May 2024

From this weekend's WSJ:

Dow Rallies as Stocks Log Monthly Gain

The Nasdaq ended the month up 6.9% despite a recent tech-stock stumble

BY RYAN DEZEMBER

A late-day rally drove the Dow up 575 points and helped all three major stock indexes finish May higher despite a recent swoon in technology stocks.

Stocks opened higher Friday following the premarket release of the Federal Reserve's preferred inflation gauge. The personal-consumption expenditures price index broadly matched Wall Street expectations, posting a 2.7% gain in April from a year ago.

Traders pulled back after a closely watched gauge of economic activity, the Chicago Business Barometer, fell deeper into contraction territory to register its lowest level in four years.

Buyers poured into the market about 15 minutes before the closing bell to bring every sector in the S&P 500 but energy into the green for May.

The Dow Jones Industrial Average added 1.5% to finish May up 2.3%. The S&P 500 gained 0.8% Friday to end the month 4.8% higher.

The Nasdaq Composite shed less than 0.1% on Friday, the third straight daily decline for the tech-filled basket of stocks. ...

Treasury yields declined Friday. The yield on the benchmark 10-year note ended at 4.512%, down from ... the year-to-date high of 4.706% hit in late April. ...

The era of low interest rates had investors piling into expensive growth stocks during down markets.

Lately, though, they have been seeking safety in shares that trade at much lower multiples of future earnings than technology stocks, such as utilities and energy. ...

From May 24th's Global Investment Strategy:

The Narrow Path To A Soft Landing

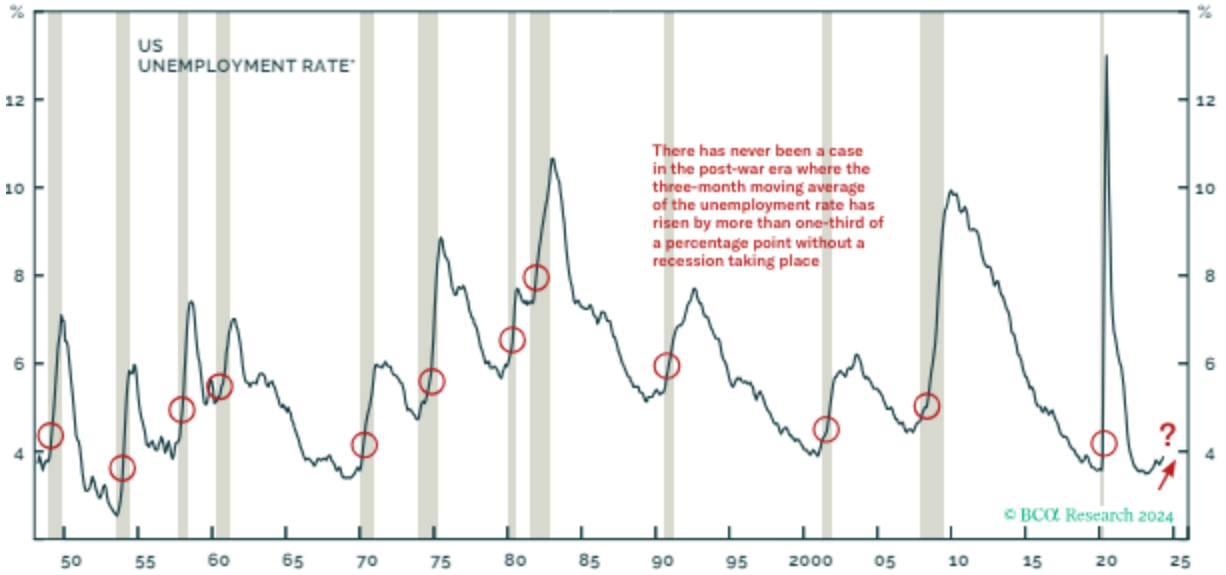
... the probability is reasonably high – around 80% – that the US and many other major economies will succumb to a recession by the end of 2025.

... Focusing on the US, here is what we are hoping to see in order to gain more confidence in a soft-landing scenario:

1. Soft Landing for the US Labor Market

CHART 1

The Unemployment Rate Is A Highly Mean-Reverting Series



* SHOWN AS A 3-MONTH MOVING AVERAGE.

NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS; CIRCLES IN THE CHART DENOTE THE TIMES WHEN THE 3-MONTH MOVING AVERAGE OF THE UNEMPLOYMENT RATE INCREASED BY MORE THAN ONE-THIRD OF A PERCENTAGE POINT FROM PRIOR LOWS.

