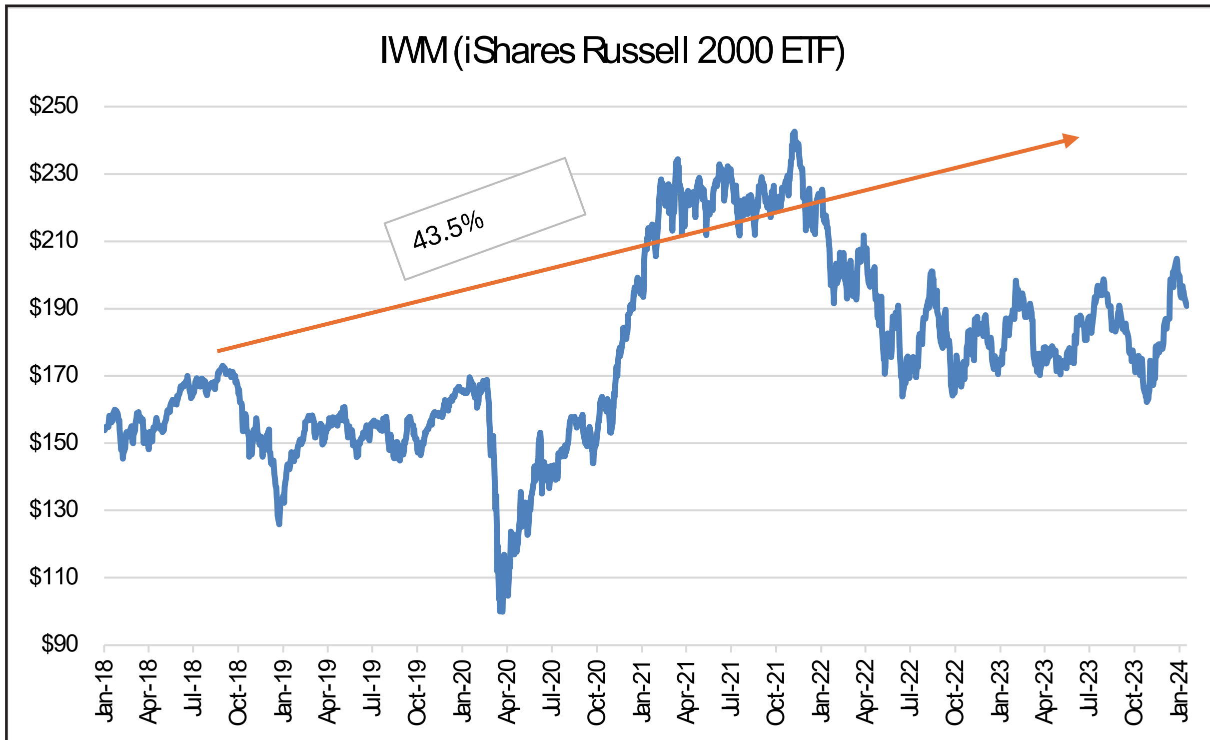
The Two Different Stock Markets

For many years now, the investment universe has separated into at least a few separate worlds. Each of those groups have a path forward that are most likely very different. Let us explain:

1. On one side, you have the very large-cap type of companies like Costco, Walmart, Nvidia, Palantir, Tesla that are part of major and well-known indexes (ie: S&P 500, QQQ, etc.) and are benefitting from an ongoing tremendous amount of inflows from passive strategies. This has been happening for many years now.
2. You also have private equity (PE) and private lending funds that have benefitted from large increase in portfolio allocations to these strategies for many years as well. Most PE firms use high leverage that the private lending groups are more than happy to lend to and therefore those two groups are now notably dependent on each other to some extent.
3. Lastly, there is the growing crowd of investors chasing digital currencies (some of them might have a future but probably not for most of them), NFTs (Non-Fungible Tokens), one day options (0DTE), and meme stocks. They primarily attract a crowd that want to get rich very quickly. In reality, many of these, most likely, have no future and will end up being worth zero ($0.00), in our opinion.
4. On the opposite side, you have all the smaller public companies which are not part of the big indices and therefore are seeing a constant selling (outflows). Indeed, individual investors, investment advisors, pension funds and professional active money managers have all been net sellers of these smaller stocks. This trend has now been in place for so long that most of these types of stocks are very cheap – many of them trade at record low multiples never seen before. This is the area that we tend to invest our capital. But as the outflow is non-stop, it becomes harder to have a rapid positive move on those stocks. They instead create value slowly unless some catalysts happen (i.e. accretive acquisitions, take overs or aggressive buybacks).

Since an image is worth a thousand words, let's look at the difference in the performance of the S&P500 ($SPY) and the US small-cap index ($IWM) over the last six and a half years to show our point clearly:

Source: Bloomberg as at February 14 close

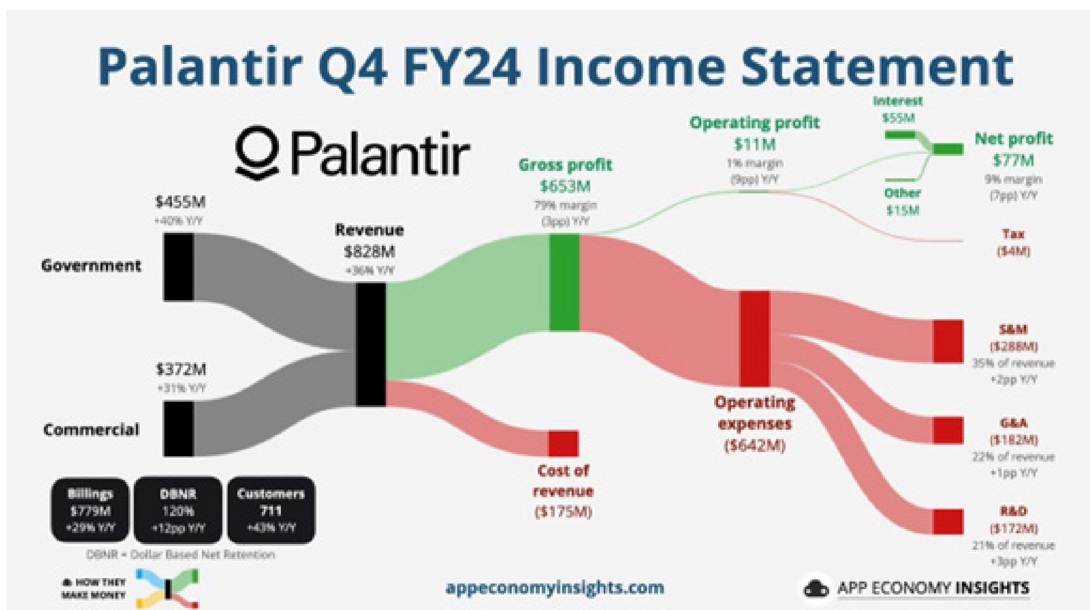


Source: Bloomberg as at February 14 close

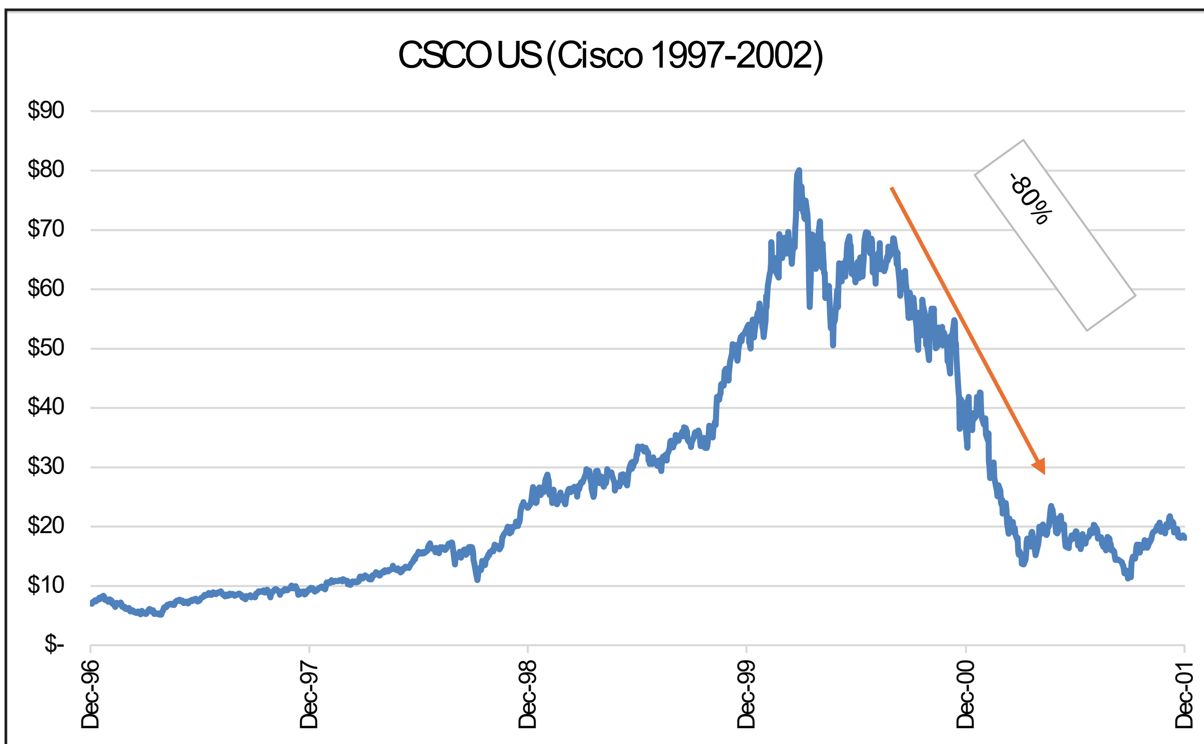
Group 1: Large-Cap Companies:

For starters, this group of stocks is now very expensive and for some specific stocks, valuation multiples are now extremely expensive and beyond any comprehension. The flow of passive money has been relentless for so long now without any regards for valuation that many of these stocks have seen a multiple expansion almost every year over the last decade. In fact, in the comment we wrote in our February 2024 letter, we show many examples of popular stocks seeing higher and higher valuations ($WMT - $AAPL - $COST, etc.). One of the most recent and extremely expensive stocks these days is Palantir ($PLTR).

