THE DANA VIEWPOINT

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Dow: 53,839

Earnings Drive Prices

Eventually. The S&P 500 is up about 10% since last fall, while earnings have grown at a faster rate, lowering the valuation of the index. With the second-quarter earnings season mostly complete, it has been another unabashedly good quarter. You don't need us to tell you that, as the S&P 500 Index reached a new high and is now up 14% for the year. Strength was evident across many market sectors, with some of the largest companies in the S&P 500 Index returning to outperformance during the third quarter.

This high level of individual stock volatility is something that we will all need to get used to. We are early in the AI technological revolution, and it is too soon to tell who the winners and losers will ultimately be. The ante, or investment, required to remain one of the key players and potential winners can be tens or hundreds of billions of dollars. The largest technology companies are using their substantial cash flows to make these investments. In doing so, they are converting their cash flows into profits for others, namely semiconductor companies. Historically, semiconductor companies have swung from large gains to large losses and back again. They are the ultimate cyclical businesses. Because semiconductor capacity is difficult to add, profits can swing wildly based on product gluts or shortages.

Semiconductor stocks proved to be a source of volatility and ultimately clipped the wings of a hedge fund investor well known on Wall Street. Leopold Aschenbrenner was born this century and graduated as valedictorian from Columbia University at age 19. He runs a hedge fund called Situational Awareness, focused on investments in the AI sector. The fund was reportedly up hundreds of percent in the first half of the year, utilizing leverage of up to four times its assets. However, a 25% correction in the semiconductor sector during July was enough to wipe out a large portion of those gains and trigger margin calls on his loans, forcing stock sales. This example highlights how even a savant invested in the best-performing assets can be severely impacted when leverage is too high during a market correction.

Volatility driven by uncertainty has come to the fixed-income market as well. The two-year Treasury yield has risen a full percentage point since the end of February, from 3.35% to 4.35% in late July. The ten-year Treasury yield increased from 3.94% to 4.65% over the same period. Inflation remaining above the Federal Reserve's target, mainly because of higher energy prices, appears to be the proximate cause. An untested new Fed Chair, Kevin Warsh, has refused to provide significant guidance on the future path of interest rates. While he has pledged to bring inflation down to the targeted 2%, the market remains skeptical.

There may be a benefit to Warsh's "less is more" approach to communication. Prior Federal Reserve guidance often required revision, and one could argue that by telegraphing its moves, the Fed ultimately made interest-rate policy less effective. There is little reason to believe that the Federal Open Market Committee is comprised of individuals with greater market knowledge than the experienced professionals at leading financial firms. By eliminating forward guidance, the Fed may not only reduce the risk of inadvertently misleading the market, but

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also make actual rate moves more impactful. This could result in greater effectiveness and credibility for the Fed. We believe these are Warsh's ultimate goals.

Even though corporate financial performance has been laudable over the past few quarters, economic concerns remain on the horizon. Employment growth is one such concern. Most economists believe that monthly payroll growth must average between 75,000 and 100,000 jobs to absorb new entrants into the workforce. For more than a year, employment growth has averaged only 35,000 to 50,000 jobs per month. As a result, a smaller portion of the population is actively participating in the labor force. If individuals are not actively looking for work, they are not counted as unemployed, which helps explain the relatively low 4% unemployment rate. The percentage of working-age males participating in the labor force has continued to decline, creating both economic and societal concerns. Increasing numbers of young people view themselves as falling behind economically. This sentiment has undoubtedly contributed to the political rise of democratic socialist movements. The political balance between the two major parties may be undergoing a significant shift this fall, and we will monitor developments closely for their potential long-term effects.

Random Thoughts:

"I am a big believer in the American private sector and would almost never advocate for heavy government involvement in technology or industry."

"American checks and balances have held for over 200 years and through extraordinary technological revolutions."

— Leopold Aschenbrenner

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