The US unemployment rate is a highly mean-reverting series. Usually, when it reaches very low levels, it starts rising again (**Chart 1**). Thus, anyone betting on a soft landing – tantamount to betting on the unemployment rate moving sideways for an extended period – is implicitly making the case for "this time is different."

Why can't the unemployment rate go down and stay down? ... When unemployment is very low, inflation becomes very sensitive to changes in the degree of slack in the economy. This means that central banks need to calibrate monetary policy almost perfectly to keep the economy from either overheating, or cooling down so much that rising unemployment begins to feed on itself.

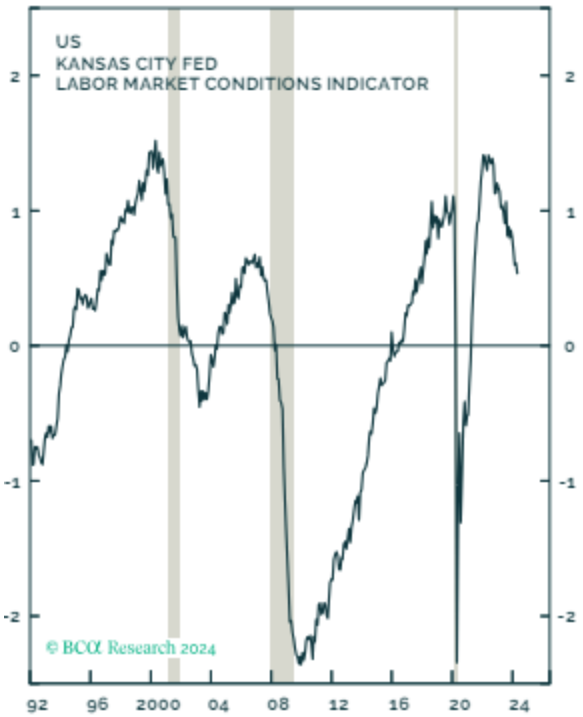
Could the Fed stick the soft landing this time? The unemployment rate has been below 4% for 27 straight months. Payrolls have grown by an average of 242K over the past three months and, coincidentally, by exactly the same number, 242K, over the prior six months. That is all good news.

Unfortunately, there is a catch: For the past two years, bountiful job openings insulated the labor market, allowing both newly unemployed workers and new entrants to easily find gainful employment. However, the jobs-workers gap – the excess of job openings over unemployed workers – has fallen by three-quarters from its peak. If the trend continues, there will be more unemployed workers than job openings by early 2025. At that point, the unemployment rate could start rising rapidly.

Admittedly, job openings are difficult to measure accurately. To supplement the official series published by the Job Openings and Labor Turnover Survey (JOLTS), we look at private-sector sources such as Indeed and LinkUp. Both sources show that

CHART 5

Labor Market Conditions Have Been Weakening Steadily



SOURCE: FEDERAL RESERVE BANK OF KANSAS CITY.

NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

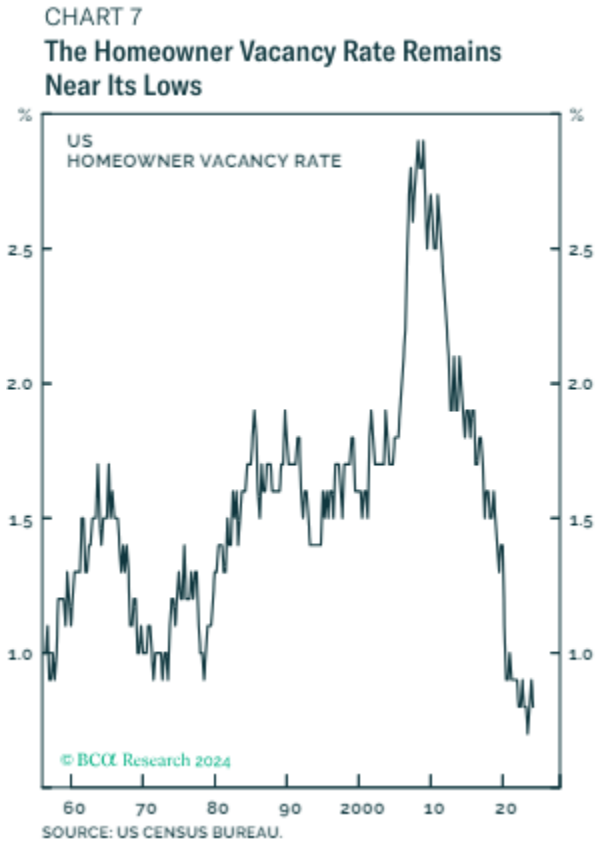
openings are declining, implying that the labor market continues to cool.