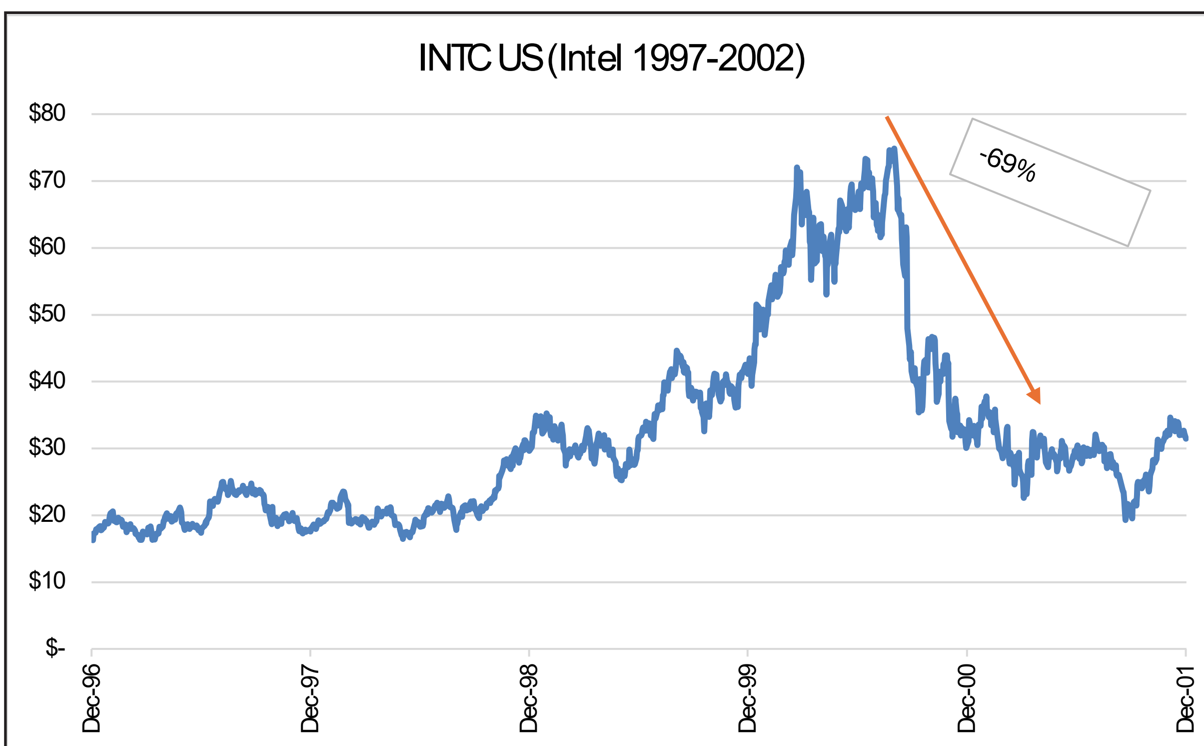
Let's take a look: The enterprise value is currently about US$280 billion (intraday as at Feb. 19, 2025) and net income for the fourth quarter was US$77 million - which means the stock trades at almost 1000 times (909X to be precise) the annualized profit of the most recent quarter (Q4-2024). Fourth quarter revenues were $827 million which means the stock trades at 84 times the annualized sales of the same quarter. (All as at intraday Feb. 19, 2025)



Cisco, which was the top stock at the peak of the last big tech bubble in 2000, traded then at around 100x its earnings as per Bloomberg. Shortly after, its stock fell 80% over next few years as the market peaked and the US economy fell into a recession. It goes without saying that the downside risk of these type of stocks are more than significant. Intel is another example.



Source: Bloomberg



Source: Bloomberg

Below are further examples of other expensive large cap stocks (using 2024 earnings or last 4 quarters) – based on Bloomberg. You know the picture:

$COST: 61.0x

$WMT: 41.6x

$AAPL: 35.1x

$TSLA: 164.3x

$MA: 38.9x

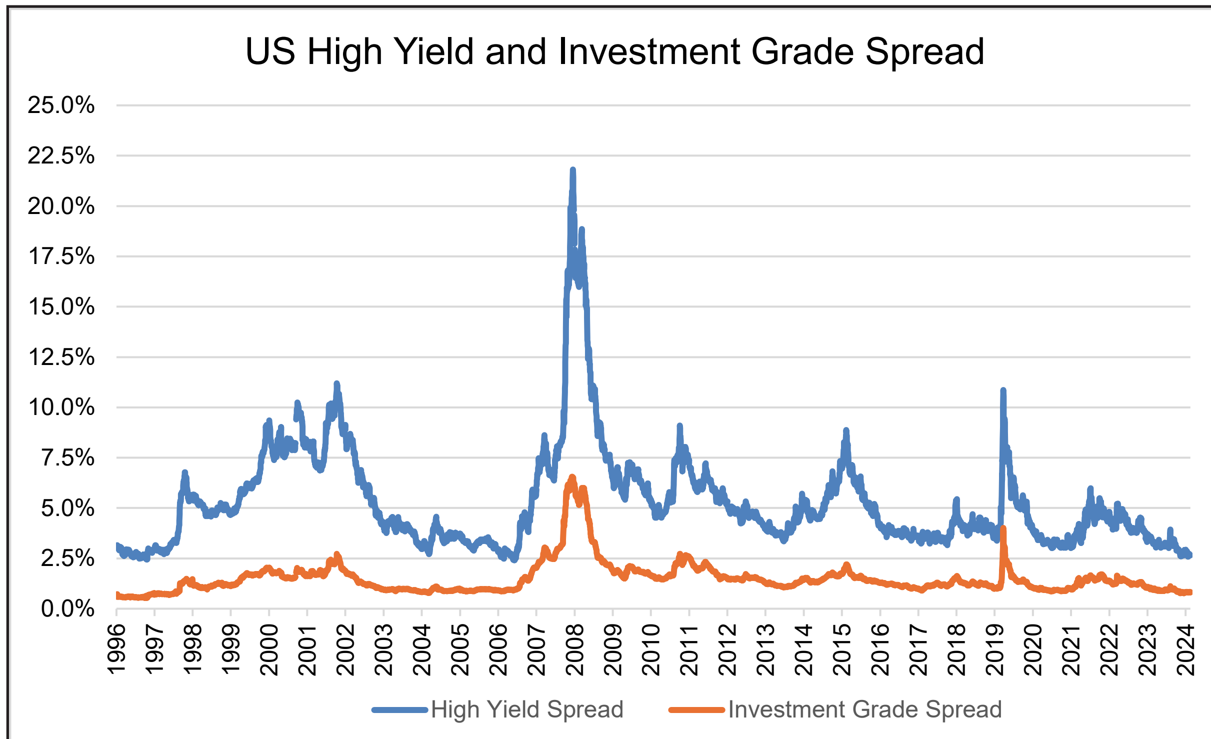
$CRM: 49.8x

All of the above are as at Feb. 19, 2025

Group 2: Private Equity and Private Credit:

