GW&K MARKET INSIGHTS

Transcript of 4Q24 conversation with Harold Kotler & Bill Sterling

GW&K INVESTMENT MANAGEMENT

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We invite you to [listen to] our quarterly conversation with Harold Kotler, Bill Sterling, and moderator Dan Fasciano as they review events from the fourth quarter of 2024 and discuss:

- The potential impact of the new US administration on the economy and markets;
- The importance of recognizing how important the outcomes of public sector and private sector cooperation in the US could be — for example, in creating new artificial intelligence (AI) infrastructure; and
- Where they are seeing risks and opportunities in the markets now.

Edited transcript

Dan Fasciano: Welcome to the Fourth Quarter Client Conference call for GW&K Investment Management. This call represents the views and opinions of GW&K Investment Management and does not constitute investment advice, nor should it be considered predictive of any future market performance.

My name is Dan Fasciano, Director of Private Wealth here at GW&K. Joining me on today's call is Harold Kotler, GW&K's Founder-Chairman and Chief Investment Officer, as well as Bill Sterling, our Global Strategist.

Harold, I'm going to start with you. New year and new-ish administration. As you've reflected upon some of the larger themes coming into the year, what observations or advice can you share about the economy and markets? And I think more importantly for a lot of us, what are you looking at?

Harold Kotler: I love the word "new-ish". Where's the "ish"? It's a totally new administration. And I think that's the theme. We just had our investment meeting this morning and I was trying to emphasize that this cooperation between the public sector and the private sector is really a game changer. And despite the personalities in Washington, it's very important for people to understand that this cooperation could have a long-term meaningful effect, and we have to be really willing to keep our eyes open and look at the opportunities that are going to be presented to the investment world and consider how we can take full advantage of the new world that's unfolding — whether it's a $500 billion new project or $300 billion, who knows? It's not important. It's the direction.

The investment business is always about incremental change. That's what we invest in, and the incremental change is positive and to the extent and degree, we don't know. But that's less important than the direction. So, I'm very optimistic. And I think: Put aside personalities, don't let that dissuade you, think positive about what's happening and, I think you all will be better off.

Dan Fasciano: That's great perspective. And I think in these times, separating personalities is helpful. Bill, I want to stick on this theme. And a similar question, I guess, but through a global lens: As you scan across the global macroeconomic landscape, what are some of the themes you're paying closest attention to? And I know you've been asked a fair amount about tariffs. Have you given much thought to the implications there, and are there any other areas we should be watching here in the US or elsewhere?

Bill Sterling: Sure, Dan. I think when you look at the global landscape, so-called American exceptionalism is continuing to be an important theme. In other words, US growth has been more robust than growth in Europe, Japan, and much of the rest of the world, including China. And that looks like it's set to continue particularly if, the new administration pursues pro-growth policies in terms of regulation and tax cuts and the like. AI is obviously an important theme that continues or even is accelerating here in terms of its implications for the US economy and then eventually the world economy, as well.

On the tariff side, that's obviously kind of a question mark or a wildcard here. There are many in the markets who think that Trump's bark will be worse than his bite, so to speak, and that there is a lot of, basically threats of tariffs, to be used as leverage to get better trade agreements with our partners, whether they're in Mexico and Canada or even in China. Obviously, if you were to go, full monty with very, very high tariffs imposed, that would create some, you know, at least short-term inflation implications and challenges for the Federal Reserve. But so far, I think the jury's out on how big of an impediment, tariffs could be to the overall economic growth and prosperity picture.

Dan Fasciano: Thanks, Bill. Harold, I want to take a point that Bill just raised. He said that US growth continues to lead the world here. We just closed the books on 2024, and US large caps are again the performance bellwether globally. The S&P returned about 25%, and most other global asset classes were in the rearview mirror. You've proven yourself a successful long-term investor. What are you making of all of this? And when you look out over the next 1 to 3 years, where do you see the opportunities and where do you see the risks?