The drop in job openings is mirrored by the Kansas City Fed Labor Market Conditions Indicator, which incorporates 24 national labor market variables (**Chart 5**). The series weakened further in April, although it still remains above its historic average. The series would need to stabilize near its long-term mean to generate a soft landing. ...

2. Soft Landing for Cyclically-Sensitive Spending

In 2022, when the consensus view called for an imminent US recession, we stood out in arguing that the lack of any major imbalances in the housing and manufacturing sectors provided enough insulation to preclude a recession at least until 2024.

Two years later, the homeowner vacancy rate remains near its all-time low (**Chart 7**). This implies that single-family residential construction is unlikely to fall much further, even against the backdrop of relatively high mortgage rates.



Nevertheless, there are some concerning developments. The number of active listings on Realtor.com is up 38% in Texas and 64% in Florida, suggesting that supply may be outstripping demand in some regional markets. According to Apartment List, rent growth in those states has already turned negative.

Nationwide, the number of multifamily units under construction has begun to decline. The Apartment List National Vacancy Index has risen from a low of 3.8% in October 2021 to 6.7% in April 2024. Given that starts and permits lead building activity, multifamily construction will likely weaken for the next few years.

On the manufacturing front, the ISM new orders index has tracked our 3-year manufacturing framework, which posits that manufacturing activity typically weakens for 18 months and then strengthens for 18 months. Historically, this framework has been a good guide for gauging the outlook for everything from the relative performance of cyclical stocks and semiconductor sales to metals prices.

This time around, manufacturing new orders peaked in June 2021 and then weakened for the next 19 months before bottoming in January 2023.

Admittedly, the recovery in most manufacturing indicators has been half-hearted since then, with ISM new orders dipping back below 50 in April. While the new orders component of the US S&P manufacturing PMI improved in May, it remains under 50 for a second month running. It is difficult to know if this sluggish recovery reflects deep-seated structural challenges or whether it simply reflects the lingering hangover from the pandemic-induced surge in goods spending.

For all the talk about reshoring, friend-shoring, AI investment, and so on, our capex intentions tracker remains dead in the water.

CHART 14

A Normalization Of The Savings Rate Could Be Painful

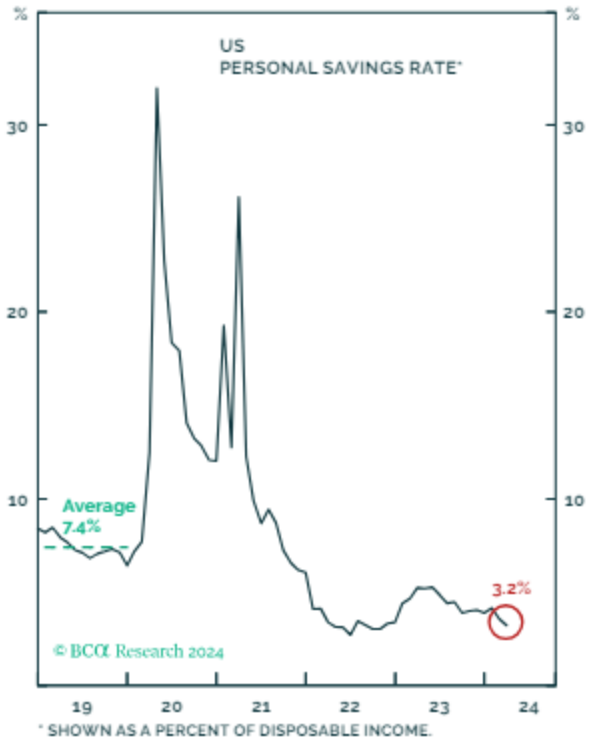
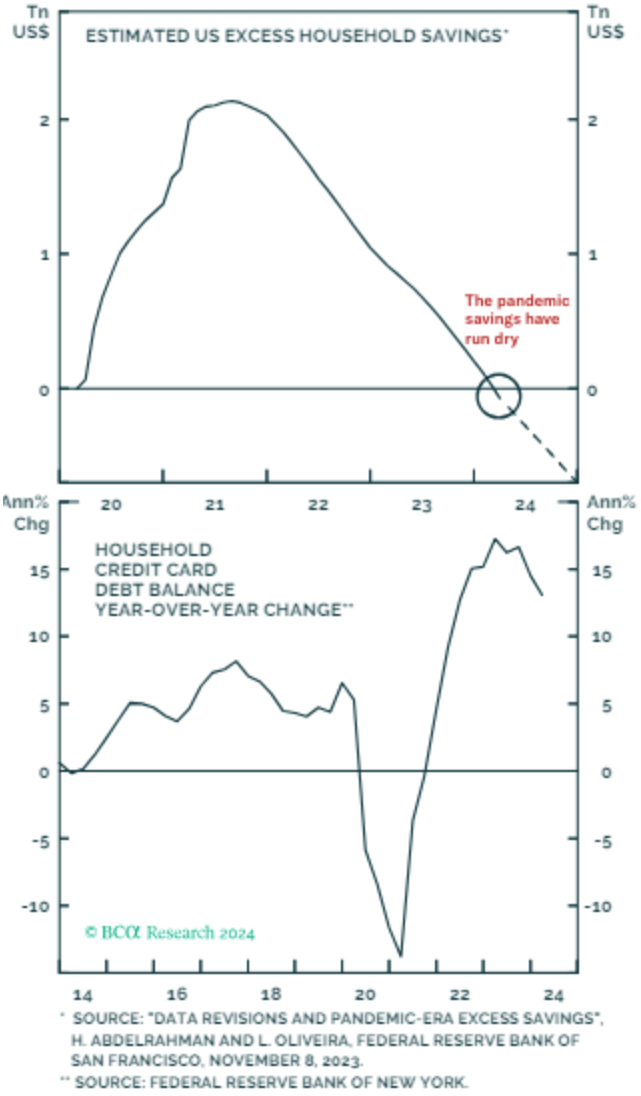


