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The Lorelei Stock Market

Is AI Its New Siren Song?

There is an old German myth that I want to share with you for its relevance to investing. You may already know it.

As the story goes, there was once a young maiden named Lorelei who was betrayed by her lover. He, it seems, had been unfaithful to her. In a fit of despair, Lorelei threw herself into the Rhine River where its magical waters transformed her into an alluring siren, a demigoddess with bewitching beauty. To exact her eternal revenge for her lover's betrayal, she would sit atop the sheer cliffs overlooking the river, combing her golden hair, and singing enchanting songs to lure the passing sailors in the waters below. Her charms would so entrance the sailors that many would lose all sense of danger, steer their boats into the rocky riverbed, and remain shipwrecked.

This little story encapsulates what we are seeing in the stock market today. Investors have heard the siren song of artificial intelligence and have decided that no matter what the costs may be, they must steer their boats in its direction.

The market's enthusiasm for AI is understandable. This emerging interdisciplinary science is already starting to revolutionize nearly everything in the human sphere. As a new and transformational technology, AI unquestionably holds great promise for the positive benefits it's able to confer on businesses and consumers. But AI also holds some challenges, which is why it is increasingly coming under legal and regulatory constraints.

Separating the mystique of AI from its investment value is critical. It requires the same level of due diligence that an investor might direct to any other kind of company being considered for investment. All companies, including those in AI, should be judged on their fundamental merits and not simply on the fact that they operate in the AI space, or that their share prices are rising.

A Replay of 1997? Or Maybe 1999?

The market's Lorelei mindset vividly reminds me of the stock market of the late 1990s.

In 1997 during the dot-com phenomenon, I was voicing caution as the stock market became increasingly stretched and as the market's mood became increasingly frenzied.

Back then, virtually any company with a ".com" after its name was eagerly scooped up by anxious investors who hoped to make ten- or twenty-fold their money in quick order. Predictably, most dot-com companies never made it past their adolescence.

Even after it became clear that many of these companies were likely to fail, Wall Street's appetite for the new and exciting world of the internet didn't subside. In fact, it seemed to become even more frenzied.

At the height of the bubble, the December 1999 episode of PBS' "Wall Street Week with Louis Rukeyser" featured a set of four prominent Wall Street investment managers who were asked to give their predictions for the stock market's prospects in 2000. Without a word of dissent, they unanimously proclaimed that the stock market would rise in 2000 because, among other things, they expected interest rates to come down. One panelist went as far as to list several internet-related stocks that she thought would be good bets in the year ahead, while other panelists listed other kinds of technology names.

In hindsight, their confidence and enthusiasm had a "Titanic on its maiden voyage" feel to it because the precise opposite of their prognostications came to pass. December 1999 marked the top of the dot-com phenomenon. Rather than rising, the S&P 500 Index fell by -10% in 2000, and then again by another -12% in 2001, and then a further -25% in 2002. All in all, the dot-com stock market gave up almost -48% of its value from its intraday highs in 2000 to its bear market lows in 2002.

Thus ended the dot-com mania of the late 1990s, shipwrecked on the rocky riverbed of one of the shallowest stock markets in history.

Fast forward to today. We now have the artificial intelligence phenomenon in which almost any company with an AI component is seen as a good investment for the future. At the end of last year Wall Street's list of top picks for 2024 contained a generous heaping of AI names. The dot-com phenomenon lasted five years from 1995 to 2000. Perhaps it will take a similar number of years for the AI phenomenon to run its course. That leaves me wondering if 2024 is AI's 1997, or perhaps its 1999?

Navigating the Lorelei Market

While AI stocks have propelled the stock market to new highs since November 2023, there are a number of other stocks from a variety of industries beyond AI that are still worth considering as part of a well-diversified portfolio. And while the stock market is currently expensive relative to most valuation metrics, reasonably priced stocks do present themselves from time to time. Selectivity is still the wisest call of the day, as it has been for some time.

Statistics show that over long periods of time somewhere around 80% to 90% of all stocks have a high correlation with the broader stock market, implying that a positive market backdrop is important for profitable investing.

Currently, the market's breadth is not especially positive. The market is still fairly narrow and is still dominated mostly by a few mega-cap technology names. That implies that the gains we have seen in recent months are likely to be transient, unless a broader swath of the stock universe participates in the rally. It bears repeating that last year, the "Magnificent Seven" technology companies accounted for about two-thirds of the S&P 500's gains. That left the remaining 493 companies not doing quite as much.

Navigating this Lorelei market calls on an investor's abilities to anticipate the market's future trends. Like navigating the Rhine, any predictions about what lies ahead are most effective when based on facts rather than emotions. This is where research and analysis are helpful.

When anticipating future market trends, my objective is always to understand the environment in which clients have to invest, and then to handicap the *probabilities* of various outcomes. While most things in the investment world are subject to multiple cross-currents, predicting one market scenario as "likely" and another as "unlikely" provides a basis for rational portfolio management.

The sticky part of this is that the timing of a prediction is often difficult to pin down. That sometimes casts doubt on the prediction itself. My physician friends will be familiar with this professional hazard, a right diagnosis with an uncertain timeline - an unhealthy man whose doctor repeatedly warns him to stop his unhealthy behaviors or to risk *death*, may brush off those warnings because, so far, nothing has happened!

History shows us what can happen in a Lorelei market, even if the timing of expected events is uncertain.

In the meantime, my focus will be on managing portfolios for long-term growth, going faster down the river when conditions permit, and slower at other times, but always minding the craggy rocks ahead.

V. Henry Astarjian

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