January 16, 2025

Dear Client,

Banyan's equity composite gained 11.8% in 2024. This would be pleasing were we not up 19.7% through November and had the S&P 500 not gained 25.0% for the year. Since the start of 2019, when yours truly officially took the helm, we have compounded at 13.8% per year versus 17.2% for the S&P 500. Click here for more details about our equity composite.

Bubbles & Business Cycles

Since the start of 2019, as noted above, our equity composite has lagged the S&P 500. Virtually all of the difference came in the last five quarters. We were neck-and-neck with the S&P 500 from the start of 2019 through Q3 2023. The S&P 500 then blew our doors off. Our equity composite has gained "only" 19.9% since the end of Q3 2023 while the S&P 500 has rocketed 39.7% higher.

The S&P 500's rocket fuel has been a small cohort of large stocks. The seven largest stocks in the S&P 500, or the "Magnificent Seven," are Apple, Nvidia, Microsoft, Alphabet, Amazon, Meta, and Tesla. Without these seven stocks, the S&P 500's total return in 2023 and 2024 was 11.3% and 11.8%, respectively, versus its actual total return of 26.3% and 25.0%.[1]

We are pleased to have kept the rocket ship in sight having owned only one of these seven. You may nevertheless wonder why we don't own all seven. They seem to only go up, after all. Our answer is simple. We are part of a loosely-knit tribe of rebels. Some call us fundamentalists. Others call us value investors. Our tribe welcomes all who dare take our oath – Thou shall not speculate.

Our oath is rooted in a simple truth. Capital withers away if not properly nourished, and only income can nourish capital. To the lender, this means interest; it means profits to the business owner. Sound investing *always* focuses on these income streams. If your focus is elsewhere, you are speculating. It is an easy habit to slip into. Many speculate and never know it.

Speculation is a risky game. Before long, capital is no longer seen as a treasured resource thirsting for nourishment. It is the speculator's gambling chips, and the market is his casino. Price action, not income, becomes his focus, and price action is driven first by popularity. His craft is thus divining what the crowd will fancy next. Income lies in a distant reality he cares little about.

The speculator thrives in markets like we have today. New technologies like AI are fertile soil for his craft. Imagination, not history, set expectations, and stock prices can grow to the sky from a

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[1] Howard Silverblatt, *U.S. Equities Market Attributes December 2024*, S&P Global (Jan. 3, 2025), *available at*: https://www.spglobal.com/spdji/en/commentary/article/us-equities-market-attributes/.

seed of truth. It can be profitable, then, to simply "[e]mbrace the expanding bubble," as *Barron's* recently urged, since "[t]here is a likelihood of building a bigger bubble."[2]

Barron's is right at least to call this a bubble. Since 1960, the yearend price-to-trailing-earnings ratio for the S&P 500 eclipsed today's level only in 1998, 1999, 2001, and 2020.[3] A recession depressed trailing earnings in 2001 and 2020, which leaves only the craziest years of the Dot Com Bubble. This implies poor returns for the S&P 500 in the coming decade if history is any guide.[4]

Unsurprisingly, "new era" thinking has emerged to suggest history is no longer a guide. "[W]e are not in a business cycle," says BlackRock, as "mega forces [like AI] transform economies."[5] So "stay risk-on," they urge, and worry "no longer about short-term fluctuations . . . leading to expansion or recession."[6] Splendid! Valuations are justified with the business cycle slain.

Then again, another drink is always the barkeep's prescription. We are therefore skeptical of this "new era" thinking. It is bold indeed to assume AI has slain the business cycle. The business cycle has merely been extended thanks to the very bubble *Barron's* speaks of. According to economists of the Austrian School of thought, business cycles have a few key attributes:

1. Malinvestment & Recessions | Business cycles are investment cycles, and interest rates are the price of time that coordinates present investments and future consumption. If interest rates are artificially low, there will be over investment, and output will exceed demand in the future. A recession follows as excess capacity is idled and labor is let go.[7]

2. The Profit Illusion | Moreover, the profit boom of the investment phase is an *illusion*. One firm's investment is another firm's income. Profits along the value chain therefore rise in an investment phase irrespective of end-demand. If demand fails to materialize as expected, however, the profit boom is erased in the bust as investing slows and capital is impaired.[8]

Financial bubbles follow the Austrian blueprint closely.[9] Bubbly valuations have the same impact as low interest rates since they bake in unrealistic expectations for future demand. Firms respond by over investing. If, for instance, a firm's market value rises by $10 when it invests $1 in capacity, much capacity will be built. The result is excess capacity since demand cannot meet expectations.

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[2] Ben Levisohn, *Why the Stock Market Could Gain Another 20% in 2025*, Barron's (Dec. 13, 2024), *available at*: https://www.barrons.com/articles/stock-market-outlook-2025-d03ad66a?st=jjdGsP.

[3] *See* NYU Stern School of Business Data (Reported Earnings from 1960 to 1987) *available at*: https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/spearn.htm, *and* S&P Global Data (Operating earnings from 1988 to 2024) *available at*: https://www.spglobal.com/spdji/en/documents/additional-material/sp-500-eps-est.xlsx.

[4] See Howard Marks, *On Bubble Watch*, Oaktree (Jan. 7, 2025), pg. 8, *available at*: https://www.oaktreecapital.com/insights/memo/on-bubble-watch, *and* John Hussman, *Pressing for Yet More*, Hussman Funds (Jan. 2025), *available at*: https://www.hussmanfunds.com/comment/mc250107/.

[5] Jean Boivin et al., *2025 Global Outlook: Building the Transformation*, BlackRock Investment Institute, *available at*: https://www.blackrock.com/corporate/literature/whitepaper/bii-global-outlook-2025.pdf.