CHART 16

Consumption Tailwinds Are Fading



Productivity growth has picked up, increasing by 3% in Q1 compared to the same quarter a year ago. However, this likely reflects payback for a string of weak readings in earlier quarters. Standing back, the trend in labor productivity has not departed significantly from its pre-pandemic trend.

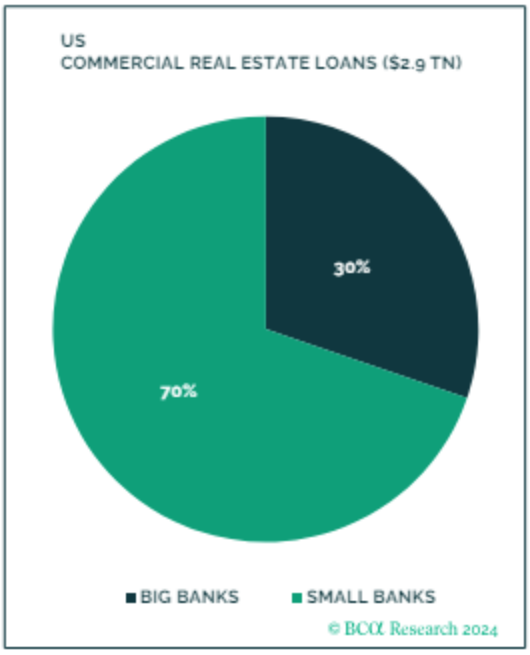
With respect to cyclically-sensitive consumer discretionary spending, the biggest challenge surrounds the low level of the personal savings rate. It hit 3.2% in April, leaving it less than half of what it was in 2019 (**Chart 14**).

The last time the savings rate was this low was during the pre-GFC housing bubble. Back then, homeowners ran up home equity lines of credit (HELOCs) to maintain high levels of spending. This time around, HELOC balances have remained restrained. Instead, households have drawn on excess pandemic savings and increasingly turned to credit card borrowing. The former have been largely exhausted, while the latter is seeing a slowdown from last year's double-digit growth rate (**Chart 16**).

To achieve a soft landing, the savings rate would need to rise to a more sustainable level but would have to do so very slowly to preclude a disorderly adjustment. That will be difficult to achieve. If many people try to save more, aggregate demand will slow, leading to weaker employment growth, and by extension, weaker income growth. Income growth could even slow so much that aggregate savings end up declining in response to higher desired savings, a phenomenon Keynes dubbed the "paradox of thrift."

