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NARRATIVE VIOLATION

For all their seeming complexity, markets are in essence a story. Or to borrow from AI-speak, they are the 'embedding' of a story. A story about how the economy, earnings and interest rates are likely to evolve. That 'story' is on any given day a compromise between several competing narratives. One plot line has the Federal Reserve on hold till the economy weakens with earnings deteriorating. Another has earnings and employment forming a trough with a Fed cut rescuing us sooner. The stream of corporate, economic and policy news drive investors from one plot line to another. But occasionally one story is so validated by events that it predominates. It becomes the controlling mental model, not just for the marginal investor but for the average investor. The market transitions from narrative flux to narrative lock. That's roughly how I would describe the period between the U.S. election and the middle of February. That was the moment when the average investor agreed that (1) the U.S. economy was poised to outgrow the rest of the world (2) based on the engine of technology mega companies (3) who were expanding their competitive lead on the rest of the world by leading Artificial Intelligence. That account, which had been gaining currency since mid 2023, became ascendant. With hindsight, it now seems like a singularity. The point where the financial world reached the global minimum of entropy—where all energy and matter in the universe were infinitely compressed.

Then came the narrative violations. In mid-January a previously obscure hedge fund in China launched a Large Language Model (DeepSeek) that it claimed (perhaps speciously) to have developed on a pittance of computing resources but that could run inference (true) at a fraction of the expense of the state-of-the-art models. Then at the end of February, the Atlanta Fed's real time estimate of 1Q GDP went from +2.2% to -2.2% in a week. In both cases, there ensued a chorus of counterspin that struck me as more denial than refutation. Among the adherents of the orthodoxy, there is now a strain of belief that the backdrop was close to nirvana when the U.S. administration upended the global economic system with tariffs. But for the force majeure, all would have been fine.

The brutal turbulence of markets since early April is a symptom of a market back in flux, trying to land on a narrative. Except this time the poles of the competing threads are not minor variants. They are miles apart—between a wrenching recession coupled with a new autarkical model of global supply chains versus something resembling the old status quo. Over the next several months, the data will gradually guide us on to one of these rails. But it will not be a smooth switch. The market will lurch between the storylines, as it grasps for each new wisp of economic data. For asset owners, the next year will be an unpleasant tangle of feints and reversals. For investment managers, desperate for a new trend, it will be a morass of mirages and phantasm.

The genius of narratives is that they reduce complexity. They take a high order reality and project it on to a basis that we can understand and communicate. At the same time, that is their weakness. Einstein warned: "Everything should be made as simple as possible, but not simpler." Often the abstraction of the story removes some underlying structure that is essential to its validity. In the prevailing story of American exceptionalism that missing structure was twofold. First the U.S. budget deficit. Since 2022 the U.S. has been spending between $1.3 and $2 trillion dollars annually more than its receipts—about 5-6% of GDP. Worse still, that has occurred without any credible plan to repay it. Our profligate brothers in Europe have meanwhile been overspending by 2.5-3%. The second great structural distortion derives from the cost of money. Since 2022 it ceased to be free. But that was masked by a fortuitous combination of termed out financing, extremely low credit spreads and most importantly, the aforementioned gusher of Federal cash. These two grey rhinoceroses have been charging at us for so long, we collectively decided that we would only worry about them when someone else decided to worry. In the warm glow of ever rising corporate earnings and AI euphoria, investors were seemingly content to ignore them and focus on a reduced form abstraction of the economic system. I would suggest that comforting delusion is now the past.

Of course, social historians will say there were signs. The rise of one day options on the S&P, the SPAC frenzy, the proliferation of crypto alt coins that seemed to have reached its apotheosis with the Fartcoin, only to be exceeded by the Melania token. The government IT software vendor trading on 100x sales and the legions of day traders on Robinhood with the diamond hands. People buying meal delivery on an installment plan. There were signs of a mass psychosis—based on a narrative that debt was almost free and freely available.

The bad news is the economic backdrop was never as felicitous as the narrative. The good news is we are entering a more sober world. A world where the consequences of risk manifest. We construct portfolios with a deep humility and recognition of uncertainty. Our portfolios have weathered the recent turbulence in financial markets admirably. We have removed some of the insurance we purchased at attractive prices amidst the complacency of last year. We expect the current unsettled state of markets to now give us occasions to buy quality assets when the markets demand liquidity.

—T. Brad Conger, CFA, Chief Investment Officer