01/2025

2024 Year-End Newsletter and Outlook[1]

BY MICHAEL C. STALKER, CFA

Due to a change in SEC rules, we can no longer report actual client returns, as we did previously. Instead the SEC requires advisors to report a model portfolio performance. We don't have a formal model portfolio. A model is an 'on paper' portfolio with none of the challenges of managing real peoples' money.

I was a unicorn for 30 plus years of reporting the reality of actual client performance.

So, to comply, I'm going to give you index returns and refer you to your report to make your own comparison. Clients had little or no stock market exposure due to its high valuation and risk. In 2024, stocks returned 24.89%. A better comparison is the bond market which returned 1.25%. I think you'll be happy with your return vs. bonds.

The 'short-term bonds for now' strategy has put us in an excellent position as interest rates have continued to rise after the Fed cut its Fed funds overnight lending rate. The yield curve is returning to normal, meaning long-term bonds pay more interest than short-term bonds (a positively sloped yield curve). The stock market is at historically high valuations, based upon the potential of AI. Politically, we may be entering a very volatile time, as the new administration seeks to make radical changes to national and international relationships.

Normalizing Interest Rates

Investors are starting to be compensated with higher interest to offset the risk of lending money for a longer time. (The extra yield is called the term premium).

There are four reasons that long term interest rates are likely to increase based on what the incoming administration has indicated.

- Large and growing government deficits
  - Increased US deficits (tax cuts)
  - Untested deficit reduction strategy, Musk, et al.
- Potential Inflation
  - Immigration policy will increase labor costs
  - Risk of tariff war increasing import costs
- Higher degree of uncertainty as norms are disrupted
  - Norm disruption can be both positive and negative

- Potential Fed interference (real estate investors hate higher rates because it reduces the value of their properties). However, the Fed does not control long term rates and any interference in the Fed's independence will likely spook markets, increasing rates.
  - As I write this, Trump in an address to the World Economic Forum in Davos, is demanding lower interest rates. And long-term rates are increasing. Interesting times ahead.[2]

Manias and Stock Mark Prices

Today's stock environment feels like previous manias, similar to the Dot Com and Pandemic events. Every mania has a strong basis in reality; something is changing rapidly and there's money to be made. A posterchild for the Pandemic Mania is Zoom, an excellent company. It's a lesson in how to lose money on the stock of a good company.

The Pandemic Goes Zoom

In the early days of the pandemic, the demand was so high for Zoom services that analysts routinely underestimated its revenue growth. The stock soared on the breathless price revisions of analysts. Topping out at a high of $559 per share, it recently traded at $79.46. Assuming a rough average purchase price of $200 during the frenzy, that's a loss of 60%, and a fall of 85% from its peak.

Figure 1

Zoom – Pandemic Wunderkind Stock, Until It Wasn't

Source: Bloomberg, MCS

Note the high volume of shares traded (lines below chart) and the price's near vertical lift off during the pandemic. This chart pattern is an investor magnet in the early period of explosive growth. Indeed, early investors look smart for about a year or two, but not so for the many who believe in buy and hold.

We're all "Zooming" these days (or the equivalent). Yet, Zoom's extreme growth rates were only possible off a low adoption base. While the customer base increased as a percentage of all available customers, the growth rate falls and with it the company's value. Zoom is an excellent example of how rapid mass adoption of a service cannibalizes future growth rates. Zoom is a profitable company, but it was a terrible investment for most.

Are AI stocks in a Mania?

