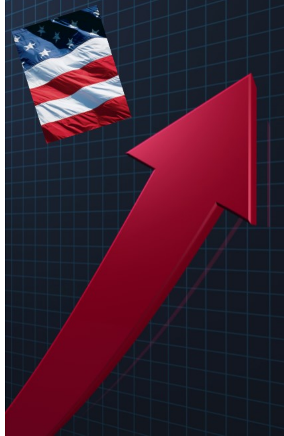
Financial Services Advisory
GROW WISER.

Fourth Quarter 2024
www.FSAinvest.com
(301) 949-7300

U.S. Market Dominance



No doubt you've been noticing that U.S. stocks have been reliably outperforming stock market indices in Europe and Asia over the past decade or two, but you might question whether that's true on a risk-adjusted basis. Assets that achieve higher returns generally come with more volatility—aka more downside risk—and so it's fair to wonder whether U.S.-oriented investors are experiencing a bumpier ride than their overseas counterparts.

A recent article looked at both sides of the issue—volatility and returns—and found that over the last 20 years ending August 30 of this year the S&P 500 Index outperformed an index of international stocks and, at the same time, exhibited lower volatility. You could call that a win-win.

The same was true when U.S. stocks were compared with emerging market stocks. The NASDAQ (large cap tech stocks) and U.S. small cap stocks were similarly dominant over the same categories of global equities. Most U.S. asset class sectors achieved higher return to risk ratios than the same asset classes abroad; the only exception was financials.

How do we explain this? The article noted that the sector compositions of U.S., European, and Asian markets are different in one particular way: The U.S. stock market is much more tech-heavy, and the economic story of the past 20 years has been the growth of leading tech firms.

Another explanation focuses on the CATO Human Freedom Index, which tracks things like the rule of law, property rights, court independence, personal freedom, and other measures of safety that a country's business class enjoys. There is a significant (positive) gap between the U.S. and most of the rest of the world, and this wind at the back has been boosted by the high degree of shareholder activism in the U.S., which tends to force underperforming companies to adapt to changing market forces.

This Freedom Index issue helps to explain why the U.S. market has been a world leader for a much longer period—since the end of World War II. From 1946 to 2020, only the Swedish stock market has outperformed the U.S., and it is followed by countries that exhibit similar business safeguards: Switzerland, the Netherlands, and Japan.

This doesn't mean that investors should go all-in on American stocks. Foreign stocks are a great diversifier, further reducing the volatility of otherwise concentrated portfolios. European and Asian companies are currently trading at significant discounts to the U.S., which means the next few years might experience some catching-up. But perhaps it's time to recognize the American investing experience for what it has been, a great run that has many of the features necessary to continue into the future.

From Our FSA Family

Happy holidays from the FSA family! This year, we created a fictional holiday party story about the firm. We hope you enjoy the story, the holidays, and time with your family and friends!

The Great White Elephant Showdown

It was that magical time of year again at the firm—time for the annual holiday party, complete with a yummy Italian food and the ever-competitive white elephant gift exchange. As usual, the stakes were high.

The Investment Team—Ron, Mary Ann, CJ, and Jordan—came prepared. Ron, known for his keen eye for strategy, had found the perfect gag gift: a coffee mug shaped like a bull and bear in a wrestling match, a subtle nod to market volatility. Mary Ann, ever the creative one, contributed an "Executive Stress Relief Kit" which included a squeeze ball shaped like a stock chart. CJ took a more straightforward approach, gifting a book titled Investing for Dummies, 1998 edition, and Jordan added a broken calculator as a joke about "market forecasts."

Over on the Advisor Team, Jim, Dave, Kim, Aaron, Mike, and Lena were no less competitive. Jim was particularly proud of his gift, a "retirement planner" that was just a blank notebook. Dave, leaning into his dad-joke reputation, brought an oversized pair of glasses labeled "For Seeing the Big Picture." Kim, always practical, contributed a piggy bank shaped like a house, while

