



Quarterly Investment Commentary

FIRST QUARTER, MARCH 2024

This Modern Age

Published in 1952, “Player Piano” was the first novel written by Hoosier native and celebrated author Kurt Vonnegut. The sci-fi story depicts a futuristic America where most jobs requiring human involvement or decision making are replaced by automated robots run by a supercomputer. While the displaced human workers grapple with a way to live in a world run by machines, the computer-driven production methods in the U.S. become efficient, flawless, and perfectly priced. The plot deals with a number of social issues, but it’s easy to see some parallels with the discussions today surrounding the potential use of Artificial Intelligence (AI). The AI phenomenon has evolved from sci-fi fantasy to tangible applications being touted for cost savings and increased productivity. Jobs in manual labor, routine everyday work, and those using advanced brain power will seemingly be revolutionized by this technology. Even the picture below was created with the assistance of AI software.



By simply prompting it to generate an image of a “portfolio manager in Indiana thinking about the impact of future innovations on financial markets,” click enter and presto. While the AI image technology is interesting and quick, you can be the judge of the finished product—we don’t see an accurate resemblance.

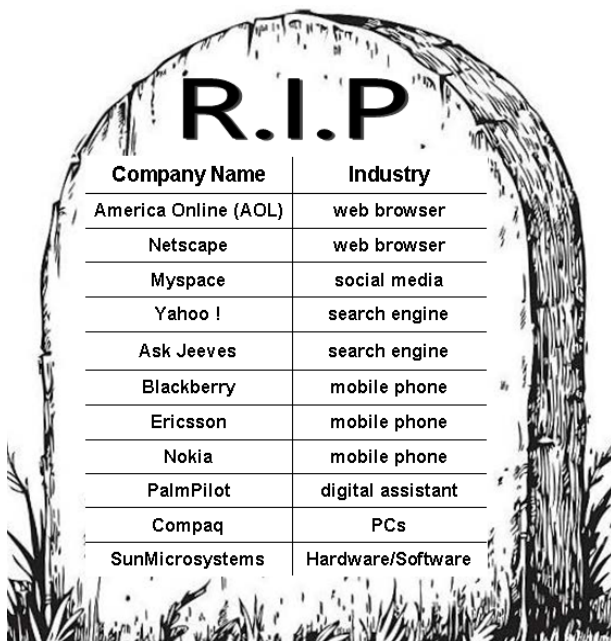
The ongoing investor optimism surrounding AI’s potential continues to lift stock prices and valuations of those select companies linked to the technology. The Russell 1000 Growth index, which is heavily concentrated in many of the stocks viewed as near-term beneficiaries of AI, is up 39% over the past year while the average stock listed on the S&P 500 index is up 19%¹. It’s not just AI stocks that are getting a boost. Areas within the pharmaceutical sector working on the next wonder drugs, and even Bitcoin following its disastrous crash two years ago, are benefiting from the heightened investor appetite for risk. The combination of potential advancements in technology, expectations of a soft economic landing accompanied by interest rate cuts, and a FOMO (fear of missing out) factor have all contributed to stock indexes reaching record highs. Although we are not overly bearish on the economic or inflation outlook, stocks are currently priced for a very optimistic future. That being said, these episodes of optimism and risk taking can be challenging to predict and sometimes go on for extended periods. For instance, the former Fed Chairman Alan Greenspan gave the infamous “irrational exuberance” speech, a phrase describing the dot-com bubble, in December 1996, but stock indexes didn’t reach their peak until March 2000.

¹ Returns of the S&P 500 Equal Weighted Index through 3/28/2024



Some talking heads on the financial news outlets would lead you to believe that a savvy investor needs to be “all-in” on companies connected to these new technologies in order to be successful. We would argue that there is not just one but many ways to approach investment success. A prudently structured investment portfolio should manage the risks that the good times and bad times don’t last forever. While the advancements taking place today have the potential of being disruptive to a number of industries, we are also aware that this is the early innings and no one can predict what will happen with AI or other innovations over the near term. Chasing the winners of the moment and paying any price regardless of fundamentals has historically been a recipe for lackluster future returns—and one we want to avoid.

As the tombstone illustrates, the corporate cemetery is full of once great tech leaders that were early innovators in their fields. Like our AI generated picture description, we’ll be thinking about and closely monitoring how this innovation can potentially impact portfolios. But we are also aware that it may be too early to identify who the true winners are (if any) at this stage.



