Investor Letter
Fourth Quarter 2024

Review of the Quarter

Financial markets performed well in the fourth quarter, with the S&P Total Return Index rising 2.4% and the Bloomberg US Aggregate Bond Index down 3.1%. The rally followed a weak period for markets during the summer. The stock market benefited from continued strong growth of the US economy, along with a 50-basis point interest rate cut by the Fed at its September meeting. Following the US election, there was a change in market leadership from technology stocks to those perceived to benefit from specific policies of the new administration. These new leaders included industrial shares, energy shares, financials and defense stocks.

Expect the Unexpected

It is always good for investors to be aware of risks which could negatively impact financial markets, and the beginning of each year provides a good opportunity to review such risks as investors assess their portfolios. Risks for investors in the coming year include:

- Market correction from high levels of valuation
- Potential war in Asia, or escalation of the conflicts in Europe or the Middle East
- Slowdown in the global economy
- Resurgence in inflation followed by another cycle of Fed tightening
- A crisis caused by the high level of debt owed by the US government

There are also some areas where developments could be much better than anticipated:

- Further positive developments in artificial intelligence
- Rapid developments in other new technologies including quantum computers, hydrogen energy or nuclear fusion
- Global economic recovery as other countries catch up to the US

Any of these risks could spark a market selloff, and any of these opportunities could send markets soaring. That said, as investors consider market risk, it is very important to remember that in the past three years the biggest developments impacting financial markets have been *totally unanticipate*d by financial markets and most experts. The pandemic in 2020 caught investors, governments, and the health care system by surprise. Financial markets fell sharply on this news before stabilizing. The inflation which followed was similarly unanticipated. Then, just when things seemed at their worst, the rapid adoption of artificial intelligence began, and markets soared as investors realized its incredible potential. It is likely that the next three years will see similar surprises.

What about the risks that were expected? Virtually every economist predicted a recession when the Fed started to raise interest rates at a rapid pace in 2022. It never happened. Others forecast a full-scale ground war in Europe when Russia invaded Ukraine. Some predicted the Middle East would have an all-out war after Hamas attacked Israel. Some saw an imminent invasion of Taiwan by China. None of these things happened, at least not yet.

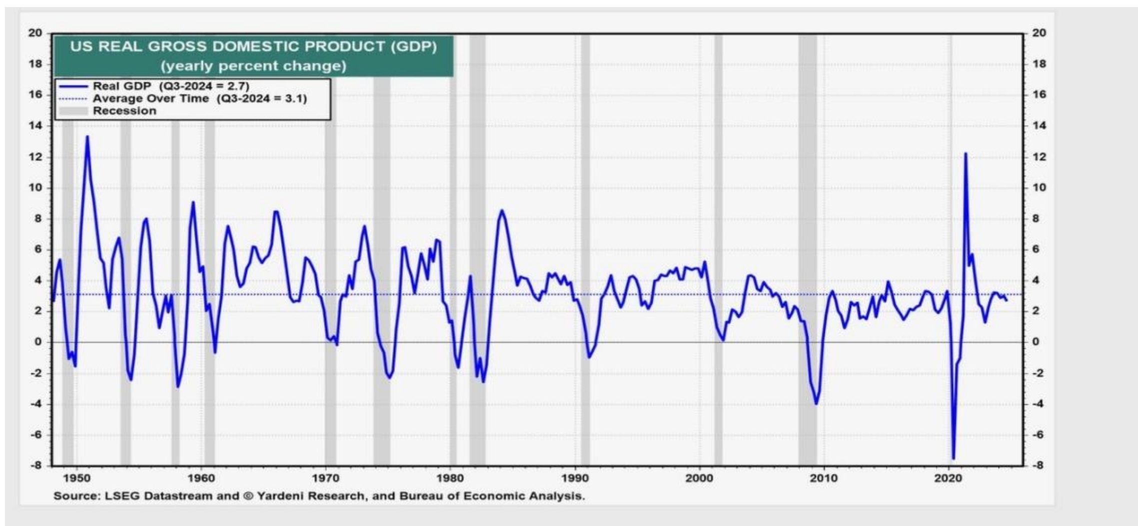
The lesson here is not that the crises that were predicted did not happen or even that they won't in the future. It is rather that investors need to be prepared not just for well-known risks, but also for ones which cannot be foreseen. Having this awareness is essential when something surprising happens, because it helps investors to maintain their investment policy even when the experts on television are all headed for the ledge.