Continued on page 4

Savings Rates at a Low

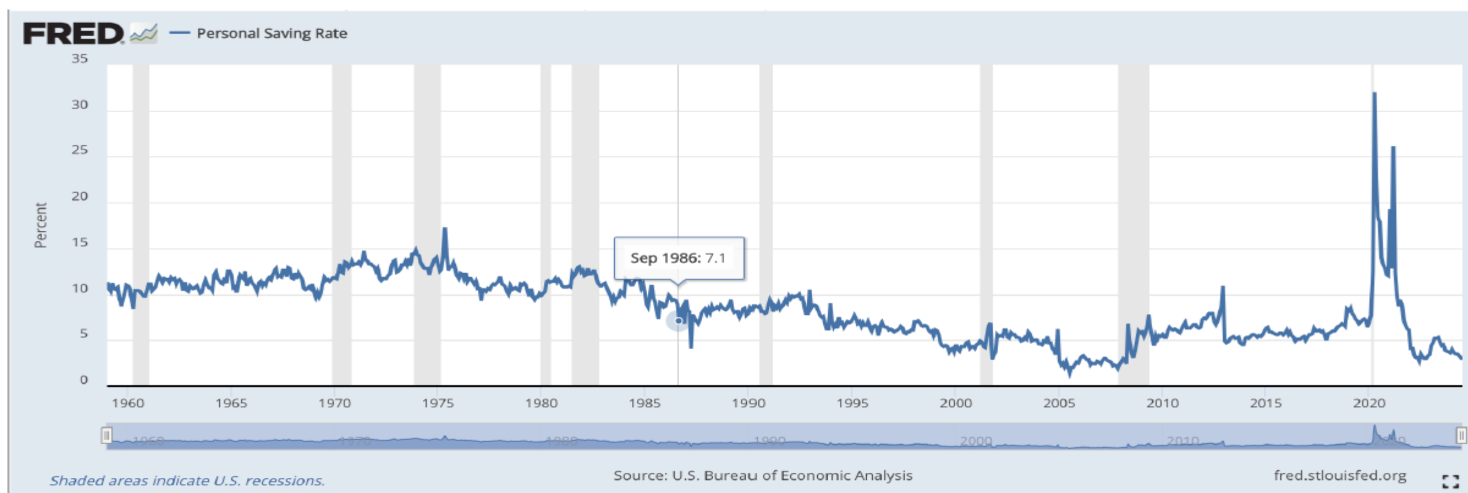
One alarming statistic that has gone somewhat unnoticed in the past year is the decline in the personal savings rate of U.S. households—that is, the amount that is saved and invested out of the total top-line income. In July, that rate had fallen to 2.9%, following a trend that began this year. That is at or near the lowest level of savings Americans have experienced since the early 1960s. To put that in perspective, the savings rate averaged 8.45% from 1959 to 2024.

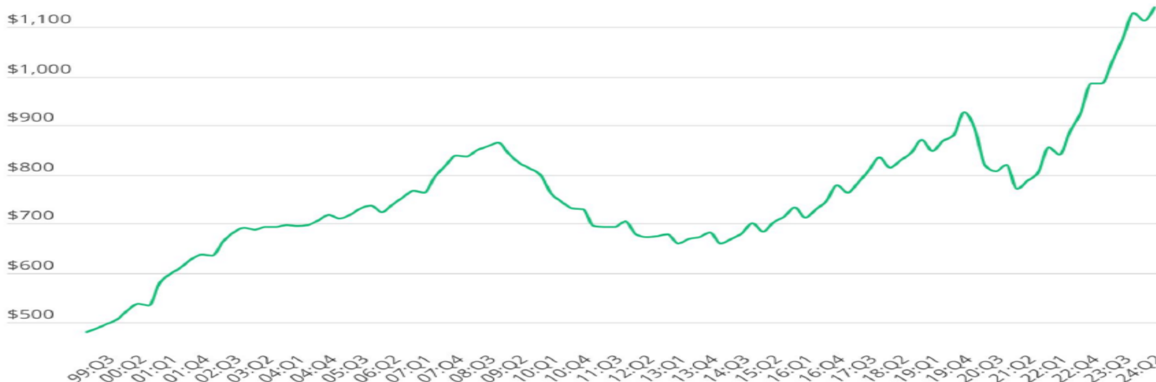
Economists might see this as good news. It means that consumers are willing to dip deeper into their pockets to spend, and consumer spending is the biggest component of economic growth. It also reflects optimism in the future: People have jobs, wages are going up, and so it's natural to imagine that this will continue into the future.

But the other side of the argument is that people's personal balance sheets might be less resilient if/when we encounter a recession or sudden return of high inflation rates. Consumer debt, and particularly credit card debt, has been rising since 2013, basically during a balmy economic climate (with the notable exception of the Covid pandemic). Credit card balances, overall, have reached $1.14 trillion outstanding, up 5.8% from a year ago.

There is evidence that the buildup in debt is concentrated among a minority of Americans which means that they are disproportionately exposed to economic shock. Lending Tree estimates that 47% of adult credit cardholders carry a balance on their cards, at an average rate of 22.76%. Just over 3% of those individuals are past due on their balances, and that number has been rising over the past two years.