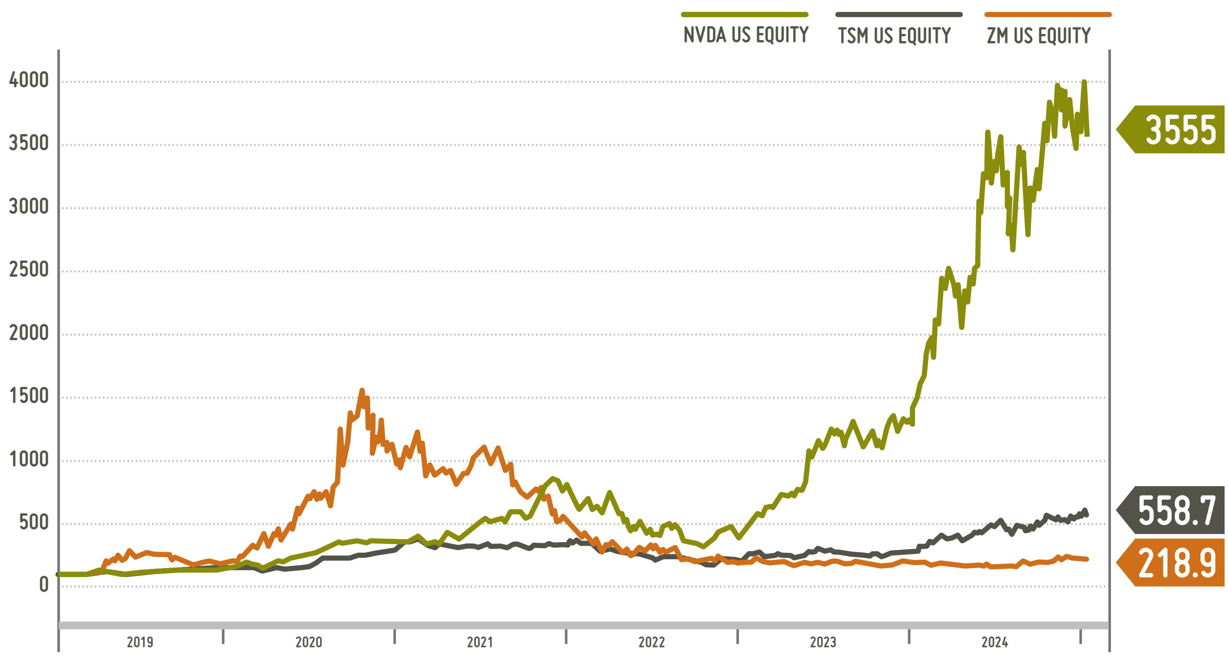
Below is an interesting comparison. The graph shows the percentage change in stock prices for Zoom, Taiwan Semiconductor and Nvidia. Zoom was a darling of the Pandemic Mania. Nvidia is the darling of the AI Mania.

> *Taiwan produces about 90% of the world's most advanced semiconductors, mostly through the Taiwan Semiconductor Manufacturing Co Ltd (TSMC), the world's largest producer and a major Apple and Nvidia supplier.*[3]

Figure 2

Comparing Stock Price Action: Zoom, Taiwan Semiconductor, Nvidia

Zoom's early price action looks like a mini-me version of Nvidia.



Source: Bloomberg, MCS

So, What Could Go Wrong?

Geopolitical Risk

Here's the rub, the valuation gap between NVDA (up 3,556%) vs TSMC (up 219%) over the past five years is gigantic even though TSMC is critical to NVDA sales growth. I believe this due to NVDA investor's ignorance of the geopolitical risk that TSMC faces in Taiwan. What do you think would happen to NDVA's sales and stock price if TSMC's ability to supply advanced chips was significantly impacted?

Among geopolitical strategy think-tanks, a credible and well-recognized risk to the current world order is a Chinese blockade of Taiwan. In fact, China's military practices blockading Taiwan. Other experts believe China is preparing for an invasion of Taiwan within the next few years. To learn more, see:

- https://www.armscontrol.org/act/2022-09/news/china-reacts-aggressively-pelosis-taiwan-visit
- https://features.csis.org/chinapower/china-blockade-taiwan/
- https://www.vox.com/world-politics/390895/china-taiwan-conflict

There's a counter argument that China has too much to lose by messing with Taiwan or alternatively, doing so would trigger a world war.[4] Clearly, in this event, a collapsing NVDA stock price, along with the rest of the market, might be the least of one's worries.

Efforts to establish TSMC manufacturing know-how and facilities outside of Taiwan, like the one recently completed in Arizona, are a clear attempt to mitigate (not eliminate) the geopolitical risk. But this does not eliminate the investment risk due an invasion- or blockade-precipitated collapse in TSMC chip supply. In addition to that, US-based TSMC plants will not be manufacturing the most cutting-edge TSMC chips[5].

Expecting Too Much, Too Soon, for Too Long = Money Loser

One of the most difficult analytical tasks to master as a stock investor is whether the expectations embedded in a company's stock price are too aggressive and thus a set-up for disappointment and losses.

