

Asking for a Friend

“Oh, not me, I was asking for a friend.” It is useful in those situations when we think that we should understand something and are feeling a little sheepish about admitting confusion. If you are reading this, it is a near certainty that you are bright and have learned quite a lot throughout the course of your successful career. Amid all the action and the corresponding and attendant narratives, you may have still found yourself rationally asking, “Wait. What?”

So, let’s start where we are. The world is awash in stories about, “Is AI a bubble?” This story often runs alongside stories that ask where valuations are relative to history with the obligatory nods to ‘it is not like 2000’ or ‘stretched markets can always go higher’ or, perhaps, followed with admonishments about ‘timing the market’ or staying invested for the long haul. We can talk about the pragmatic reality of AI, but it strikes me as a bit of a myopic view, given that AI is not the only thing that is very dearly priced. A great many asset classes are shearing off their prior all-time highs daily. In the chart below, one can observe that gold, copper, silver, equities, global equities and, of course, chip stocks are all taking out highs. In fact, in the chart you will see that silver is actually the standout - even over and above the SOX semiconductor index over the last several years.



Despite the financial press’ assertion that we are experiencing a post-2022 bull market, we could quite easily and convincingly argue that we are long into a cycle that has largely been unbroken for quite a few years. Reflect, if you will, on the entirety of the period going back to 2000. Alan Greenspan, you may recall, ushered in what it referred to as the Fed Put, meaning that the Fed will always come in with some kind of financial alchemy to ward off evil markets. The interventionist model was upgraded in the wake of the Great Financial Crisis (GFC) where the US Government introduced Americans to full-on intervention which resulted in shotgun marriages of troubled institutions and bail outs. It even introduced programs with names like Troubled Asset Relief Program (TARP) which sounded ominously like something necessary to put over your house in Missouri after a tornado blows your roof off. Fitting, I suppose.

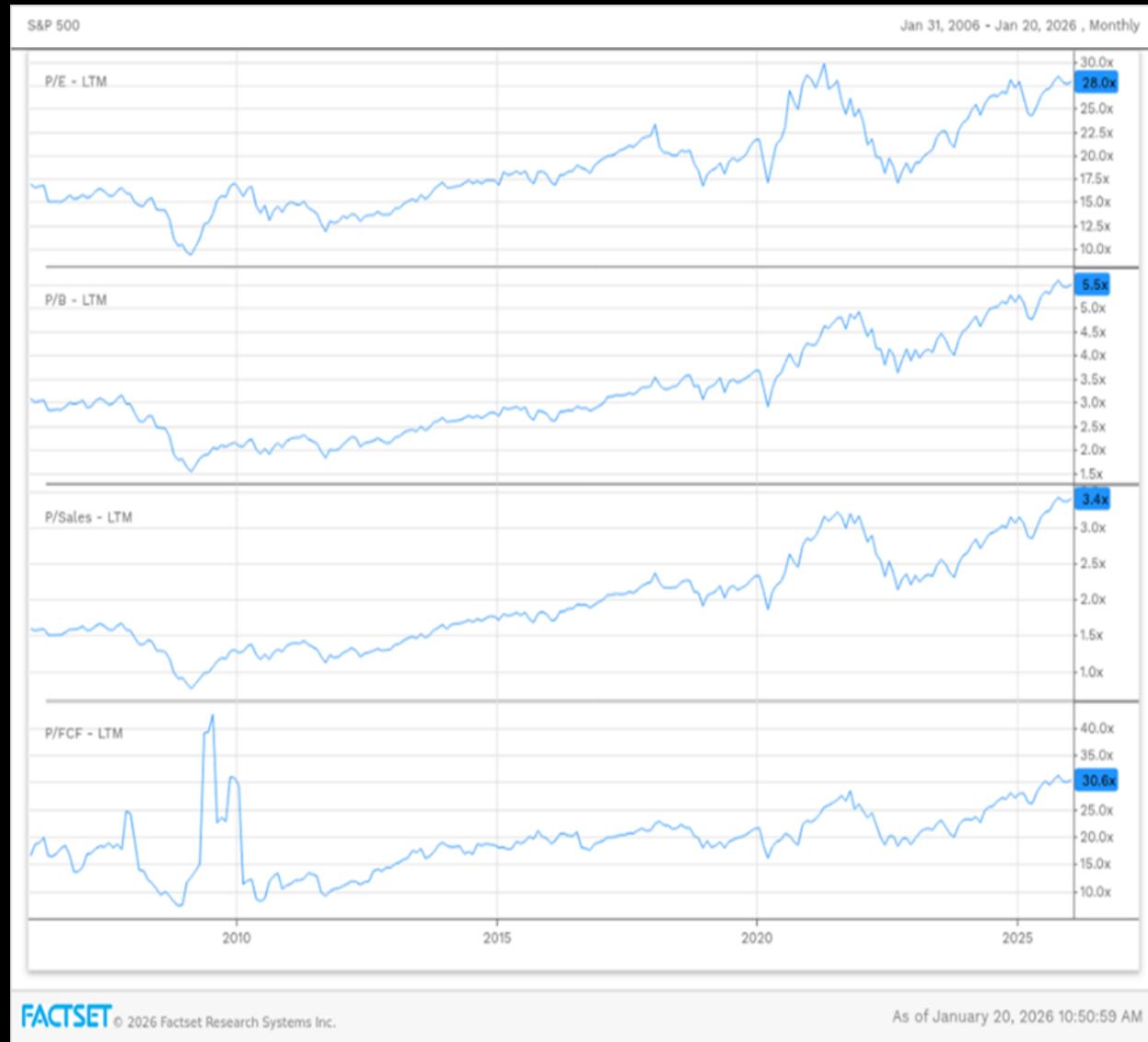
Despite experiencing a few rocky points around 2015/2016, no acknowledged recession occurred again until the Covid era. The Covid era was not only notable in that it presented an ‘existential’ threat to our existence as many insisted at the time, but in that it also unleashed hyperscale interventionism wherein the state ran a two-pronged assault, one in the bright light of day with massive direct payments weighed in the trillions alongside some covert ops that involved stealthier moves like buying securities which the Fed is expressly prohibited from buying. With the act of simply lowering rates seeming ‘so 1990s,’ the government graciously and copiously borrowed to intervene, making direct payments to consumers and business owners while mandating forbearance on housing and student loan payments, resulting in the shortest ‘recession’ in US history (2 months). What a glorious time to be in debt in America.

