with incredible capital spending requirements, strong competition and continuous and large R&D spends.

So, we will leave 2024 knowing that new alliances and partnerships may emerge in place of the old. Rates and markets go both ways, sometimes in ways that give us pause. The Dow Jones Industrial Average just had its longest consecutive period of down days since 1974 while the markets are generally still in record territory. Alongside a couple of other contributing factors, it will be completely without historical precedent in modern times if the combination of the interest rate increases and increases in unemployment from a very low base that occurred during the Biden administration did not result in a recession. So, there are things that exist together at this moment which generally do not. It is rare in an investors lifetime that they see truly unprecedented conditions, but in this geopolitical, financial, fiscal environment one could be forgiven for not having seen some things coming. As mentioned, it is rare to prepare for very unlikely scenarios. A Roman poet from the 2d century is credited with the phrase rara avis in terris nigroque simillima cygno which effectively means a bird as rare upon the earth as a black swan. The Romans assumed that there were no black swans because they had not experienced them. In the 17th century populations of black swans were found in Australia by a Dutch explorer. So, while the term became popularized to suggest that there were certain things you just couldn't expect nor predict in the early 2000s, we should not excuse ourselves from the effort of trying to see nearly all possibilities. Things happen. Rare things happen. Humans and, perhaps, Americans even more so, tend to place higher odds on outcomes that they want. Yet, the most likely way to actually get what you want in the long run is to position yourself to use the most information possible and weight possible outcomes based on their actual probability rather than how much you favor the outcome. Although it is easier said than done we can certainly assume that most drivers are bad and likely to do unpredictable things when we drive. Investors need to bring that same pragmatic view to investing. You can still enjoy your trip and you are a lot more likely to arrive safely. In times where the things you didn't expect are occurring daily, it is probably wise to broaden your view a touch to see a broader range of possibilities.

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