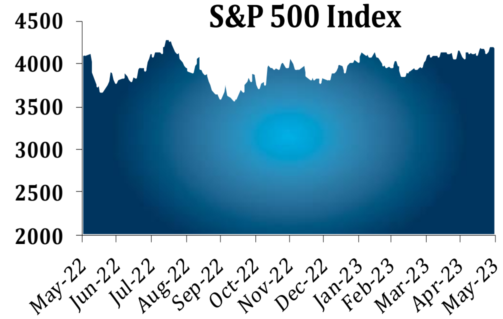
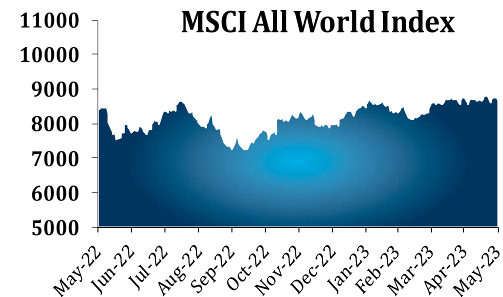
This Month in the Markets

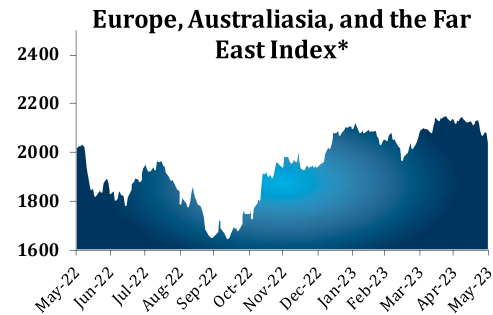
May 2023

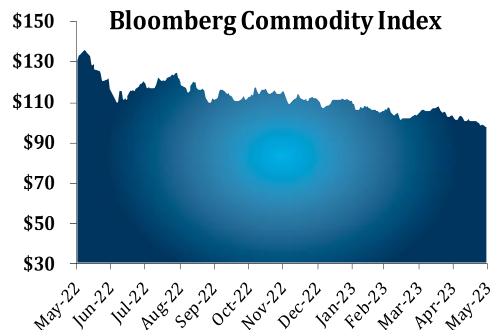
Equity Commentary

Analyzing AI









*MSCI EAFE Index

The equity market stalled in May as the MSCI ACWI Index fell 1%. The MSCI ACWI World Value Index declined 4.2% compared to the rise of 2.0% in the MSCI All Country World Growth Index. The bulk of this significant divergence was likely due to the explosive returns in artificial intelligence ("AI") related stocks versus "old economy" names (see further commentary below). International markets underperformed the U.S. as the S&P 500 gained 0.4%, and the MSCI EAFE and Emerging Market Indices slid 4.1% and 1.7%, respectively. The leadership in the U.S. market was narrow, driven by large-cap technology shares, as the S&P 500 Equal Weighted Index lost 4%. The MSCI ACWI Information Technology Sector index was the top performer, posting a gain of 8.2%, driven by a surge in AI-exposed names. The MSCI ACWI Energy Sector was the under-performer, with a loss of 9.0% as the price of crude collapsed in the month, falling 8.9%.

ChatGPT and AI have become front-page news. Peter Berezin from BCA Research has a great series of videos on Twitter which aligns with much of our thinking below and can be found here:

www.twitter.com/PeterBerezinBCA/status/1662536915281666052

The following are some brief thoughts on the space and potential implications from an economic and investing angle.

1. AI is likely to follow an exponential path and not a linear path of development. This means the changes, benefits, and risks will be more rapid than in some prior historical disruptions. AI and large language models that back generative processes do not need to sleep. They get better and better and more optimized at increasing scale. This is unlike some mechanized developments in history and is likely to lead to a greater breadth of disruption at a faster pace.

2. Discerning the winners and losers from this phase change will be essential as disruption and economic dislocation could happen rapidly. Current long-term winners with large moats and competitive advantages may differ from the future beneficiaries. Winners could quickly become losers, and losers could suddenly become winners. The disruption could be massive in scope and speed.

3. There are potential devastating security risks. According to a survey conducted by Reuters/Ipsos, 61% of respondents believe AI is a risk to humanity.* Mr. Berezin recently stated, "The safety risks around AI are huge, and we think there is more than 50/50 chance AI will wipe out all of humanity by the middle of the century". If AI is used maliciously, it can potentially unleash devastating consequences as its power of destruction could be significant. Governments and interest groups are pushing for regulation and safeguards to hold this in check. Still, it's unclear if these will be developed promptly or even advanced enough to throttle back progress in a safe manner.