The immediate post-Covid era caused a stumble with 2022’s ‘not-a-recession’ during which GDP contracted for two quarters (a measure frequently associated with recession), but which was not flagged as such by the NBER. So, in effect, we started around 2001 in a recession, followed with the 2007 recession and a maybe/partial one during the Covid era. With the average historical period between recessions being about 7-8 years since 1980, one could be left guessing as to why or how we have avoided a true recession in arguably the last seventeen years or so. The incredible rinsing and repeating of an ever more aggressive Fed and Fiscal Policy engine cannot be overlooked. In the past, I have likened it to spraying ether into an old engine that won’t start. It may well help get it to start up, but it very well may ruin the engine eventually. The net result has been what some have called a ‘valuation regime shift,’ wherein equity valuations (CAPE) have held at or above the mid-20s since around 2013 following the stimuli of the GFC.

This persistently higher level has convinced many investors that the recession monster is doomed because the Fed, the government or Trump will never let markets or the economy materially decline. It is difficult dispute that there is strong intent in government to keep valuations elevated relative to historic norms. Perhaps not surprisingly, that view was also historically prevalent in places like Rome, Spain, Japan and the US. During some unfortunate events in the late 1800s and early 1900s, in fact, government and, occasionally scions of industry intervened to stabilize markets in the US, as well, for example. After the 1920s during which the US experienced one of the longest, strongest productivity and growth periods in US history (amplified by easy credit and high liquidity), the US government was compelled to embark on unprecedented intervention and stimulus programs again in an attempt to restore growth and good order during the enduring tumult of the 1930s.

