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Conference Call

The 4-5-6 Markets

January 28, 2025, Conference Call

(This transcript has been lightly edited)

Good morning, everybody. This is Jim Bianco. Welcome to the conference call. This is typical housekeeping. First of all, I did make a slight change to the handout based on what happened in the stock market yesterday. I'm going to discuss that and uploaded it to the website, so if you want to hit download again, you'll get the new and improved version. Most of you are on the webcast, but for those of you that listen to it audibly, I'll do my best to try and call out slide numbers. And again, there is a question window on the webcast. Go ahead and throw in any questions you have. I see it right here in front of me, and if I catch my eye, I will answer it at the appropriate time during the call. Otherwise, I will pick them all up at the end of the call.

The 456 markets are what I want to talk about. Now, what is that? As it shows here on my little outline, I think over the next several years, and this is the case I want to make, cash is going to return you around 4%, because roughly speaking, that's about where the neutral funds rate is. Bonds are going to return you around 5%. That's roughly where the yield is of the aggregate index right now. I mean, you'll have good years, and you'll have bad years in there too, but this is over a period, a longer period. Stocks will average you over 6%. And in this environment, it's largely because of the valuation, which I'll go through. And then I'll talk about the appropriate asset allocation.

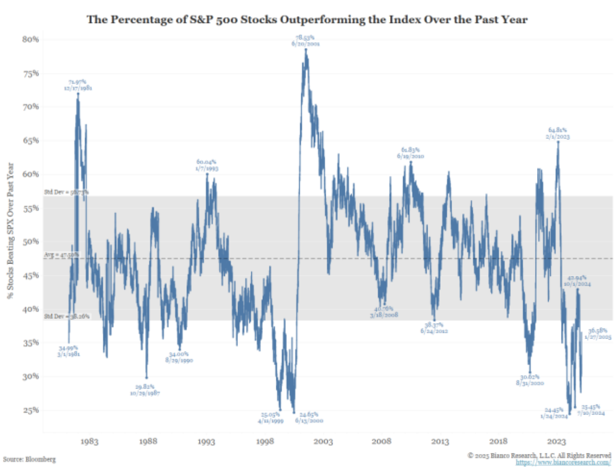
And what I'll mention about asset allocation just as a little teaser, active in bonds, and I've got some slides to kind of go through this, tends to outperform a lot more than active in stocks. So even though your bonds will return you five, stocks return you six, that gap might be a little bit closer. In other words, the era of TINA is over. And TINA being, there is no alternative. Bonds are an alternative. And we are going to see them and cash and stocks roughly over a period of several years. Now, maybe this year's another 20% a year for stocks, but roughly over the next several years, be somewhat competitive with each other.

And if they are, and if the returns lower, this is actually a bullish call for active equity managers. Problem right now, if you're an active manager and you're depending on a giant tailwind to push the beta part of your portfolio up 15 or 20%, so in a bad year, you perform 15%, you could just turn to your customers and go, good news, we performed 15%, even though the market was up 26. Then that's not, maybe this is not the environment for you, but if you're a stock picker, or you want to return to thematic ideas and stock picking, a slowing down of that giant beta tailwind would actually be beneficial. You could still get the same returns. You just won't, you'll just look better relative to the beta returns in the market.

So, these are the things I want to talk about. But what I want to first start off with is that first section, my assumptions. Yesterday's sell up was a financial event, not an economic event. I'll get to that in a second. The economy is growing at its potential 2.5, a bit of K shape. Recessions or financial crisis has changed the economy as it did in 2020. That's an old theme that I talk about a lot, but it's worthy of mentioning over and over again, because so many people don't think of it that way. Inflation will average 3%, another old theme about which I've been talking. And the years of good returns have made everybody momentum investors. And I think that that's really what's been driving a lot of this.

So, let's start with what happened yesterday. The S&P was down 1.5%. The NASDAQ 100, the NDX was down almost 3%. And the S&P Technology Index was down 5%. Yet, if I go with Ryan Dietrich, his post over on the right, he's chief strategist at the Carson Group. In an alternate universe, these could have been the headlines. This also happened yesterday. Finances closed at an all-time high, twenty-two of the 30 Dow stocks closed higher. The transports were up 1.5% to a new all-time high. The Dow is less than 1.5% from an all-time high. Apple posted its best day in four months. Amazon is at an all-time high. 349 stocks in the S&P closed higher. I might add 82%, 400 of the five hundred stocks, beat the index yesterday. Momentum is up 7% year to date. Small caps and mid-caps have outperformed today and are now outperforming the S&P 500 year to date. High yield closed higher as there's no credit risk available.

And then before I qualitatively comment, I'll just go through the other charts. The middle chart here, right here, this came off of a Bloomberg story this morning, which is in our news clips highlighted. This is market breadth relative to returns back to two thousand. And so, what you see is it's all of the instances when the market was down 1.5% or more. Look at that dot here. That was yesterday. More stocks were advanced and declined at a 1.5% decline. And since 2000, that has never happened. Basically, you have more decliners. What this highlights is this final chart here. The massive concentration in the market. Thirty-three percent of the S&P is the mag seven. The other technology stocks collectively are 12%. Financials are second place at 13%. Healthcare, which also had a good day yesterday. Consumer staples also had a good day yesterday as well.



The stock, one of the reasons that the stock market has been such a difficult thing for active managers to beat is the second chart. The percentage of stocks in the S&P 500 that have outperformed over the last year. So, this is the last year. The 82% number I gave you earlier was yesterday. So, in the last year, only 36% or roughly a little bit more than one third of the stocks in the S&P 500 outperformed the broader index. So, if you're an active manager and you're surveying the world, two thirds of your options are going to lead to underperformance. Now, that's because of the massive concentration with the big, big push in the mag seven stocks.

Now, I'm not an expert on AI, or maybe I am an expert on AI because I became aware of deep seek on Friday. So, I've had three days to figure out what it is. But let me just give you my simple take as to how I'm looking at this. The mag seven stocks have tremendous moats when it comes to building AI. The amount of chips you need to buy, the amount of cost and training, the power requirements, and it still blows my mind that Microsoft, in order to power future AI data centers, has signed a 20-year agreement to restart one of the reactors at Three Mile Island and buy 20 years of power from a new so you need a nuclear power plant to fuel or to get the energy power needs for these data centers. That's a tremendous moat. So, to put it bluntly, the AI, the leaders of AI on January 20th were in the front row of the inauguration. Behind them was the president's cabinet. Then deep seek came out.

Let me give you my simple take on deep seek. Hey, we did the same thing you guys do with older chips that are not on the ban list for export because of their sensitivity, and we did it for one-thirtieth the cost. So, all of a sudden, that moat that the AI, mega cap trillion-dollar companies had doesn't look like a moat. The cost has come down. A lot of competitors can now get into this space. And this is and the power needs have gone down, too. Look at the uranium ETF yesterday, URA. It was down 10 percent because all of a sudden because Friday we were talking about restarting nuclear power plants because of the tremendous power needs that AI's data centers and hyperscale's were going to need. Monday, we're looking at this and we're saying maybe they don't need as much power because all of a sudden, they found cheaper ways to do this. Mark Andreessen of A16Z called it, you know, AI Sputnik. At the moment, Sanjay Nadella of Microsoft tweeted out that he is tremendously impressed with what Deep Seek has been able to accomplish. So, no one is pushing back and saying this is a fraud, at least not yet. It's open source so you can see it.

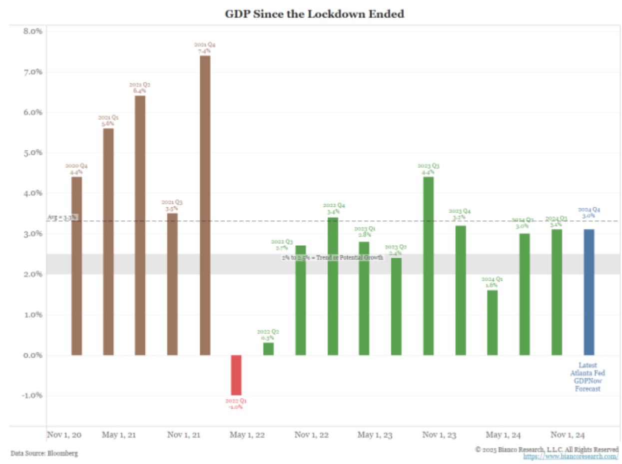
So, what happened to the Mag 7 stocks yesterday? Simple. Their moats, you know, the water level in their moats went down. That is the fear is that the water level on their moats went down quite a bit. And a lot of other people are going to come into this market. And those big fat margins that they were hoping for are going to go down a lot. Are they going to go away? I mean, that's the thing that, you know, infuriates me about some of the press coverage. You know, well, you know, this is not the end of AI. This is not the end of the Mag 7. No one said that. No one has implied that.

How about this? On Friday, NVIDIA was a $3.4 trillion company. Maybe it's a $2 trillion company. I'm just kind of throwing that number out for illustrative purposes. I haven't done any analysis. But maybe it's a $2 trillion company. And it's still a major force in AI and a major force in the market. You just lost 40% of your money. That's the risk. So don't tell me, don't worry, you know, NVIDIA is not going to zero. I know it's not going to zero. But am I going to see a big loss in my investment in the NVIDIA stock? That's what really needs to be asked.

Why? Because they don't need to buy the high end, big margin, really expensive chips. They could do it with the second generation, third generation chips. And according to what I've read, DC, the normal AI program that they would have, would have to buy one, about 15,000 of these H100 chips that NVIDIA sells. H100 chip is forty grand a piece and you need 15,000 of them. They did it with the H800 chip, which is a lot less money. And instead of 15,000, they did it with 2,000. So yes, that's going to hurt. That's going to hurt NVIDIA's top line, especially when everybody's got all that hope.

So really what happened was seven big stocks and things related to it, like uranium and constellation energies and the like, really took a hit yesterday. But the rest of the market seemed to be fine as far as we were going to go. And that leads me to my next assumption, the economy.

So, I'm going to go through the assumptions again, and then I want to talk to you about why we're going to see a four, five, six type of world. So, the next assumption on the economy is, here's GDP since the lockdown. Now again, I've used this chart many times, the shaded area is two to two and a half percent. That is what economists think the economy would do with its potential. No one's speeding it up, no one's slowing it down, leave it alone, let it do its own thing, it'll grow to two and a half percent. Nine in the last ten quarters, it has grown at least that or higher. The blue line here is the Atlanta Fed GDP, Q4 GDP is out tomorrow. Today we got durable goods, it was a beat. So, this is probably as good a metric as any as far as what tomorrow is going to bring. And it's probably going to be another at potential or better.



So, at the top line, the economy is doing good. Yes, it's a K-shaped economy. There's no doubt about that, that it's a K-shaped economy, meaning that the bottom half of income is not doing as well as the top half of income. Bankrate just updated their survey a couple of days ago, they say 59, 59, 59% of the public cannot produce $1,000 in an emergency. They'd have to borrow it, put it on a credit card, you know, make other lifestyle choices in order to produce $1,000 in an emergency. Forty-one percent basically have at least $1,000 in their savings account is what that survey is suggesting. So yes, there are those problems. The top half of income is doing much better than the bottom half, hence the K-shape of the economy. But the top line is doing well.