The lesson here is to stay prudent with your spending habits and not to let the good times impact maintaining a healthy saving rate. During times of economic prosperity, it is important to balance enjoying the fruits of your labor and building a resilient balance sheet for when the good times stop rolling.





The Fed's Other Lever

All eyes are pretty much always on what the U.S. Fed is doing, but most of the attention goes to only one aspect of its manipulation of our economy. You read about whether the Fed is thinking about raising or lowering interest rates, pundits offer up their opinions, economists read the tea leaves of the Fed meeting minutes, and press conferences. From all that, it would be natural to believe that this is the only lever that the Fed is pulling when it wants to raise or lower the temperature of economic activity.

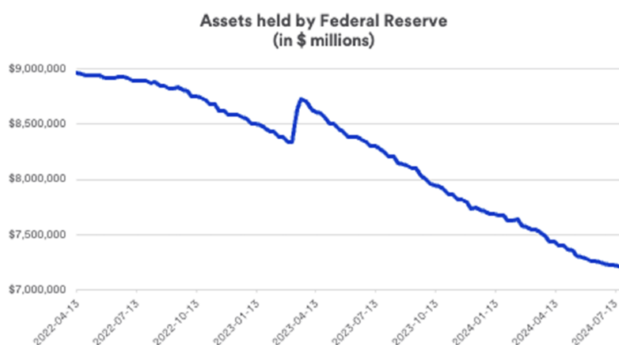
But the other handle is the Fed balance sheet. Whenever the Fed wants to give the economy a kick in the pants (think the Great Recession of 2008-09 and the Covid-related decline), it makes money out of thin air and buys Treasury securities and mortgage-backed securities.

Buying mortgage-backed securities helps lower longer-term interest rates that are generally not influenced by the Fed funds rate. The manufactured money used to buy these securities increases the money supply and lowers yields. When the Fed starts selling off the mortgage bonds, it does the opposite: it tends to reduce the money supply and cause longer-term interest rates to go up.

The same general principle holds for Treasury securities. When the Fed wades into the Treasury market, it tends to bid at lower yields, lowering what the government has to pay on the bonds (and taking pressure off of the federal debt) and lowering bond rates generally. The money supply is increased, and banks generally wind up with more money to lend at more attractive rates. More lending tends to equal more economic activity.

So, what is the Fed doing today? The Federal Reserve system increased its balance sheet to a record $9 trillion in the aftermath of the 2008 Great Recession crisis, and these so-called quantitative easing programs did shock the economy back to life. Beginning in April of 2022, the Fed began cautiously allowing the bonds on its books to mature, which reduced their holdings until the Covid crisis. At this point, it was forced to enter another (albeit short-term) purchase policy. As you can see on the chart, the Fed has gone back to net selling so that today it holds just over $7 trillion on the balance sheet.

What's the goal? Nobody knows. It's possible that the so-called "quantitative tightening" will take assets down to roughly the $4 trillion level that existed before the Great Recession. Ultimately, the future direction of the economy will dictate the Federal Reserve's policies moving forward.



Source: Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation), retrieved from FRED, Federal Reserve Bank of St. Louis. As of July 31, 2024.

AI Everywhere - But Who Wins in the End?

Chances are, you've already interacted with a chatbot when you tried to contact a retailer about your online order. And the experience may or may not have been frustrating. Chatbots are perhaps the biggest use cases for companies to use artificial intelligence (AI); an estimated 58% of companies doing business with other businesses (B2B) and 42% of companies selling to consumers (B2C) now "employ" chatbot assistants to interact with customers. Sixty-six percent of global financial firms have adopted a chatbot to help customers with online transactions, and the chatbot market in the healthcare industry (i.e. talking to AI rather than a doctor or nurse) will surpass $543 million in 2027.

And then there's the generative language models, including ChatGPT, Google's Bard, DeepMind's Gopher and AlphaFold, Meta's LLaMA, Claude from Anthropic, to name a few. Well, there are an estimated 14,700 artificial intelligence startups in the U.S. alone, and their cumulative market share includes roughly half of all Americans who use digital assistants currently.

The point of all this is that AI is no longer a technology of the future; it's deeply embedded in our day-to-day lives. But at the same time, it's one of those technologies that is hard to invest in; there is no easy way to know which of the major players will outcompete the others, or whether artificial intelligence technology will eventually be evenly distributed, like the Internet, across thousands of companies, with nobody owning significant market share and, therefore, outsized profits.

