Socratic Method Applied to Things That Make You Go…, Hmmm

So much information and so little time. So, this month's commentary will pose questions with, perhaps, a short commentary attempting to question assumptions and premises and possibly even recast some of the narrative surrounding recent events.

How can the market be down so much before my trip and up so much as soon as I returned?

My four-year-old grandson has taken to starting answers with a drawn-out "Whelllp," like an old Nebraskan farmer. Seems apropos here, so I will give it a shot.

So, why did the market roundtrip so fast? Whelllp, you know, because people. Short answer, I know. But, largely true. Research in investor psychology and behavior is pretty interesting. As is often the case, in the near term, investors are simply exhibiting their tendency to act out of fear and greed. Spaced among the generally frantic crowd are also opportunistic short-term traders who are just trying to make a trade, get a dime.

Although it was forgotten as soon as tariff talk started, this was not the first time the market has swooned. Long forgotten now is the November news of Deep Sink, a Chinese company that can do what US tech titans do in AI for 95% less money. Oh, yeah.

But, the big news which captured investor attention and triggered their flight response before its pause subsequently triggered their fear of missing out was tariffs.

The good news? It doesn't matter. Markets move. It's what they do. Forever and always they will. If they never moved, you would make little to no money. So, embrace the change.

Is the trade war over?

When the Trump tariff news hit, a tsunami of bad news broke about the end of capitalism and trade. Simultaneously, devoted acolytes maintained that Trump was, in fact, a 4D chess player capable of quantum, stealth moves in outer space. About 90% of people, let's say, held one of those two polar views. A very slim band of people in the middle, myself included, thought change creates change and negotiations of any kind are quite difficult and time consuming. Changes involving international negotiations more so. Change involving international trade negotiations even more. So, how would any thinking person believe that all bad or all good would arise quickly. Who would even pretend that the fog could lift quickly? Further, no one even really questioned the likelihood of unforeseen, contingent results nor the possibility of multiple starts and stops.

So, we entered a period of difficult, lengthy negotiations that were to be fraught with hopes bolstered and hopes dashed, ultimately to land somewhere in the land of practical reality. Who could have reasonably assumed, otherwise? Oh, that's right, the obsessed haters in one balcony and the sycophants in the other. But, it is OK, ladies and gentleman, because this show promises to have something for everyone.

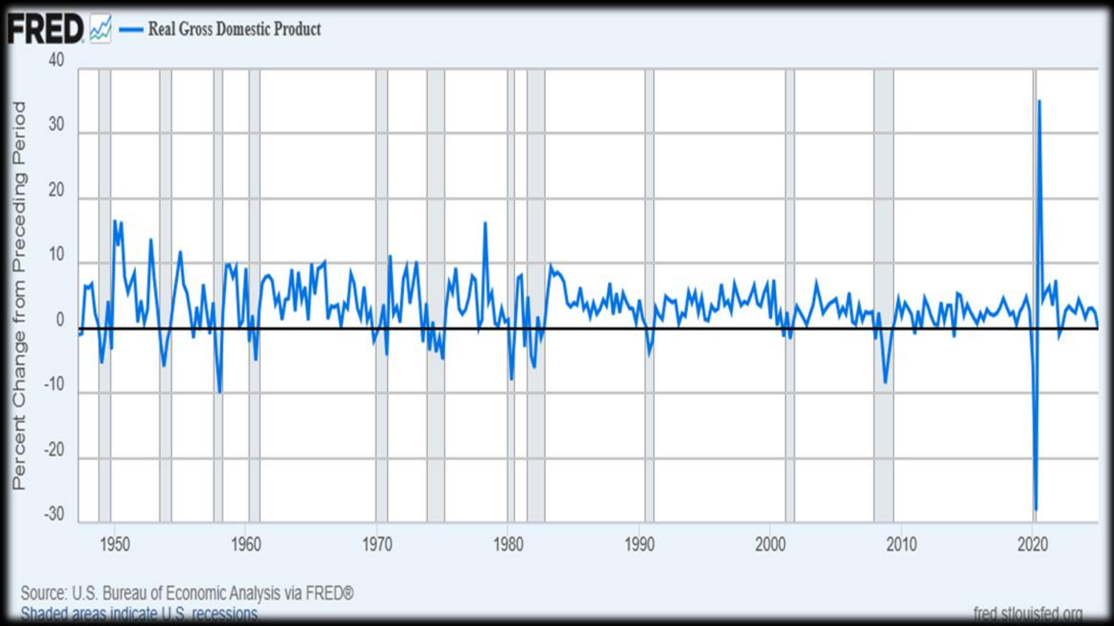
Just don't be surprised when you are surprised. China's Xi may offer to drop all tariffs and give Trump Boardwalk- in return for Taiwan and the F47 avionics package. And, a few countries may agree to balance trade in one fell swoop by buying henceforth export restricted technology. Hey, if we are dealing, let's deal.

The good news? For those fretting against the potential loss of open and free trade, rest easy. The world has had total free and open trade about as often as pure communism – never. Further, trade relations have been changing since Eve offered Adam an apple.

Why are recession odds so low after my trip and, yet, so high before I left?