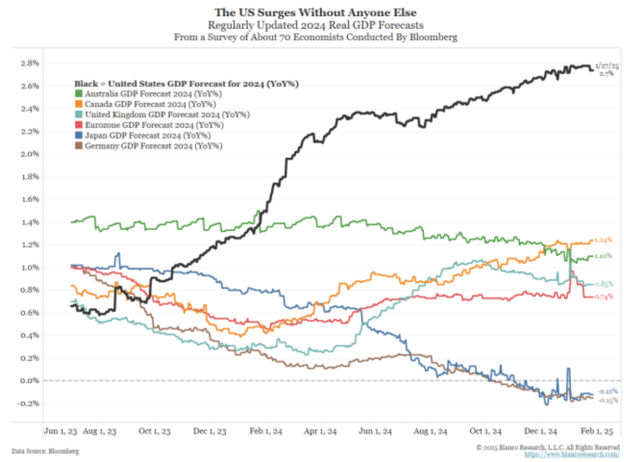
Monetary policy, financial market returns, and I'm talking about asset class level returns. You can't say, well, the bottom half is doing bad, so we have to cut rates, or the top half is doing good, we have to hike rates. You have to look at the entire economy, and it's all doing pretty good.

Economic expansions do not die of old age, they are murdered - Rudi Dornbusch
Post WW2 Recessions and Their Triggers

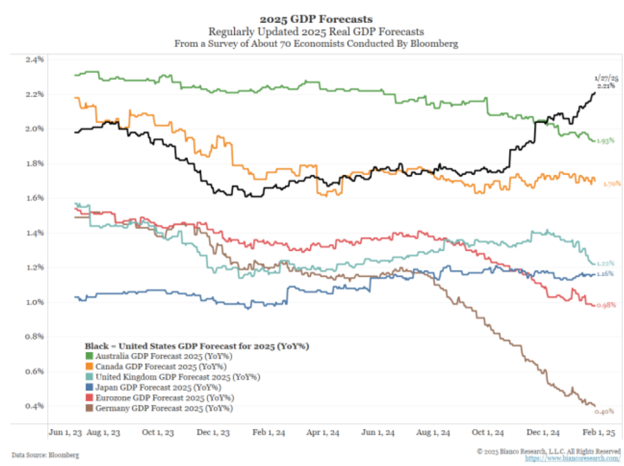
Start	End	"Murder Weapon"
Feb 1945	Oct 1945	Dramtic Drop in Miltary Spending (End of WW2)
Nov 1948	Oct 1949	Demobilzation of the WW2 Economy
Jul 1953	May 1954	Dramtic Drop in Miltary Spending (End of Korean War)
Aug 1957	Apr 1958	Suez Crisis/Sputnik
Apr 1960	Feb 1961	Tight Monetary Policy
Dec 1969	Nov 1970	Vietnam War
Nov 1973	Mar 1975	Arab Oil Embargo
Jan 1980	Jul 1980	Highest Inflation of the Century
Jul 1981	Nov 1982	Punishing Interest Rates (15% 10-year)
Jul 1990	Mar 1991	Iraq Invades Kuwait (~200% rise in Crude Oil)
Mar 2001	Nov 2001	Tech Bubble Popping/September 11
Dec 2007	Jun 2009	Housing Crash/$145 Crude (July 2008)
Feb 2020	Apr 2020	COVID-19

What about a recession? I've talked about this many times, so I'll go through this quickly. A recession cannot be determined in the data, and I keep reading all the time, oh, this data is looking bad, maybe we'll have a recession. The natural state of the economy is to grow, it's a capitalist economy. Potential is two to two and a half percent. You can make the state, you can make the case the data looks iffy, and you could see a protracted period of below potential growth, agree with that, but contraction, as I've used this for a long time, I've used this economic expansions, do not die of old age, they're murdered. A murder weapon, like COVID-19, like Iraq invading Kuwait, like the Arab oil embargo, something that comes along and scares everybody, that's what causes a recession. Short of that, well, maybe you might make the case that we're going to have a protracted period of below average growth, I don't think so, but that's a reasonable expectation. Recession don't ask an economist, and I don't mean that to disparage economists, it's going to be an outside event, it's going to be something of which we didn’t think.

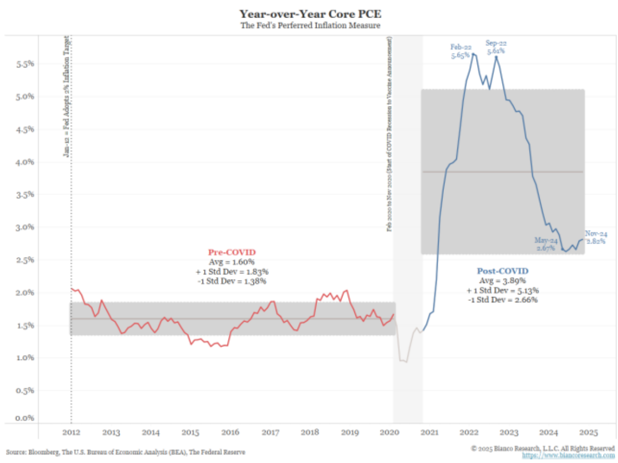
Again, my last example was the last time I thought there was that murder was Silicon Valley Banks, Republic Bank, Signature Bank, followed up by Credit Swiss, that we had a rash of big bank failures, and that that was going to usher in some financial crisis. The Fed did the term funding of credit facility to BTFF, I think, the bank term funding facility to BTFF, and some other moves, and they saved it off. The point is, that's the way you got to think about it, is there has to be this event like COVID, like the housing market rolling over, something bad has to happen, scares everybody, they change their behavior, contraction. Otherwise, if you say that the market's overdone, I don't think we have a recession, I think you're talking about 1% growth. Because the only way, because 90% of the time since World War II, we've had expansion. The 10% we haven’t been when we've had a big event.



Lastly, on my assumptions, the US has been the tower of power. This is the 2024 update from economists on their estimates for 2024 GDP. Why are we still estimating 2024 GDP? Because all the data is not in yet. Q4 GDP is out tomorrow, and then it gets revised for the next two months. So, the final word has not been written on this. Anyway, we have most of the data. So, these should be at this point in late January after the year is over, fairly accurate forecasts. The US, as I like to say, this is the Sesame Street song, one of these doesn't look like the other. So, the US is clearly the leader in the clubhouse for 2024.



What about 2025? The expectations are the US is doing better, the black line. Everybody else seems to be catching up with the US, with the exception of Germany. We had a story in news clips yesterday that basically said Germany is a mess, it's getting worse, and no one knows what to do about it from an economic standpoint. I understand that the DAX index is at an all-time high like a lot of others. I would attribute some of that to the advent of indexation in the world that the biggest buyer of German stocks and everything else is an index. And a lot of the indexes are in the world index. And if everybody's putting their money in the world index, German stocks get bought, even if their economy is falling apart. And to be fair about German stocks, their valuations are much more attractive than the US.

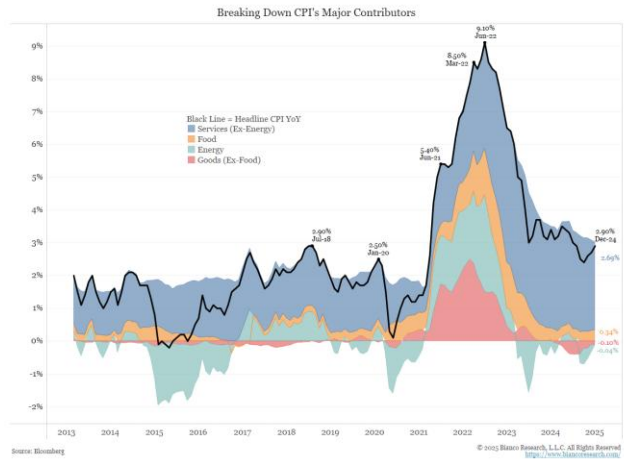


Inflation. So, my assumptions on inflation are 3%. We're not going back to 2%. This is not pre-pandemic. So again, I've used this chart before. This is core PCE.

The Fed's favorite metric is the same chart color-coded. The line is the average. The shaded area is the standard deviation. If you're not statistically oriented, 66% of the readings should be inside the shaded area. This visual gives you an idea when it's extreme and the like. This is what inflation did from 2012 when the Fed adopted its 2% target to 2020. It averaged around 1.6% in its tight standard deviation range.

This is what it's done since November of 2020. What I did was the day that the vaccine was announced. The recession and up until the vaccine announcement, I left in gray. I left that as the transition period out. But this is what we've done in the post-COVID period, defined as the day after we announced the vaccine. Inflation has averaged 3.5% with a much wider standard deviation. And if you look closely, it looks like it might be bottoming for the first time since the peak over two years ago.

This is not this. Although the Fed wants to tell you that this is rapidly going to become this. I disagree. It is not going to become that. As far as inflation goes, a couple of quick other charts on the assumptions.



Here's a breakdown of inflation right there. This is the black line at 2.9% CPI. And you can see what the chart shows you is the blue is virtually all of it is in services. Services is what's driving inflation. It's much bigger than the pre-pandemic era. That's wages. And that's the super core is supposed to measure wages, which is up over 4%. All the goods, food and energy collectively are very, very low. But we've got a service issue on inflation.

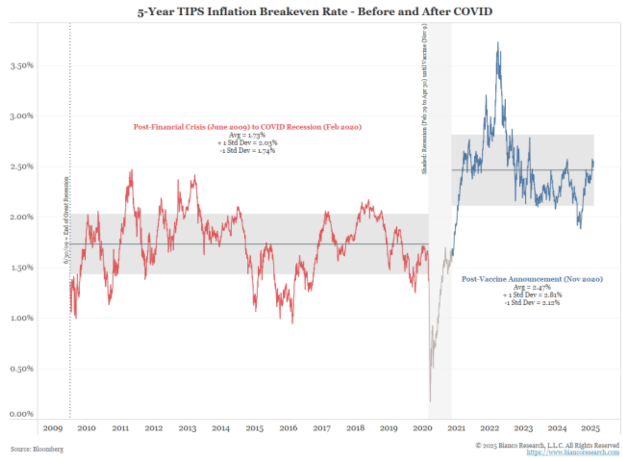
Lastly, let's talk about inflation expectations. Here is the two-year inflation break-even rate, the tips of inflation break-even. For those of you who are not familiar, take the two-year yield. There is an instrument called the Two-Year Treasury Inflation Protected Security or TIP. It pays you whatever the inflation rate is. You get the inflation rate plus a real yield. You subtract the two on top of that and you get what the market thinks the inflation rate is going to do.

Is it accurate? No. It's the point spread. It's like watching the point spread in the Super Bowl. It's useful to know. I don't even know what the point spread is right now. It's useful to know that which one team is favored over the other. That's good information. But does that mean, and I'm going to make it up, if the Chiefs are a two-point favorite, does that mean they're going to win the game by two points? No. But it gives you an indication that the perception is they are the better team. That's very useful. It gives you an indication of that is the expected outcome. So that's what these dos, is they give you an expectation of the outcome.