Harold Kotler: Well, I think the opportunity is the small cap area. The argument has always been that small cap depends upon short-term rates coming down. Because they borrow more from banks than from long-term debt. And that short rates may not come down as quickly, which is possible. But that doesn't mean that it's not a good place to invest.

I think the ability to free companies from merging and acquisitions and consolidation in the small cap area, that entrepreneurship is still alive and well, and they have underperformed dramatically from certainly the largest seven companies that everybody talks about. So, I think there's great opportunity for small cap land ahead.

But I do want to say these large cap companies — and we had a discussion about this just this morning. People say, oh, they're so expensive. And everybody goes back to the bubble in the late 1990s, when stocks were selling at infinite multiples. This is not a bubble. Yes, they sell at 35 times earnings. But at 35 times earnings, if they continue to grow at 15% to 20%, it's well justified. You don't have to grow at 30% – 35%. That's not required to justify a 20% – 30%, 30x multiple. So, I think there are opportunities everywhere. But certainly the one that has lagged the most and I would put the most emphasis on is the small caps.

Dan Fasciano: I do appreciate the way you just kind of went right there and put a stamp on it. And it's good to hear. You touched on that relationship between small caps, in particular, and rates. Bill, let me go back to you for a moment here. The Fed had held its targeted fed funds rate between 5.25% and 5.5% for more than a year. And then we got to late in the third quarter last year and at the final three meetings, lowered targeted fed funds by 100 basis points. Let me start off by asking, what's currently priced in for 2025? But more importantly, where do you land on this growth/inflation picture here in the US? And let me pile on one more: Are there any themes we should be watching as we make our way through 2025?

Bill Sterling: I think what's priced in is another 1 to 2 cuts to the fed funds rate over the course of this year. But, you know, with the proviso that that requires inflation and growth to settle down to more sustainable levels. Maybe the surprise in recent months has been that US GDP growth has continued to run around 3%, which is well above its 2% type of trend rate and inflation's been a little sticky, as well. So, I think the Fed is probably on pause for the next few months here, but sometime — probably June, July — they'll be ready to cut again; and maybe once more by the end of the year. I think that's most likely. Then in terms of themes to monitor, I think the wild card, as I mentioned earlier, is tariffs — to the extent that those are large and result in higher-for-longer inflation – could have higher-for-longer implications for the Fed as one risk scenario. But as I said, the jury's still very much out on that topic.

Dan Fasciano: Harold, you went right into the kind of equity conversation, and where you saw the opportunities. But as Bill was talking a little bit about what he's seeing in terms of Fed activity, maybe we'll move on to rates here. As I looked at the screens this morning, you can get a 2-year municipal bond offering, for about 2.75% of yield; go a little further out, maybe 10 years in munis, and you can get about 3%. I can run out right now and buy a 2-year Treasury note and maybe get 4.25%. So, while you've given us a positive backdrop on equities, particularly small caps, should I go out and buy a 2-year Treasury right now and get 4.25%?

Harold Kotler: I think it's fair to say that the yield curve is going to be pretty stagnant this year, whether the long rates are 4%, 4.5%, maybe 5% at the worst time this year, with a bad reading. You're going to get your coupon, you're going to get your cash flow, you're going to get your protection. Bonds offer you a stable, I think, valuation and cash flow. Where you go in the yield curve is your choice, and what instrument you use is your choice. But I think the key is that there's not going to be a dramatic shift in interest rates this year. People think rates are so high at 4% or 4.5%, but people in my age group who bought their first house decades ago paid a lot more, and that 4% or 5% is about the average in the United States.

So, it's a normalized rate. The other part of this is that people have to adjust the internal rate of return, and the real estate market is stuck because no one wants to move assets at these cap rates. But you know what? We'll get used to it. And rather than getting a 20% – 25% internal rate of return, you get a 17% – 19% internal rate return. It's going to be the new world. But it's not so bad. We have to get used to the environment. You know, it was zero and investors were thinking the world's coming to an end, and now there's some stability. I think within stability things will start to happen.

