BOSTON PORTFOLIO ADVISERS

# Third Quarter 2024 Outlook and Commentary

The second quarter delivered nine more record highs on the S&P 500 index. In contrast to the broad-based stock market gains from late last year and early this year, the second quarter rise was exceedingly narrow. Fueled by the continued artificial intelligence (AI) mania, two stocks--Apple and Nvidia--comprised nearly three-quarters of the S&P 500's 4.3% quarterly return. Most stocks fell during the quarter, with the average S&P 500 stock declining 2.6%. For a brief time on June 20th, Nvidia became the most valuable company in the world. At that point, the combined market value of Apple, Microsoft and Nvidia was an astonishing ten trillion dollars. The last time three companies constituted such a large percentage of the U.S. stock market was … never.[1]

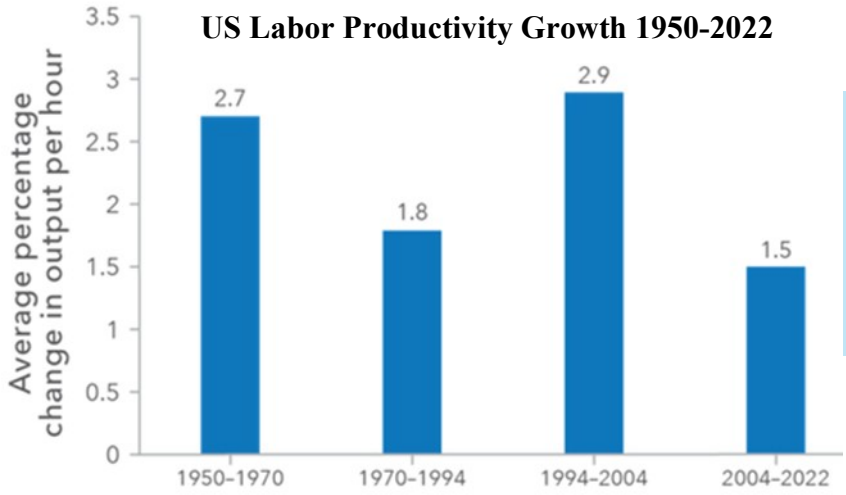
Businesses of all kinds are pouring hundreds of billions of dollars into developing or deploying AI applications that may transform the U.S. and global economies. Regular readers know that we are very dubious that the coming transformation, no matter how profound, can justify the valuations of some of the anointed AI winners. Putting aside what the investment of hundreds of billions of dollars will do for Apple, Microsoft and Nvidia, what might it do for the U.S. and global economies?

In the mid and late-1990s, massive amounts of money flowed into companies building out the infrastructure of the internet (fiber optic cables, wireless networks, etc.). The frenzy of investment created overcapacity, and one company after another was forced to take huge and painful write-offs. While the returns on investment were poor for individual companies, that wasn't the case for the U.S. economy writ large.

The chart on the next page illustrates trends in productivity since 1950. Labor productivity measures how much economic output workers create for each hour worked. When productivity is high, good things happen. Companies can give workers robust wage hikes without significantly raising prices on their products and services. The economy can grow rapidly without creating excessive inflation. Productivity grew at a solid rate in the 1950s and 1960s thanks to innovations in areas such as plastics, air transportation, and solid-state electronics. Productivity growth slowed in the early 1970s and remained subdued for over twenty years. With the widespread adoption of desktop computers and related software in the late 1980s into the 1990s, productivity picked up again. Investments in telecommunications and the internet helped sustain that productivity boom well into the 2000s.

[1] That's not quite true. In the early 1800s the U.S. stock market consisted almost exclusively of banks and insurance companies and the number of public companies measured in the dozens. The First Bank of the United States and subsequently The Second Bank of the United States comprised a very large portion of the overall stock market value. If we date the modern stock market to the advent of railroad stocks in the 1830s, then it is correct to say that the top three stocks have never represented such a large percentage of the overall market, and it's never been close.

By 2005 the surge had run its course and productivity growth has been depressed ever since (save for a temporary increase early in the Covid pandemic). Productivity seemed to pick up in 2023[2], but it's much too early to know if the U.S. economy has entered an extended period of elevated productivity.




Source: economicstrategygroup.org. Growth rates are averages of quarterly estimates for the period.

Will AI spark a productivity boom in the way that plastics, avionics and electronics did in the 1950s and 60s and desktop computers and the internet did in the late 90s and early 2000s?

