

Did Boring Leave the Building?

Three months ago, we wrote, "After more than a few years of excitement, we believe we are on the precipice of boredom and could not be more excited." The relative calm lasted about two months before the geopolitical cards were thrown in the air due to the current military conflict in Iran. With baseball season upon us, a quote from Yogi Berra comes to mind: "It's tough to make predictions, especially about the future." While financial markets are currently lurching from headline to headline delivered via Truth Social, it is imperative that long-term investors consider how the future investment landscape is changing.

The possible outcomes emanating from the Middle East are too disparate to allow for meaningful conviction. Things could go terribly awry, resulting in a bogged-down conflict with a perpetually closed Strait of Hormuz and massive disruption to regional oil and gas infrastructure. A considerably more favorable outcome would be a newly contained Iran that is no longer an imminent and provocative threat to its neighbors - resulting in dramatically lower oil prices in the short-term and a meaningful reduction in risk premiums in the longer term. The space between these two, where the likely outcome lies, is so vast that making definitive statements about the future is currently a fool's errand.

When presented with a situation with wide-ranging potential outcomes that could dramatically influence macroeconomic variables such as commodity prices, interest rates, and currency values, it is important to avoid overreacting to any single data point. Stepping back and taking a broader view of the situation is necessary to better frame the opportunities and risks that lie before us. This perspective is necessary to remain focused on individual long-term investment objectives and corresponding time horizons.

We still firmly believe in what we wrote about the boring economic cycle and the benefits it provides to investors. "Instead of capital investment being focused solely on the development of AI data centers, we highlighted how a boring economic cycle produces more investment opportunities. A boring economic cycle encourages more productive capital allocation based on observable fundamentals. **When economic conditions are predictable, investors are more likely to fund many types of businesses.** Strong fundamentals abound and sustainable business models compete for capital. Capital flows towards long-term projects such as infrastructure, technology development, and workforce investment rather than short-term speculative opportunities. This leads to broad economic growth. The expanded scope of opportunities results in healthier markets and improves the overall quality of potential investments. Instead of placing all our economic growth eggs in one basket (currently AI), they are dispersed throughout the economy. This allows investors to price assets more accurately. They are afforded the opportunity to make decisions based on earnings, cash flows, and long-term prospects rather than speculation or fear of missing out on the ONLY game in town."

For the first two months of the year the markets agreed with us. Investors called the "AI trade" into question as hyperscalers began issuing debt to fund their capital spending needs. The market had previously exhibited no real desire to figure out the exact return on this investment when the companies were only using their own cash flow. However, once the bond market became the mechanism to fund spending, investors wanted to know how they were going to be paid back. At the same time, energy prices were increasing and some data centers became the subject of local opposition to their existence. While none of these issues were big enough to slow down the capital spending, equity values for these companies were priced towards perfection and the subsequent selloffs were sharp enough to weigh on the various market indices even prior to the Iranian conflict.

At the same time, broader economic conditions continued to improve. The unemployment rate remained steady, inflation continued to moderate, and interest rates were slowly moving down as the market priced in several rate cuts. The combination of this backdrop and the decline in technology stocks led to a broadening of investment returns away from "secular growth" and towards economically sensitive and value-oriented stocks. It was the epitome of the boring cycle we had described and the outcome we preferred.

Nostradamus, we are not as we also wrote, "A boring economic cycle includes both geopolitical and monetary stability. Neither has been present for the past several years, though there are signs that both are possible. On the geopolitical front, while no fall of the Berlin Wall, a peace dividend appears imminent, global conflict does show signs of peaking. Robert E. Lee is often quoted as having said, "It is well that war is so terrible, lest we should grow fond of it." That appropriately summarizes our current situation. Resolution of the war between Ukraine and Russia is slowly coming into view, while neighbors in the Middle East appear to be participating in a necessary, though currently tenuous, détente. In many ways, the combatants need a break, if for no other reason than to retrench and reevaluate. The benefits of a meaningful reprieve would extend well beyond the borders of these conflicts, which have become proxy wars drawing in the collective energy and attention of the world." Hubris is easily dispelled in our business.

While that détente has been broken on many fronts, if the current situation leads to a significant and durable change, then the human and financial costs incurred will have been for a meaningful purpose. **Regardless of the ultimate outcome, we must incorporate some dramatic changes to the macroeconomic environment into our investment decisions.** These include higher energy prices, a more difficult set of choices for the Federal Reserve, and an increasingly complicated geopolitical backdrop. These evolving fundamentals have significant implications for the prospects of various industries and specific companies. The result of so many major variables changing quickly is an investment environment characterized by significant volatility across all asset classes and individual securities. This volatility, while unnerving, is the long-term investor's friend as it can provide both attractive entry and exit points for individual investments. Note the number of portfolio transactions over the last month.

Volatility has also extended to the fixed income markets, where the treasury market has gone from pricing in two rate cuts this year to a potential rate hike. This type of volatility is not normal in the fixed income market, and, when combined with the current uncertainty around the outcome in the Middle East, is pushing bond rates significantly higher than they were several months ago. This allows us to build bond ladders once again at very enticing rates, allowing investors to lock up significant levels of attractive, high-quality income for many years.

We have written many times about embracing volatility and positioning portfolios for the long term. We have also noted regarding equity portfolios, "we would expect to find opportunities in that choppiness to exit some positions that have reached full value while also investing in new ideas that will benefit from a refreshed and extended economic cycle." **We have taken advantage of this recent stretch of choppiness to reposition equity portfolios and to further invest fixed income portfolios at considerably higher rates.** Eventually, the uncertainty in the Middle East will begin to lift, and a solution will come into view. While we may have been early on our call for boredom, the benefits of a boring cycle remain in front of us when we exit the current conflict. **Over any reasonable timeframe, the economy and earnings continue to grow, enabling equity markets to broaden and move higher.**