Dan Fasciano: It's really great perspective, and really one drawn upon experience which is helpful to hear. Thank you for that. Bill, I can't get through this call without going back to a point you raised earlier about AI. If you ask anyone, I think it's safe to say that the topic has evolved from being largely academic to really now an omnipresent theme.

Harold talked earlier about public-private cooperation. The new administration has already announced a $500 billion, multi-year infrastructure program. You've shared views about AI in past writings and conversations. Can you give us some of the real-world applications you're seeing? And more importantly, I suppose, what are you making of AI as it relates to growth, productivity, and potentially things for us to watch for?

Bill Sterling: I think it's obviously a very important theme because it has the potential to raise the productivity growth rate of the US economy substantially. In the late 1990s and early 2000s, we had productivity in the US running at 3% annualized, and then it fell back down to around 1% – 1.5%, thereafter. I think there's a good chance in the next decade it gets up to 3% again. That would mean a $7 trillion bigger US economy even just 10 years from now, even though those numbers sound small, they're very important. But when you look at real world implications, the rate of progress of the AI models coming out of the leading tech firms, continues to be astonishing. You're already seeing software developers almost double their productivity based on using these tools.

I think what's happening in the area of self-driving vehicles is fascinating. With some of the advances Tesla has been making, or, Google's Waymo division with the self-driving taxis you see in many cities now. This $500 billion, so-called Stargate venture by OpenAI, Oracle, and SoftBank, who are teaming up with Microsoft and Nvidia — $500 billion is an incredible amount of infrastructure spending that's being planned over just the next four years.

I did a little historical analysis to see how big the Manhattan Project was back in the 1940s, and that was about $30 billion in today's dollars. So, this is about 17 times bigger than the Manhattan Project, that's largely being funded by the private sector, but with considerable encouragement from the new administration. I think we still are in the early innings of what AI could mean for the economy, but at the end of the day, it probably means greater productivity and greater prosperity.

Harold Kotler: I have to endorse what Bill just said. There are skeptics, but I think that would be a very big mistake. Yes, we don't know how it's going to evolve. I saw an interview on medicine, technology, and cancer research and how it applies to health care. It's truly going to be a game changer. I wrote in one of my quarterly letters that it's like inventing the wheel. People can pooh-pooh that, but I think it's like inventing the wheel. This changes the value, the proposition, the success rate, the intelligence. It's really, really wonderful. And to have a government participating with the private sector and encouraging it, we're all just driving to change to make the world a better place. And I think this will.

Dan Fasciano: You know, we've kind of gone through the questions quickly enough here. I want to follow up with that. You don't think there's too much hype at this moment with AI, Harold?

Harold Kotler: I think that's the mistake. I think because many people dislike the personalities in Washington, they dismiss it as over-hyped. And I think that's a mistake. Get through it. This is not about personalities. This is about technology. This is about the private sector. This is about capital going to the right area at the right time and making it work. And if you want to get bogged down in stuff, then you'll miss it.

Dan Fasciano: Bill, I asked you earlier and maybe final question to you. Are you a user of AI currently? Where are you seeing it in our industry or around you?

Bill Sterling: Oh, sure. I think, like many people, I try all the AI models, and it's great for generating ideas, or doing research on any topic you can imagine. And it just keeps getting better and better month after month. As I mentioned, I think what it's going to do for computer programing productivity is astonishing. Beyond that, many people in the AI world that I follow are thinking we could end up with 100 years of technological progress over the next decade or two, based on the accelerating advances from basically research and development that will be created by having millions and millions, essentially, of artificial drop-in remote workers that are being created by AI as it moves to creating more and more agents that will be able to operate on their own. So, I think it's still early days in that transition.

Dan Fasciano: Well, I certainly appreciate both of your perspectives on all topics, but that one specifically. Guys, I want to thank you both for sharing your thoughts.

As always, should anyone listening in have follow-up questions, please do get in touch with your GW&K advisor, and to all our clients and friends listening in, we hope you have a happy and healthy start to the new year. We'll look forward to reconvening in April. Take care.

Disclosure