PARKSIDE INVESTMENTS

Market Commentary

July 1, 2024

Dear Parkside Clients and Friends,

About twenty-five years ago (at Cedar Hill Associates) we wrote a letter to clients discussing how the stock market at the end of the last century was behaving in a seemingly irrational manner. As a reminder, the late 1990s corresponded to the "dot-com bubble" where companies in technology, media, and telecom – even those that were recent startups and barely had a business plan – were all the rage with investors as the internet phenomenon grew into an epic frenzy. What was particularly noteworthy was the market's divergence from normal fundamentals in the final stages of the mania. In 1999, the S&P 500 Index gained 21% – but more than half of the stocks in the index were down for the year! We vaguely remember a statistic from the time highlighting that unprofitable companies (operating expenses greater than their revenues) generated greater than a 50% return for the Russell 1000 Index (another large cap benchmark), while profitable companies were largely ignored by investors – generating a 0% return for the year.

We recall this as we believe the current fascination with Artificial Intelligence ("AI"), although not nearly as extreme, has to some extent resulted in a similar stock market dynamic. Over the last 18 months, AI has garnered significant interest in the financial markets and seems to be virtually the only investment theme of interest in the financial media and with shorter-term traders. Similar to the end of the 1990s, investment returns in the overall stock market today have been highly concentrated toward the largest technology/AI-focused businesses, almost to the exclusion of the rest of the market. For example, over the last 18 months, the S&P 500 Index (market capitalization weighted) is up 45%, but the S&P 500 Equal Weight Index (more reflective of how all the components of the large cap market are performing) is up 20%. Although a 20% return for the equal weight index is a very good return (and above historical averages), it continues to lag the more common benchmark due to the concentrated returns toward technology/AI.

To be clear, AI may have profound business effects for decades to come, much like the advent of the internet did in the late 1990s. Similarly, we could also draw parallels to other recent periods of noteworthy technological advancements, including the development of both the personal computer and smartphone, migration toward internet and mobile commerce, the shift toward cloud computing, cryptocurrencies, etc. Although each of these periods were transformative and created new industry leadership, they were also typically followed by economic reality falling somewhat short of overly optimistic forecasts (and valuations reverting back to more normal levels even for the most successful companies).

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In the late 1990s, two stocks that best reflected the hope (and hype) of technology and telecom were Cisco Systems (provider of hardware, software, and services for the internet) and Qualcomm (a digital wireless semiconductor manufacturer). In 1999, the share price of Cisco rose 131% (after rising almost 150% in 1998) to make it the third-largest market capitalization company in the US, while Qualcomm rose a staggering 2,600% to end up in the nation's top-20 market cap companies. Each of these companies were regarded by most pundits as consensus "must own" stocks for the future. However, at some point companies that are almost universally loved ascend to unsustainable stock valuations that are nearly impossible to maintain. In the case of Cisco and Qualcomm, early 2000 was the beginning of a prolonged period of negative stock performance, as insatiable demand for their products transitioned to oversupply and increased competition. Cisco declined over 80% from its all-time share price high in March 2000 over the subsequent three years, and nearly 25 years later remains well below their internet bubble peak. Qualcomm declined over 85% from its highs over the ensuing three years and took 20 years to get back to 1999 levels.

The lesson from the internet bubble (as well as other technological revolutions) is not dissimilar to other bubbles – although each period appears to be transcendent from prior technologies. It is important to remember that highly concentrated markets have existed in the past, usually with the same post-bubble results to follow. To reiterate, current valuations in AI and related companies are not nearly as extreme as the internet bubble, but the same could be said of each of the other technological revolutionary periods noted above. Our perspective is that, similar to the past technology advancements, the current AI hype will diminish in the coming months/quarters and market observers will be looking for the next shiny object to latch onto.

Artificial Intelligence is clearly the technology breakthrough captivating interest today and does offer potentially far-reaching implications for business and society for years to come. However, as of now it is still unclear whether companies – purchasing tens of billions of dollars in advanced semiconductor chips, to be used by massive data centers to gather unimaginable amounts of data to provide potential AI solutions – will even generate an incrementally meaningful tangible economic benefit from all of this initial spending. In each of the prior technological advancements, the durability of the stock price boom was usually measured in years (not decades) and the initial perceived winners did not necessarily generate durable excessive profits. We are of the belief that this result will also become evident with AI. Perhaps more importantly, there will be derivative beneficiaries of AI that will be more significant both in duration and economic impact than the initial technological spend.

We find the domestic shift toward onshoring manufacturing supply chains, as well as the significant supply/demand shifts within all forms of energy, of greater interest than the current fascination with AI – due to our belief that those secular trends are likely to be far more durable and consistent generators of long-term economic profits. The onshoring of manufacturing, which is a reversal of the globalization movement over the prior two decades, has significant investment implications. The need for onshoring became apparent during the COVID

shutdown, as supply chains were disrupted due to the inability of getting critical products out of Asia. Additionally, rising geopolitical pressures with China have many companies seeking alternative sources of goods that are free from potential sanctions and other risks.

As companies bring production back to the US, massive investment will be required to rebuild the manufacturing infrastructure. In addition to construction of factories and logistics operations, onshoring often involves investment in advanced technologies and automation to improve productivity and competitiveness, presenting opportunities in sectors like robotics, AI, and advanced materials. Furthermore, a resurgence in local manufacturing can stimulate job growth and economic development, potentially boosting consumer spending and demand across related industries. Obviously, all of this will result in an uplift in domestic demand for electric power (benefiting utilities) and fossil fuels (benefiting oil/gas companies).

In addition to the impact onshoring will have on domestic energy demand growth, the buildout of AI data centers (which demand four to five times the power of traditional data centers) and the expanding penetration of electric vehicles will also drive a surge in electricity consumption in the coming years – putting further pressure on electric supply. With the intermittency pitfalls of renewable energy (i.e., wind and solar) and regulatory/cost hurdles preventing greenfield nuclear power expansion, there will be a dearth of electric capacity options that can be added to the grid over the next five years to satisfy the 24/7/365 power requirements of data centers. The only viable solution will be to construct more gas-fired electric generation facilities. This should provide attractive growth opportunities for the natural gas producers and pipeline operators—which have largely been eschewed by the market over the past decade.

Investor euphoria around a concentrated sub-segment of the market is often rooted in the assumption that economic and financial fundamentals are not applicable to periods of "transformative" technological inflection, but historical outcomes for those over-hyped companies/sectors often end up following the same (or at least similar) pattern of mean reverting performance. We have found the greatest investment opportunities typically arise when the market's speculative hopes for one segment of the market comes at the expense of overlooking the promising fundamental realities of another. As such, similar to the prior periods of technological advancement, we believe maintaining a diversified approach to attractively valued growing investments is the best route toward protecting and sustainably growing wealth over the longer term.

Should you have any questions, feel free to give us (or anyone on the Parkside Team) a call.

Sincerely,

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