First Quarter Recap & Outlook

Investor sentiment remained bullish during the first quarter as all three major stock indexes (S&P 500, Dow Jones Industrial, Nasdaq) touched all-time highs during the period. The S&P 500 stock index is up just over 10% year-to-date, following a fourth quarter rally of 11%. As the table below illustrates, the S&P 500 index has closed at an all-time high 22 times so far in 2024, nearly two years after reaching the previous high. Prices tend to influence investor mood, so when the S&P 500 reaches all-time highs, it typically leads to more all-time highs throughout the year. The stock rally in the first quarter also had broader contributors than last year’s “Magnificent Seven” leaders that were responsible for much of the returns.

S&P 500 All-Time-Highs (ATH)

| Year | # ATH | Year | # ATH |
|------|-------|------|-------|
| 1989 | 13 | 2009 | 0 |
| 1990 | 6 | 2010 | 0 |
| 1991 | 22 | 2011 | 0 |
| 1992 | 18 | 2012 | 0 |
| 1993 | 16 | 2013 | 45 |
| 1994 | 5 | 2014 | 53 |
| 1995 | 77 | 2015 | 10 |
| 1996 | 39 | 2016 | 18 |
| 1997 | 45 | 2017 | 62 |
| 1998 | 47 | 2018 | 19 |
| 1999 | 35 | 2019 | 36 |
| 2000 | 4 | 2020 | 33 |
| 2001 | 0 | 2021 | 70 |
| 2002 | 0 | 2022 | 1 |
| 2003 | 0 | 2023 | 0 |
| 2004 | 0 | 2024 | 22 |
| 2005 | 0 | | |
| 2006 | 0 | | |
| 2007 | 9 | | |
| 2008 | 0 | | |

The advance in stock prices was accompanied by interest rates ticking higher as well. The yield on a 10-year U.S. Treasury drifted from 3.9% to 4.2% during the quarter. Although the volatility in the bond market has normalized somewhat from the last couple of years, the rise in longer term yields led to returns for high quality taxable bonds being flat to slightly negative². Signs of elevated risk taking are also appearing in bond markets.

² The Barclays Intermediate Govt/Corp bond index return -0.5% during the first quarter 2024.



Yield spreads, which refers to the difference in yields of certain lower quality “junk” bonds and those of high-quality U.S. Treasuries, have narrowed to pre-pandemic levels³. Investors, feeling confident about the rosy economic outlook, are taking on more risks in lower quality bonds for a yield premium that is well below historical averages. Buyer beware as we believe at this point the slight yield premium does not outweigh the risks for investors crowding into high yield bonds.

The first quarter also saw signs of the Federal Reserve (Fed) and markets better aligning on the future path of short-term interest rates. What was largely expected to be 6-7 rate cuts at the beginning of the year has now shifted to 2-3 rate cuts by year-end. There are still a number of over/under risks with this outlook. If inflation remains stuck or begins to drift higher, fewer rate cuts will occur or rate hikes could possibly resume. On the other hand, weaker economic conditions or an unforeseen market crisis could be met with more rate cuts than expected. There’s also the chance the Fed cuts rates too soon or aggressively and reignites inflationary pressures. Each scenario is plausible and would require repricing in financial markets from current expectations. The markets are also beginning to pay more attention to the U.S.’s massive deficits and spending programs after years of going unchecked. These longer-term government issues will require some tough decisions and bi-partisan agreements before it leads to consequences that are presently unknown.

These are peculiar times and a period where there is a wide range of potential outcomes for financial markets. Instead of attempting to guess where stock prices or interest rates will be in a year, we prefer to monitor valuations and gauge the mood of markets to assist in offering a yardstick on future return potential. Markets today appear more complacent and speculative than guarded, which prompts some reflection. As stated, we are not overly pessimistic about the current economic conditions or the path of inflation, but equity valuations and the blistering 5-month rally give us pause. We continue to recommend balancing some of the risks in the equity market with high quality bonds which generate reasonable yields and appear attractive. As we navigate the current bull market, we believe it’s important to stay rational, stick to sound investment strategies, and continue to monitor risks.

³ As measured by the US High Yield BB Option Adjusted Spread