One of the important benefits of an AI-based productivity boom would be to decrease pressure on inflation and interest rates. It may be that the bond market is counting on that. Although interest rates are high relative to three years ago, they aren't high by historical standards. Consider the 1990s, by which point the double-digit inflation of the late 1970s and early 1980s was very much in the rear-view mirror. (For younger readers, U.S. consumer prices rose by more than 10% a year for three straight years beginning in 1979, largely the result of soaring oil prices following the Iranian Revolution and the Iran-Iraq War). Interest rates had come down dramatically from their peak, but 30-year fixed rate mortgages were over 10% for much of the decade. The benchmark 10-year U.S. Treasury bond which currently yields a bit under 4.5%, spent most of the 1990s yielding between 5.5% and 8.0%.

The stock market does much better when interest rates and bond yields are low, so a return to the interest rates of the 1990s would be a big problem. One reason to worry about interest rates going higher is the rapidly climbing federal debt, financed by the issuance of Treasury bonds. Absent dramatic and seemingly unlikely fiscal restraint, Treasury bond issuance will climb sharply for the foreseeable future. For now, demand remains strong, but at some point, the U.S. Treasury may need to pay higher interest rates to convince investors to buy all of the bonds it needs to issue. Fortunately, interest rates are determined by a lot of factors, inflation being the most important. If inflation continues to subside and reaches the Federal Reserve's 2% target this year or next, and if AI driven productivity gains help keep inflation in check over a longer period of time, perhaps interest rates will remain relatively low by historical standards.

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[2] It's unlikely that the 2023 uplift was due to AI. More likely, it came from the benefits of cloud computing, which has allowed companies of all sizes to transition away from software maintained on their own computers and utilize software that is accessed via the internet (the "cloud").

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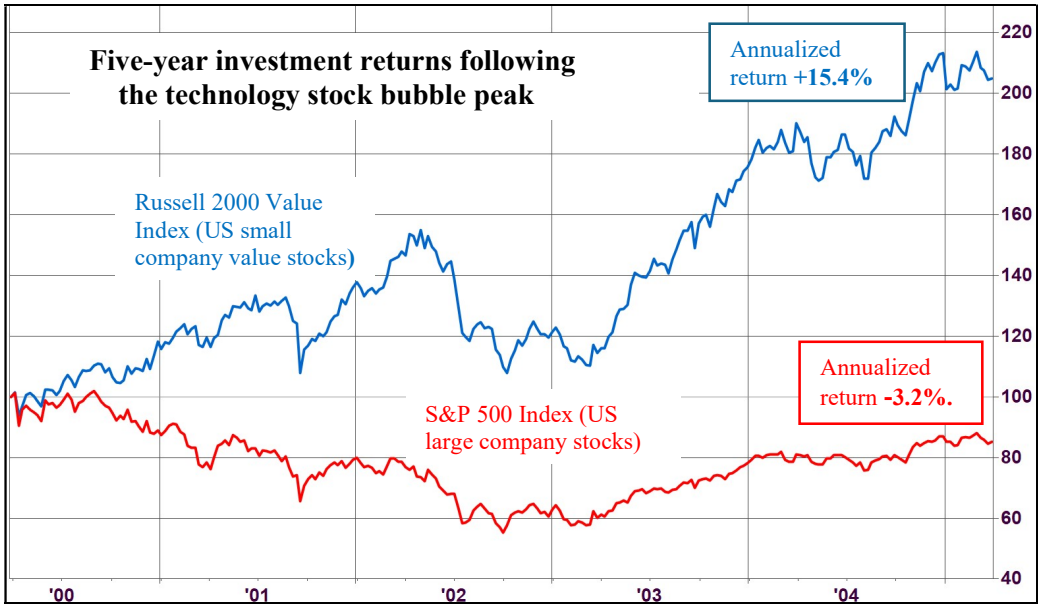
Three months ago, we noted in these pages that large company U.S. stocks such as those found in the S&P 500 might not be the best place to look for attractive returns going forward. The chart below illustrates how dramatically investment performance can diverge following times of extreme valuation. The blue line is the Russell 2000 Value Index, which tracks small company stocks with value characteristics. The red line is the S&P 500. As the technology stock bubble was peaking in March of 2000, small company stocks were languishing. Discerning investors could find good small company stocks at extremely attractive prices. Over the subsequent five years, the S&P 500 lost significant ground, returning -3.2% per year. Over the same period, the Russell 2000 Value Index generated a stellar 15.4% per year.




Source: FactSet. Investment returns include dividends and are indexed to a base of 100 on March 31, 2000.

None of this is to make a specific prediction about the future performance of small company value stocks or any other stock market sector. Instead, the purpose of the chart is twofold: first to remind the reader that extreme valuations—and we are inclined to think that a ten trillion-dollar value for three companies is extreme—can lead to poor performance; and second to point out that even in the midst of very high valuations, there are almost always attractively priced areas of the investment universe. Now more than ever asset class selection and individual stock selection are critical.

*Boston, MA*
*July 10, 2024*

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