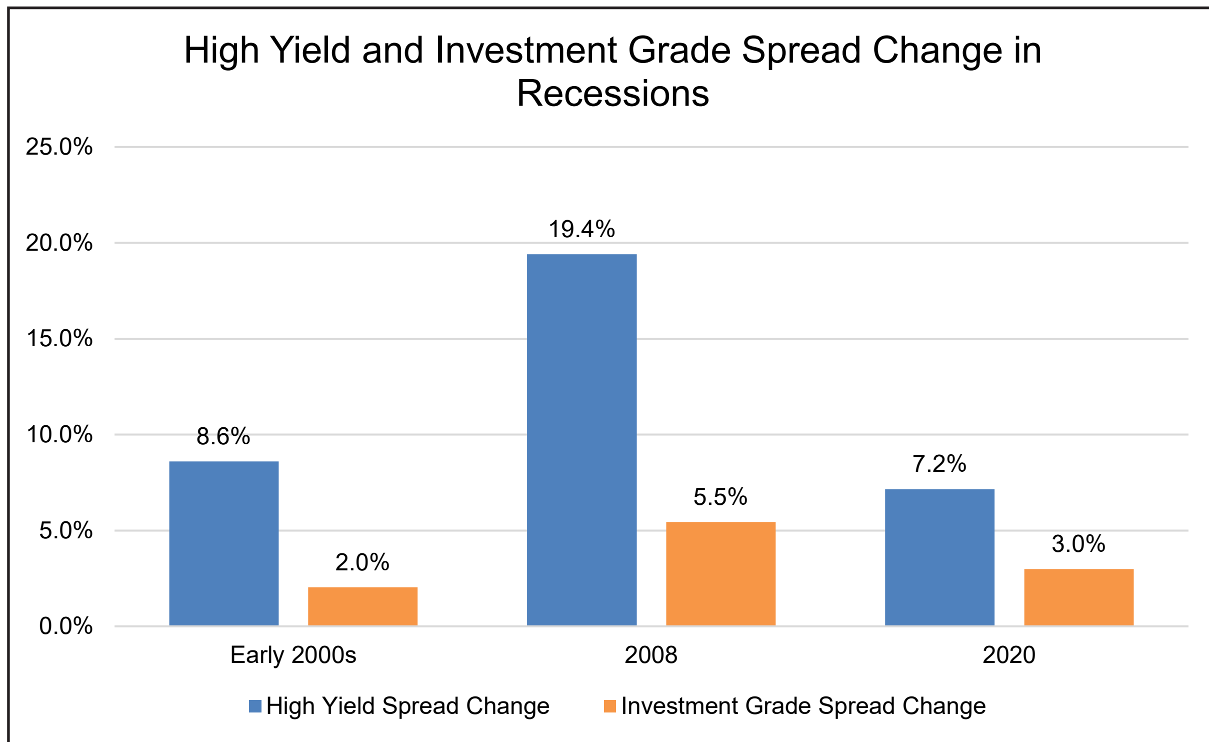
We believe that when the US falls into a recession, there is great downside risk for many of the valuations used to value holdings held by Private Equity (PE) and Private Lending groups.

First, the credit spread paid currently is close to record low (which means the market is "max bullish" on the economy).



Source: ICE Data, FRED

Historically, when recessions happen, those spreads widen substantially, which translates to a substantial reduction in the value of those bonds (or loan equivalent).



Source: FRED

On the PE side, because of the operational & financial leverage in many cases, the value can decrease substantially during a recession. In the 2000 crash, PE buyout funds had a peak to trough decline of around 27%, in the global financial crisis, those same buyout funds peak to trough decline was 28%.[1]

Group 3: Retail Focused:

We won't elaborate too much on this group, but most readers would be aware that the speculation is running high with digital currencies, NFTs, "shit coins" (see list below for the biggest) and one day options (0DTE). One day options are now capturing over 50% of the S&P 500 option trading according to Bloomberg.[2] This evidence of exuberance indicates to us that these investors are not pricing any negative risks or events. The "getting rich quick" won't work for most people and eventually a lot of pain should be felt when reality comes in.

Meme Coin	Market Cap
Dogecoin	$36,655,379,236
Shiba Inu	$8,954,599,148
Pepe	$3,870,326,961
OFFICIAL TRUMP	$3,207,872,123
Bonk	$1,180,662,137
FLOKI	$877,015,116
Official Melania Meme	$664,908,878
dogwifhat	$594,536,621
SPX6900	$555,138,557

Source: coinmarketcap.com, as at intraday Feb 18, 2024

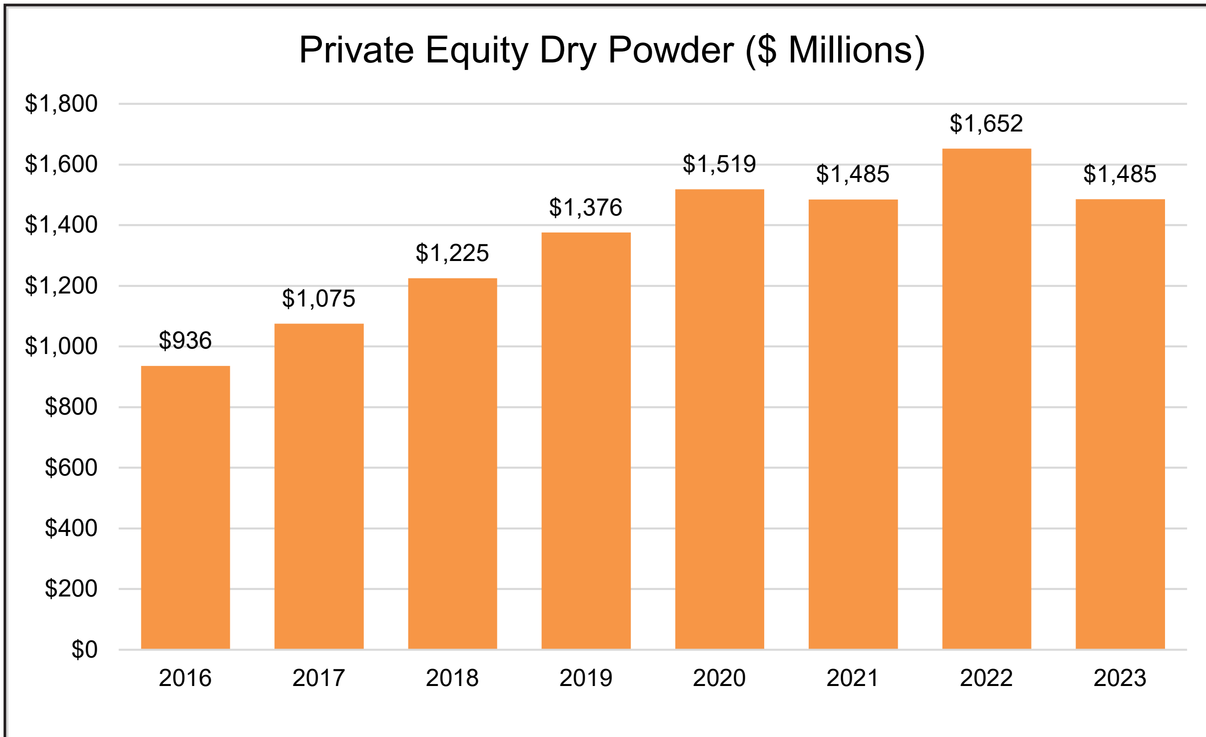
Group 4: Small Cap:

This group of stocks – the smaller type of companies – have been tremendously affected by the negative flow over the last many years. Individual investors, investment advisors, pension funds and professional active money managers have all been net sellers of these smaller stocks.

1 Neuberger Berman "The Historical Impact of Economic Downturns on Private Equity"

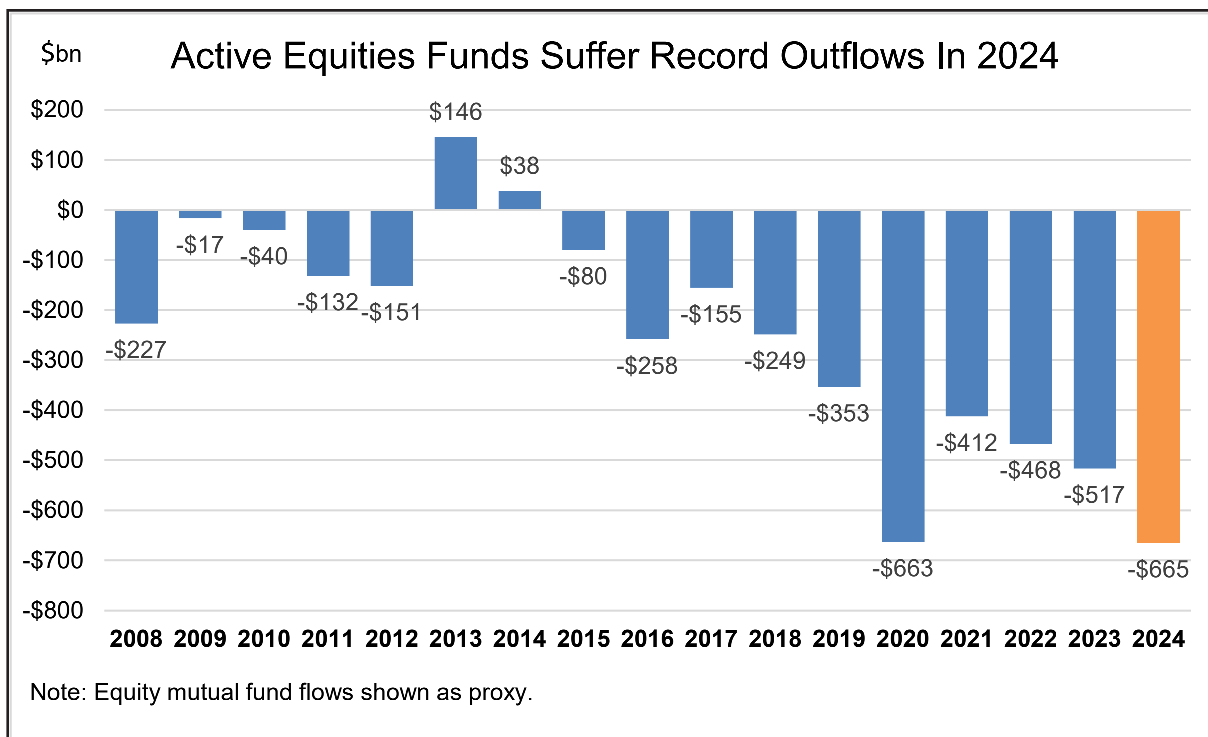
2 https://www.bloomberg.com/news/articles/2025-01-03/zero-day-options-are-most-popular-on-s-p-500-as-dominance-grows