In my previous Newsletter, I discussed a significant risk to AI development / deployment; the lack of sufficient power / electricity infrastructure. Goldman Sach's report[6], which I just obtained, confirmed this thesis:

> *Brian Janous, Co-founder of Cloverleaf Infrastructure and former VP of Energy at Microsoft, believes that US utilities—which haven't experienced electricity consumption growth in nearly two decades and are contending with an already aged US power grid—aren't prepared for this coming demand surge. He and Davenport (GS Utilities analyst) agree that the required substantial investments in power infrastructure won't happen quickly or easily given the highly regulated nature of the utilities industry and supply chain constraints, with Janous warning that a painful power crunch that could constrain AI's growth likely lies ahead.*

Perhaps a more prosaic reason why the upward stock price is unsustainable for NVDA; AI advancement appears to be slowing. This is coming from tech moguls themselves. Sundar Pichai, CEO of Google said at a DealBook Summit in December 2024[7]:

> *I think the progress is going to get harder. When I look at [2025], the low-hanging fruit is gone," said Pichai, adding: 'The hill is steeper ... You're definitely going to need deeper breakthroughs as we get to the next stage."*

Importantly, AI is not yet producing profits for its corporate users. From the article "OpenAI, Google and Anthropic Struggle to Build More Advanced AI[8]":

Three of the leading artificial intelligence companies are seeing diminishing returns from their costly efforts to develop newer models.

OpenAI isn't alone in hitting stumbling blocks recently. After years of pushing out increasingly sophisticated AI products at a breakneck pace, three of the leading AI companies are now seeing diminishing returns from their costly efforts to build newer models…

> *The recent setbacks also raise doubts about the heavy investment in AI and the feasibility of reaching an overarching goal these companies are aggressively pursuing: artificial general intelligence [AGI]). The term typically refers to hypothetical AI systems that would match or exceed humans on many intellectual tasks. The chief executives of OpenAI and Anthropic have previously said AGI may be only several years away…*
>
> *[Anthropic CEO Dario] Amodei said there are "lots of things" that could "derail" the process of reaching more powerful AI in the next few years, including the possibility that "we could run out of data."*

Another piece of evidence that AI stocks are a bit wacko is that you can buy Taiwan Semiconductor (TSMC) for 25% less on the Taiwan exchange than buying US market traded TMSC ADR (American depository receipt)[9]. This is partly because the US ADR is much more liquid. Yet, the 25% ADR price gap is quite high compared to the 6.4% average over the past decade; is it a sign of irrational exuberance?

Going back to the Goldman Sach's (GS) report, it does an excellent job of discussing the bull and bear case for AI. Even the bearish view concludes that one should be invested because AI investment is going to continue and while the 'killer app' that justifies enormous AI investment is missing, it may eventually be found.

Another way to say this is there is a tremendous amount of money momentum into the sector; partly motivated by FOMO (fear of missing out). There's another reason that the GS report says buy despite the well-articulated reservations; the business of brokerage firms like GS is to encourage risk taking, not discourage it. GS can't afford to miss out on the fees associated with the Tsunami of money going into the sector. So, GS did the next best thing; it produced a report with the pros and cons, leaving it up to the investor. Caveat Emptor.

My takeaway is that the expectations about AI stocks are extreme in the same way that expectations about Zoom, as a stock investment, was extreme. Zoom is a leader in its space, at the right place at the right time, with sufficient capacity to capitalize on an unforecastable (pandemics are foreseeable, but who knows when?) event.

Zoom and similar services enabled a major societal disruption in the way people work, as will AI. Had there been no pandemic, I doubt I'd be writing about Zoom. And billions of dollars would not have been lost in commercial office real estate. AI promises to be more disruptive. Frankly, I'm unsure how to bet. Half the battle for AI investment success may be not owning the equivalent of office real estate.

Just this week (January 27) Deepseek, a free Chinese open-source architecture AI model that has become instantly popular, has wiped out over a trillion dollars of AI stock valuations by upending the investment story of AI. Deepseek AI, using older generation hardware, claims it was created for a small fraction of the cost of AI platforms like Chat GPT. The release of Deepseek and its surging popularity has forced investors to reassess which companies will be AI investment winners and losers. Stay tuned. The societal game changing story of AI remains and may be accelerating.

A World Gone Bananas!

> *'Artists don't create society, they reflect it'*
> *– Ben Elton, British Comedian and Writer*

Sooo, what better place to step back, breathe and reflect than the art world and Sotheby's recent sale of a banana duct taped to a wall.