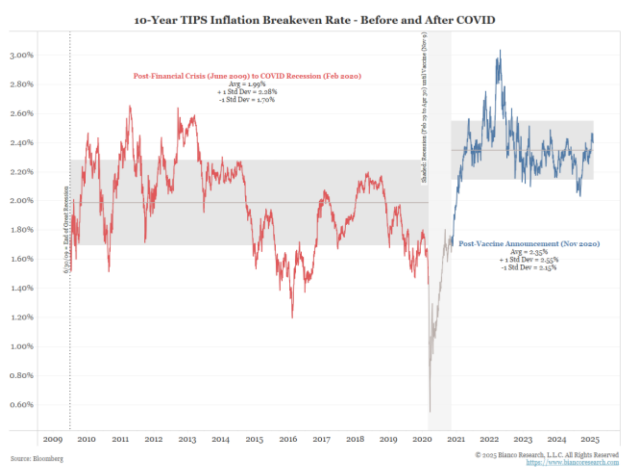
So, the blue line is the two-year tips break-even rate. It bottomed a week before the meeting, the week before the September FOMC Fed meeting when they cut fifty basis points. It has gone straight up since then. And now that it's gone straight up, it's making new highs. This chart is updated through yesterday, right now. Now, why don't economists look at this? Because they think it's heavily influenced by gasoline prices. But since the Fed meeting, gasoline prices are down. Yes, they've gone up a little bit, but they're lower than they were the day of the Fed meeting. Gasoline has gone down; inflation expectations have gone up.

The impulse that we're going to have inflation over the next two years, the impulse in the next two years is that inflation is so strong that even lower gasoline prices cannot stop it. Karen asked a question that just caught my eye. Could deep-seat driven re-rating of MAG-7 prices in a negative wealth effect where wealthier consumers pull back on spending and lower growth trends? That all depends on two things. One, are wealthier consumers looking at their portfolios and saying, great, look at this portfolio, let's go buy a Tesla or let's go on another vacation because their portfolios are up? The wealth effect in stocks may not be as great and or does the whole market go down?

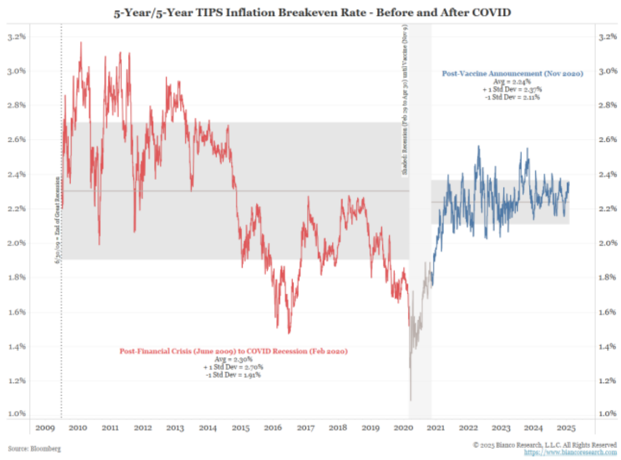
As I pointed out yesterday, even though the market was down 1.4%, the vast majority of stocks were up. And eventually with the re-rating, you might not see as deep a decline in the market. Remember, as I get there, I'm talking about 6% over the next decade or so with 3% inflation. But if the MAG-7 re-rating is severe enough, and the other stocks follow through, and you get a big enough sell-off, and the key there is the other stocks follow through. They did that yesterday. I know it's only one day. Then you could maybe talk about some kind of negative wealth effect. But for right now, I'd say probably not until we see something else that suggests that it would be more than that.



All right, so back to inflation. So, inflation expectations two-year up, gasoline prices down. It's a five-year tenor. Same chart. This is the five-year inflation break-even rate, the five-year yield minus the five-year tip. What is the market's expectation for inflation over the next five years? Same format. There's the mean, and there's the standard deviation. This is 2010. This is 2020. And this is what inflation expectations did at the five-year tenor before COVID. This is what they're doing after COVID. There has been a re-rating in inflation that we expect more of it over the next five years.



So, over the two-year tenor up, even though gasoline prices are down, over the five-year tenor, we expect more inflation. Same chart. This is the 10-year tenor right now. So, over the 10-year tenor, the average is up, but the standard deviation ranges kind of overlap. So, it's not as great a move.



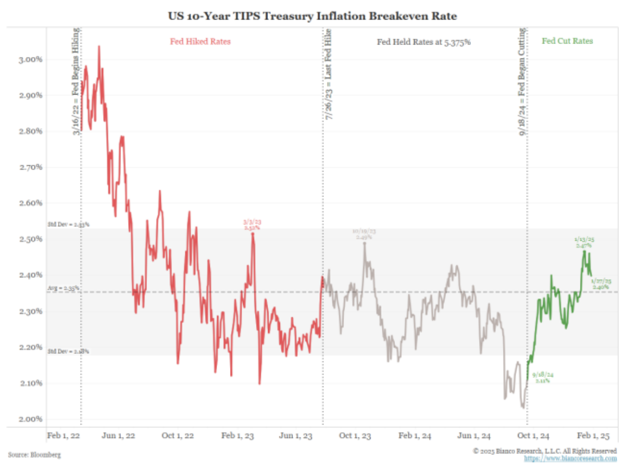
Well, the Fed's favorite metric is the five-year, five-year. What that is that we know what the five-year inflation expectation is. We know what the 10-year inflation expectation is. So, we could back into what is the five-year inflation expectation in five years? So, the five-year, ten-year, ten-year minus five-year, the residual is the five-year, five-year. And Fed economists and everybody else says, look, this is the standard deviation in the mean before COVID. Here it is after COVID. Oh, my God, please send the FOMC to Oslo and give them all the Nobel Prize in economics. What a wonderful job they have done in reining in inflation expectations. They are unchanged with a tighter range.

That is technically correct. But I think what they're missing is what the market is trying to tell you is over the next two years to five years, you've got an inflation problem. Starting around 2030, you don't have an inflation problem. Powell said transitory in 2021. He retired the phrase at the end of 2021 when he got nominated. He kept saying it while he was waiting to get nominated. So, if the market is saying that we've got another five years of inflation, that's a nine-year inflation cycle. We're beginning year four of the nine-year inflation cycle. That sounds about right. Inflation runs for about a decade. And then in the 2030s, it will go away.

And so that's the way I read this instead of just let's give everybody the Nobel Prize. They're doing such a wonderfully good job at this. And by the way, speaking of inflation, I've talked about this before. Dan Tarullo, who's a Fed governor from 2009 to 2017, in October of seventeen went to Brookings Institute. Monetary policy without a working theory of inflation. This is Tarullo's presentation. I will explain two conclusions that I drew from my experience. One is substantive monetary policy, and the other one is more a psychological observation. The substantive point is we do not know at present habit theory of inflation dynamics that sufficiently works well enough for businesses to use in real-time monetary policy. I give these presentations about 3% inflation, and people come up to me all the time and say, but it's about technology. It's about government spending. It's about money supply. And what Carillo is saying is we've tested every one of those theories upside down, forward, and backward. The correlation is zero. They're not good predictors of what inflation is. Because the other part is, as he would say, is there's a psychological standpoint on it. Monetary policymakers were formerly trained in almost instinctual attachment to some problematic concept and hard estimate variable.

In other words, what he's saying is the people that run up to me and say, no, it's about AI is going to lead to a giant deflationary wave, and there's going to be no inflation. He's saying, yes, people do that all the time. And yes, we test it all the time. And yes, it doesn't work. There is a psychological component to inflation. Do people feel like we're in an inflation period or not? That's why the Fed looks at inflation expectations.

I have argued I don't think it's a thing, inflation expectations. What I mean by that is that it's not a thing in that you can't measure it. I agree that if people think we're in an inflationary period, they will adjust their spending patterns and their business patterns and maybe their business models. But all these surveys that we look at, University of Michigan or the TIPs, they're all not good at predicting the future. They're good at telling us what people expect. And what I showed you, they expect more inflation in the next five years. But they're not good at telling us what will actually happen in the future. And that's what I mean by it's not a thing. I can't measure it. I don't have a doubt that the theory is not good. It's just that it's not a measurable idea.



And then finally, to put this idea in perspective, here is the ten-year TIPs break-even, same chart color-coded. So, in red right here, this is March of twenty-two when the Fed began hiking. The Fed began jacking up rates. They were hiking rates seventy-five basis points a meeting in the summer of twenty-two. What did inflation expectations do? They went straight down. The green part of the chart is when the Fed started cutting. What are inflation expectations doing? They're going straight up and they're at the highest level of 15 months.

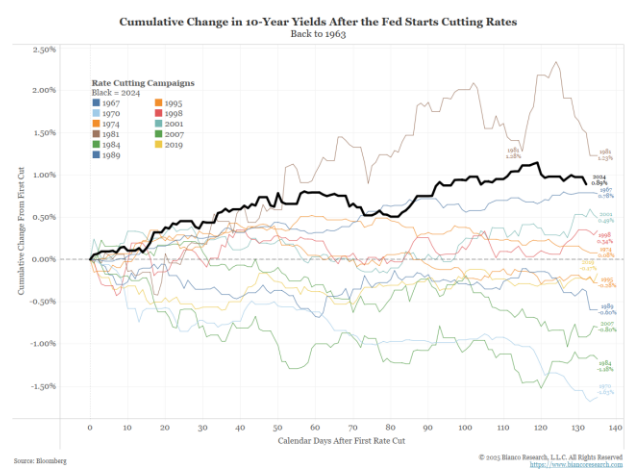
Restated, the Fed's worried about inflation and they're cutting and they're hiking rates. I can relax about inflation. The Fed thinks that they need the Nobel Prize in economics because they've done such a great job, and they can cut rates. Time to worry. We don't have the TIPs in the market in the seventies. But I would postulate this is classic inflationary 1970s, 1980s type behavior. The market is very worried about inflation. And because it's very worried about inflation, if it doesn't see a central bank that is fighting the inflation fight, it worries. It sees a central bank that is not fighting the inflation fight, is fighting the inflation fight, it relaxes.

Now, so far, I've talked about its MAG7, it's not anything else. The economy at the top line is doing okay. Inflation is going to stay elevated at the 3%-ish level. No, I'm not an 810 Zimbabwe guy. I'm more into the 3% level and that gets into when I talk about interest rates and the like. And the last thing I want to talk about is returns.

So, here's the twenty-four total returns. The Bloomberg Ag, the broad investment grade market was 1.25%. Bills, remember, the Fed didn't start cutting rates until September. 529, it's what the 3-month bill index returned. High yield returned eight. The MSCI World Free Index, free means free floating. So, the free floating, so the weighting is on the free floats. Eighteen percent, 25% for the S&P, 26% for gold. By the way, this is the first time ever that gold and the S&P were up more than 25% in the same year. And 120% Bitcoin. Other than bonds, and other than bonds, this is a pretty good year for everything else in the second good year in a row.

And most people, as I like to say, are momentum investors. They think that the beta in the market, especially at the risk end of the equation, owes them a 20% year, because that's what they've been getting the 20% year. In other words, they're momentum investors. And I love this meme from the original Top Gun, that was some of the best flying I've ever seen until you got killed. This is the problem with momentum investing. Momentum investing means you are the single best investor we have ever seen until momentum turns. Then it's like the plane hitting the canyon wall, and you're killed. So that's the problem with momentum. It works great until it doesn't, or whatever other metaphor that I want to use.