Some sell the small caps to buy the large caps or to allocate to popular ETFs because that's where the momentum is. Others, like investment managers, sell small caps because they're having steady redemptions or closing out funds for lack of performance. No matter what the reason is to sell, small caps have been sold indiscriminately by many groups of investors for so long that we currently have a large group of stocks that are extremely cheap and attractive. Therefore, these stocks have, in our opinion, substantially less downside if a recession hits. We now see many of these companies buying back their shares which is accretive to current shareholders, and many are also subject to a possible take over at nice premiums (Private Equity has over $1 trillion of cash to deploy).



Source: Pitchbook

Conclusion: The passive strategies phenomena, which is likely to continue, has put such tremendous pressure on the valuation of small-cap stocks that they are now providing today what is most probably the best risk/reward profile of any equity category in our opinion.



Source: Bloomberg

What are the long-term consequences of Passive Strategies?

Mike Green, who is very knowledgeable about the consequences of the megatrend of passive strategies, estimates that about 45% of equity investment decisions have moved to passive (we subscribe to his Substack and recommend it). Here is the link.

Here is what we see:

1. The ongoing trend of increasing amounts of money being allocated to large-cap passive strategies at the expense of other stocks is likely to continue but its effect on price might diminish. If you add $200 billion to a $10 trillion market it should have a smaller effect than when the size of the ETF market was only **$2 trillion**.

2. The volatility on stocks which are part of the index could increase more than the stocks that aren't in the index. When ETFs flows swing between inflows and outflows and back and forth, they impact only the stocks that are part of these ETFs and not the disregarded ones – Call this one of our predictions – a rise in volatility amongst the big names part of the big indices.

3. As the shareholder base collectively represented by ETFs gets closer to 100% market share of the investment world (vs 45% currently), we will get closer and closer to the potential of extreme volatility (huge move up on positive flow – huge move down on negative flow). This is likely to take us to the point where a "CRASH" is very possible and even worse if combined with a big reason to sell (ie: Black Swan event, wars, bad recession, etc.). Keep in mind that as the size of the pie allocated to passive strategies continues to grow, the Active Manager size shrinks proportionally. Therefore, when corrections happen, there is a smaller pool of active buyers showing up as the ETFs crowd sells. So, what happens if ETFs have for some reason very big outflows? It seems very simple to us, you get a huge correction and/or a CRASH! Indeed, supply exceeds demand as active managers have very little money to buy!

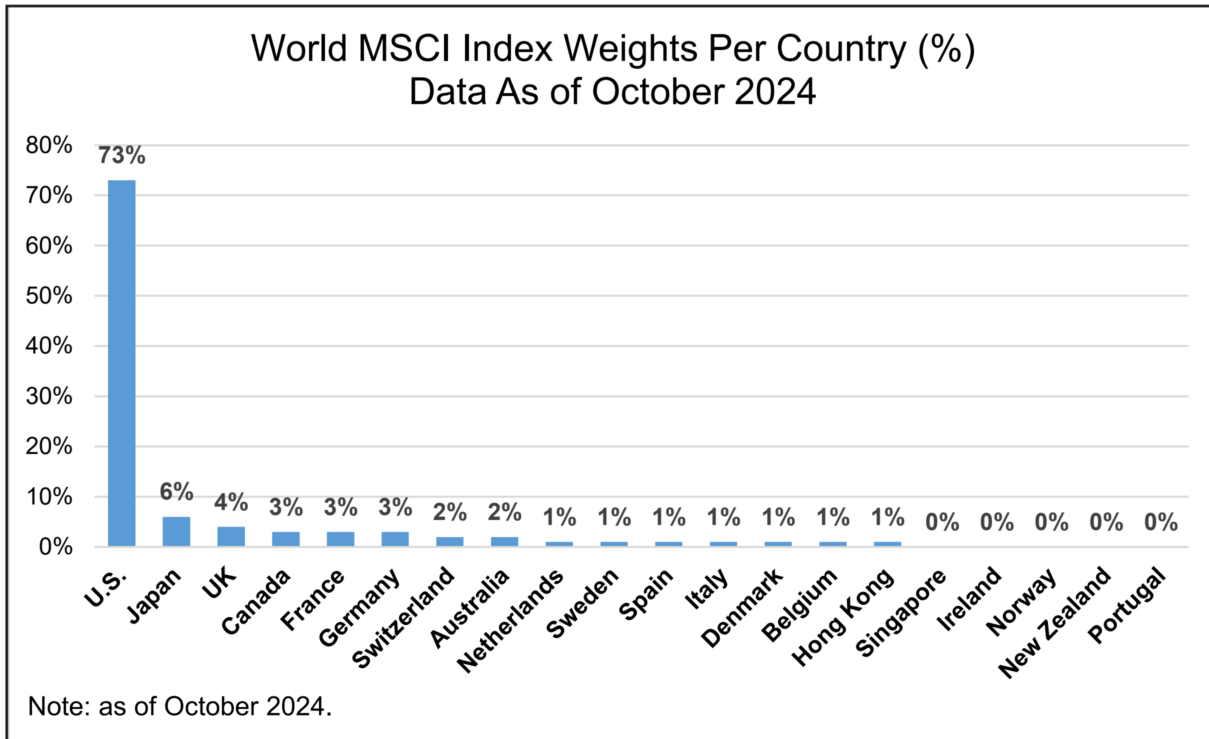
In terms of what could cause a large flow out of those ETFS, here is a list of some of the things we closely monitor, but we all know the list is a lot longer than this:

1. War
2. Recession
3. Trade conflicts across multiple countries
4. Unexpected policies from President Trump that investors don't like
5. Nvidia stock having one of its drawdowns – read our July 2024 letter
6. Long-term rates going higher because of never-ending government deficits (US – UK – France – Canada, etc.)
7. A reversal of the extremely positive sentiment currently ongoing

Here are other signs stocks are at risk of a correction - Sentiment toward US stocks is extreme:

1. The whole world is putting their money into large cap US stocks through ETFs, in November, US Equities took in 97% of Equity ETF Flows[1] (very little going anywhere outside the USA).
2. Most investors are already in (buying power is lower going forward) as the US already represents 73% of World MSC Index Weight. Check this chart on the next page:

1 https://www.ssga.com/us/en/intermediary/insights/us-equities-win-best-in-show



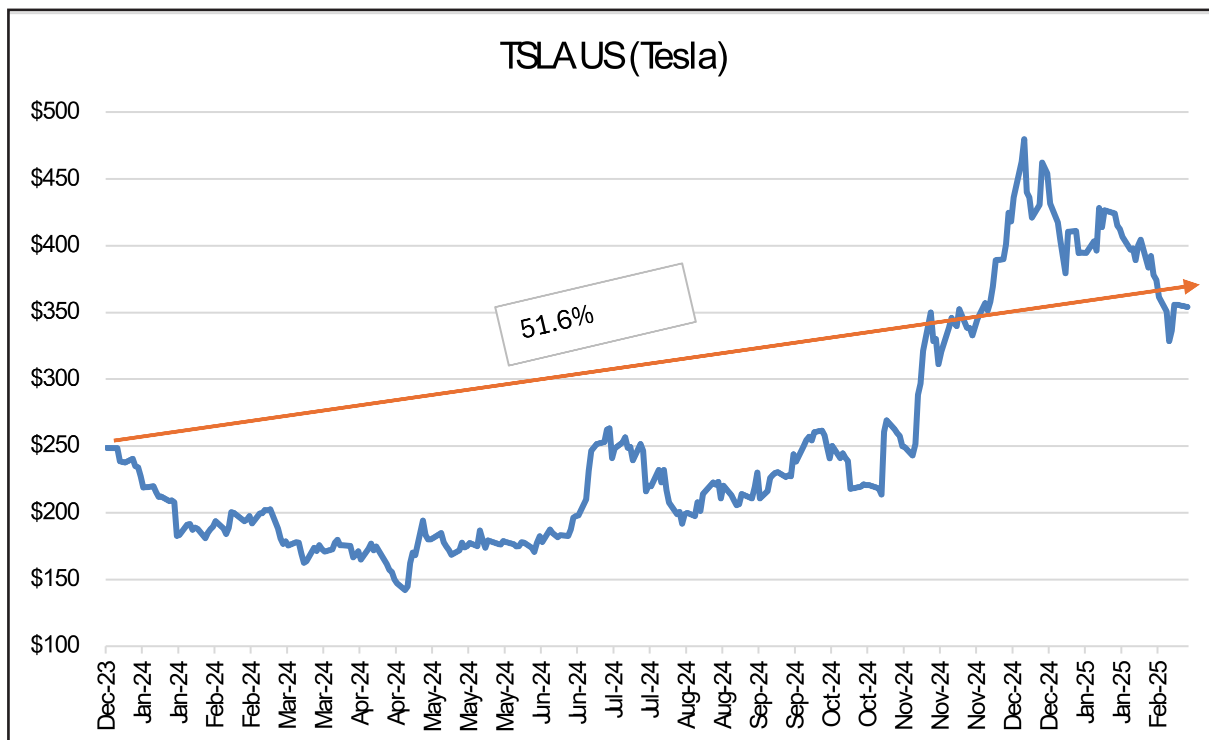
Source: MSCI Inc.

