CAPITAL INVESTMENT COUNSEL

The Columns

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Visualize someone just starting to hit their stride. They're not there yet but the potential is there. They're moving up the ladder so, they buy a house. Not a reckless house, but a stretch. The kind of stretch where the monthly payment makes you swallow hard the first few months you write the check.

It takes time but things start clicking. Their income climbs and climbs dramatically. The house that used to feel like a reach becomes a comfortable part of the budget. They delivered on the promise faster than most people expected, and now they're the solid bet everybody wants a piece of.

Now swap that person above out for the S&P 500. Ten months ago, the bears had one line they hollered from the rooftops: the market's too expensive, it's trading at 25 times next year's earnings! I get it. Sometimes expensive is just expensive. But sometimes expensive is a phase before the growth kicks in.

We can probably all agree that social media can make most things sound worse than they are, and stock market Twitter may be the purest example of it. I feel for the folks who sold out last fall, while the doom-and-gloom crowd kept saying this reminds them of the tech wreck in 2000. I was there in 2000. This AI boom doesn't remind me of that, and the biggest reason is that these companies have been producing earnings. Lots of them!

That 25 P/E that worried everyone last year would have been a stretch if you weren't paying attention to what's happening underneath it. We're all lucky enough to be in the middle of one of the largest investment booms in history right now. The current AI buildout currently sits sixth on the all-time list, slotting in ahead of the dot-com spend of 2000 and right behind electrification. Pretty good company to keep. AI spending is presently running at 2.4% of gross domestic product. The railroad boom of the 1880s hit 6% of GDP. And the king of them all, World War II, ran 37%. So where does the market sit versus next year's numbers? After all the negative talk, a war in Iran, and the highest oil prices in four years, the S&P looked around and said hold my beer.

Since last October, the market has rallied 11%. And here's the problem for the bears: the P/E they were so worried about dropped to only 20 because forward earnings grew roughly 30%. Think about it this way. Investors paid a premium of 11% more and received 30% more earnings in return. That's almost as good as a Harris Teeter BOGO.

There's one big difference with the AI boom compared to the others. Railroad track laid in the 1880s carried freight for fifty years. The fiber buried during the dot-com boom still moves internet traffic today. The GPUs (Graphics Processing Unit) powering these data centers have a shelf life of *five to six* years. That's a different kind of asset, which means we need the AI spending to keep growing.

That's good news for the chip makers, but the hyperscalers need to become more efficient in their spending to keep their profit margins high. Let's go back to the person in paragraph one. That stretch house works fine as long as the income keeps rolling in. For the AI trade, the income is rolling in. Let's just keep an eye on it.

The market's direction is the thing we all pay attention to, but a close second is *which sectors* are driving it. When the economy is humming, you expect areas like technology, trucking and heavy equipment to do well. A strong economy drives more orders, which means more activity, more shipping and more sales at the retail level.

Over the last month, I'm seeing small signs that the economy may be slowing a touch. Nothing dramatic. But the stocks may be hinting that we're taking a breather.

Last fall, against a backdrop of relentlessly negative headlines, three influential groups quietly began moving higher: the infrastructure builders (PAVE), the heavy industrials (XLI) and the truckers, led by Old Dominion (ODFL). Nobody was calling for a pickup in the economy, but those groups moved higher well before the headlines. Old Dominion gained 30% over the past year against 20% for the S&P 500. Lately though, they may be losing a step. Over the last month, the S&P is up 4% but XLI is down 2%, PAVE is down 3% and ODFL is down 13%. Then on Tuesday, Dick's Sporting Goods or Richard's, as we call it in our house, dropped 30% on weaker-than-expected earnings. Dick's offers a good take on the American consumer, so we'll be watching how this develops. Maybe it's nothing more than sector rotation. But stocks could be due for a pullback, and this might be the first clue that one is underway.

Interest rates are hitting 19-year highs. Most of the talk is doom and gloom, so let's spin the story around and look for a positive. I call this one the "Dip and Rip." On July 31st, the 10-year Treasury closed at a new one-year high of 4.7%. That put it above 75% of its three-year range and is a genuinely stretched reading. Thanks to Sentiment Trader for the stats on this one.

With all the negative headlines, you'd think that high-rate peaks were a negative and they are.......for about a month. This is the Dip. Historically, this setup shows that one **month** later, stocks were lower 60% of the time. So, a pullback wouldn't be out of character, and that lines up with what those industrial and trucking stocks have been telling us above.

However, going out one **year** later is a different story. Here's where the potential shows up. Stocks were higher 79% of the time, with an average gain of 11%. The dip hasn't shown up yet. But I plan on buying my favorite companies if it does. Keep "Dip and Rip" in the back of your mind the next time you catch yourself getting too bearish: that Rip higher is a move worth catching. If you have any comments, feel free to contact me at heddins@capital-invest.com or call at 919-656-0836.

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