CARDEROCK
CAPITAL® MANAGEMENT, INC.

April 10, 2024

In our firm's experience over the past 38 years, Quality Growth stocks have been rewarded for their steady cash flows, predictable returns and serviceable debt loads across a variety of sectors and themes. While our investment results have never exactly correlated perfectly with markets in the short term, we are encouraged to know that our longer-term results have not left clients behind. The S&P 500 Index gained just over 10% during the first quarter while Carderock stocks were not far behind at 8%. For sure, a much stronger start of the year than anticipated.

Continuing the theme from 2023, momentum in Artificial Intelligence (AI) companies have been the dominant beneficiaries within the S&P 500 Index. In looking back over the past 15 months, investors have been hyper fixated on AI's potential to reshape the US economy - projecting changes in consumption, goods, services and labor. We do agree with the consensus that AI is in its beginning stage and the prospects look promising, but as for investing, it is too unproven and narrow in scope.

The current environment reminds us of the late 1990s when the Technology sector received all the attention with the anticipation of future profits and growth of the Internet. But as we all found out, it took years for winners and losers to be evident. Today, we find ourselves in a similar cycle, but our view is that the associated risks in AI stocks are too high relative to the expected returns. In time, these companies will start to differentiate themselves as the cycle matures producing sustainable sales **AND** profitability that will clear the path for making investment decisions based on sound fundamentals rather than on just "hype".

For the remainder of the year, we see the following factors driving our investment process:

- Inflation remains stubborn, limiting the Federal Reserve's ability to cut rates.
- Manufacturing activity continues its upward trend, increasing the attractiveness of Industrial and Cyclical sectors.
- Valuations in Stocks remain lofty but will not deter us from investing in Quality Growth stocks with excellent long-term growth prospects.
- Speculative activity and IPO issuance has been muted by high interest rates, freeing up Capital toward more productive investments.
- Labor markets, GDP and earnings growth remain strong, making a recession increasingly unlikely.

Furthermore, our recent and expected activity can be summarized as follows:

- Cash reserve targets currently stand at 10%, a multi-year low that reflects our improved outlook on Stocks.
- Buying activity has marginally exceeded selling over the past year as we rotate into new issues with better growth prospects, which we expect to continue.
- We will continue to buy Treasury bills for equity cash reserves, as short-term rates remain attractive.
- Interest rate spreads on high quality bonds between short and long-term maturities should continue to narrow, and we expect to lengthen our maturity schedule over the coming months as short-term rates slowly come down.

While it's been a great start to the year, we think the current underlying trends are closer to their beginning rather than in its final stages. Of course, there will be "bumps" along the way, but we expect these to be short in duration and shallow in magnitude. As always, feel free to call us or review your investment progress with any questions you may have.

Warmest Regards,

Dan

Daniel A. Kane, CFA
President

Stephen

Stephen F. Knapp, CFA
Portfolio Manager and Director of Research

Random Gleanings

"We've now witnessed several periods in which the momentum factor seemed to be running out of steam, only for it to come surging back. Far from entering bubble territory, momentum could have a fair way to run. Momentum enjoyed prolonged multi-year periods of outperformance in the 1960s and again in the 1980s. It's worth thinking about what links these periods: they saw strong nominal GDP growth driven by higher consumer spending and a housing boom; they saw moderate but not persistently low inflation; they saw increasing participation in stock markets; they saw technological innovations that dramatically altered the fabric of everyday life. It's not all that hard to think that the years to come might hold something similar." Edward Cole, *"Momo Goes Vertical",* **Financial Times,** April 3rd, 2024.

"At the press conference following the December 13, 2023, meeting of the FOMC, Chairman Powell cast himself as a hostage to fortune. 'I want to assure the American people that we're fully committed to returning inflation to our 2% goal,' he pledged. It may be no easy thing to bring off. The index is complex and subject to sampling error. 'The economist,' admonished Okar Morganstern in his 1950 classic *On the Accuracy of Economic Observations*, 'will do well to guard against an interpretation of 'data' which are often anything but economic measurements; rather they are tools in a continuing struggle for power.' Sound advice for central bankers, too." James Grant, *"The Inflation We Choose",* **Grant's Interest Rate Observer,** February 2nd, 2024.

"Today's large language models (LLMs) have learned to recognize patterns but don't understand the underlying concepts. They will therefore always produce silly errors, says Marcus. The idea that tech companies will produce artificial general intelligence by 2030 is 'laughable'. Generative AI is sucking up cash, electricity, water, copyrighted data. It is not sustainable. A whole new approach may be needed. Ed Zitron, a former games journalist who is now both a tech publicist and a tech critic based in Nevada, puts it more starkly: 'We may be at peak AI.'", Henry Mane, *"AI Keeps going wrong. What if it can't be fixed?",* **Financial Times,** April 6th, 2024.

"In The WSJ's latest poll of swing states, 74% of respondents said inflation has moved in the wrong direction in the past year. This assessment is simply not true. If hard economic data count for anything, we can say unambiguously that inflation has moved in the right direction in the past year. In the 12 months through February, inflation was 3.2% compared with 6% a year earlier. Yet the average person thinks it went up. When it comes to the economy, the vibes are at war with the facts, and the vibes are winning. People consume media that confirms their biases, and the media and the public are negative for the same reason: They are worried about the country. It will take more than lower inflation to change that." Greg Ip, *"What's Wrong With the Economy? It's You, Not the Data"*, **The Wall Street Journal,** April 4th, 2024.

"In principle, then, there's no reason to get out of stocks just because the fed funds rate is high. That is a headwind to valuation, and makes it harder for companies to grow, but usually rates are only that high because corporate conditions are good. Meanwhile, higher rates are by definition bad for bonds. It therefore makes sense for stocks to outperform bonds when even the yields on Treasuries are moving sideways." John Authers, "A Higher-for-Longer Good Friday From the Fed", **Bloomberg,** April 2nd, 2024.