3. Another good sentiment indicator is the fact that many popular stocks went up through 2024 despite little growth or some disappointments…

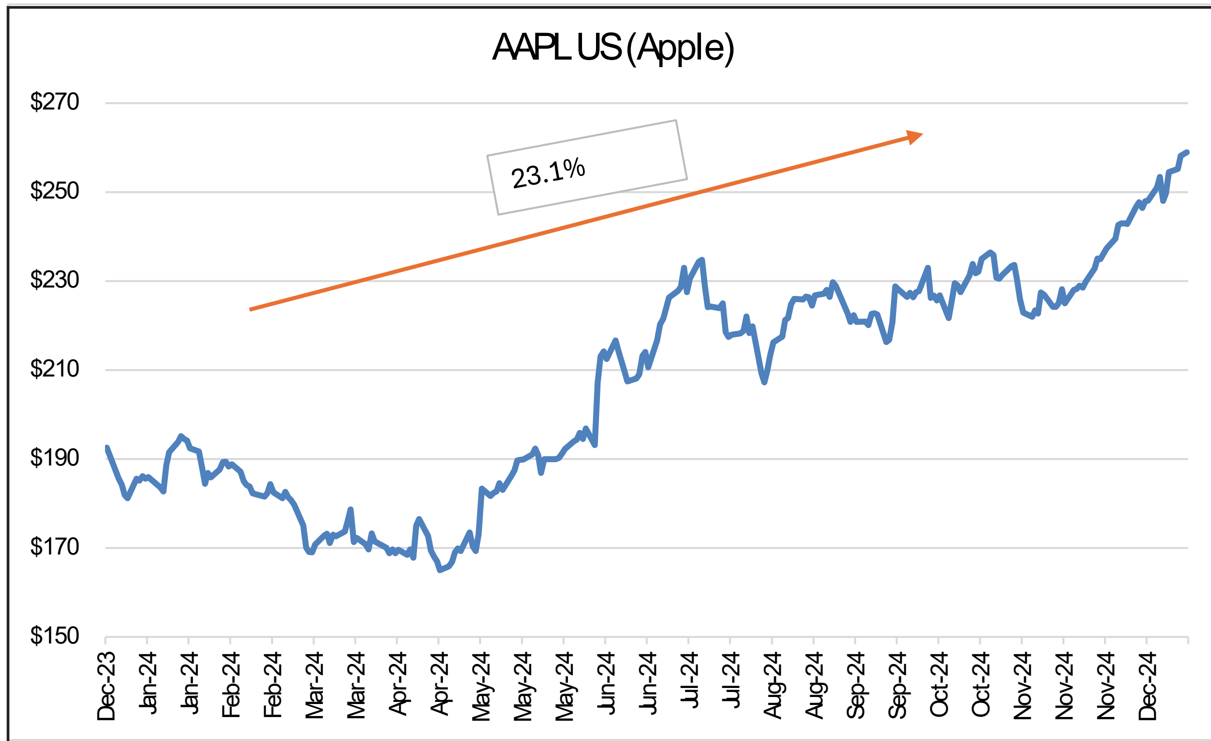
a. Tesla stock is up about 50% with sales up 1% and EPS and margins down significantly.

b. Apple stock is up about 23% with sales up 2% and EPS down 1%.

c. Walmart stock is up almost 100% as they continue to perform “better” with 5% sales growth and 13% EPS growth in 2024. But Walmart today trades at a higher multiple than the 1990’s when the company was growing sales at a much higher growth rate (instead of 15-20% a year).



Source: Bloomberg as at Febraury 18th 2025 intraday



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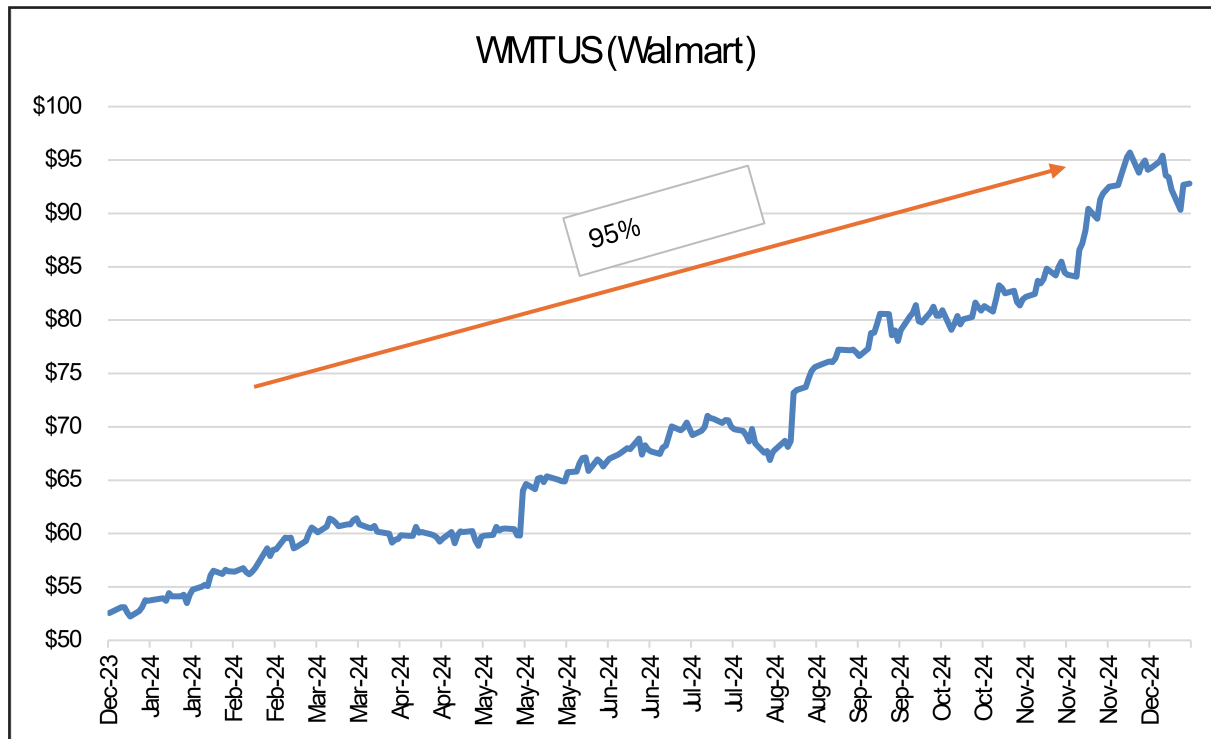
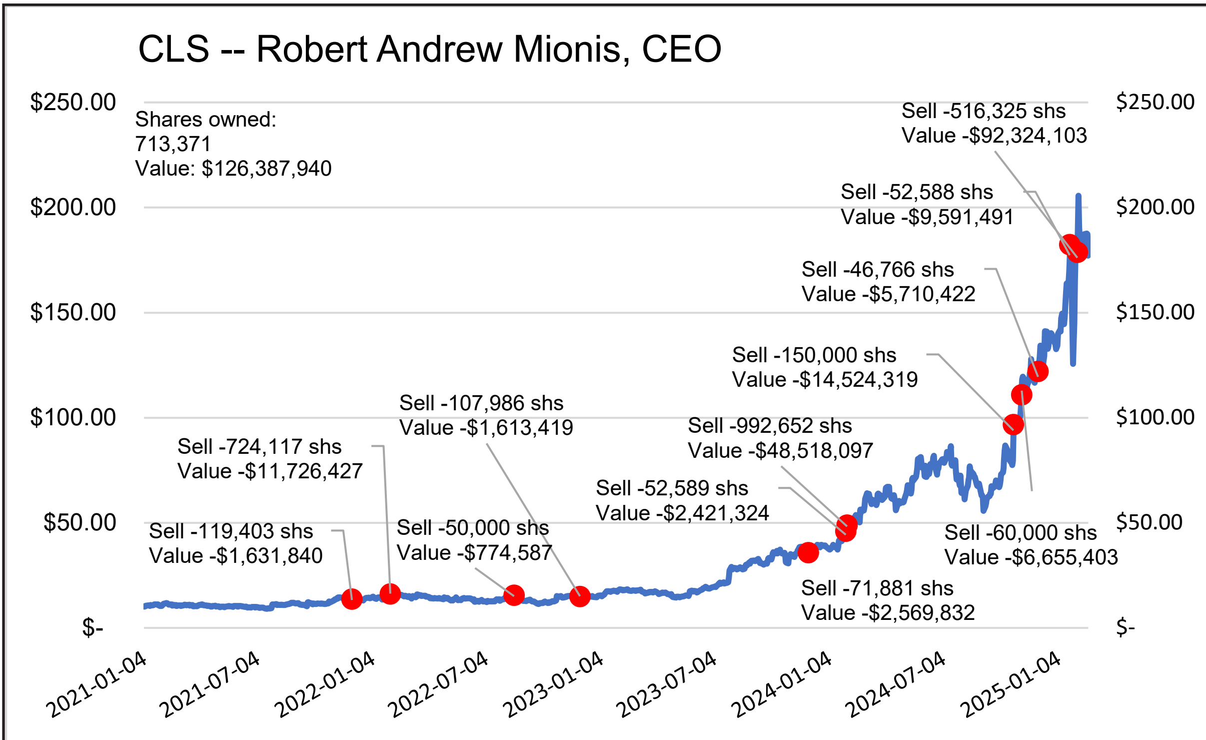