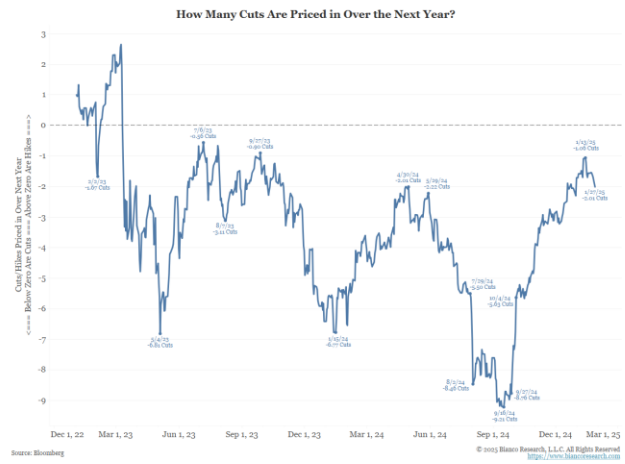
And what is driving a lot of the expectations in the market is momentum. Why does everybody think we're going to get another 20% year in the stock market? Because the last two years have been twenty. Why does everybody think bonds are completely uninvestable asset class? Because they have been for the last couple of years. But that has no bearing on what they will be going forward. And that's what the rest of the presentation is about, what to expect going forward.



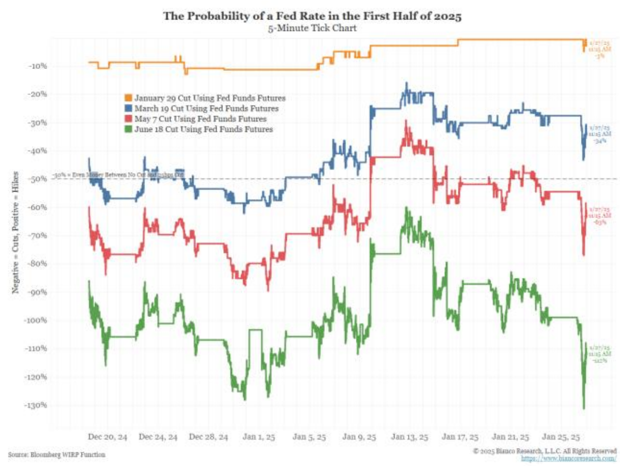
So first of all, I will talk about bond yields. So, this, again, is a chart indexed to day one, the day that the Fed started cutting rates. Here's all the rate cutting cycles back to 1967. And I used the discount rate prior to 1980. And you can see that the black line is 2024. This is the second biggest rate rise we have seen after 135 days in the last 60 years, with the exception of the 1981 period. The funds rate was at 20%. Yes, it was twenty. In May of eighty-one, they cut it to sixteen. The bond market didn't like it. It shot up the 10-year yields to the high 15% range, like 15.8%. Yes, the 10-year yield was 15.8% in 1981. And Ed coined the term bond market vigilante during that period.

So, I would argue what you're seeing in the market is a rejection of the policy. Given the assumptions that I just gave you, that the economy is growing at potential, that inflation might be 3%, we don't need the Fed to be cutting rates. They're just adding to inflation worries. And that's being reflected along into the curve.

Charlie Evans, the former Chicago Fed president, did an interview with Bloomberg on January 7th, highlighting everything that is wrong with Fed thinking. So, he was asked, why are yields, the 10-year yields, soaring when the Fed is cutting rates? He pointed to two things. He said it was deficits and tariffs and AI. So, in other words, why is it that it looks like the 10-year yield is rejecting Fed policy, Charlie Evans? Oh, it's Trump's fault. And then the default, when I don't have an answer for anything else, it must have something to do with AI. In other words, it's not us at the Fed. We're on our way to Oslo to get the Nobel Prize. We can't be wrong. We're never, ever wrong. So, if something bad is happening, blame the orange guy in the White House. It's always his fault. And if you can't figure out why it's his fault, just mumble the words AI. It must have something to do with that. It could never be that the market is rejecting the policy. This is the problem at the Fed right now, as summarized by Charlie Evans.



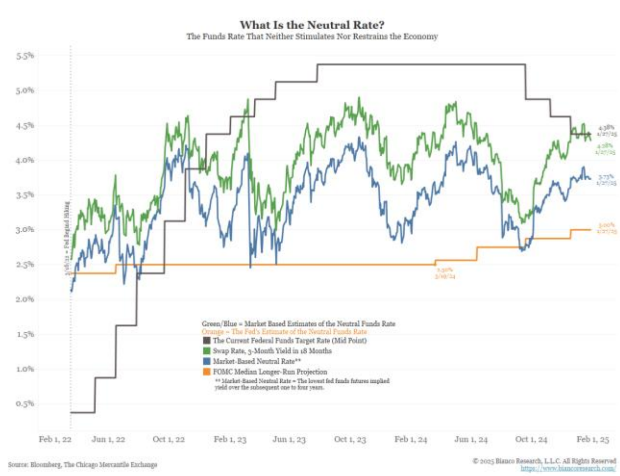
But so let me give you where I think we're going to go with the 4% on cash. That's going to be the fastest one to go through. How many rate cuts are priced in for the rest of this year? Two. But it was one and a half last week before the stock market sold off. And maybe there was a little bit of a fear that we were going to have a financial market crash. And that's why we added in another one. So where are those two rate cuts coming from? So, there is a Fed meeting tomorrow. The probability that the Fed is going to cut rates tomorrow is effectively zero. It's 3%. It was zero. That's zero. But it just kind of ticked off at 3% as some people bought crash insurance. But only 3%. There's a 97% chance that they're not going to move. They're not going to move tomorrow. And they're not going to offer a dot chart tomorrow. The only thing that's going to be worth about tomorrow is going to be the guidelines on what he says in the presser. I know Powell's going to be asked a lot of questions about why yields are rising, and is Trump a mean, terrible person, and are tariffs going to wreck the world? He's going to defer and not give non-answers on all of them. He wants to just get out in one piece. That's what I think he's probably going to wind up doing.



So tomorrow, no rate cut. The March meeting is in blue. That is a 34% chance that the Fed is going to cut rates at the March meeting, or a 66% chance of no rate cut at the meeting. So, the March meeting looks like it's going to be a hold too for the time being, unless we get strong data, or we get a dramatic plunge in stock prices.

And then the May meeting in red is where it gets interesting. The May meeting is a 63% chance that the Fed is going to cut rates in May, or that is a 37% chance that the Fed is going to hold. But I would argue two meetings out, or actually three at this point. It'll be two meetings out after tomorrow. Anything between 66% and 33% is basically coin toss range. Because there's going to be a lot of payroll reports, a lot of CPIS, a wait in a month on seeing what deep seek means and everything else. And yet the market is still at coin toss territory.

I would argue, if we make it through tomorrow, which we will, March, which is likely, and May without a rate cut, the rate cut cycle ended in December. So, we'll see. But for right now, the Fed seems to be put on hold.



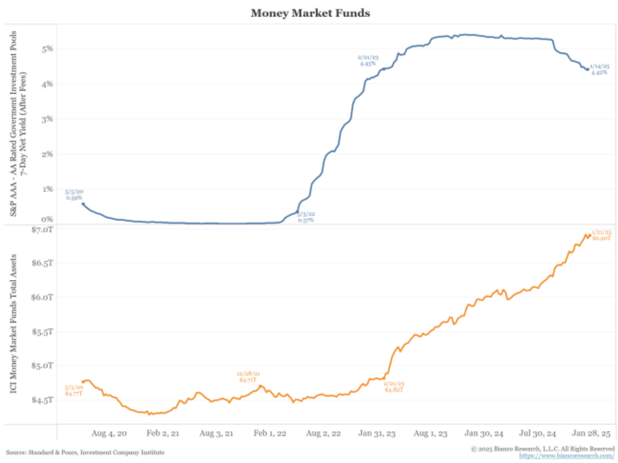
Why is the Fed on hold? Here is a chart of the black line is the funds rate. Four and three-eighths is where the funds rate is right now. Again, that's the black line. The orange line is the Fed's long-term dot, strung together from meeting to meeting. Where do they think the long-term interest rate is? Where do they think they need to go to neutral? That's 3%. So, we're at four and three-eighths, and the Fed thinks that neutral is 3%. So, they think we need to cut rates five more times in order to get too neutral. You'll hear Powell talk about that they think rates are restrictive. And this is why they think rates are restrictive.

Again, we're not going to get a new dot plot tomorrow. We get it on every other meeting on the quarter. But the green line and the blue line are market measures of where they think neutral is. So, the blue line is the lowest point on the Fed funds futures yield curve. So if you do, if you have a Bloomberg, you do FFA, Commodity CP, or you go to CME.com and look at the forward curve, like, where does the April, May, June, July, August, September, and, you know, 25 contracts and 26 contracts all settle out in their implied yield, 100 minus the price is the implied yield. What is the lowest point on that yield curve? It doesn't matter if it's a different day every day. What is the lowest point on that curve? It is three and three-quarters on the Fed funds rate curve.

The green line is the five-year, five-year, or I'm sorry, the green line is not the five-year, five-year. It's the three-month yield in 18 months. In other words, looking at the forward curve, look at the two-year rate, looking at the, you know, the two-year rate, looking at the three-month rate, looking at the bill that matures in a year, the bonds that mature in 15 months, you get back into what does the market think the three months the yield will be in 18 months, in a year and a half. That is four and a quarter. So somewhere between three and three-quarters and four and a quarter is where the market thinks neutral is. That's four percent. That's one rate cut from here, and the market's not that precise.

So, we've got maybe one to go to get too neutral on the market. Notice that neutral is always above what the Fed's estimate is. So, the market thinks, largely because of those inflation expectations, that the Fed only needs to maybe cut one more time to get too neutral. That's why

I said if they don't pull the trigger by May, they could maybe come to the same conclusion that maybe four is the new neutral. And we're kind of done here right now.

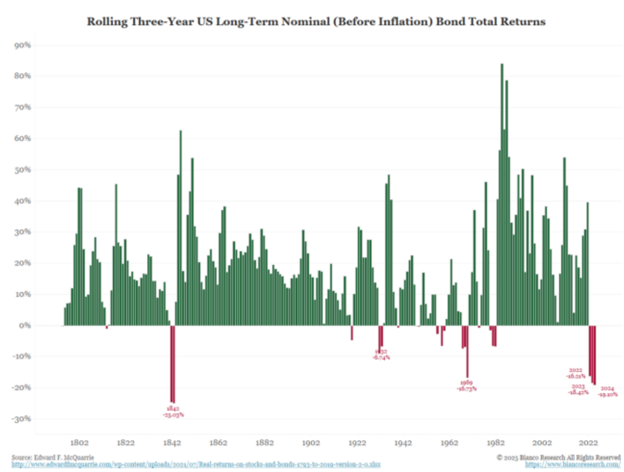


And if they are, here's money market rates. S&P gave us a measure of what is the average yield in a money market right now. It is 4.42. Why is it higher than the funds rate? Because a lot of these funds, these money market funds, when they knew, the Fed was going to start cutting rates, they'd buy nine-month bills, one-year bills, six-month bills, with a much higher yield before the Fed started cutting rates or maybe after the first fifty basis point cut. They have not rolled off yet. So, this number will continue down even if the Fed doesn't cut rates, but I think it'll settle out somewhere around four.

Assets in money market funds, everybody thought this was going to be the Tina moment when the Fed started cutting rates, everybody's going to run out of money market funds. They're not. They're continuing to go higher. So, I think if the Fed doesn't keep cutting rates, cash is going to return you 4%. In a 3% inflation world, this is good news for the retirees in Boca. You could put your money in a money market fund. It has effectively no risk because the NAV is $1 every day, and it will give you more than the inflation rate. For the first time in many years, which is why you're not seeing the assets in money market funds coming out.