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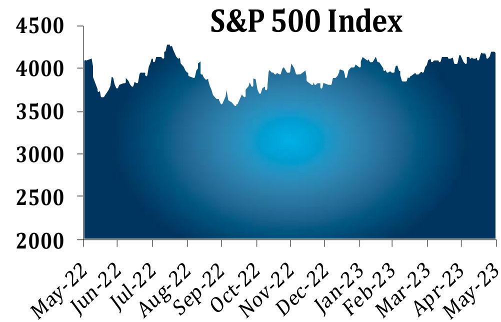
Equity Commentary

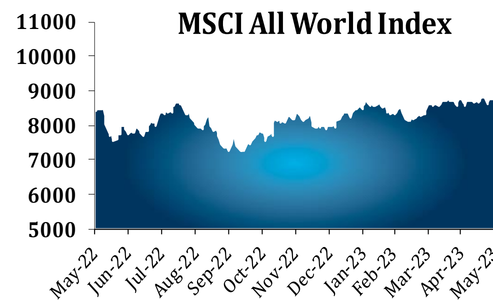
4. There could be multiple effects from a labor and economic perspective. If one thinks about the industrial and agricultural revolutions, both led to rapid economic growth. Similarly, AI should boost productivity significantly and, thus growth, in a more pronounced way. The offset to this, however, may be the substantial decline in various jobs as tasks get automated and even creative endeavors get replaced. The risk is that, because of the broad swath of jobs that can be affected, the labor lost may be significant in proportion to other economic phase changes of history and result in considerable job losses. Prices may fall for various digitized services, but demand for these may remain stable. Thus, supply becomes almost limitless, and demand stays stationary, leading to a deflationary impulse over time. For example, the will you need to draft from a legal perspective may cost $5 instead of $500, but you only need one will. Another example Mr. Berezin uses revolves around the agricultural revolution, where food production increased, and prices fell, but people did not eat more. From an investing angle, a deflationary environment could lead to lower longer-term interest rates and bond yields. Conversely, prices may rise for physical goods and inputs that AI cannot produce or are subject to material physical constraints. Certain goods and services are bound by temporal or physical limits that AI cannot overcome.

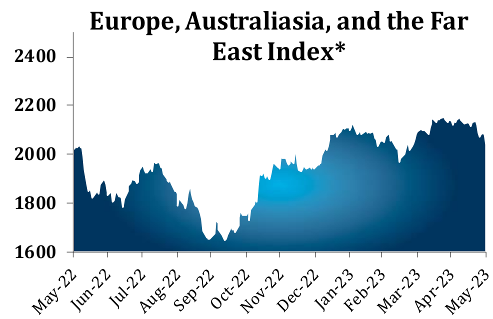
Putting aside all the hype and excitement of an AI future, as investors, we still need to consider the investment merits of companies and their valuation rationally. An increasing proportion of the market is now exhibiting characteristics not seen since the 2000s, when the market entered a tech bubble. Some technology shares are now echoing this period and appear to offer similar valuations. As a result, we are not buying some hyped names and, in fact, may be selling some of our holdings that have been swept up with the momentum surrounding AI. Valuation is important; at some point, it may encapsulate overly optimistic or excessive expectations, and therefore the prudent course of action is to book your gains.

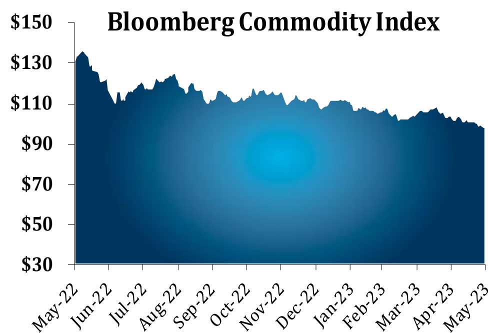
Citizens Financial Group Inc. (“CFG”) was the largest underperformer in the portfolio for the month, falling 15.4%, as the banking crisis continued to linger and pressured regional banks. Broadcom Inc.(“AVGO”) was the top performer in the month, up 29%, which rose along with various AI-exposed names with the prospect of accelerating growth with further adoption. Anchor trimmed this position during the run-up in May.