Whelllp, because people. Yup. People. You see there are these analysts paid to make predictions. They can be right or wrong, but it is best to try to look reasonable and not stray too far from the predictions of other analysts – kind of blend in. So, pretty much all the analysts' predictions ranged from 10-50%. What was curious about that was that we already had contraction in the first quarter. Two quarters makes a recession (unless, like the last Administration you get a pass and they don't call it a recession). So, in effect, we were already halfway there before the tariff talk even started in earnest. Yet, predictions stayed quite low because labor force and other things, you know.

A curious fact emerges, however, when one looks back at past quarterly data. When a contraction quarter has been reported, the US is either in recession or going into one within a year about 80% of the time. Interestingly, I have never once heard anyone point that out. An inverted yield curve is also a frequently identified recession indicator. It inverted and stayed inverted for about as long as it ever has. The recessions typically follow after it corrects. It has. The Sahm rule was as near a perfect predictor of recessions as ever there has been and it lit up several months ago. So, whether you 'feel' like a recession is coming or not, there are some things that would lean toward it far more than might be suggested by a 10% chance.



Throw into your estimation the trade tariff pause which could foreseeably do a few things. One, it will likely pull imports forward while tariffs are not being charged. Higher imports reduce the net Export component of GDP. DOGE is, meanwhile, very efficiently culling spending and employees (~300K) from government. Government spending is a component of GDP calculations and is actually something like 20%+ of GDP. Consumer spending, another big component, is confronted with the twin risk of higher prices and tapped out credit. Consumers comprise close to 70% of US GDP, by the way. Lastly, capital investment is somewhere in the mid- to high-teens as a percentage of GDP. If CEOs are bewildered by how all this will shake out, it is possible that they will not act too hastily. Certainly, given the changes taking place, some investments will be re-looked or possibly delayed. For those math people wondering how those numbers could add up to more than 100%. Whelllp, remember, the US pretty reliably imports more than it exports and the factor in the GDP equation that captures it is X-I or exports minus imports, which for a country with a trade deficit result in a negative adjustment to GDP. In our case, it runs close to -3%.

But, they say, unemployment is still low, so there must not be a recession here or coming. It has actually been low at the start of other recessions. In 1969, it was 3.5% before rapidly escalating to over 6% in 1970. And, the Bureau of Labor Statistics, as we have discussed before, has been using creative, scientific wild guesses at employment data since, at least, Covid and there is little evidence that methods or data integrity are much better now.

Lastly, suffice it to say that all recessions do not come on with sequential quarters of contractions. Some fairly, actually very, significant recessions seem to have originated with a 'skip pattern' where a quarter of contraction is followed by a growth quarter and, thereafter, continuing contraction. I am not an economic forecaster, so I don't have to publish a likelihood or probability of recession, but I do not feel like 10-20% is a rational forecast for those charged with assessing such risks. And, as you will see in what follows, we don't really need to know precisely whether we will have a recession or not. There are other ways to manage our exposure.

The good news? If you were born around 1950, you have seen about a dozen recessions and none of them killed you. Candidly, that works out to be a recession about every six years on average which corresponds very well with the average length of a business cycle, of course. Our last recession was 2020. Lived through that one with Covid. Que sera, sera. Whatever will be, will be.

If a recession were to occur, what would it mean for markets?

There are seldom clearcut pronouncements that can be made regarding near term market movements. What is generally held, however, is that markets don't much like lower earnings. If you think about market levels in terms of the price paid for a dollar of earnings, you might rightfully assume that a business making less money is worth less money. The same is true for markets, of course. Further, markets tend to both place lower multiples on companies in periods of slow growth and tend to overshoot. For example, a multiple of 25X earnings might be reduced to, say, 17X earnings. If a company or market is valued at $50 and is earning $2, in a recession, the 17X multiple would pull the price to $34, of course. Assuming that the recession hurts their earnings, as well, and earnings fall to $1.50. Then, that 17X multiplied by $1.50 in earnings could result in market price of $25.50. So, earnings fell 25% and the market price, due to the multiple contraction and earnings decline combined, fell by almost 50%.

In typical recessions, multiples can hover in the 14-17 range quite frequently. The current Price to Earnings ratio of the S&P500 is about 28X.

The good news, recessions often bracket dramatic markets. In fact, one could argue that they are nearly symbiotic. You can almost not have one without the other.

Are there really companies with only $500MM in earnings that are bigger than the GDP of EU countries?

Yes, Virginia, there are companies with Price to Earnings ratios of over 500X that do have valuations larger than some EU countries' GDP despite only earning $500MM. In fact, the rise of Artificial Intelligence and such are driving investor excitement. To be fair, some of the companies involved have printed significant earnings gains which leads many to dismiss any comparison to the 'clear' folly of investing in silly, unprofitable companies of the dot-com era. The part of the historical narrative that is lost in the discussion of the tech bubble and the dot-com era is the fact that there were some very real, high tech companies with very real and growing earnings during the dot-com era. Everything was not sock puppets and Superbowl commercials. I often see corollaries between some companies today and those in the optical networking space in the 1990s. In the 90s, there were numerous companies growing earnings at 40%, 60%. They were real and they were, in many instances, building the infrastructure for the communications economy we live in today. Optical networking, switching and the like had really never been rolled out on a large scale. Many of the companies that brought that technology to the fore are no longer with us or have, yet, to regain their highs of the 90s. Yes, really. Why? Were they bad companies? No. If, however, one values a company at 500X their earnings and their earnings do not continue to grow exponentially, it is easy to see that it could take many decades to 'earn into' the price. Or, conversely, witness an implosion in the stock price prior to attempting to regain the track higher over a longer period of time.