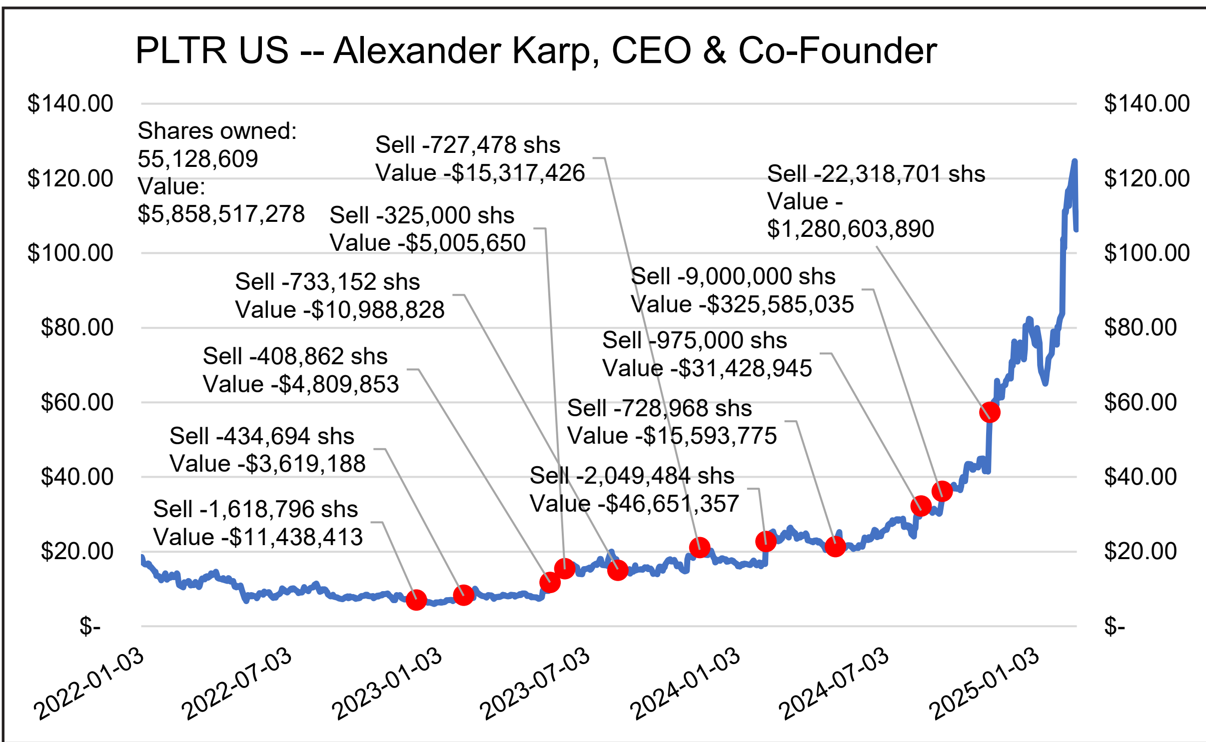
Source: Bloomberg as at Febraury 18th 2025 intraday

4. Heavy insider selling is another sentiment indicator at a high level compared to long-term trends – what do they know? Look at some examples below…

Other signs stocks are at risk of a correction - <u>Insiders selling heavily</u>:



Source: INK Research, Timelo



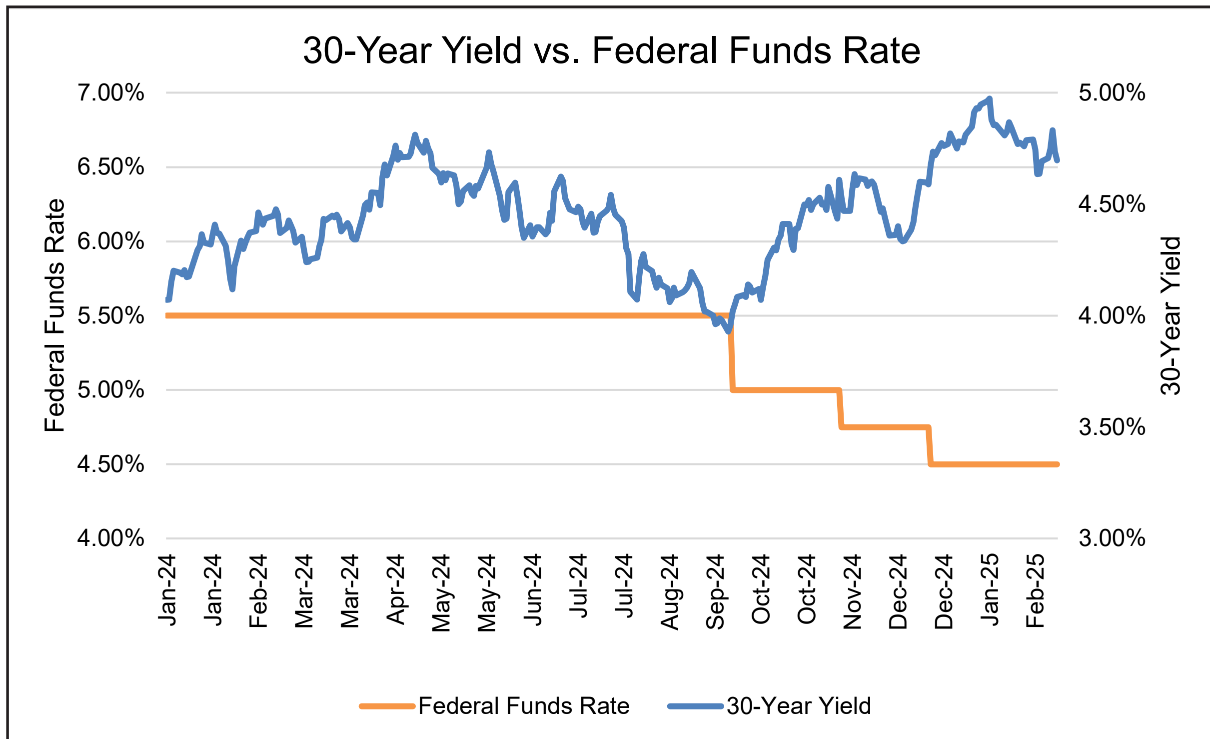
Source: INK Research, Timelo

When is the next recession coming?

First, let's look at some statistics where we see risks.

Interest Rates RIsk

Since the Fed cut rates by 100 basis points (Sept 18th, 2024) – 30-year rates are up 100 basis points and yet the S&P 500 is up 9%. Higher rates put pressure on governments, businesses and families on their ability to pay their debt and future purchases therefore reducing the potential size of the economy.