So, 4% on cash, 5% in bonds. Let's start with a long, big picture on bonds, the ten-year yield. Treasury has data on this. Going back, I put some lines on it. We usually see interest rates run in big 30 or 40-year cycles. 1981, that was 15.84 on the ten-year yield was its peak. 2020, that was 0.51 was its low. That was the 40-year bull market in bonds. We're in a higher period right now of interest rates. It's year 4 or 5 of a multi-year rise in interest rates.

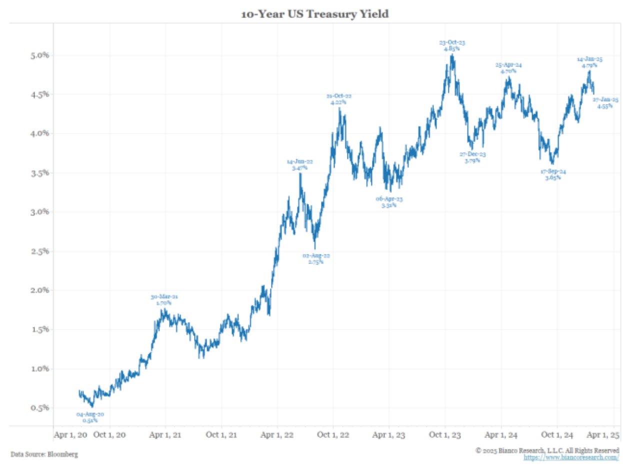
Now, again, multi-year rise in interest rates can also mean a couple of years of falling rates along the way, especially if we have a recession or dramatic slowdown. It's not going to be a straight line the whole way. But a lot of people have said that, oh, the bond market returned 1.25%. You just said it's a multi-year bear market. See, the most uninvestable asset class that the world has ever seen is the bond market.



The rolling three-year return in bonds. This comes from Ed McCrory at Santa Clara University. He calculated bond total returns back to 1793. Dr. Jeremy Siegel used a lot of his work in the book Stocks in the Long Run. Over the last three years, the bond market has lost to 19%. And that's through the end of 2024. So, these are yearly numbers. That is the worst period since 1842.

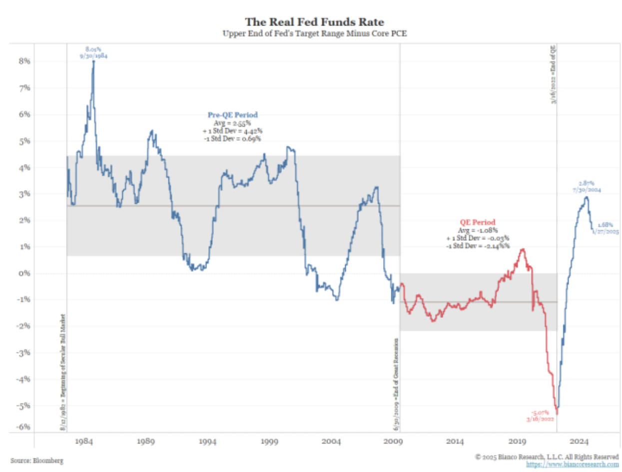
Now, what happened in 1842? We got down to $30,000 of debt. We had no more debt in the market. So, when you had a big sell-off, somebody lost five grand. That's literally what it was. So, it wasn't significant. But the point is, not what happened in 1842, is that we've never seen a sell-off like this. We never contemplated a sell-off like this. So, everybody's a momentum investor. So, the momentum investors conclude bonds are an uninvestable asset class because of what has happened. And stocks are the only investable class because what has recently happened. And risk, the only place to get risked is Bitcoin because of what has recently happened, up 120%. That is just taking the past and projecting it into the future.

The problem with the bond market argument is we had to get off a half a percent yield and zero funds rate and get back to somewhere near 5%. That was epic pain and the worst period in 180 years. If you know anything about convexity and duration, when you have very low coupons, you have very long durations. Long durations mean that bond prices are very sensitive to movements and interest rates. So, when rates go up and prices go down with low coupons, zero coupon, one coupon, they go down a lot. When you have a 4% or a 5% coupon, the durations shorten, that's convexity. So, when bond yields go up, they don't go down as much. To replicate over the next three years, zero to five produced a 19% loss. To replicate over the next three years, another 19% loss with the shorter durations and the bigger coupons, I did some back of the envelope calculations just for illustration, you got to go to 16%.



We'd have to see the 10-year yields go to 16% to lose you another 19%. I would argue, if that actually happened, and I don't think it happened, I'm just trying to illustrate bond math, that horrible pain that we saw in the bond market is now behind us, because to repeat it, we'd have to see 16%. But just for thought experiment purposes, the bond market would be the best investment, it would only lose you 20%. What do you think the stock market would be if we saw 16% 10-year yields in the next three years? Down 80%, something along those lines would be my guess.

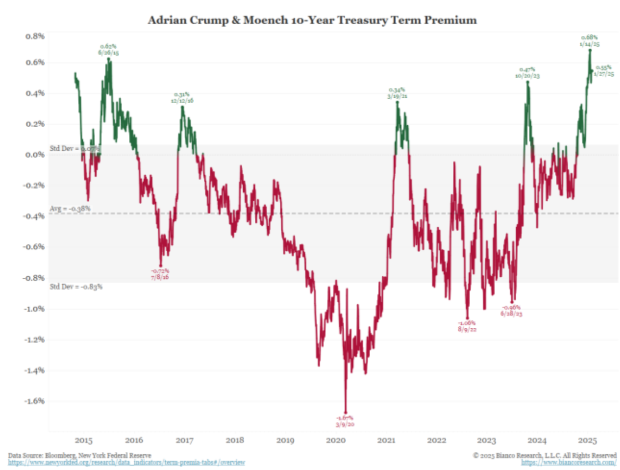
My point is, it's not going to happen. I'm just trying to tell you that this scream that bonds are an uninvestable asset class, to get from A, half a percent to 5% required enormous pain and suffering, and that will not be repeated. So now you've got shorter durations, and you've got bigger coupons. But where are bonds right now?



So here are real rates. I use the Fed's favorite measure, the funds rate minus core PCE. I could have used the 10-year minus CPI, it'd give you roughly the same thing you're seeing here. A lot of people look at real rates and say, look, they're at a 15-year high, they're at the highest level since 2007. And that that is very restrictive, and that's going to hurt the economy and that nothing of the sort has happened.

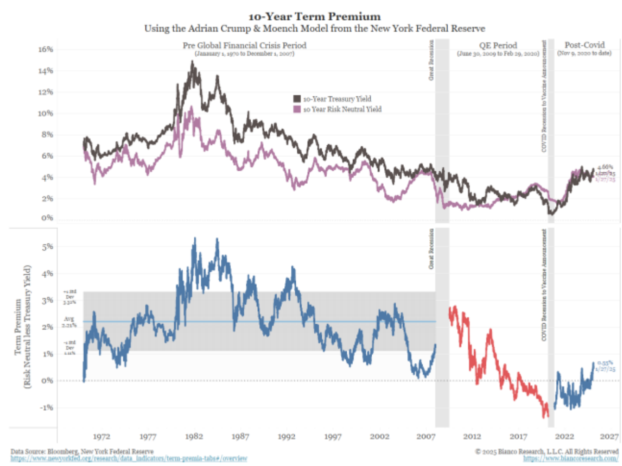
What is happening is people are looking at rates thinking that the current levels that they're seeing in rates in the next chart is term premium, thinking that they're abnormal. And what I want to argue, again, this is color-coded, that this is the period from 1982 to 2008. The average real rate during that period was 2.55%. So, two and a half percent. During this period, we'd invented the internet, we had the PC revolution, we had massive bull market in the 80s and 90s in stocks, we had tremendous growth in the economy, we did with two and a half percent real.

Today, now we say two and a half percent real is going to destroy humanity. No, what the mistake is, is this QE period from 2008 to 2022, that was the abnormal period. And that was when real rates averaged minus 1% during that period, during the red period. This is never going to be repeated. This should be compared to the pre-QE period, and it's pretty normal. Again, we're near the neutral rate in funds. We're near, this is kind of a normal average going forward real rate.



Term premium. We're making the same mistake with term premium. So, here's the term premium. For those of you that are not familiar with term premium, it's the forward curve. We know what the 10-year yield is, and what the nine-year yield is, and what the eight-year yield is, all the way down to the one-year yield. What if I bought a one-year yield? What one-year yield do I need in two years to get the two-year yield? And you keep doing that daisy chain math, I'm trying to keep it simple, so that you calculate all the way through all these forward curves, what is the yield that I need, what is the implied yield in the forward curves of the 10-year yield? And you compare it to where the 10-year yield is, and that difference is term premium.

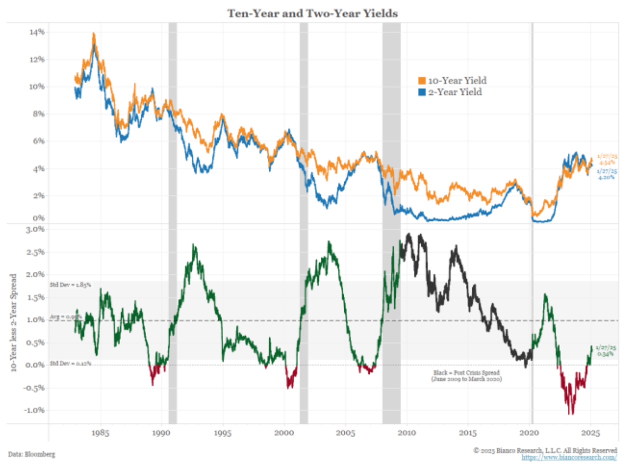
It is currently at the highest level since 2015. It's at a nearly a 10-year high, nine-and-a-half-year high right now. And everybody looks at this and says, this means the market has tremendous risk. This means the bond market is going to blow up. This means it's going to give you another 16% or 19% loss going forward. And I think they're misunderstanding what term premium is. It is a theoretical argument.



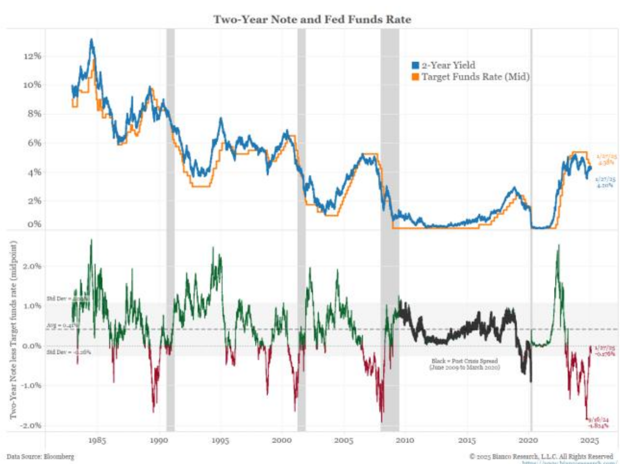
So let me look at the same chart this way. So here it is back to 1972. The black line on this chart is just the 10-year yield. That's all the black line is, is the 10-year yield, full stop. The purple line on the chart is the risk-neutral yield, all those forward yields strung forward. The bottom chart is the term premium. So, what I want to show you here is this is the term premium since 2022, the highest level since 2015. This is what term premium was prior to the financial crisis. It averaged 2.21%. Currently on term premium, we are at 0.85%, but at a nine-year high. This was average.