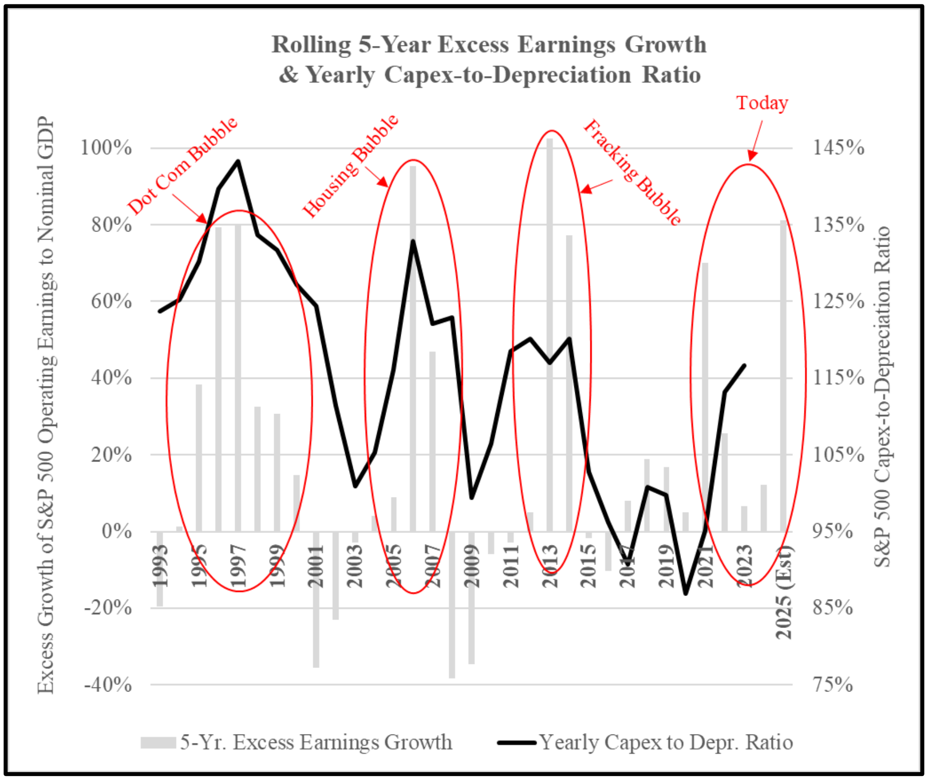
[6] *Id.*

[7] Steven Horwitz, *Austrian Economics: An Introduction*, Cato Institute (2020), pg. 67-68.

[8] Randall Holcombe, *Advanced Introduction to The Austrian School of Economics*, Edward Elgar (2014), pg. 73.

[9] *See Id.* at 104-05 *and* Alasdair Nairn, *Engines That Move Markets* (2nd Edition), Harriman House (2001), pg. 509.

The below chart illustrates this well. Over time, growth of the S&P 500's earnings and nominal GDP match closely. The cumulative growth of both was identical, in fact, from 1960 through 2020. The two diverge markedly in the short-run, however, and the divergence is tightly correlated to the S&P 500's capital expenditure (or "capex") cycle, which rises in the investment phase of bubbles.



[10]

As the Austrians predict, the earnings boom of past bubbles was largely an illusion. Investments are depreciated over years, but firms supplying the inputs (i.e., early-stage factors of production) see their profits rise immediately. A profit boom occurs irrespective of end-demand. When end-demand fails to meet expectations, however, investing slows and the boom turns to bust.

We are now in the investment phase of another bubbly business cycle. Four big investors in AI compute capacity are Amazon, Meta, Microsoft, and Alphabet. Their combined capex in 2025 is expected to be $257 billion, up 74% from 2023, but their combined depreciation charge will be about $136 billion. Nvidia, meanwhile, is expected to earn $105 billion in 2025 selling AI chips.

AMZN, META, MSFT, & GOOG				**NVDA**		
(Billions of Dollars)	Capex	Depr.	Difference	*(Billions of Dollars)*	Sales	Earnings
CY 2023	$ 147.5	$ 89.1	$ 58.41	CY 2023	$ 58.0	$ 27.6
CY 2024 (EST)	$ 214.8	$ 109.0	$105.85	CY 2024 (EST)	$ 123.4	$ 66.5
CY 2025 (EST)	$ 256.8	$ 136.3	$120.49	CY 2025 (EST)	$ 191.7	$ 104.5

Data from FactSet, Depr. Estimates Our Own

[10] S&P 500 operating earnings, capex, and depreciation data from FactSet and S&P Global. GDP data from Federal Reserve of St. Louis. Estimates for 2025 nominal GDP growth from Vanguard.

This shows the circular nature of the "Magnificent Seven" (excluding Apple and Tesla since they are not big players in AI). The crowd, awed by AI, rewards the big four with a higher valuation for investing in AI compute capacity. They respond by investing more in AI compute capacity, which juices the earnings of their supplier, Nvidia, who is also rewarded with a higher valuation.

As with all bubbly business cycles, this profit boom will continue so long as the crowd is cheering, but end-demand must ultimately meet the crowd's lofty expectations to avoid a bust. If it does, and it is nowhere close today, then it would be the first time.[11] Betting that "this time is different" is a speculation our oath forbids. ***Building permanent wealth*** with well-nourished capital is our focus.

Sincerely,

Drew Estes, CFA, JD
Portfolio Manager

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[11] Alasdair Nairn, *Engines That Move Markets* (2nd Edition), Harriman House (2001).