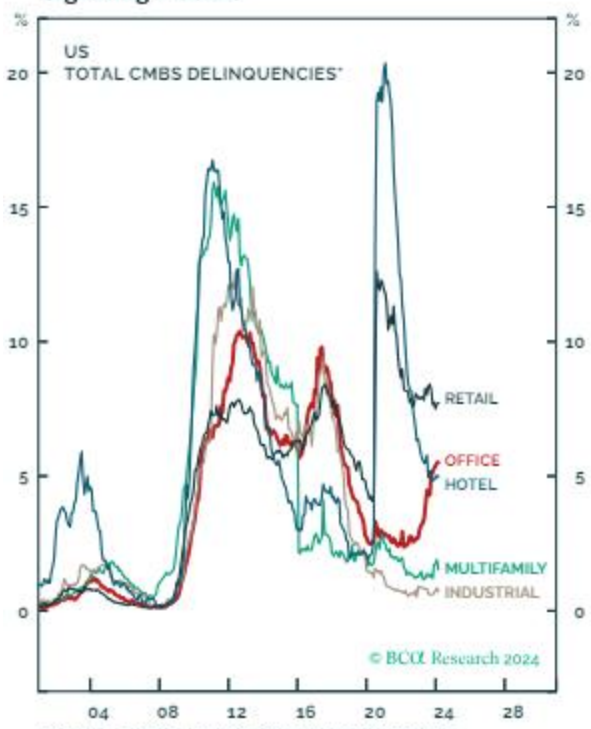
3. Soft Landing for the Financial System

CHART 18
Regional Banks Are Not Out Of The Woods (II)



SOURCE: FEDERAL RESERVE.
NOTE: DATA AS OF MAY 2024.

CHART 19
Rising Office Loan Delinquencies Are Signaling Trouble



* SOURCE: TREPP LLC, MOODY'S INVESTORS SERVICE.

Following the surprise collapse of Silicon Valley Bank last year, investors became temporarily obsessed with the health of regional banks. While those fears have passed, many of the underlying problems remain. In particular, mark-to-market losses on commercial bank balance sheets are about the same as they were a year ago.

US regional banks are still heavily exposed to commercial real estate (**Chart 18**). Delinquency rates on office loans keep trending higher (**Chart 19**). Given our earlier discussion of multifamily real estate, it is quite likely that delinquencies in that segment will increase as well.

Banks continued to tighten lending standards in Q1, albeit at a less aggressive pace than between Q2 2022 and Q3 2023. Lending standards lead loan growth by around one year. Thus, it is likely that bank lending will slow over the coming months.

This message is consistent with banks' reported decline in demand for various loans. ...

The trailing 12-month default rate on speculative-grade debt has risen from a low of 1.2% in February 2022 to 5.8%. Thanks to the thawing in capital markets, 16% fewer companies have defaulted over the past six months compared to the prior six months. This suggests that the 12-month default rate will decline over the coming months.

The problem is that investors already expect this to happen. The 12-month default rate would need to fall by more than 40%, to 3.3 percentage points, to justify the current level of corporate spreads. This may be difficult to achieve even in a soft-landing scenario. It will be next-to-impossible in a recessionary one.

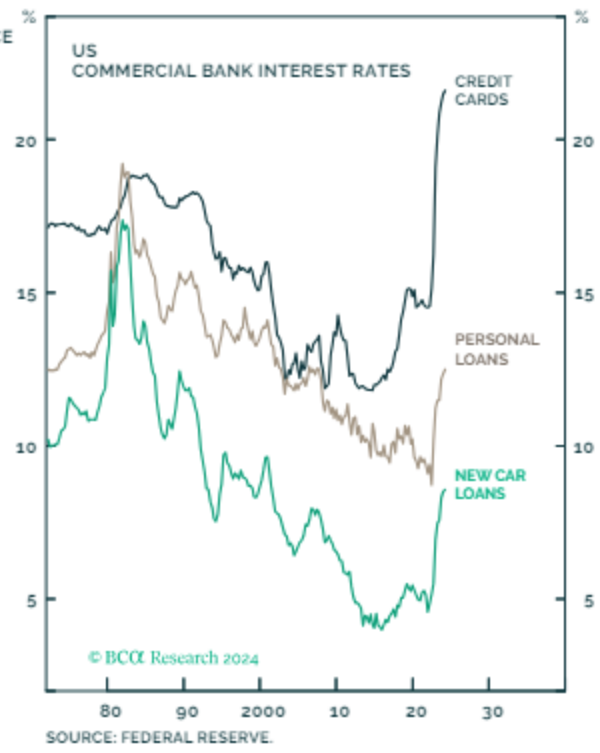
In the consumer segment, the delinquency rates on credit cards and auto loans in Q1 rose to the highest levels since 2012 – a year when the unemployment rate was over 8% (**Chart 24**). Credit card interest rates are at record highs (**Chart 25**).