This is what we did with term premium during the QE period. What I think we're doing with term premium is returning to normal. It's a higher inflation world. It's a higher growth world. We need more term premium. And term premium is getting built into this market. And that's why you're seeing it going up. It's, again, what does people, when people say term premium is at a nine-year high means a lot of risk. No, what it means is that the prior period was completely mispriced. This is closer to normal than what we were living through in the last decade. That there's a lot of risk suggests this was normal. It was not normal.

Like I said, if you look at this, this is starting to return to what we saw in the prior decade. And again, we had growth. We had bull markets. We had innovation with that type of level of term premium. We don't need the term premium to be that low.



Quick, one last thing about the bond market, the two-year, 10-year yield, here it is back to the early 1980s. It averaged ninety-nine basis points over the last 40-plus years. Let's call it one hundred basis points. If the funds rate is going to bottom out at four, actually, I should do this chart, I should do it this way. Let me start with the two-year funds rate, and then I'll go back to that chart.



Same chart, two-year funds rate. It averaged forty-one basis points over forty-one basis points over the last 40 years. So, if the funds rate bottoms at around 4%, what is normal, if the yield curve returns to normal, where should the two funds curve trade, two-years trade, 440? Where are they right now? They're 420 thereabouts. So, they're a little bit below it. They've been as high as 430. So, they're just slightly below it.

So, 4% funds rate yield curve normalizes, which is what it's doing right now. We should have a 440 funds rate. Well, if we have a 440 two-year note rate, but if we have a 440 two-year note rate, where should the 10-year note trade? One hundred basis points above that if the yield curve is normalizing, that's 540.

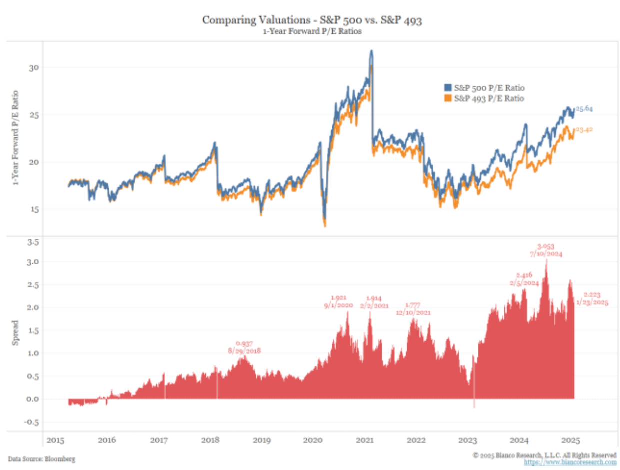
So that's why I produce, you know, I've been arguing for a while now that October of 2023, 5% 10-year note was not the high of this cycle. We got the 480 before the CPI report earlier this month. We're at 460-ish right now, 455-ish right now, that ultimately, I've been saying five to five and a quarter is where we're going to go. I said that for two reasons.

Reason one, I want to see a new high. I think we're going to get a new high. Reason two, if you look at the yield curve, the funds rate is, you know, the 440 two-year, 540 10-year. That is kind of the neutral-ish ranges for all that. So that's where five, five and a half comes from as well. And given shorter durations and longer coupons, if it took all year to do that, or it ended the year at that, you're still going to wind up with like a 4% total return in the bond market, at least this year, if that's what happens.

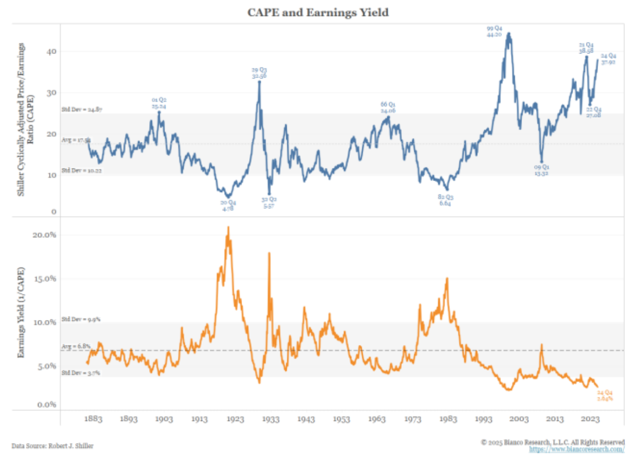
But if I had to give you a guess, I think it's more like we're going to hit five and a half in the first half of the year, maybe slightly higher if I had to guess. Would it come up short?

Out of my four, five, five and a quarter, or would it go a little bit above it? I'd say the error rate in my mind is we go a little bit above it first half of the year, come down in the second half of the year, not that we have a recession or anything, but we come down and then we actually wind up with a 5% or 6% return in the bond market this year. So, four on cash, five on bonds. What about stocks? Stocks, it's all about valuation. Market cap to GDP, it'll get updated tomorrow when we get the GDP report. It'll be in our news clips. 200%. The only time that it was higher was November 21.

Market cap to GDP is higher than it was at the tech bubble in 2000, higher than it was in 1929. So, this is called the Buffett indicator. By this measure, the market is extremely fully valued, if not overvalued. Wall Street's favorite estimate is the one-year forward PE ratio. What is the one-year forward PE on Wall Street? In other words, what is their estimate for the next year's earnings divided by the price? The S&P 500 is 25.5. That's really toasty, 25.5. You've only seen one other period and that was the tech bubble in 2000 that was higher.

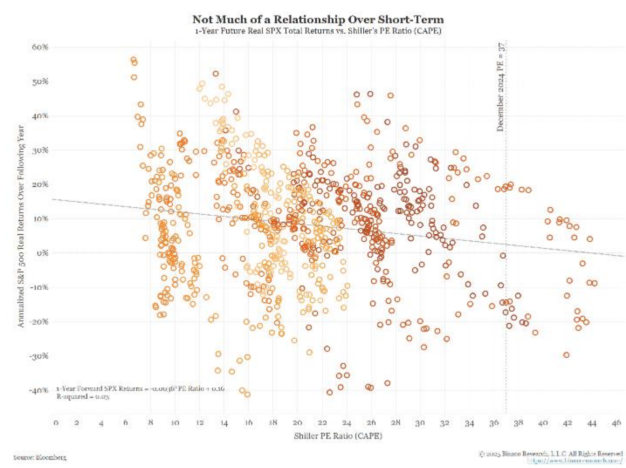


Oh, but it's so driven by the MAG-7. Bloomberg actually has an S&P 493 series, and you can get the one-year forward PE ratio on the S&P 493. So, in other words, take out the MAG-7, it's twenty-three. Still too high. This shows you the difference. The MAG-7's influence on the forward PE is the largest it's ever been. Look at that for the last year or so. Its differential is two points on it. That's huge. But nevertheless, it's not enough to say the stock market represents compelling value if you take out the MAG-7. I argue that, by the way, the rest of 2000's forward PE is over thirty right now. So, it's pretty high.

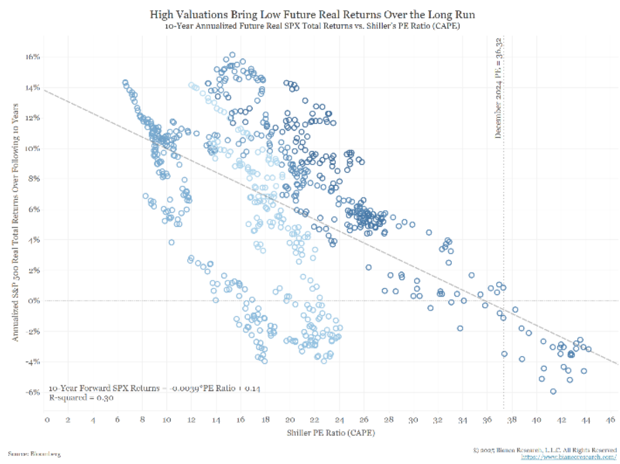


But how do I produce six? So, I look at the CAPE earnings. I look at the CAPE. So, this is Bob Shiller, won the Nobel Prize in Economics in 2013 for his asset valuation measure, which starts with the cyclically adjusted PE ratio or CAPE. This is a rolling 10-year average and yes, it goes back to 1880 that Shiller has done this. He's at Yale University. It is currently at 38 is where it is. The only periods that have been higher in the last 150 years on his valuation measure is right before the Fed started hiking in the fourth quarter of twenty-one in the tech bubble. We are slightly higher now than we w ere at the 1929 valuation.

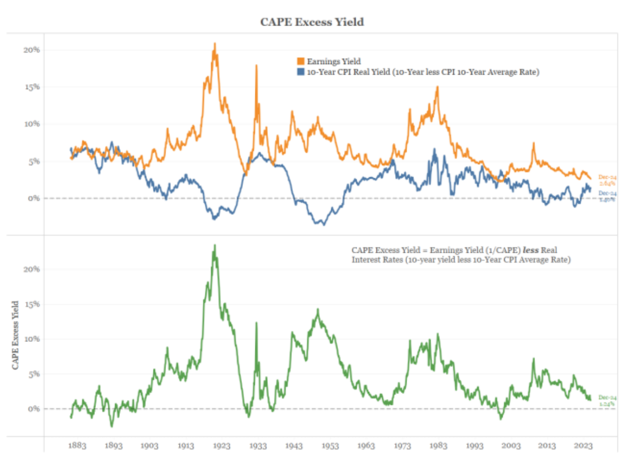
So, he says take one divided by the CAPE or the reciprocal of the CAPE and you get the earnings yield. The earnings yield right now is 2.64%. That's what you get for the earnings yield. So, if you're buying stocks, they have an earnings yield of 2.64%.



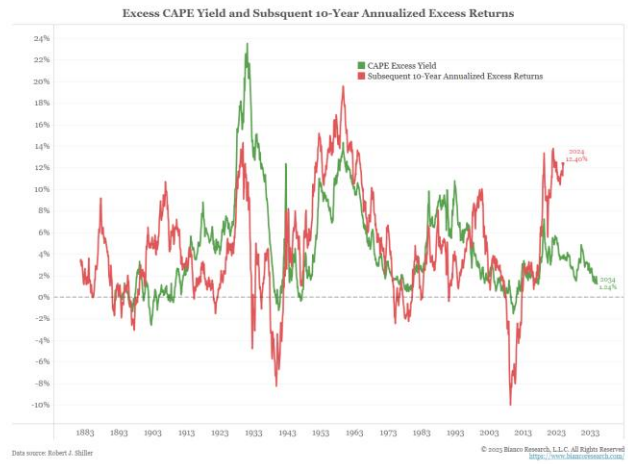
As far as the CAPE goes, there's been a lot of variations in the scatter graph going around in social media. Here's the CAPE ratio. Here's the next one-year return. This is where thirty-seven is right now. This is over the next year. It's a bit of a shotgun blast and even around where the CAPE is at 37. So, is this a good indicator of where the market's going to go in the next year? No.



But what about the next 10 years? So same chart. Here's the CAPE. Here's the next 10-year return. Much more of a relationship. And if you look at what all the previous numbers have been around a 37 CAPE, we haven't had many, there hasn't been a period where you started with a 37 CAPE and that in the next 10 years, you actually wound up with a positive return. And this is real returns. These are real returns after inflation.