* https://www.reuters.com/technology/ai-threatens-humanitys-future-61-americans-say-reutersipsos-2023-05-17/









*Merrill Lynch Global Broad Market, Ex US Dollar Index

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Fixed Income Commentary

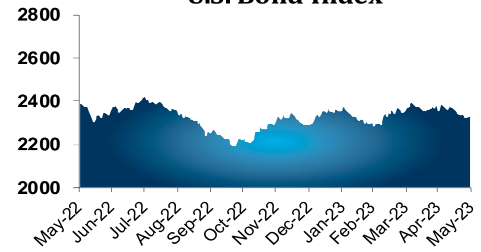
Divergent

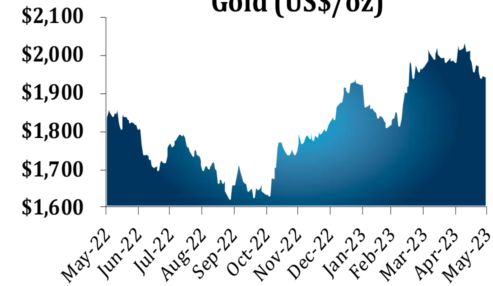
Last year marked the strongest pace of monetary tightening since the 1970s. The Fed raised rates from 0.25% to 4.0%. Since year-end, the Fed has raised the fed funds rate a further 1.25% with the fed funds (upper target) sitting at 5.25%. The latest hike came on May 3rd when the Federal Open Market Committee (FOMC) signaled it could pause rate hikes going forward. However, Chair Powell did stress that "we'll be driven by incoming data" and that they remain committed to bringing inflation down to their 2% target. He reiterated his intention to keep rates elevated. After declining in April, Treasury rates were up across the curve in May, with the 2-year rising 0.40% to 4.4% and the 10-year rising 0.22% to 3.64%. Powell also spoke of the banking sector, where he expects slower lending to tighten credit conditions for households and businesses.

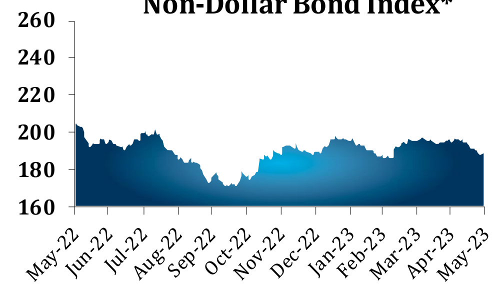
Deciphering the economic tea leaves is particularly challenging at present because we see numerous conflicting signals. For example, the divergence between the Bloomberg "Soft Data" Surprise Index (comprised of business and consumer surveys) and the Bloomberg "Hard Data" Surprise Index (composing housing, industrial, labor, and retail sales data). The survey-based "soft data" surprise index is deeply negative, while the "hard data" surprise index is deeply positive. The differential between the two indices is the highest it has been since October 2002! Even within the "soft data" category, we are seeing some stark divergence. For example, the Services Purchasing Manager Indices (PMIs) show resilience, while manufacturing PMI's are primarily in contractionary territory.

We have also seen conflicting readings from inflation data. The latest Headline Consumer Price Inflation (CPI) figure, reported by the Bureau of Labor Statistics, was 4.9% year-on-year (YoY). This compares to only 2.9% according to Truflation, a privately calculated inflation rate. Truflation's inflation index has different weights than the inflation measures reported by the government (CPI and PCE) and is updated daily, while government-reported figures are reported monthly. The component with the most notable difference is housing. Truflation uses data from Zillow for its housing component, which has been on a clear downward trajectory since July 2022 – their latest reading is 4.2% YoY. Meanwhile, YoY Shelter inflation in the CPI only just peaked in March 2023! The latest reported figure is 8.1% YoY. To get a sense for (government entity reported) inflation momentum we can look at 3-month (3M) annualized rates of change. Headline CPI is running at a 3M annualized rate of 3.2% (and trending lower), while Core CPI which excludes food and energy, has been steady at 5.1%. Thus, the food and energy components have driven the decline in headline inflation. Shelter accounts for 42% of Core CPI. Shelter has been a major contributor to the elevated inflation readings since the second half of 2022. The shelter component of CPI peaked in February 2023 at 9.4% (3M annualized) and has trended lower each month since (7.2% latest reading). Chair Powell has cited core services excluding shelter inflation (known as "super core") as the measure he believes offers the best gauge of underlying inflation momentum. On a 3-month annualized basis, super core inflation is running at ~4%. This measure is well off from the 9% high recorded in June 2022, however the 3M annualized rate has remained at 4% for the last 3 months.

The FOMC meets again in mid-June. At the time of writing the market is pricing in a ~30% chance of another 0.25% rate hike on June 14th, as per Bloomberg's model based on fed fund futures. Note, the probability began the month at 0%, and reached a high of 70% on May 26th before ending the month at 30%. Recent speeches by Fed officials pointed to the benefits of "skipping" a hike at the June meeting to observe how previous monetary tightening impacts the economy, while stressing they would be ready to increase rates if necessary. Concluding what is necessary looks like an unenviable job…







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