Irrational Exuberance Redux? Been There, Done That! Lesson Learned: Hope for the Best, Prepare for the Worst

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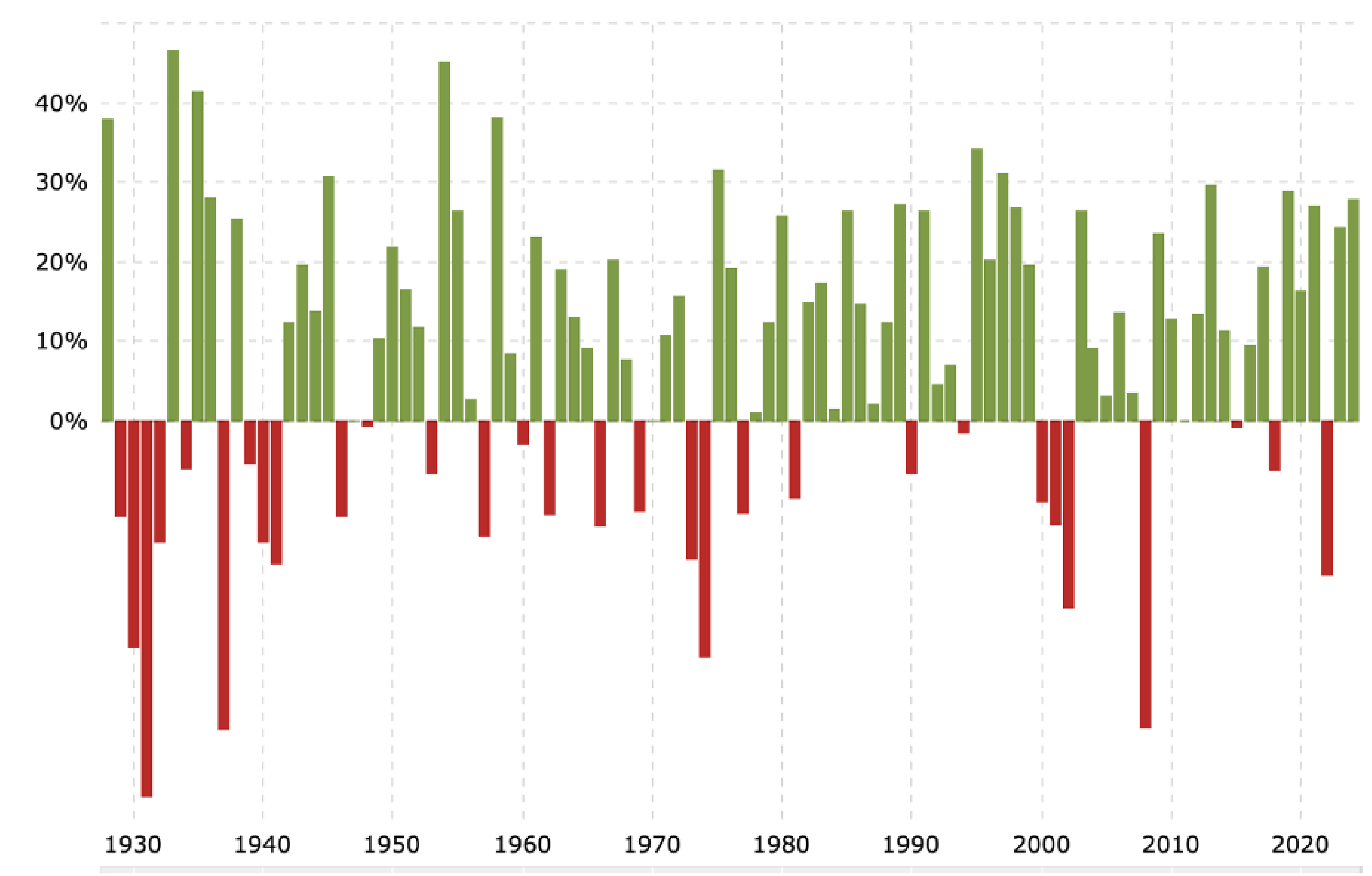
A truly momentous year in the equity markets is winding down. The popular S&P 500 index looks to finish 2024 solidly above 20%, marking the second consecutive year of 20% plus returns. Such an occurrence is rare, since 1950 the S&P 500 has only posted consecutive 20% plus total returns twice, 1954-55, and the large cap growth/dot.com bubble period of 1995-98, with 1999 returns coming is just shy of 20%. Following the 1954-55 period the S&P 500 posted a relatively flat return year in 1956 of 2.62%, followed by a negative 14.32% return in 1957. Many readers will remember the "Dot.com bubble" period that began in 1995, a market environment that was described early on in1996 by Fed Chairman Alan Greenspan as irrational exuberance. When that tremendous period in the U.S. equity markets came to an end early in the year 2000, the S&P 500 did something that had not previously happened since the beginning of WWII. Since the 1939-1941 period, the S&P 500 had not posted more than two consecutive negative year total returns. From the year 2000 through 2002, the S&P 500 fell a cumulative 47.15%.



Of course, past performance historical statistics are not reliably predictive of future returns. We truly are living through a period of previously unthinkable innovation in computer technology and scientific discovery in areas of physics and genomics and this is showing no signs of slowing down. Thus, given the time in which we are living, it is not unthinkable that we could continue to experience market performance not seen since the late 1990s. But history does suggest that the next several years warrant a heightened level of caution.