CHART 24

Credit Card Delinquencies Are Back To 2012 Levels ...

CHART 25

... With Credit Card Rates At Record Highs



During their Q1 earnings calls, a number of prominent banks and credit issuers noted that charge-offs on consumer loans are starting to decline. This is good news, but it is doubtful that this trend will persist if the labor market continues to cool. To feel confident in a soft landing, we would need to see lending standards and delinquency rates stabilize.

4. Soft Landing for Inflation

US inflation reaccelerated in the first quarter, causing bond yields to rise anew. ...

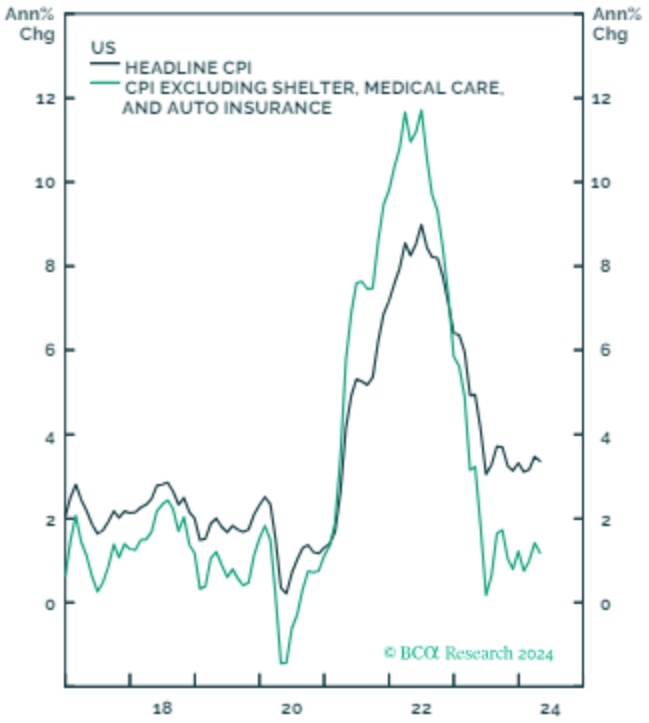
Outside of a few pandemic-related "catch-up" categories such as shelter, health care, and auto insurance, CPI inflation on a year-over-year basis has been below 2% for 12 straight months (**Chart 27**).

More fundamentally, the weakening of the US labor market is causing wage growth to moderate. It is difficult to see how inflation can rise meaningfully unless wage growth heats up again.

Nevertheless, the Fed still needs to tread carefully. The Cleveland Fed's model estimate of 10-year inflation expectations stands near a post-GFC high. Going into the pandemic, the PCE deflator was 7% below where it should have been had the price level grown by 2% per year since

CHART 27

Outside Of A Few "Catch Up" Categories, Inflation Is Back To Target



Lehman’s bankruptcy. Now, the price level is about 1% above its target-consistent trend line.

Another inflation wave could cause long-term inflation expectations to become unmoored. The Fed will not want to take that risk. This makes it more likely than not that the Fed will eventually find itself behind the curve in easing monetary policy. If that happens, a soft landing will be difficult to pull off.

5. Soft Landing for the Rest of the World

Last year, the global economy experienced a "Great Decoupling," as growth in the US rebounded but growth in most other major economies remained moribund. However, starting in April, a convergence of sorts has occurred. This can be seen in the narrowing in growth projections, economic surprise indices, and the PMIs.

The convergence in economic fortunes has led to a tightening in interest-rate differentials. This, in turn, has resulted in a modestly weaker US dollar.

Slightly cooler economic data from the US accounts for part of the convergence. So far in Q2, Goldman’s US Current Activity Indicator has averaged 0.5% compared with 0.9% over the previous four quarters.

The bulk of the narrowing gap in growth expectations can be attributed to stronger data in a few other major economies. European growth, in particular, has perked up, thanks mainly due to the stabilization in global manufacturing activity, lower energy costs, and rising real wages.

Chinese growth has also improved over the past few months on the back of rising exports. The export PMI hit a 9-month high in April.

We are skeptical that China’s export boom will last. The Biden administration has ratcheted up tariffs on Chinese imports and the EU is threatening to do the same.

China’s EV production has soared over the past three years. But with the domestic auto market saturated and Chinese EVs piling up at European ports, EV production will slow. Among other things, this could reduce copper demand.