The good news? Situations like this are reasonably easy to see and avoid. Warren Buffett has not, yet, to my knowledge made any overtures to the company described. Nor have you. Problem solved.

Is Pete Rose's reinstatement in baseball related to the NIL, fantasy leagues and lotteries?

For those of us in the Bible belt, it is not difficult to see that gambling has become a central part of many people's lives in a way it had not been in decades past. Whether you consider it a vice, a sin or harmless diversion, you will likely agree that it is a little interesting to be able to gamble on who the next Pope will be on Polymarket, while checking to see if your bet on Shedeur Sanders going in the first round or second or at all pans out.

You are thinking, "Understood, but how does that connect with the NIL and Pete Rose?" Whelllp, you now have young people being offered millions before they are old enough to drink. You had Shoeless Joe Jackson and Charlie Hustle compromised by gambling. Is it a stretch to imagine that some University of ~~Alabama~~, ~~Georgia~~ player might not be compromised at some point. And, is it also not a given that paying players increases the transparency of their commercialization and, thereby, makes them fair game for all wagers?

So, what are the odds that ~~UNLV or Ole Miss~~ some university who maybe had a recruiting violation or two in their past gets busted for a major gambling fix in the next twenty-four months? Probably higher than the combined odds of the trade war being over, a recession starting and a 500X earnings company going to the moon.

In any case, one would have to wonder if we have not – with crypto, day-trading, meme stocks, gambling, NIL, online gaming – mainstreamed or gamified financial risk taking for millions of Americans.

The good news? Most readers, although sometimes tempted, can either avoid or control this behavior. Frankly, you were most likely to engage in high-risk gambling behavior if you had started gambling by age 12. By the late twenties, you were probably beyond most of the risk. The fact that you are reading this would indicate that it is someone else's problem.

Given all that what should I invest in?

Patience. Yes, at the moment, patience. The overwhelming urge that grips investors to either buy or sell is not always rational nor is it always constructive. Such reactions are caused by that crocodilian amygdala that bypasses a lot of thoughtful reasoning that would, otherwise, take place. Yet, sometimes, not reacting is what is best for you. If you have ever had the experience of walking in the woods and almost stepping on a baby deer or rabbit, you can appreciate that they instinctively know to stay put and wait it out or, at least, wait until the opportune time to react. It is a worthy consideration for investors. For those who would say, "I can not sit and watch my asset values gyrate or, conversely, watch the market run away from me," I would ask, "Why not?" Frankly, you would be in esteemed company. Consider, for example, that Warren Buffett is sitting on hundreds of billions in cash in Berkshire Hathaway. What did he do during the recent turmoil? Basically, nothing. He didn't even rush in to buy things knocked down nor did he go in and buy that 500X earning company in the always exciting AI field even though he could very nearly just buy it outright for cash and take it private if he wanted. But, what did he do and why? What is he invested in? Aside from holding a handful of companies he likes, he is investing in patience. The reasoning is not difficult to understand, although it can be terribly difficult in practice. What Buffett has long liked to do is to find good companies at very reasonable valuations and own them.   His doing nothing might imply that he does not see the kind of value or risk/reward that he desires. He would likely agree that he is a little too old and has seen a little too much to let the machinations of a market driven by rumors and emotion to make him react. He waits patiently for what he is seeking. He does not let fear or greed stoke adrenaline compelling him to action for the sheer sake of motion. Motion, in this instance trading, has little value for investors like Buffett. There is an old saying that markets are, in the short run, a voting machine, but, in the long run, a weighing machine (accounting for earnings). So, the movements that are driven by popularity and sentiment have never been proven to be durable. In fact, sentiment or investor confidence has never been shown to exhibit a consistent correlation with markets over time in virtually any market in any country on earth. So, then, it would not be the likely driver of decisions for someone who has been largely regarded as a great investor over the long term.

So, the lesson should be fairly evident. If you want excitement, buy a jet ski. If you want to build wealth over time, be patient.

The good news? As highlighted above, cycles are your friend. Variability is your friend. If you exercise great patience, you, like Buffett, Sir John Templeton, George Soros, Jeremy Grantham and others can calmly invest when others are frantically trading.

[Note to Investors: The comments herein are intended to provoke thought, inform and entertain. They are not intended as specific investment advice. As often as not, the contents reflect information that the authors' feel is not adequately disseminated or understood by investors. Some discussion topics are presented for emphasis due solely to their lack of popular reporting and may not reflect the primary determinants of any specific investment decisions. In all instances, investors should consult their appropriate advisors before making any financial, tax or legal decisions.]