I began my career as an equity analyst/portfolio manager in 1996 and by 1998 it was very clear that the equity markets were increasingly pricing in a near-term future corporate performance expectation that were very unrealistic. The "canary in the coal mine" that preceded the bursting of the bubble valuations that had inflated during the late 1990's was a cautionary forward guidance in late 1999 by the Nvidia (NVDA) of that period, Cisco Systems (CSCO). With the introduction of Chat GPT artificial intelligence (AI) chat bot the U.S. equity markets have become fixated on the rapid investment cycle ushered in by AI development, which was made possible by Nvidia's advanced GPU chips, which made Nvidia (NVDA) to undisputed AI investment proxy. The equity markets, like those of the late 1990s, have become fixated on AI, Nvidia (NVDA) and many second and third derivative themes, such as Microsoft (MSFT), Amazon (AMZN), Alphabet (GOOGL), Taiwan Semiconductor (TSMU), and many previously "boring" electric utility companies that have come into focus given the challenge of the large AI hyper-scaler companies like, Microsoft (MSFT) and Amazon (AMZN) in finding adequate and reliable source of energy to power the rapid build out of AI data centers.

Since the end of WWII, the United States has been the dominant nation globally when it comes to technological innovation. This innovation dominance has resulted in significant outperformance of U.S. equity markets vs. those of our democratic peers. See the following illustration of this relative outperformance:

The US accounts for 74% of the MSCI world market capitalization, also a new all-time high.

Regions as of percentage of MSCI World market capitalisation

Source: SG Cross Asset Research/Quant Research, FactSet

Investor psychology plays an important role in markets. When markets become fixated on a new and exciting technology, characterized by "fear of missing out" or FOMO, this almost guarantees that the equity markets will eventually over-shoot. The tricky part of investing during major technology inflection periods is to participate, as fully as possible, in what can be almost parabolic investment returns, while guarding against the valuation air pocket that such periods typically produce as they begin to overshoot. The problem for many investors is that markets can remain over-valued for much longer than most fundamental investors think possible.

As we enter 2025, we are far more cautious as we think about the potential for outsized market returns over the next 2-3 years than we were after the Bear Market losses of 2022. That Bear Market troughed in October 2022 and going into that trough I included part of Miller Value Partner's latest investment commentary in which Samantha McLemore wrote: "A *peak-to-trough S&P 500 drop of 24.5% ranks as the 12th worst in the post-Depression period. Historically, an investor has earned above-average returns buying after a 20% market decline. The market averaged low-to-mid teens annualized returns over* 1, 3 *and* 5 *years whether we faced a recession or not. While we could expect more downside to the ultimate*

low, it hasn't historically taken that much patience (1 year) to be nicely in the green." It was in that August 2022 commentary when I went on record that inflation had peaked, and our economic base case was a "soft landing." One year later, as of August 31, 2023, the S&P 500 was higher by 15.94% and CNBC on August 22, 2023 wrote in an article written by Lorie Konish, titled As economists point to a 'soft landing for the U.S. economy, here are 3 financial risks for consumers to watch: "The forecast for the post-pandemic U.S. economy once called for a recession. Now many experts are backing off those predictions. In the latest about-face, 69% of economists surveyed by the National Association for Business Economics, or NABE, said they see a "soft landing" on the horizon. That's a "significant shift" from March's survey, according to NABE, when a similar share of respondents leaned toward a recession."

I certainly do not always get near-term market prognostications right, nor do I always get near-term economic forecasts right, but the second half of 2022 was a period when I had an unusually clear view of how the equity markets and economy were likely behave over the next one to two years. I have less clarity today, but with the unfolding of an almost perfect economic soft landing over the last two years and two consecutive 20% plus gains in the S&P 500, equity market valuations are, by almost all measures, stretched. Adding to the risk of stretched equity market valuations, the change in administrations in Washington D.C. introduce significant policy uncertainties that most certainly will widen the range of potential economic outcomes, both positively and negatively, over the next 12-24 months.

In anticipation of entering this period of stretched equity market valuations and greater economic uncertainty, I have been working on either adding "buffered" market ETFs to portfolios, along with a hedged multi-strategy mutual fund to portfolios in order to attempt to preserve recent gains and modestly hedge against a significant correction or bear market period in the coming years. These securities are admittedly an imperfect hedge, but in the accounts where I have introduced these securities, I will increase the allocation as the current bull market progresses. For larger and more diversified accounts, I will be introducing a more sophisticated options strategy that will be designed to hedge against a significant market correction or bear market without imposing any material cap on market upside capture. The downside to most ETF or funds which provide downside protection is that they also inherently will cap upside performance when the markets are in a strong bull market as we have seen over the last 24 months. This new options strategy will require account holders to sign an options agreement and sub-advisory paperwork with our outsourced option manager. There will be a cost for that outsourced manager, but the options strategy is designed to generate incremental call selling income in excess of the cost of the subadvisor. More details to follow in the first quarter of 2025.

As I once again make my closing comments on another year in the markets, I feel very fortunate to such loyal and committed clients. Seven Summits Capital has grown significantly over the last five

years because of much appreciated referrals from existing clients and the outsourced Chief Investment Officer relationship with Redstone Capital Management in Scottsdale, AZ and Dr. Martin Curry in Maryland. I wish the happiest of holiday seasons to all of my clients and colleagues.

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