To feel more confident in a global soft-landing scenario, we would need to see more stimulus from the Chinese authorities. The measures announced so far are inadequate, including the much-ballyhooed RMB 500 billion in funding that state-owned enterprises are set to receive to enable them to purchase vacant apartments. According to BCA’s China strategists, this program will be equivalent to only 4% of property developers’ total financing needs over the next 12 months.

Investment Conclusions

The path to a soft landing remains in place, but it is a narrow one. The most likely outcome is that the global economy will undergo a “phase transition” in late 2024 or early 2025 once labor markets cool to the point that unemployment starts rising.

Stocks typically peak a few months before recessions begin. If concerns over inflation subside before concerns over a recession resurface, that offers a short runway for stocks to grind higher.

Whether investors seek to play what will likely be a “last hurrah” for equities is a matter of preference. Last year, we were bullish on stocks, but that was when valuations were cheaper and a recession was less imminent.

We turned neutral on global equities at the start of this year. ... we expect to downgrade stocks to underweight during the summer. ...

Follow-ups

From this weekend's WSJ:

The AI Revolution Is Already Losing Steam

The pace of innovation in AI is slowing, its usefulness is limited, and the cost of running it remains exorbitant

By Christopher Mims

Nvidia reported eye-popping revenue last week. Elon Musk just said human-level artificial intelligence is coming next year. Big tech can't seem to buy enough AI-powering chips. It sure seems like the AI hype train is just leaving the station, and we should all hop aboard.

But significant disappointment may be on the horizon, both in terms of what AI can do, and the returns it will generate for investors.

The rate of improvement for AIs is slowing, and there appear to be fewer applications than originally imagined for even the most capable of them. It is wildly expensive to build and run AI. New, competing AI models are popping up constantly, but it takes a long time for them to have a meaningful impact on how most people actually work.

These factors raise questions about whether AI could become commoditized, about its potential to produce revenue and especially profits, and whether a new economy is actually being born. They also suggest that spending on AI is probably getting ahead of itself in a way we last saw during the fiber-optic boom of the late 1990s—a boom that led to some of the biggest crashes of the first dot-com bubble.

The pace of improvement in AIs is slowing

Most of the measurable and qualitative improvements in today's large language model AIs like OpenAI's ChatGPT and Google's Gemini—including their talents for writing and analysis—come down to shoving ever more data into them.

These models work by digesting huge volumes of text, and it's undeniable that up to now, simply adding more has led to better capabilities. But a major barrier to continuing down this path is that companies have already trained their AIs on more or less the entire internet, and are running out of additional data to hoover up. There aren't 10 more internets' worth of human-generated content for today's AIs to inhale.

To train next generation AIs, engineers are turning to "synthetic data," which is data generated by other AIs. That approach didn't work to create better self-driving technology for vehicles, and there is plenty of evidence it will be no better for large language models, says Gary Marcus, a cognitive scientist who sold an AI startup to Uber in 2016.

AIs like ChatGPT rapidly got better in their early days, but what we've seen in the past 14-and-a-half months are only incremental gains, says Marcus. "The truth is, the core capabilities of these systems have either reached a plateau, or at least have slowed down in their improvement," he adds.

Further evidence of the slowdown in improvement of AIs can be found in research showing that the gaps between the performance of various AI models are closing. All of the best proprietary AI models are converging on about the same scores on tests of their abilities, and even free, open-source models, like those from Meta and Mistral, are catching up.

AI could become a commodity

A mature technology is one where everyone knows how to build it. Absent profound breakthroughs—which become exceedingly rare—no one has an edge in performance. At the same time, companies look for efficiencies, and whoever is winning shifts from who is in the lead to who can cut costs to the bone. The last major technology this happened with was electric vehicles, and now it appears to be happening to AI.

The commoditization of AI is one reason that Anshu Sharma, chief executive of data and AI-privacy startup Skyflow, and a former vice president at business-software giant Salesforce, thinks that the future for AI startups—like OpenAI and Anthropic—could be dim. While he's optimistic that big companies like Microsoft and Google will be able to entice enough users to make their AI investments worthwhile, doing so will require spending vast amounts of money over a long period of time, leaving even the best-funded AI startups—with their comparatively paltry warchests—unable to compete.

This is happening already. Some AI startups have already run into turmoil, including Inflection AI—its co-founder and other employees decamped for Microsoft in March. The CEO of Stability AI, which built the popular image-generation AI tool Stable Diffusion, left abruptly in March. Many other AI startups, even well-funded ones, are apparently in talks to sell themselves.