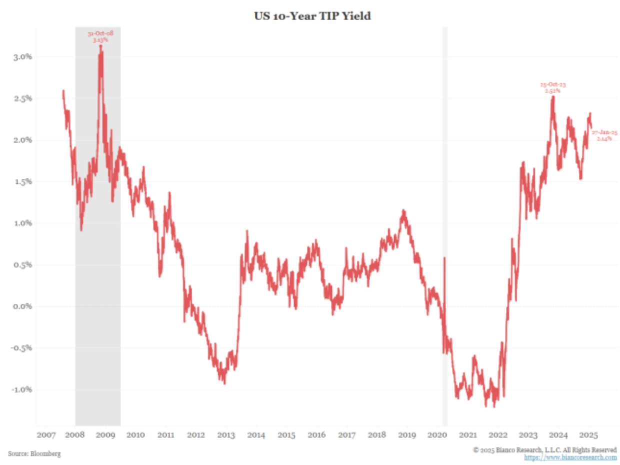


So let me explain that a little bit more, real returns. So, the orange line here is the CAPE. The blue line is the rolling 10-year average on real yields. It's calculated by Bob Shiller. Subtract the two and you get what's called the excess yield. That's this green line. So, what should the stock market return you above real yields? 1.2% is what it should return you. It's very, very low right now.

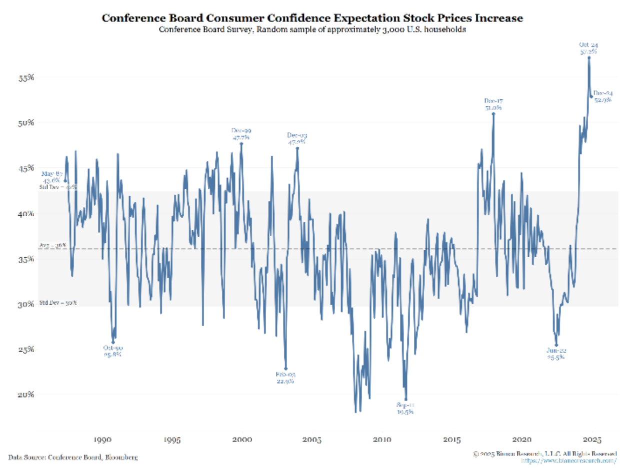


So, what he suggests is take that green line, the excess yield, push it forward 10 years. So that's out in 2034, the 1.2%. And the red line is the actual excess yield of return. What has been the return above the inflation rate, above the real yield. And that's a pretty good fit. And what this is suggesting is the next 10 years are going to be a real slug. They're going to be a real slug. They're not necessarily going to be negative, but they are going to be a slug.

So, what he's suggesting here, cash is going to give you four, bonds are going to give you five. In that world of bonds giving, you five, I think we're going to have an inflation rate in the three-ish range, so-called three to three and a half. So, one and a half to 2% real is what bonds are going to return you at five. Bonds return you five, they're going to give you one and a half to 2% real rate. Cash will give you 1% real rate. Stocks should give you something along the lines of a 3%, should give you somewhere along the lines of a 3% real yield or a nominal yield in the six range.

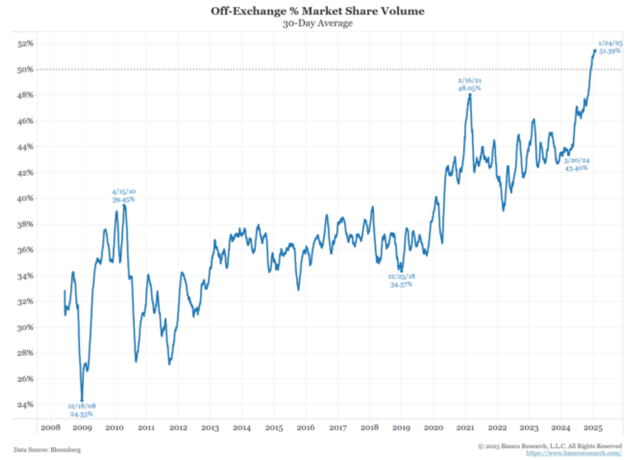


Real yields, the tip yield tells us what the market thinks the real yield is going to be over the next 10 years, 2.14% as of last night's close. That's pretty much consistent with what the 5% yield is, 3%-ish inflation world, 2% real, bonds will return you somewhere around five-ish percent.

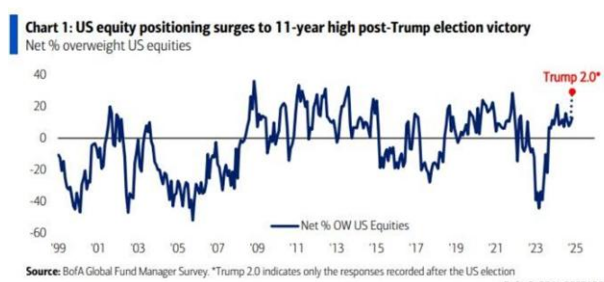


A couple of other charts really quick on momentum because everybody's a momentum investor. What gets people bullish? Make the stock market go up a lot in the past, then they expect it to go up a lot in the future. Conference board surveys 3,000 households. In crypto speak, these are normies. What do normies think the stock market's going to do? The highest percentage in the 37 years they've done this survey think it's going to keep going up. Why? Because it has been going up.

The other thing that's kind of interesting too, is this came from a story that we had news clips the other day. Recently, like in the last month now, the percentage of off-exchange volume, volume that occurs in dark pools and the like, has now ceded 50% of all of the volume in the stock market. This gets reported on the consolidated tape. It's just not happening on the ice exchanges, or the New York Stock Exchange, or the NASDAQ, or one of the recognized exchanges. It's occurring off-exchange.

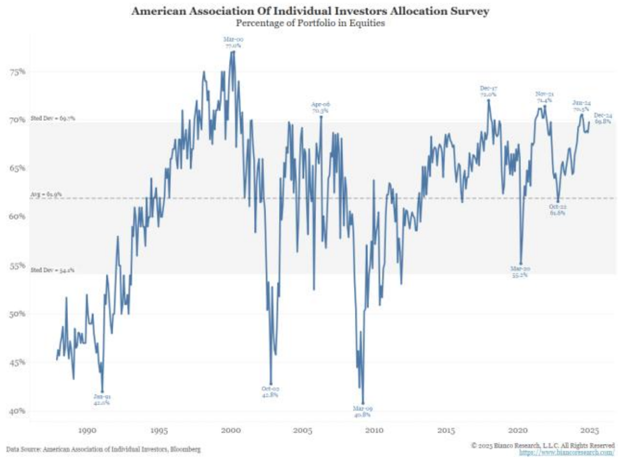


Why is that happening? Because what they've argued is that when you do a trade, pay for play, like the old Robin Hood used to be, and a Citadel or a Jane Street would actually cross the trade for you on their own books, that's an off-exchange trade. If you are trading in sub $1 stocks that don't trade, off on an exchange, that's an off-exchange trade. So, what this is, is this is a measure of speculation. At 51%, so many people are trading in small dollar online accounts where their order never makes it to New York Stock Exchange floor, it's just crossed by Citadel, and they take a little slice in the middle of it for crossing by Citadel, and that little slice, and they kick back to the broker, and that enables everybody to trade commission-free. Or they're trading in sub $1 penny stocks and the like, that's the highest it's been in probably forever, that we've got more stocks trading off-exchange than on. This is part of the momentum trade.

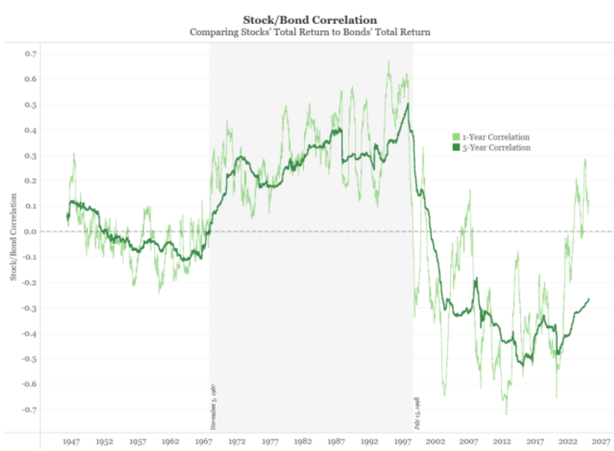


Another part of the momentum trade is they asked in the December Bank of America Global Fund Manager Survey, their equity positioning after Trump won the election, it's the highest in

11 years. Why? It's momentum. Everybody's into the momentum trade right now, and they expect the stock market to do wonderful things for the moment.



And then finally, the American Association of Individual Investors, you pay $100 to $200, you become a member, they survey their members, how much of your portfolio is in stocks, it's 70%. You can see they've been doing this survey for over 30 years, that's pretty high. Here's the average standard deviation, it is right above, it is right above. It’s above 66% of all the readings that we've seen in the last, or actually, excuse me, it's above 17.5% of all the readings, 82% of them are lower, the other 17.5% are down here, which is 33% if you add them all up together, or 16.5%, excuse me. So, 84% of all the readings on asset allocation in the stocks have been lower than what we've seen now over the last 30 years. That's the point I'm trying to get across with this. So, there's a lot of momentum. So, four, five, and six.



The last point I want to bring up is positioning. So, the stock bond correlation, I've talked about this chart many times, I'm going to summarize it really quick. This is the total return of stocks to the total return of bonds. And it's the prices back to World War Two, the green, dark green line is a rolling five-year correlation. The light green line is a rolling one-year correlation. The rolling one-year correlation is shot higher above zero for the first time, you know, basically in almost 30 years, 28 years. And the five-year correlation is starting to move higher as well.

What does that mean? When the correlation is positive, that is the shaded period, that is 1968 to 1998. When the five-year correlation is positive, I've called that the inflation period, the inflationary mindset period. People are concerned about inflation. You can have the eighties. Oh, we are concerned about inflation, but there isn't any. So, both stocks and bonds rally huge. You can have the seventies. We are concerned about inflation, and we have both. So, both stocks and bonds go down together. They go up together, they go down together. That's what happened from the sixties to almost the year 2000.

Since the year 2000, the correlation has been negative. They move opposite each other. That's the deflation mindset. That is the worst deflation. When you're worried about deflation, risk assets fall. That's bad for them. Safe assets like treasuries rally. When you're relieved there is no deflation, risk assets rally, safe assets like stocks go down. We invented the 60-40 portfolio. And it's not called the forty, that's crash insurance. You owned it because the concern was deflation. You owned it because in case of deflation, bonds would soar. In 2020, they went to half a percent because we all thought that the COVID shutdown would lead to massive deflation, and it would save you from the losses that you had in stocks.

But if the correlation is returning, just like my tips, two-year, five-year inflation break evens, we're not worried about inflation. Stocks and bonds are going to move up and down together. Well, then where's bonds fit in the portfolio if they're going to move up and down together? The assumption is that stocks aren't going to return you 18% and bonds are going to return you two and you just scream peanut all day long. There is no alternative. Take all of your money, Mr. 82-year-old, and put it in NVIDIA. That's almost what we've been arguing for the last decade or so, that bonds are going to return you five and stocks are going to return you six. So, bonds are going to be a lower volatility because they are by nature return vehicle than stocks. They're going to give you most of the return of stocks with less of the volatility.