Surprises will always be part of investing but predicting them is by definition impossible. The best investors can do is to set an asset allocation they can live with, invest with the best managers, be patient, and let compounding work for them over time.

Recessions are Becoming Rarer

It seems like investors and economists are always talking about the next recession. When will it happen, how serious will it be, and how long will it last are questions that understandably are always being discussed. Given that recessions are always on people's minds, one might assume that they happened relatively often. In fact, though, recessions are quite rare, especially in the past 60 years.

The chart below shows the past 100 years of stock market performance, with the grey areas indicating when the economy was in recession. From 1948 through 1982, recessions were fairly common. During this period, they occurred every 4 years, and often lasted a year or more. Since 1982, however, recessions have occurred on average every 10 years, and they have generally been relatively short and shallow, with the exception of 2008-2009.



Why has the frequency of recessions changed? It is impossible to say for sure, but some good explanations come to mind. First, the US economic has evolved from highly cyclical industries (manufacturing, agriculture, etc.) to less cyclical ones (services, government, consumer product, health care). Secondly, the Federal reserve has done a better job than in the past of smoothing the

economic cycle. Consider the recent period when the Fed was forced to raise interest rates rapidly to counter inflation. It was widely expected that the rate increase would trigger a recession, but it did not happen. This can be attributed to a less cyclical economy and to a Fed which did a great job.

If recessions are rarer, does that mean that investors have nothing to worry about? No. A less cyclical economy still poses lots of risk for investors. For one thing, the existence of less economic risk may lead investors to take on more financial risks including borrowing, valuation risk, etc. Secondly, while recessions are rare, they still happen. The recession of 2008-9, for example was a severe and relatively long one, and many investors lost considerable amounts of their capital.

Artificial Intelligence Implementation Update

As mentioned above, artificial intelligence has been one of the drivers of the stock market rally. So far, most of the money spent on AI has been on companies creating AI products and infrastructure such as Nvidia, Microsoft and Google. The stocks which have benefited from the AI boom so far have reflected this. But investors should be asking when the benefits of the huge investment in AI by companies outside of the technology sector will start to appear. We have been looking into this and unfortunately it is too early to point to much specific evidence in company financials or broad economic data.

One place the impact of AI could show up eventually would be in productivity numbers. After all, if companies and workers are using AI then presumably they would become more productive. In fact, a recent report from Goldman Sachs suggests that AI could increase US productivity by 1.5% per year over the next decade. This would be a huge increase, since US productivity growth has only averaged 1.2% per year in recent years. Measures of productivity for US workers have showed gains in the past two years, which coincided with AI adoption. Of course, this period also coincided with the recovery from the pandemic, so it is impossible to say for sure where the improvements in productivity are coming from.

Another place where the benefits of AI could be seen would be in company earnings reports or in their commentary on earnings. Here the evidence is still fairly light outside of the tech sector. There has been commentary from several energy companies including Vista and Constellation. Both have seen demand for electricity surge due to rapid demand for data centers, reflecting how the economy is evolving to meet the needs of AI. Constellation has even entered into an agreement with Microsoft to restart one of the nuclear reactors at Three Mile Island. (To be clear, they are restarting Unit 2 which operated until 2019, not Unit 1 which experienced a serious accident in the 1970s). In short, there is justifiably a lot of interest in artificial intelligence, and billions of dollars are being invested for the purpose of improving efficiency in virtually every part of the economy. The potential payoffs are huge but will take a number of years to reach their potential, and there are certain to be some substantial successes and disappointments along the way.

Thank you as always for being a client.

Best regards,

William R. Andersen, CFA
Principal and Chief Investment Officer