Having enjoyed our own more recent period of government induced liquidity, the CAPE has generally hovered above the 80th percentile since around 2013 and currently stands at about the 2d percentile even when measured solely against the ‘structurally higher’ period since 2000. High yield spreads (the interest paid above the risk-free rate on high yield bonds), meanwhile, are currently lower than 95% of observations throughout history, which essentially means that bonds, as well as stocks, are priced for perfection. As per the below chart, trailing PEs, price-to-sales, price-to-book and price-to-cash flows ratios are further confirmation that equity valuations have inflated substantially since the early 2000s. As a general rule, such ratios tend to rise and fall and most often cluster around the long-term averages and spend relatively little

time at the extremes. For example, according to Alliance Bernstein research, the previously mentioned yield spreads tend to stay tight, on average, for only about twenty-eight months. They have been so for more than two years now.



Despite a perennial bullish narrative from most investment firms, many have quietly acknowledged forward equity returns possibly being depressed due to the elevated Shiller PE or CAPE ratio. Most have not incorporated the tight high yield spreads into their published forecasts. According to many, the S&P500 could be expected to produce an annualized return of about 2% per annum over the next 8- to 10-year period. When we have utilized a model that combines high yield spreads and the Shiller PE, a possible return range of somewhere in the vicinity of .5 -1.0% emerges for the five- to eight-year forward period equity price return, as well. Notably, our analysis excludes dividends which is potentially good news in some dividend carrying portfolios. While the S&P500 currently bears a substantially lower than historic yield at approximately 1%, it is still possible to construct equity portfolios with somewhat higher

dividend yields. Interestingly, it would still be quite possible, as well, to derive a positive return on a bond portfolio, especially for an investor holding actual bonds or bullet ETFs (think of a basket of actual bonds that mature within the ETF at a specified date) who could, of course, hold bonds to maturity and be redeemed at par regardless of equity market. One could, likewise, construct equity and bond holdings that could seek to leverage the preferential tax treatment of qualified dividends and tax-free bonds to enhance after-tax returns where applicable.

The operative question for many individual investors is not whether one believes that valuations are structurally higher or will revert to the mean, but rather how to construct a portfolio that achieves one's objectives. A common scenario is that of an investor who is or will soon be dependent upon the portfolio for cash flow. For some time, many advisors have held that an investor can pull 4% a year from an equity portfolio over a very long horizon. A real-world challenge in that simplification is that investors tend budget in dollars rather than percentages. A client spending \$200,000 a year off a \$5MM portfolio does not easily reduce spending to around \$140,000 after a major equity drawdown, for example. In the same market drawdown, another investor allocated to around 40/60 equity/fixed income producing 3% dividends and 5% in bond interest would meet the income need without encroaching on principal. This is, of course, only a simplified illustration and one that would require, among other things, that dividends and interest be paid without interruption. Although there can be no assurance that any portfolio will achieve its stated objects, the illustration simply highlights how allocation and focusing on the objectives can enable one to navigate market conditions. This is essentially a tangible example of 'managing to objective.' An investor managing to objective can relinquish the emotion associated with seeing the all-equity portfolio potentially decline in value to, say, \$3.5MM or the balanced investor feeling left behind as other all-equity investors potentially make higher returns. The investor managing to their unique objectives rather than chasing benchmarks may also be more likely to exhibit the kind of steady, disciplined investor behavior associated with long-term success.



Viewed in this context, whether AI is in a bubble seems somewhat immaterial. Upon hearing it recently as silver put in highs alongside gold, equities, copper, international equities and other asset classes, I imagined a befuddled diver surrounded by bubbles being asked if AI might be a bubble. "Yes, Martha, AI could very well be among the bubbles." So, suffice it to say that a great many questions you have been having may very well have some legitimacy. Accordingly, it is more than reasonable to question, even if only for a friend. In the meantime, it is worth noting that markets revert; prices change; and, value matters.

Since AI has been mentioned, it is worth signing off with one more brief note on AI. Like many these days, I, of course, utilize AI to source information on a myriad of topics. For example, I recently asked it to pull data on housing prices versus personal income and it dutifully and promptly fetched the number of bank branches in Papua New Guinea and the number of Hispanics in Harney County Ohio from the Federal Reserve website. You can imagine how perplexed I was, not only at the response, but also in the fact that the information was sourced from the Federal Reserve website. I was left to wonder how I got that kind of response from artificial intelligence that we are being told will soon cure cancer, as well as why the Fed apparently pays researchers to report on the number of bank branches in Papua New Guinea. (Around 1.6 per 100,000 residents if you end up looking for an ATM in Papua, by the way).

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