Source: Bloomberg

Budget Deficit Risk:

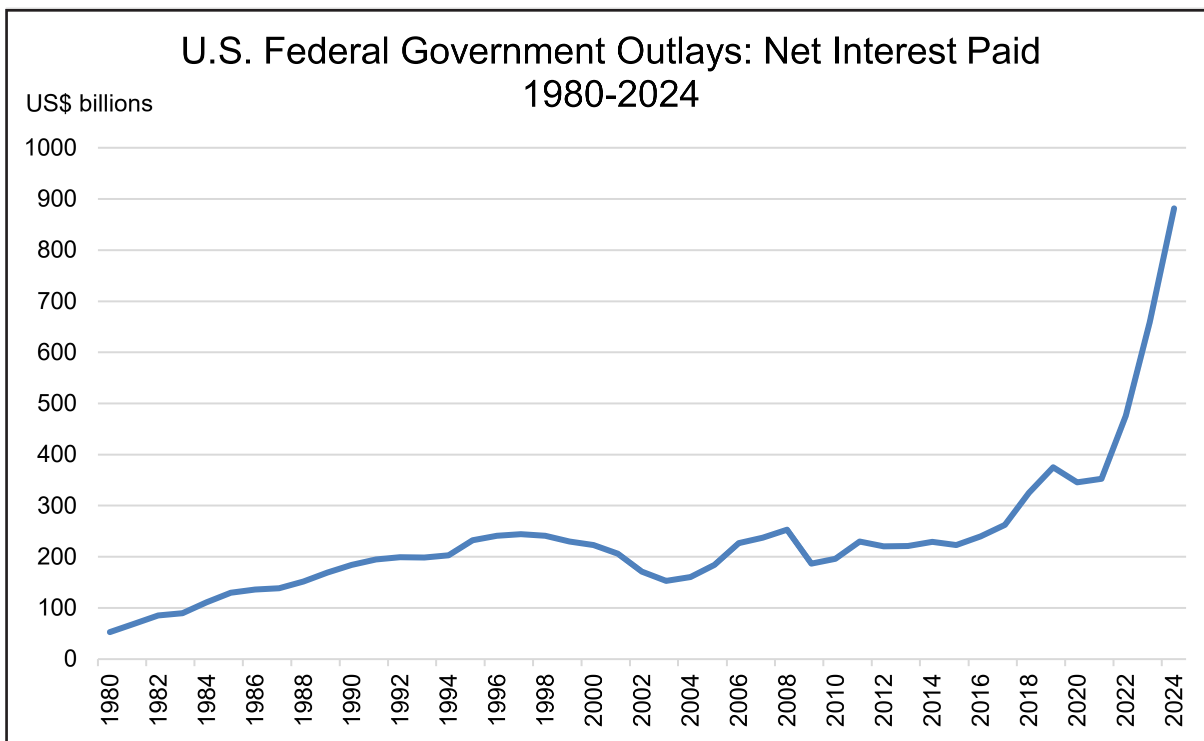
We have never seen such large government deficits from so many countries in relatively good economic times (unemployment very low). For example:

- France at 6.1% of GDP for 2024 as per Reuters
- US at 6.4% of GDP for 2024 as per CBO (forecast to rise to 6.5% for 2025)
- India at 4.8% of GDP for 2024-2025 as per Reuters (was 9% in 2020)
- UK at 4.8% of GDP for 2023-2024 as per the UK House of Commons

Those large deficits will have to be addressed with spending cuts or higher taxes or a combo of both. Either way, this is bad news to GDP growth. For instance, the US has ~$7.6 trillion of debt maturing in 2025 which will be renewed at higher rates in addition to requiring more borrowing from the current high budget deficit. This will result in an increase of close to $200 billion of interest expenses (about the same again in 2026 and 2027).

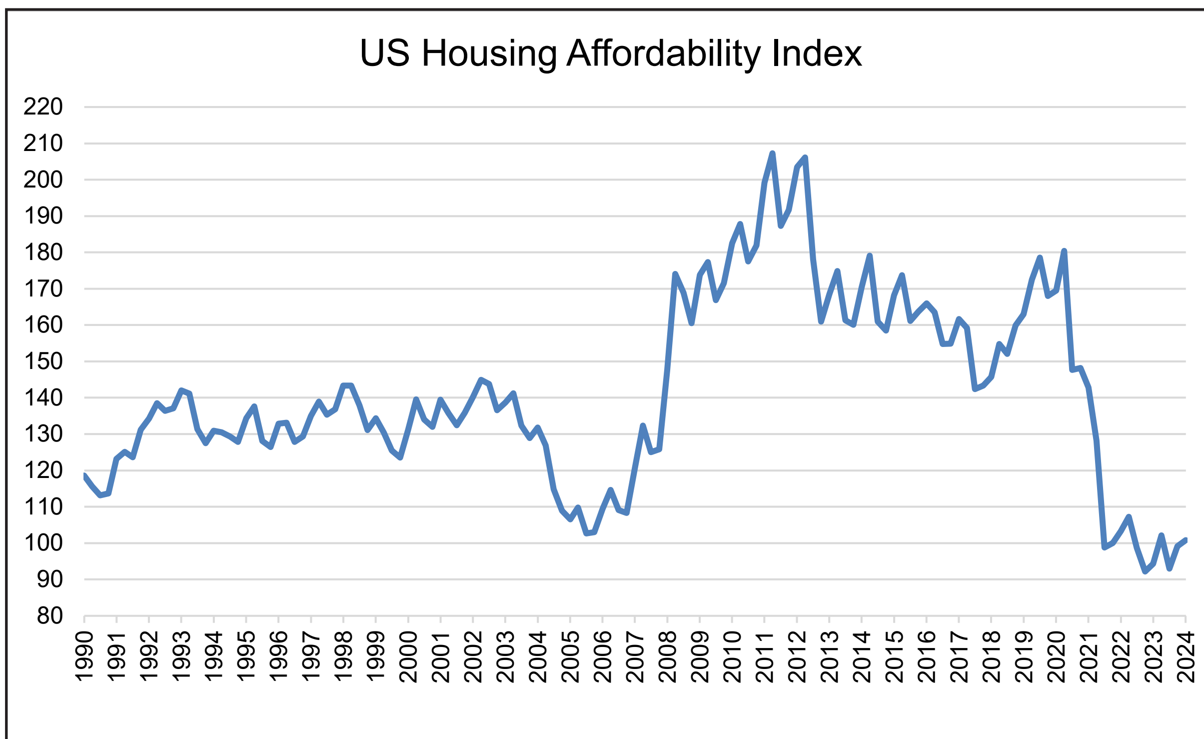
Those deficits will get worse when we fall into a recession. Already for the first four months of fiscal year 2025 (October 24'-January 25'), the deficit is predicted to be $838 billion, $306 billion worse than the same period in last year.[1] One silver lining remains D.O.G.E, the Department Of Government Efficiency, has now become operational and there is hope the deficit will come down hard in the next few years.

1 Congressional Budget Office; Department of the Treasury



Source: St. Louis Fed, Timelo

Significant decline in housing construction: As housing is a big-ticket item, if we were to see a big drop, it would definitely increase unemployment and maybe cause a recession. Affordability is at the lowest level currently because of high mortgage rates and the fact the average home price has gone up substantially in the last 5 years. Check out the following chart:

