L&S ADVISORS

Risk Management
Transcends Everything

QUARTERLY REVIEW & OUTLOOK **Q4-2024**

"Things are seldom what they seem."

W. S. Gilbert

Equity markets experienced strong gains in 2024. High yield on average was the best performing segment in the credit markets. Despite numerous known risks facing the US and Global economies, each of which on its own could have caused a recession, no event unfolded in this manner and the economy has remained resilient. Expectations for monetary policy action and the path of interest rates followed suit with less cuts projected in the Federal Funds Rate. A small segment of the economy made an outsized contribution to the overall trajectory of GDP.

Where might we go from here? We believe less regulations and lower taxes should lead to an increase in corporate profits and in earnings growth. Tariffs are a negative price consequence for consumers and all else equal, leading to inflation. In a pro-growth environment, faster economic growth may coincide with higher inflation, and that may lead to a pathway for interest rates higher than previously contemplated. Ultimately, we believe earnings should matter most and we expect an increase in earnings in 2025.

What about the credit market? The Fed has cut rates by 100bps from the Fed Funds rate and the 10-year yield has increased by 100bps. The yield curve, inverted for a record amount of consecutive time, is in the process of normalizing and steepening. With very tight credit spreads, the yield curve is communicating there may be a reacceleration of growth and inflation and not that a major slowdown or recession is on the horizon. This environment of tight spreads and ample liquidity, in our opinion, is conducive for companies to be able to refinance debt and support balance sheets as well as for increased M&A and capital markets activity. We would also point out that credit spreads are mean-reverting and at prevailing spread tightness leave little room for additional tightening.

Thematics can play an important role in our investment process. Nothing encapsulates this better than our interest in investing in bottlenecks like those associated with AI, Power Generation, & Infrastructure.

AI is growing rapidly with technology diffusing across the global economy on its way to becoming fully entrenched. AI requires exponentially more power, uses and generates more data. Data centers can be constructed completely between 1 and 2 years, a mismatch, much faster than grid planning happens. Already today, both city and rural areas near datacenters have the most unreliable power on the electric grid. There is double the existing data center capacity that is currently online already in

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construction in various stages. The digital economy consumes so much power that demand is now straining supplies of electricity around the world, and in our view the grid is not prepared to handle the data center construction boom underway.

Electric grids pressured from prolonged periods of underinvestment are impacted further by the stress from variability of renewables sunlight/darkness and wind/no wind. There has been an increasing growth in the contribution to the overall power mix from these sources. We are seeing companies like Microsoft and Amazon sign > 20-year, long term power contracts directly with utilities for twice the rate that power costs today. These companies require clean and reliable power to facilitate growth in data, AI, and digital services. There is an issue of power supply today as there is an obvious mismatch in the growth in demand for clean and reliable power vs the time it takes for the supply growth to become available.

Based on the amount of investment and adoption in AI, more buildout is imminent. Power will be a limiting factor, action is needed not only for the base load now, but for what is inevitably a growing demand for power. Much capital expenditure is required. Capital expenditure is revenue for the value chain times a multiplier for the economy. This gives us some conviction and visibility into investing thematically in this bottleneck.

Let's highlight 3 potential areas of concern for 2025. Digital assets and crypto have seen a dramatic rise in popularity and appreciation in value. The cumulative size of these assets has grown so large that they have the potential to impact other tangible areas of the economy. Historically the mixing of leverage, speculation, and deregulation has not ended well and some of that exists in this realm. There could be economy-wide impact from a pullback or correction in digital assets.

Concerning geopolitics, known risks associated with China tensions, Russia and Ukraine, & the Middle East have been percolating in the market while making new highs over the past year. The trend of deglobalization which began in Trumps first presidency and continues through Biden's, is still in effect today. We are seeing the impacts of tariffs today in the behavior of companies in purchasing and additional ordering of materials, parts, supplies, presumably before tariffs take effect. There could be additional unintended consequences from tariffs in addition to distorted economic data. Tariffs could also be tougher in talk than what transpires in reality.

Debt and higher interest rates can be less of a concern when rates are moving lower, but with an accelerating economy, the previously conceived lower pathway of interest rates has moved higher. A reacceleration of inflation could be problematic, it could indicate a need for policy rates to move higher.

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Please reach out any time with questions or to discuss your portfolio further.

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