Today's AI's remain ruinously expensive to run

An oft-cited figure in arguments that we're in an AI bubble is a calculation by Silicon Valley venture-capital firm Sequoia that the industry spent $50 billion on chips from Nvidia to train AI in 2023, but brought in only $3 billion in revenue.

That difference is alarming, but what really matters to the long-term health of the industry is how much it costs to run AIs.

Numbers are almost impossible to come by, and estimates vary widely, but the bottom line is that for a popular service that relies on generative AI, the costs of running it far exceed the already eye-watering cost of training it. That's because AI has to think anew every single time something is asked of it, and the resources that AI uses when it generates an answer are far larger than what it takes to, say, return a conventional search result. For an almost entirely ad-supported company like Google, which is now offering AI-generated summaries across billions of search results, analysts believe delivering AI answers on those searches will eat into the company's margins.

In their most recent earnings reports, Google, Microsoft and others said their revenue from cloud services went up, which they attributed in part to those services powering other company's AIs. But sustaining that revenue

depends on other companies and startups getting enough value out of AI to justify continuing to fork over billions of dollars to train and run those systems. That brings us to the question of adoption.

Narrow use cases, slow adoption

A recent survey conducted by Microsoft and LinkedIn found that three in four white-collar workers now use AI at work. Another survey, from corporate expense-management and tracking company Ramp, shows about a third of companies pay for at least one AI tool, up from 21% a year ago.

This suggests there is a massive gulf between the number of workers who are just playing with AI, and the subset who rely on it and pay for it. Microsoft's AI Copilot, for example, costs $30 a month.

OpenAI doesn't disclose its annual revenue, but the Financial Times reported in December that it was at least $2 billion, and that the company thought it could double that amount by 2025.

That is still a far cry from the revenue needed to justify OpenAI's now nearly $90 billion valuation. The company's recent demo of its voice-powered features led to a 22% one-day jump in mobile subscriptions, according to analytics firm Appfigures. This shows the company excels at generating interest and attention, but it's unclear how many of those users will stick around.

Evidence suggests AI isn't nearly the productivity booster it has been touted as, says Peter Cappelli, a professor of management at the University of Pennsylvania's Wharton School. While these systems can help some people do their jobs, they can't actually replace them. This means they are unlikely to help companies save on payroll. He compares it to the way that self-driving trucks have been slow to arrive, in part because it turns out that driving a truck is just one part of a truck driver's job.

Add in the myriad challenges of using AI at work. For example, AIs still make up fake information, which means they require someone knowledgeable to use them. Also, getting the most out of open-ended chatbots isn't intuitive, and workers will need significant training and time to adjust.

Changing people's mindsets and habits will be among the biggest barriers to swift adoption of AI. That is a remarkably consistent pattern across the rollout of all new technologies.

None of this is to say that today's AI won't, in the long run, transform all sorts of jobs and industries. The problem is that the current level of investment—in startups and by big companies—seems to be predicated on the idea that AI is going to get so much better, so fast, and be adopted so quickly that its impact on our lives and the economy is hard to comprehend.

Mounting evidence suggests that won't be the case.

Positions

As clients focused on Capital Appreciation, including individual stocks may have noticed, the cash in their accounts has been climbing. This is the direct result of there not being any stocks that meet our buying criteria. While we could add to Funds, with Excessive Optimism, waning Momentum, and the S&P 500, Nasdaq, and Dow near all time highs, we are more comfortable holding excess cash at this time.

CLF - fell 11.1%, 3.8x average volume on a 4/23 Negative Earnings Surprise (-.31 actual vs. -.063 estimate). On 5/14 there were 2 Buy, 4 Hold, 2 Sell recommendations with an average Target Price (TP) of 20.08 from the 6 analysts that had updated their recommendations post earnings, with 1 maintaining, and 5 lowering their TP. Earnings estimates for the quarter ending 6/24 dropped .302, and .158 for 9/24. We sold for 3 clients @ 18.02.

HEES - fell 18.5%, 7.6x average volume on a 4/30 Negative Earnings Surprise (.6771 vs. .853), and another 7.3%, 3.4x on 5/1. On 5/22 there were 2 Buy recommendations with an average Target Price (TP) of 68.66 from the 2 analysts that had updated their recommendations post earnings, with both lowering their TP. Earnings estimates for the quarter ending 6/24 dropped .232, and .206 for 9/24. We sold for 4 clients @ 48.33.