blue river
CAPITAL MANAGEMENT

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To say that little happened in the second quarter could be misleading, but in rereading our first quarter newsletter it feels like we could recycle large segments of it. Inflation continues to be a key focus for the market with many anxiously hoping for the Federal Reserve to start cutting interest rates. The "Magnificent 7" (Amazon, Apple, Microsoft, Meta, Netflix, Tesla, and Nvidia) are still stock market darlings, and the market is "top heavy" based upon the enormous market capitalizations of these companies, many of them central to the excitement of artificial intelligence.

At a high level, activity in the market was relatively mundane. The S&P 500 Total Return (which includes dividends) advanced nearly 4.3% in the second quarter, bringing the year-to-date rise to about 15.3%. International stocks, as measured by the MSCI All Country World Index ex-USA, increased modestly up 0.96% in the quarter but still represented a slight drag on performance. In bond land, interest rates rose at the beginning of the quarter but ended the quarter nearly unchanged.

Looking closer at the domestic stock market, strong leadership from the "Magnificent 7" clouded greater dispersion amongst the rest of the market. The S&P 500 Equal Weight Total Return Index, which, as the name suggests, weighs each index constituent equally rather than the normal market capitalization weighting, was down about 2% in the quarter. Smaller stocks, as measured by the Russell 2000 Total Return Index, were also down in the quarter, finishing almost 2.3% lower than Q1.

With this narrow recent leadership in the market, we continue to believe that it is prudent to position client accounts for the possibility that market expectations for AI are overdone or misplaced.

We are not technologists and especially in these early days of artificial intelligence, our ability to predict how it will impact our day-to-day lives—and more importantly which companies and their stocks will benefit most from its advances—is limited. However, we can look at many occasions where companies rocketed up the list of the world's most valuable companies based on sky-high expectations which don't completely come to fruition.

For example, starting in 2000, Cisco (CSCO) spent nearly two years as the world's most valuable company. Cisco's hardware was central to the internet revolution and the excitement of its potential. Undoubtedly, the internet has changed the world and probably in more ways than anybody could have predicted. Yet, Cisco's market valuation is down more than 65% since its peak in March 2000.

A recent MarketWatch article drew comparisons between Nvidia's meteoric rise and Cisco during the dot-com bubble. The 200-day moving average (DMA) is a popular indicator amongst traders to identify a stock's momentum. A stock trading above its 200 DMA is considered bullish. However, it can also indicate overexuberance in certain instances. In 2000, Cisco set a high watermark by trading 80% above its 200 DMA. Towards the end of June, Nvidia set a new record by trading nearly 100% above its 200 DMA. Especially considering Nvidia's size, this rapid increase in its stock price is staggering and potentially a sign of excess, and we believe implies monopoly like expectations in an industry that has a history of competition.

We are not brash enough to predict a similar demise for Nvidia (NVDA) or other AI darlings, but history does not look very favorably upon chasing performance, and it is possible that the broader market's tepid performance is indicative of some of the uncertainty around domestic issues and geopolitics.

When the time comes for us to write our third quarter newsletter, we will be weeks from the United States Presidential Election. While data suggests there is little difference in stock market performance whether democrats or republicans have control of the executive branch, there are a few issues that could have broad implications.

As James Carville famously said when it comes to elections, "it's the economy stupid." Obviously other issues matter as well, but inflation and the economy are often top of mind. Interestingly, there is little consensus among how Americans feel about the economy. In a recent Wall Street Journal opinion piece, former Federal Reserve Vice Chair Alan Blinder pointed to recent Gallup and Pew Research polls where mid-40 percent of Americans rated their personal finances as excellent or good, but less than a quarter of those respondents felt national economic conditions were excellent or good.

Stubborn inflation is a culprit of discontent, with the consumer price index up about 20% since President Biden took office. In our opinion, presidents often receive more credit or blame for economic conditions than they duly deserve. For example: economic cycles are unrelated to presidential terms; while the White House proposes a budget, Congress controls the purse strings; the size and complexity of the US economy means that fiscal policy changes and implementation often take time to filter through and extend beyond a president's term; and monetary policy, controlled by the Federal Reserve, can either be stimulative or restrictive and not necessarily in alignment with fiscal policy.

Half of the Federal Reserve's dual mandate is stable pricing, which they define as average inflation of 2% (full employment is the other half of the mandate). However, persistent federal budget deficits are likely complicating matters for the Federal Reserve's efforts to rein inflation back to their 2% target. The last time the US had an annual budget surplus was 2001, and it seems there is little appetite to balance the budget, especially given geopolitical tensions, the reversal of globalization, and the possibility we are in a new Cold War.

During the COVID-19 pandemic we got a glimpse of the critical importance of semiconductors and the ripple effect in supply chains due to any disruption in their availability. The small island nation of Taiwan is responsible for about two-thirds of global semiconductor production and approximately 90% of the world's most advanced chips like Nvidia's prized graphics processing units. Considering the importance of semiconductors in the evolution of business and defense, along with the testy relationship between Taiwan, China, and the US, it is understandable why the US government is eager to subsidize the construction of new domestic semiconductor foundries.

The US and its allies thus far have avoided direct conflict in Ukraine and Gaza, but the proxy war characteristics of the battles against Russia and Iran are unmistakable. With the risk these wars escalate, it seems likely that countries will want to bolster their defense capabilities. The North

Atlantic Trade Organization estimates that 23 of its 32 member nations will meet their commitment to spend at least 2% of gross domestic product on defense in 2024, up from just seven in 2022. Interestingly, global total defense expenditures are at record highs in dollar terms, but as a percentage of GDP global defense spending is hovering near 60-year lows, according to World Bank data.

The world is full of uncertainty and countless variables that we cannot control. As investors, we remain committed to our core tenet of thoughtful diversification as a method to mitigate the risks posed by an ever-evolving world. Stocks have historically been an effective hedge against inflation, and we expect that will remain true as companies that provide valuable goods or services are able to pass along price increases. In fixed income, while yields are more attractive than they have been for much of the last decade, we still favor shorter-term bonds in case inflation is not going away as quickly as we all hope it will.

Internally at Blue River Capital Management, we also remain committed to focusing on the things we can control, namely being diligent in our investing, proactive with our clients, and delivering the best service we can. Fortunately, six months into this new venture we are seeing rewarding results. We have been averaging about one new client per week and have earned our first referrals, which is among the greatest compliments we can receive. It is a privilege to work with all of you. If you ever have any questions about your accounts, markets, or anything else financial, please let us know.

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Index Definitions:

S&P 500 – A representative sample of 500 leading companies in leading industries of the US economy. The S&P 500 Index focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

MSCI ACWI Ex-US – A market-capitalization-weighted index maintained by Morgan Stanley Capital International (MSCI). It is designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI ACWI Ex-US includes both developed and emerging markets.