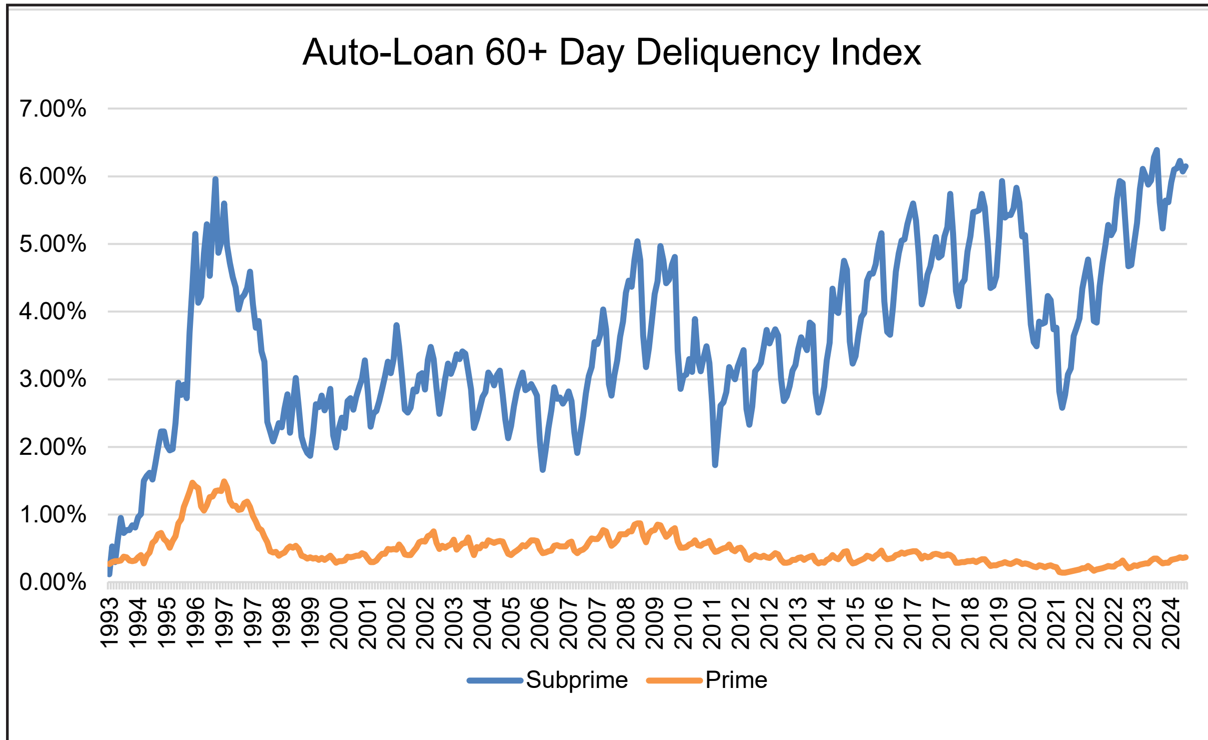


Source: National Association of Realtors

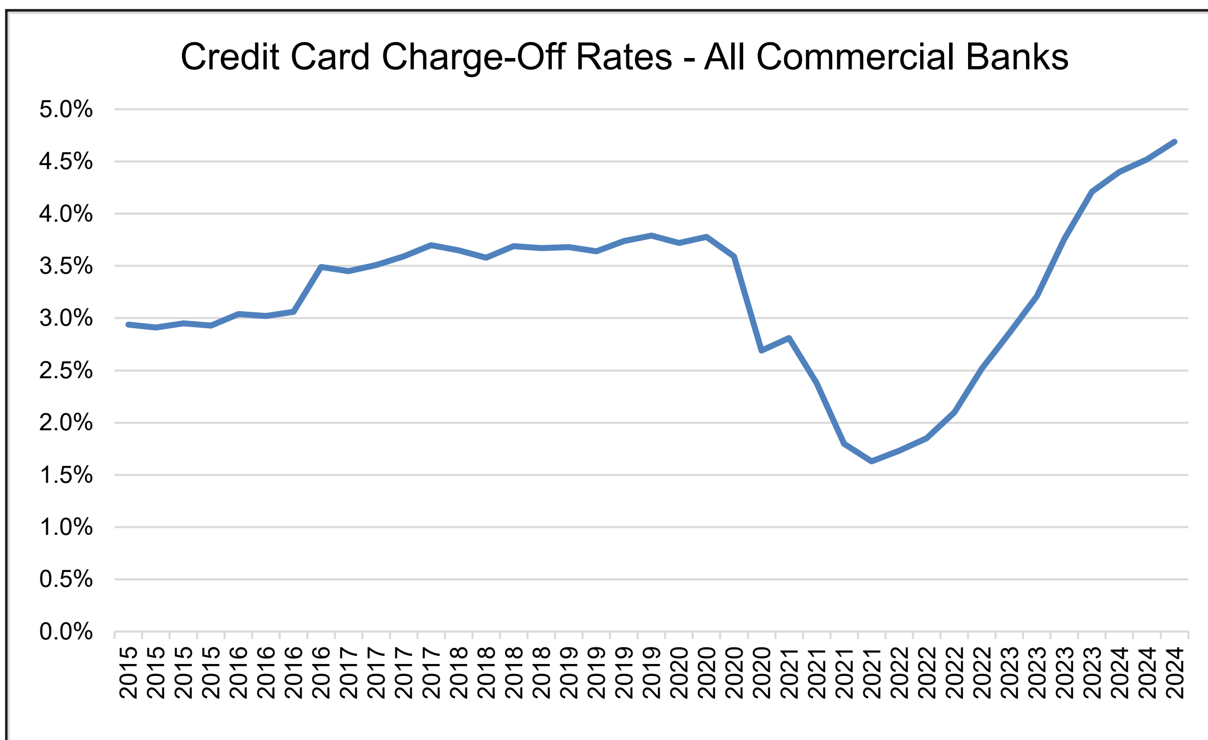
Population growth stalling (less people = less economic growth):

Canada and USA had huge population growth (legal and illegal immigration) over the last few years boosting real and nominal GDP. Since then, both countries have made the decision to reverse this population growth (at least temporarily). The lack of population growth is just going to be another hurdle to GDP, something we have rarely seen in the past.

Car & Credit card losses show us there is a good portion of the population not doing well:



Source: Fitch



Source: FRED

The bottom line is this: We will have a recession sooner or later. Remember, on average, stocks go down between 20% and 40%. But the next recession could be worse, as the debt, interest expense, valuation of the large-cap stocks are all at extreme. Be careful out there.

Once and when we are in a recession, a bear market will ensue.

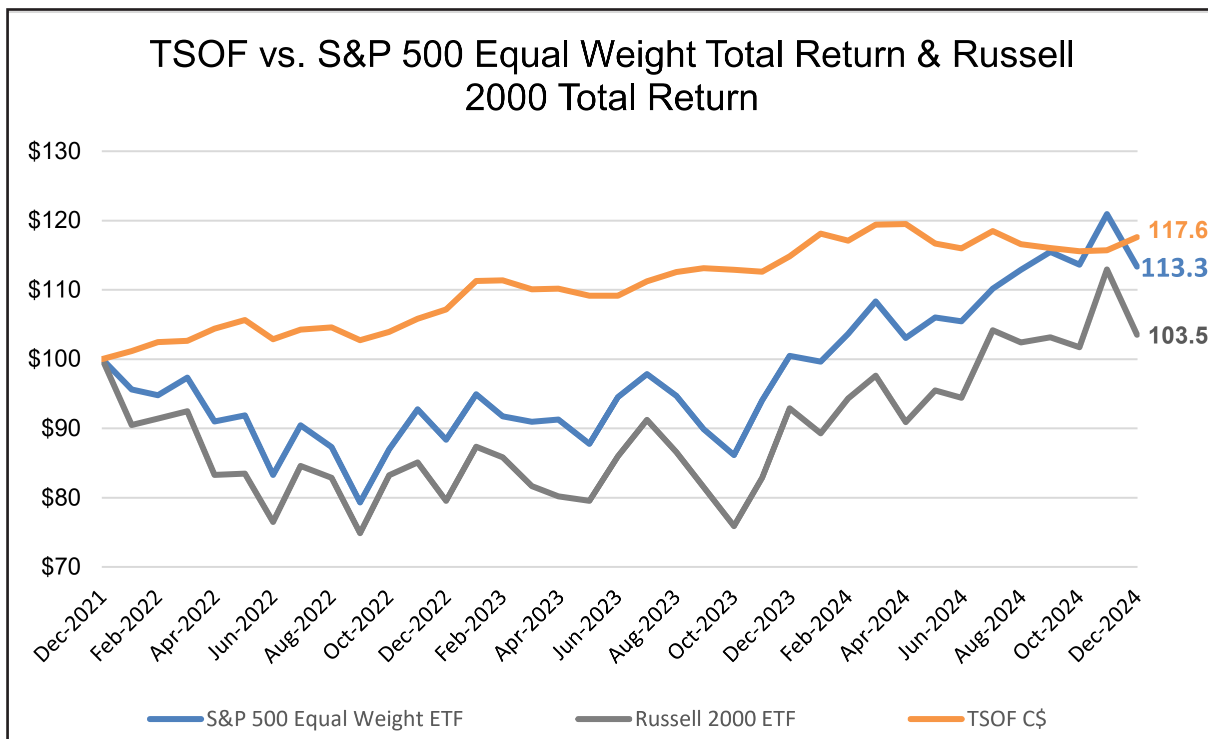
In a bear market, "buy the dip" doesn't work – and today the crowd doing this strategy of buying the dips is bigger than ever. Proof of this is the net buying of ETFs on NVDA crash day where 10 of the top US ETFs brought in $10.5bln in fund flows.

Portfolio Positioning

We will fully recognize that 2024 wasn't our greatest year or even disappointing, Rome wasn't built in a day. If we look at the return for the average stock from the beginning of 2022 to the end of 2024 (which included a bad year and two great years for the markets for the average stock), someone could conclude we are on the path of achieving reasonable return with less volatility through a full cycle.

To show this more clearly, let's look at $RSP which represents the return of the average stock (equal weighted) of the S&P500 compared to our return. It's even better if we adjust for volatility – check the chart below.

The future is exciting as there are so many opportunities on the short side with lots of stocks at record-breaking valuations ready for huge drawdowns as well a many great opportunities on the long side with extreme low valuations for stocks that are outside the indices. Although, patience will definitely be required as the timing of seeing the bubbles burst is unknown, the opportunities are clearly there over a long-term horizon.



Source: Factset, Timelo

In summary, as explained in this long comment, we believe the risks and sentiment are generally too high toward the large cap and the best ideas (risk/reward adjusted) remain in the smaller companies that are not part of big indexes. Chasing expensive names is like playing the musical chairs game. The music will stop soon in our opinion. We still see too many negative economic signposts and a potential recession, especially considering the efforts to bring down the high budget deficits of many countries (cutting government spending is good for the long term and bad for GDP growth in the short term). We remain focused on putting more money into our highest conviction ideas but keeping an overall low net exposure to the markets. We intend to take advantage of the upcoming higher volatility that we are predicting.

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