People with very long memories, and market historians, will note that in the 1980s, something new was introduced. It was called software, to be run on the fancy new thinking machines called computers. Some of the leading names of the era were Ashton-Tate (database software), Lotus (spreadsheets), Tandy and Coleco (computers), and many other companies that you have probably never heard of because they went out of business despite having, at one time, a huge market share lead on the competition.

We still have software, and like AI, it's a big part of our lives. Not all the early pioneers in software technology industry have survived, so in 10 or 20 years there's a good chance we won't remember some of the AI pioneers that loom so large today.

MAJOR PLAYERS IN THE AI MARKET WORLDWIDE

- **Google Inc. (US)**
- **Microsoft Corporation (US)**
- **NVIDIA Corporation (US)**
- **Intel Corporation (US)**
- **Samsung Electronics Co., Ltd. (South Korea)**
- **IBM Corporation (US)**
- **Amazon Web Services, Inc. (US)**
- **Oracle (US)**
- **Meta (US)**
- **Salesforce (US)**
- **Cisco (US)**
- **Siemens (US)**
- **Huawei (China)**
- **SAP SE (Germany)**
- **SAS Institute (US)**
- **Baidu, Inc. (China)**
- **Alibaba Cloud (China)**
- **iFLYTEK (China)**
- **Hewlett Packard Enterprise Development LP (US)**

How Japanese Interest Rates Affect Stock Prices

The sudden downward lurch for the market in July/ August put a brief spotlight on something called the yen carry trade. The trade was cited as one of the causes of the selloff. But what, exactly, are we talking about?

On the surface, the yen carry trade looks like a way to print money. The Bank of Japan has kept interest rates at or near zero for decades, which means that Japanese banks basically offer free money to borrowers. A hedge fund can borrow from a Japanese bank (whose currency is the yen) and then buy Treasury bonds that are paying, let's say, 5%. Five percent yields minus zero percent borrowing costs, with almost no risk, is a pretty nice risk-adjusted return. And the return is actually greater because very little of the hedge fund's money is actually invested. This is borrowed money.

But of course, hedge funds aren't interested in 5% annualized returns on their borrowed money, and so they invest more adventurously, say, in tech stocks. And apparently, they have been doing a lot of this. The graph shows that the yen's borrowing cost has closely tracked the price movements of U.S. tech stocks this year. The downtrend of both (right side of the graph) represents a move by the Bank of Japan to raise interest rates, creating actual, measurable costs to the leveraged yen borrowing activities.

How big is this carry trade thing? Put another way, is it possible that another rate rise by the Bank of Japan will wreak additional havoc on the U.S. markets? A recent report found that Japanese banks have lent foreign investors and others roughly $1 trillion up to the first quarter of the year. That's about one-fiftieth of the aggregate value of U.S. stocks, which doesn't sound too concerning until you realize that it only takes a handful of sales to start a trend and spook the investor herd, hence a small unwinding being blamed for a 3% drop in a broad-based U.S. index.

Of course, none of this will affect the underlying value of U.S. companies. It's a reminder that forces that have nothing to do with the production, revenues, and profits of companies can cause the market to temporarily react in unpredictable ways.

The Great White Elephant Showdown

(continued from page 1)

Aaron added an ironic twist with a DIY "Build Your Own Hedge Fund" kit, complete with Monopoly money. Mike brought a tiny model of a yacht labeled "Your Future, If You Follow My Advice," and Lena delivered the ultimate gag, a box of chocolate coins labeled "Your Bonus."

The Client Service Team, made up of Jamie, John, and Ann, had their own clever gifts up their sleeves. Jamie brought a "client satisfaction bell." John had everyone laughing with his gift, a framed photo of the firm's printer with the caption "The Real MVP." Ann decided to bring humor to the digital age with a "retro tech bundle," complete with a floppy disk and an old flip phone.

Then there was the Operations Team—Kim D.—who had become a legend for her creativity in the white elephant exchange. She went all out this year, gifting a life-sized cutout of Warren Buffet which quickly was used for all of the party's photos.

As the night went on, the gifts were stolen, swapped, and re-swapped. After the last gift was stolen, Dave stood up to give his traditional holiday toast: "Remember, it's not just about the gifts! It's about the memories, the laughs, and the tax deductions."

Financial Services Advisory
One Church Street | Suite 901
Rockville, Maryland 20850
301.949.7300

Due to various factors, including changing tax, political, economic and market conditions or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this commentary serves as the receipt of, or as a substitute for, personalized investment advice from us. Please remember to contact us, in writing, if there are any changes in your personal/financial situation or overall long-term investment objective.