Thoughtfully stroke your chin as you gaze upon this…

Figure 3

'Comedian'

Who's the joke on…?

Source: Sotheby's

The above sold for $6.2 million at a Sotheby's contemporary art auction. Breathtaking!

You can watch the auction here:
https://www.cnn.com/2024/11/21/style/video/banana-duct-tape-auction-sothebys-digvid

Lest you tut-tut the stupidity of the person (crypto-bro, Justin Sun, founder of the cryptocurrency TRON) who bought this 'work of art' with crypto, consider Sotheby's justification for its value:

Sotheby's calls Cattelan "among Contemporary Art's most brilliant provocateurs."

"What you buy when you buy Cattelan's 'Comedian' is not the banana itself, but a certificate of authenticity that grants the owner the permission and authority to reproduce this banana and duct tape on their wall as an original artwork by Maurizio Cattelan," Galperin (of Sotheby's) said.[10]

"This is not just an artwork; it represents a cultural phenomenon that bridges the worlds of art, memes, and the cryptocurrency community," Justin Sun commented[11]. Of course, he ate the banana (gasp!). Not to worry, it's the 'certificate of authenticity' that holds the 'value'. The owner gets installation instructions and a role of duct tape. Note: He's gotta buy the replacement bananas to keep the artwork fresh… or is it ripe?

Yet Justin does have a point about art, memes, the crypto community and the current investing climate. Bananas have a lot of appeal, until you step on one.

Bottom Line

MCS clients are well positioned to take advantage of this increasing interest rate environment. It's too early to move into longer term bonds, since short-term bonds remain very competitive without the long-term risks. After a historically unprecedented 10-year yield drought, the interest rate increases over the past 18 months are welcome from a saver /conservative investor / retiree perspective. Not so great from a borrower's perspective – I'm looking at you, USA!

Trump's ambiguous policies on tariffs are potentially inflationary. Cutting taxes (popular) is easier than cutting deficits (unpopular when it requires higher taxes). The jury is out on the new administration's ideas about increasing government efficiency. Trump's 'I'm crazy', hard-ball opening style of negotiation creates a lot of uncertainty and potential underlying resentment. Markets don't like uncertainty. That said, it can be an effective negotiating strategy if you're in the power position. If it's employed in a near military equal's situation e.g. with China / Russia, it may be dangerous and misinterpreted, leading to dramatic consequences (both unanticipated and unintended).

Long term interest rates have risen due to inflation fears and a normalization of the yield curve. A recession does not appear imminent. Interest rates grinding higher would put downward pressure on stock, bond and real estate prices. Real Estate is already under downward pressure with higher cap rates and higher mortgage interest rates.

Stocks are historically very expensive, but that won't prevent them from going higher in the short run. Please contact me if you want to play it, michael@mcsfwa.com or 541-345-7023. I'm not inclined to play a game with high stock market valuations implying poor long term returns, yet I also know the stock price momentum can last much longer than one expects.

Endnotes

[1] This report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

[2] https://abcnews.go.com/Business/trump-demand-lower-interest-rates/story?id=118025230

[3] https://www.theguardian.com/world/article/2024/jul/19/taiwan-semiconductor-industry-booming

[4] https://warontherocks.com/2024/06/a-chinese-economic-blockade-of-taiwan-would-fail-or-launch-a-war/

[5] https://spectrum.ieee.org/tsmc-arizona

[6] https://www.goldmansachs.com/images/migrated/insights/pages/gs-research/gen-ai--too-much-spend,-too-little-benefit-/TOM_AI%202.0_ForRedaction.pdf

[7] https://www.cnbc.com/2024/12/08/google-ceo-sundar-pichai-ai-development-is-finally-slowing-down.html

[8] Metz, Rachel; Ghaffary, Dina Bass; and Love, Julia; "OpenAI, Google and Antrhopic Struggle to Build More Advanced AI"; Bloomberg News; November 13, 2024

[9] Yang, Charlotte and Wang, Cindy; "WSMC's 25% Arbitage Trade Is Too Dangerous for Hedge Funds; Bloomberg News; January 16, 2025

[10] https://www.voanews.com/a/how-a-viral-duct-taped-banana-came-to-be-worth-6-2-million/7871610.html

[11] https://www.nbcnews.com/news/us-news/man-spent-62-million-banana-duct-taped-wall-says-going-eat-rcna181172