INVESTMENT PERSPECTIVE Q4 2024

SIX IMPOSSIBLE THINGS BEFORE BREAKFAST

Alice laughed. "There's no use trying," she said. "One can't believe impossible things."

"I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."

— Lewis Carroll

I have always thought that the distinguishing trait of great investors was a powerful imagination. Every newly minted MBA or CFA initially perceives the world through a discounted cash flow model where company valuations trace out a linear path. After a few years in practice, they realize that the real world is a lot more volatile than their spreadsheets. Real businesses are prone to shocks. But more importantly, financial analysts soon apprehend that financial assets often latch on to new narratives that amplify small changes in spreadsheet models into large deviations in values. Sooner or later, our pilgrim arrives at Keynes' blunt assessment: *"Thus the professional investor is forced to concern himself with the anticipation of impending changes, in the news or in the atmosphere, of the kind by which experience shows that the mass psychology of the market is most influenced."*

The skill of investing does not reside in the most accurate spreadsheet but in the best mental picture of the future. Legendary trader Paul Tudor Jones had an injunction framed in his office: "The obvious is obviously wrong." The expression did not mean that the obvious was unlikely to transpire. Instead, "wrong" meant "unlikely to be profitable." Investors should not be rewarded for betting on high probability outcomes.

The most unsettling feature of today's financial landscape is just how unified opinion is around the "obvious." Goldman Sachs surveyed 300 investors at a conference in London this month. Fifty-eight percent of respondents believed the U.S. would be the best performing equity market in the world. Europe got 8% of the votes. Which sector would perform best in 2025? Technology won 42% of the votes. Would the U.S. Dollar gain relative to the Euro? Seventy two percent agreed. These forecasts are wildly skewed from an unconditional forecast or base rate. What shocks me most is how normalized they appear. Their probability accords with a mundane extrapolation of the last few years. To me, they embody a distinct failure of imagination. Byron Wien, the legendary Morgan Stanley strategist, used to conduct a White Queen exercise every year. The rule was to list events that the market assigned less than 1/3 likelihood that were actually at least toss-ups. I can think of at least a few "impossible things" that could overturn the status quo.

1. A new German government drops the debt brake and embarks on an European version of the IRA/Chips Act. At least a few other European countries join. China is invited in.
2. Germany restarts a nuclear facility and the EU relaxes some Green Transition policies, i.e., milk cow herd quotas in the Netherlands are abandoned.
3. The ECB drops all pretense and floors interest rates.
4. Russia and Ukraine agree to a cease fire mediated by France and China.
5. No break-out consumer application for AI emerges. Open-source, low cost LLMs proliferate. Investors begin to question $250 billion in data center investment. At least one hyperscaler cuts capex budget for 2026 relative to 2025. There is at least one major merger of LLM providers, i.e. Mistral and Anthropic.
6. The Federal Reserve does not cut rates due to re-emerging inflation. Trump turbo charges DOGE savings, and inflation abates to 2% by end of year.
7. U.S. tariffs are revealed to be a hollow threat. All our trading partners commit to address bilateral trade deficits through voluntary export restraints and some U.S. re-shoring.
8. Treasury Secretary Bessent convenes a new Plaza Accord to stimulate U.S. exports. Japanese Yen trades at 120 and Euro trades at $1.15.

Assume that any of these scenarios has at best a market probability of 1 in 5 and most are 1 in 10. In this context, success is hitting 3 of the above cases. But even one or two of these conjectures is enough to upset the expectations of Goldman's median respondent.

My unease with the current constellation extends beyond its lack of resilience to the unforeseen. One of the core tenets of the "obvious" case rests on some magical thinking. U.S. S&P 500 earnings are forecast to grow from $243 per share in 2024 to $311 per share in 2026 — implying an annualized growth rate of about 13% for the next two years. From 2000 to 2024 the earnings per share growth rate was 5.9%. The acceleration in growth in the next two years is due entirely to an expansion in net profit margin from 11.4% to 13.4%. That boost in margins (absent lower interest costs and tax rates and extraordinary top line growth) seems to depend solely on productivity driven by AI. Of course, anything is possible. But in a market narrative obsessed with recent trends simply extending, it seems odd that the one structural break happens to be a doubling of earnings growth driven by a quadrupling of margin growth. Of course, missing earnings by a few dollars is not a cataclysm. But recall that the market's overall price earnings ratio at 22x rests at least somewhat on extraordinary underlying earnings performance. So a small miss on earnings could translate into a bigger impact on price-to-earnings multiples.

Since the U.S. election, the market's central narrative of tech-led U.S. exceptionalism supported by a beneficent monetary and fiscal policy has solidified in to investment doctrine. Financial assets that don't align with that doctrine have in our view become extremely attractive. We have not yet placed a plaque in our office admonishing all that "The obvious is obviously wrong." But we have oriented portfolios to allow for some imagination of the improbable.

—T. Brad Conger, CFA, Chief Investment Officer