But as the commercial says, but wait, there is more. But first of all, here's my breakdown on a stylized portfolio allocation. Forty percent in actively fixed income, and I'll explain that next. Twenty percent a basket of stocks like the S&P 500, passive basket of stocks. Thirty percent hot sauce. That's a term Eric Balcunas at Bloomberg coined, which I liked. Alternatives, growth, AI, crypto, whatever. So, what you're looking here at, if 40% is you're looking at five-ish or a little bit more, and I'll talk about the little bit more in a second, over the next decade with low volatility. You're looking at six-ish or a little bit more than six-ish with a little higher return of volatility. The 30% hot sauce is you're looking for something in the 9% to 10% annualized range with a lot more volatility.

In this case, you might have some stuff that turns out to be clunkers. Maybe you put 2% or 3% of your money in crypto and it goes to 30,000. You lose 70% of your money, fine. But you put 5% in some AI theme, and it goes up ten baggers. And it more than makes up for your losses. And when you add it all together, you're hoping for about a 9% or 10% return. And as long as the yield curve is very flat, 10% in cash giving you a 4% return when the yield curve steepens out a lot, you can distribute this into any one of these categories you want. That's how I think we're going to see the new portfolio.

S&P Dow Jones Indices
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SPIVA® U.S. Focus

Mid-Year 2024 Highlights

Report 3: Fund Underperformance Rates – U.S. Equity Categories

Fund Category	Comparison Index	YTD (%)	1-Year (%)	3-Year (%)	5-Year (%)	10-Year (%)	15-Year (%)	20-Year (%)
All Domestic Funds	S&P Composite 1500	76.56	76.17	90.09	85.91	90.08	93.42	94.31
All Large-Cap Funds	S&P 500	57.31	57.05	86.08	77.26	84.71	89.54	91.77

Report 4: Fund Underperformance Rates – U.S. Fixed Income Categories

Fund Category	Comparison Index	YTD (%)	1-Year (%)	3-Year (%)	5-Year (%)	10-Year (%)	15-Year (%)
U.S. Fixed Income							
General Bond Funds	iBoxx $ Overall	38.46	23.53	43.18	40.00	64.62	62.50
Core Plus Bond Funds	iBoxx $ Liquid Investment Grade	8.57	61.00	21.28	63.10	93.55	-

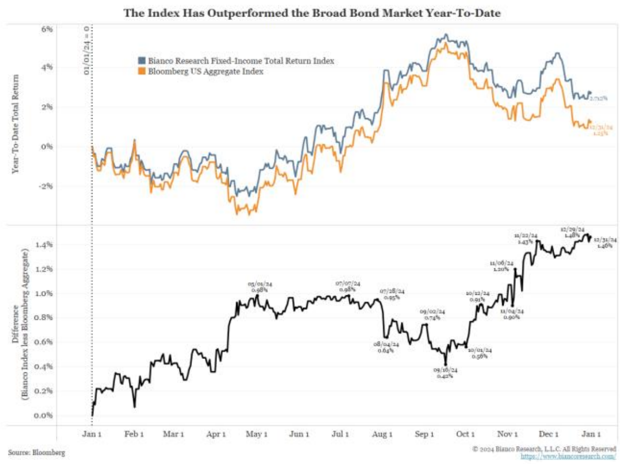
But wait, this is 40% in bonds, right? Yes, but they're not crash insurance. I don't expect this to return me 15%, this to suck, but they're just there for crash insurance. I expect this to be competitive with everything else. And that gets me to the next chart. But wait, there's more. SPIVA, S&P index versus active. You could Google the word SPIVA, index versus active, and it'll come up. They put out a report twice a year. Here's the mid-year 2024 report. They look at active managers, compare them to the benchmarks.

So, the top panel here is all domestic funds and all large cap funds. In pink, and this is the percentage of people that underperform. So, in pink are all of the instances of 80% or worse underperformance, so all inequities. The bottom half are the broad categories of bonds. General bond fund core plus. Or yellow is all of those that are less than 50% underperformance, meaning the majority outperform the benchmark, all in bonds.

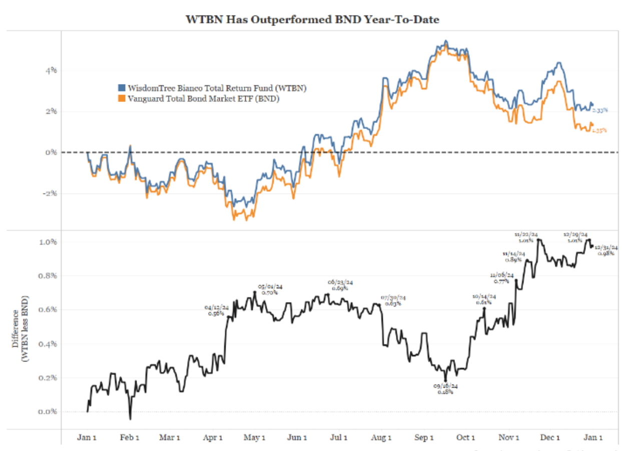
So let me give you the argument that I've been giving for a while. Stock managers cannot beat their indexes, bond managers can. Why? In stocks, your biggest weightings, in fact, I wrote an op-ed in May in the Financial Times about this. In May, or in stocks, 34% of your portfolio or 33% of your portfolio is the MAG 7. If you passed your CFA and you understand anything about valuation and all the traditional metrics, those stocks have had red flags on them left and right. Okay, you looked like a genius yesterday, but beforehand, if you didn't have 33% of your portfolio in the MAG 7, you had no chance of outperforming your benchmark.

Everybody's given up on active equity managers, and that's why they are constantly underperforming everybody by SPY, IDV, VOO. Those are State Street, BlackRock, and Vanguard's versions of the S&P 500. Collectively, between them, there's like $2 trillion in those. Just by the index, be happy, it only goes up 20% every year at your birthright, and don't overcomplicate it.

But in bonds, your biggest weightings are your companies that have, or your countries that have, or your structures, companies, countries, or structures that have problems. That's why they're big weightings. You over-leverage yourself. So, your countries that borrow too much debt, Japan, your over-leveraged companies that are about to become non-investment grade, your bad structures. An active manager can look at that, see the red flags, avoid them. They do become problems and outperform. So, the majority of managers outperform in fixed income.

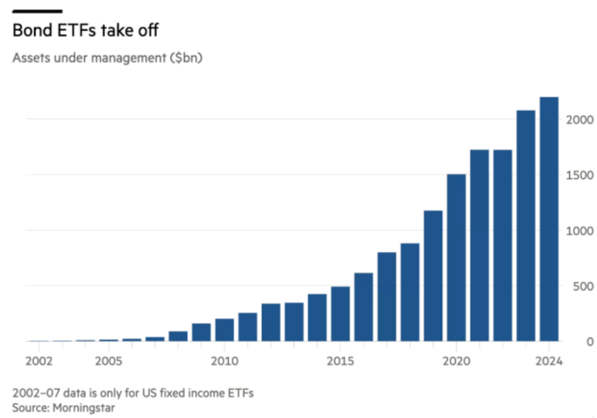


So, if we're in a 5% or 6% world, 5% bonds, 6% stocks, bonds should actually do a little bit better. Stocks should return you somewhere around 6%, and that gap might actually be a little bit closer. And this is the gratuitous commercial here. And that is, we manage an index, B-T-R-I-N-D-X, or you go to biancaadvisors.com. In 2024, our index was up 146 basis points above the aggregate index.



WisdomTree has an ETF, WTBN, that tracks our index. It outperformed by ninety-eight basis points. So, we returned somewhere at around 2.3, 2.4% for the year, where the index was up 1.25 for the year.

According to Morningstar, year to date, we were in the 19th percentile, meaning we outperformed 81% of the 470 funds in the core bond universe. Active management works in fixed income. Now, the good news for equity is you might be rolling into a period where active management will work. The problem you've always had with equity is you pick good ideas, and this gigantic tidal wave of money goes into indexes, and all the bad ideas go up.



Not only that, but I also read an interesting story earlier this week in news clips. One of the reasons why you're having such a hard time getting IPOs is no one's giving money to active managers to buy IPOs. They're just plowing it into IVVVOO, and nobody IPOs straight into the index. So, go to the active guys that would buy IPOs, start giving them money, and you'd actually get more IPOs.

So, if we're going to go into a period where we have had the Sputnik moment, as Mark Andreessen calls it, for AI, the Mag7, no, they're not going to zero. It's just that the moat that you think that they have, and the margins that they command as we go to something that is as important as the internet invention itself, AI, is not what you think it is. There's going to be dozens, if not hundreds of competitors, and the cost of this stuff is going to go down.

You could do it yourself, is what we're ultimately arguing, not you and me personally, but maybe a Vanguard says, 'you know what, we're not going to contract out to Google for our AI, we're going to buy the chips and build it internally, because we don't need a contract with Three Mile Island in order to power it, and we don't need to spend a billion dollars on chips, we could do it all ourselves, and we could train our own model for a couple of million dollars, and then we can have our own internal AI.

All of a sudden, the moat that those Mag7 stocks have, they're not there. Their valuations have to come down. Those companies are going to drag down the index. Everybody in SPY, IVV, and

VOO are going to start to realize, if this scenario unfolds, you throw a dart, you could be Dave Portnoy picking letters out of a Scrabble bag and outperform the index, because these big cap weightings are going to just drag it down.

Not a huge loss, but anything else will outperform, including active management, and then that could be the dawn of active management. Look, if you've got a good idea, you think it's a 15% return, it's going to be a 15% return in a lower beta environment than a higher beta environment. Does any active manager say, 'this stock is a great idea, I think it's going to return 20% if the S&P is up 15%, but I think it's going to return 8% if the S&P is up 5%.' No, you think it's going to return 20% regardless of what the beta environment is.

So, a lower beta environment will push money back to active management. Active management can now beat the hurdle of low beta. Will more than the majority of them beat it? That remains to be seen. But right now, 80% or 90% of them can't, and that should come down quite a bit. A lot more should start to beat them.

So that would be the case for active, but that's going to take years to convince people of this. And in the meantime, active bonds are going to be a competitive investment, and that's why I've got the 40% in that portfolio again. Not because it's crash insurance. Technically, in an extreme scenario, it could serve at some version of crash insurance, but more likely than not, it's just going to be competitive with the environment we have going forward.

And remember my scatter graph here really quick. That doesn't mean that this year is going to be 4, 5, and 6. It means over the next several years, there's going to be 4, 5, and 6. So that's how I'm thinking about the longer term, truth be told.

That's why when I was thinking about getting into the ETF space, I waited until the end of twenty-three, although we started talking about its years earlier, and I went initially with total return fixed income because it's kind of my bailiwick. I understand it a little bit better, and I think it's got a good fit for what we're going to go forward.

Lastly, I know I'm talking to a bunch of professional managers. I'll just say this. I fully know that I will have a year or two that I'll be in the fourth quartile but thank God it wasn't the first year. The first year, we were in the top quartile. So, it helps us to get off of zero. Everybody has a fourth quarter year. It's naive to think that you won't. And I will have a fourth quarter year too, but thankfully it wasn't the first year.

So that's where I've been with this. Thank you for listening. I'm opening it up for questions. If anybody's got any questions on anything I've said or anything else, let me know. Speak now or forever hold your peace as far as questions go.

Interestingly, we usually get a whole lot of questions, and I'm not getting any questions right now. So, I pretty much said what I need to say. I'll end the call here. I'll thank everybody for continuing to listen to the call, and I will catch you again in this format in the next couple of weeks. Good-bye.

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