July 9, 2024

During the quarter, the stock market continued its steady ascent led by a few Artificial Intelligence ("AI")-related companies. While headline news likes to hype the vast stock market gains in the S&P 500 Market Cap Weighted Index (2nd Qtr. 4.3% and 15.3% Year to Date), after looking deeper into the Index, during the 2nd Quarter, there was negative breadth (199 issues up and 301 issues down) highlighting the magnitude of a very concentrated market. In fact, four stocks had contributed over half of the gains in the S&P 500 (Microsoft, Meta, Amazon, Nvidia) so far this year, a sign of a top-heavy, large capitalization Index that has not been witnessed in this magnitude since the 1998-2000 Technology "dotcom" bubble era.

Though a comparison to the Tech Bubble cycle 25 years ago is not perfect, we believe there are a couple of key parallels and conclusions to be drawn from that period. First, the Federal Reserve was in a similarly awkward position with a strong domestic economy (greater than 4% GDP growth) and roaring stock markets, while global markets were faltering in dramatic fashion. This led to multiple changes to interest rates (both down and up) as cycles changed; all preceding the 2008 market collapse. Today, Europe and China are facing similar economic malaise while US growth remains strong but slowing, and the Federal Reserve is primed to respond accordingly.

Second, many investors "felt good" during the 1998-2000 era being heavily invested in the Technology sector and eschewing diversification, only to achieve subpar results over the following decade. This highlights the risks of overconcentration on one theme and chasing the fad of the day. Through this and many other market cycles, Carderock has stuck to its discipline of owning an equity portfolio of higher quality, diversified and profitable companies that allows our clients to side-step heavy stock market declines that follow these types of theme cycles. And while we now find ourselves in a similar cycle where a quality portfolio of securities is not keeping pace on a relative measure, we believe in staying the course and remain confident in knowing this market cycle will eventually end.

From here to the end of the year, we see the following trends informing our investment process:

- Growth remains positive but will decelerate, as consumers cut back on discretionary items relative to staples.
- Labor markets will remain strong, providing a cushion under economic activity and making a recession unlikely.
- Interest-rate sensitive sectors will continue to be squeezed, as capital expenditure and homebuilding plans are delayed until rate cuts commence.
- The Artificial Intelligence investment theme and its narrow set of winners will continue to make strides, despite little to no revenue to show for the technology's users so far.

In addition, our recent activity can be summarized as follows:

- Cash stock reserve targets stand at 10% of a fully invested Equity allocation.
- Our low cash targets reflect "bullishness" allowing us to rotate among new issues and sectors on our list.
- Buying continued to outpace selling, as we remained focused on cutting weaker names and keeping capital gains relatively low.
- We continued to buy Treasury bills to supplement cash reserves, as short-term rates remain high.
- Bond maturities across all accounts average roughly 2 years, and we expect to add exposure to longer-term bonds as short-term rates come down over the next few years.

We remain positive about the economy over the next 18 to 24 months as growth prospects remain attractive. And while a small cohort of issues have outpaced thus far, we believe the benefits of growth will broaden and extend to Quality Growth issues over time.

As always, feel free to call us to review your investment progress and to ask any questions you may have.

Warmest Regards,

Daniel A. Kane, CFA
President

Stephen F. Knapp, CFA
Director of Research

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

"With apologies to Winston Churchill, never have so many invested so much in so few. Year-to-date, the market cap-weighted S&P 500 has jumped by 15.8%, or 10.8% percentage points above the equal-weighted version of the index. It's the second year in a row that the equal-weighted gauge has lagged its market cap-weighted counterpart by double digits, something that hasn't happened since 1998-99, the final two years of the dot-com bubble. In fact, just four stocks- Nvidia, Meta, Amazon, and Microsoft- have delivered 55% of the S&P 500's year-to-date performance. Jim Paulsen argues the 496 have-nots will catch a bid when the Federal Reserve begins cutting rates, thus broadening the rally." Jim Grant, "*Hopes and dreams*", **Grant's Interest Rate Observer**, June 21st, 2024.

"Steven Rattner recently argued in the wake of Biden's trade restrictions that tariffs violate the principle of comparative advantage. However, the global trading system has long diverged from one in which countries specialize in comparative advantage. We must make the distinction between low Chinese prices associated with comparative advantage and low Chinese prices associated with weak domestic demand. Even adjusting for differences in productivity, Chinese wages are low. It is these relatively low wages, not comparative advantage, that explain China's weak domestic demand as well as its low export prices across the world." Michael Pettis, "*No, trade surpluses aren't caused by comparative advantage*", **Financial Times,** May 28th, 2024.

"The Gartner Hype Cycle illustrates a common path for new technology and suggests a 'plateau' can be reached once its true usefulness registers in the market's consciousness. How to get there? First, tech companies need to identify where their hype machine has gone wrong. The truth about AI is that it can be useful and even financially beneficial when people are given time to experiment with it. As Microsoft, Google and Amazon pitch their AI tools, they should warn their customers that the tech can take years to get used to and narrow down the potential use cases more explicitly." Parmy Olson, "*Nvidia's Explosive Growth Masks AI Disillusionment*", **Bloomberg,** June 20th, 2024.

"Polling data do not obey the laws of arithmetic. Many Americans consistently tell pollsters that they're modestly satisfied with their personal finances, but they believe the national economy has gone to the dogs. What's going on here? What people believe about the national economy comes from the media, which tends to skew negative. If negativity bias really is getting worse, that's a problem. As the late Sen. Daniel Patrick Moynihan said, people are entitled to their own opinions but not to their owns facts." Alan Blinder, "*The Economy is Good. Why Don't People Know It?*", **The Wall Street Journal,** June 25th, 2024.

"Industrial policy is back as a powerful motivator for government intervention. Economists recognize three valid arguments for such interventions: externalities, coordination failures, and the supply of public goods such as infrastructure. Industrial policy works if it changes the structure of the economy in a beneficial direction but runs the risk of provoking international retaliation. This is something that China has learnt recently, with its race to dominate new 'clean' technologies. The wisest way to pursue industrial policies is to target the identified problem while minimizing damaging side-effects on international co-operation, trade openness and domestic economic performance. This, alas, is unlikely to be how this ends, any more than it was in the 1930s." Martin Wolf, "*How not to do industrial policy*", **Financial Times,** June 18th, 2024.