

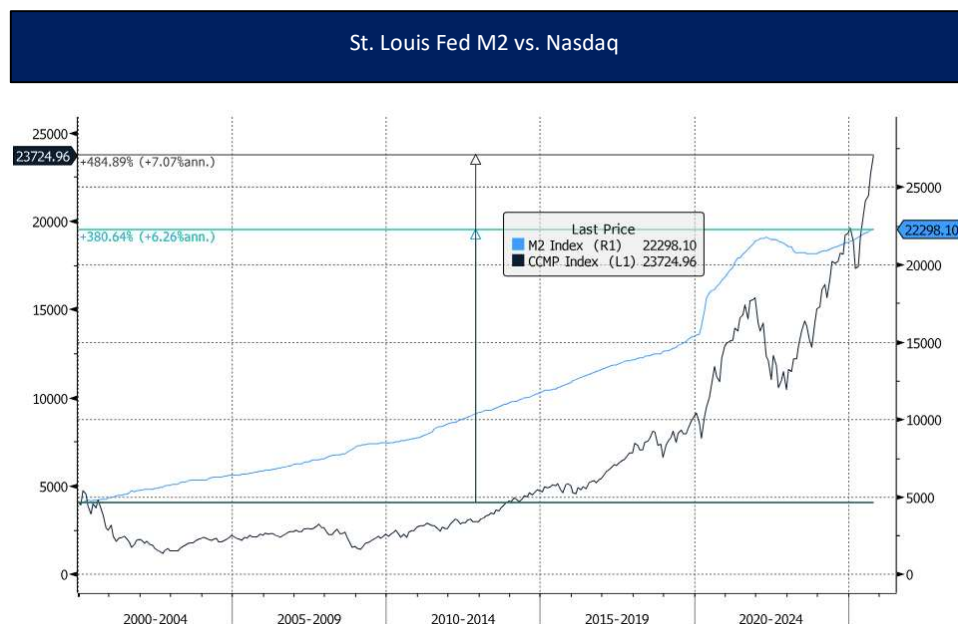
Reading the Tea Leaves

The markets are a confusing place to be right now. It is worth highlighting some of the key themes that are pushing markets ever higher, while analyzing near universal concerns many have expressed recently warranting caution. To contextualize, the Nasdaq closed at 22,872 on Monday which is just below its all-time highs and close to 50% above the levels seen during the “Liberation Day” correction just seven months ago. This rally has been driven by a few factors, not the least of which is the incredible expectations for AI and technology as well as the incredible amounts of spending that have accompanied that exuberance.

Additionally, liquidity remains historically robust with money market fund assets recently touching an all-time high at 7.57trn (yes, trillion). Fixed income assets have also been rallying, thanks in no small part to a string of rate cuts by the Federal Reserve in their effort to return policy to what they feel is a more normalized range. These moves, in conjunction with a few other inputs, have resulted in financial conditions moving back to their easiest levels since 2022 all while volatility has remained subdued.

The most interesting part of this move is not the move itself, but the general market sentiment. In short, whether market professionals or retail investors, all seem unanimously confused, unsettled and wary of what they see. Specific concerns vary, but the themes are the same: private credit is too big, and the assets are overdue for a correction; AI valuations are too far ahead of revenues and feel like a bubble; the outlook for jobs and employment in the U.S. feels bleak and getting bleaker while the cost of everyday life is too high. The phrase “this is not sustainable” is on repeat the past eight weeks and covers everything from groceries and home prices to equity valuations and levels of indebtedness. And yet the trend of higher everything has sustained for a very long time, so the question remains – why?

Below is a very telling chart. The chart compares M2 as published by the St. Louis Fed from January 1st, 2000, until today versus the Nasdaq composite over that same time period. The resemblance is striking. During that period, M2 has grown at a 6.3% annualized rate while the Nasdaq is up 7.1% annually.



One can argue which of these charts is the driver of the current situation and which is a passenger, but the correlation and the implication are the same. There is a technical in the economy, and broader market, that money is creating money, asset price appreciation begets price appreciation, and the cycle of compounding continues. In an economy where each recent wobble or headwind has been met with a policy response that at a minimum includes liquidity, and often times revolves around it, this is not a surprise.

So, what are we watching out for that could put an end to the tailwind or “stop the music” as they say? There are a few forces that could cause a significant deleveraging and negatively impact asset prices. The first is returns on AI investment lagging expectations which could lead toward a reset of the investment in that technology and the accompanying reset of valuations. There have also been recent questions on the depreciation timeline of the GPUs which, if they become obsolete faster than expected, would have significant negative financial implications. The second would be private credit proving to be over-extended meaningfully, leading to investors calling for a return of capital which may come at the expense of the portfolio assets’ valuations. The third would be an unsustainable U.S. deficit leading to capital flight from the U.S. And the final, and potentially least interesting of all would be a good, old-fashioned recession caused by spikes in unemployment related to both AI and government-related spending cuts leading to a reduction in consumer spending.

Each of the scenarios mentioned above warrants a deep dive and discussion that would take this commentary from two to twenty pages, so will spare everyone for now. Just note that while we are respectful of the market and keenly aware that the liquidity and technicals remain in full force, there are several potentially strong headwinds that can derail things. Additionally, it is worth mentioning that there is the potential for any one of the above forces to happen in conjunction with or because of another.

In summary, this ends where it began – markets are a confusing place right now. U.S. data is a mess due to the prolonged government shutdown; the FOMC is split on whether to cut or pause and the clarity on tariffs, geopolitics and everything else appears to be non-existent. Prudence through active portfolio management, not fear, will be the theme over the near term.

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