James Investment Research, Inc.

Market Commentary

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JAMES
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Key Insights

• **Persistent Inflation and Policy Shifts**: a Persistent inflation continues to challenge the U.S. economy, influencing the Federal Reserve (Fed) to adopt a cautious stance, adjusting interest rate cut expectations and delaying the timing of the first cut.

• **Federal Reserve's Strategic Caution:** The Fed is carefully monitoring economic data, which currently shows little justification for immediate rate cuts, suggesting a strategic delay in monetary policy adjustments.

• **Market Reactions to Economic Indicators:** Rising interest rates and a lower-than-expected GDP report have raised concerns of stagflation, impacting both equity and fixed income markets, with significant adjustments in rate-sensitive sectors.

• **Financial Market Performance:** April experienced a downturn in financial markets, with the S&P 500 Index and other indices declining due to rising bond yields and market adjustments to changing rate expectations.

• **Bright Spots in Earnings Amid Challenges:** Despite market volatility, a majority of S&P 500 companies exceeded low-set profit expectations during the earnings season, demonstrating corporate resilience amid economic uncertainties.

• **AI's Transformative Impact and Ethical Considerations:** The rapid advancement of artificial intelligence continues to reshape industries and daily life, presenting opportunities and challenges requiring thoughtful governance and ethical frameworks to ensure equitable benefits and minimize disruptions.

Monthly Recap

Persistent Inflation & Shifting Monetary Policy

As we entered April, the U.S. economy faced continued challenges, notably persistent inflation, which posed significant risks to financial markets. The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures Price Index (PCE), stayed above the 2.0% long-term target rate. Specifically, the core inflation figure held steady at a 2.8% annual rate in March, unchanged from February and slightly exceeding economists' forecasts.

Monetary Policy Shifts in 2024

The outlook for U.S. monetary policy has undergone notable shifts in 2024. Just a few months ago, the money and bond markets were anticipating as many as six rate cuts for the year. However, the current market sentiment, as reflected by Fed Funds Futures, now suggests expectations for fewer than two rate cuts—less than the three rate cuts the Fed itself had projected. Furthermore, the anticipated timing for the first rate cut has been delayed from March to June, and now to September, highlighting a cautious approach from the Federal Reserve in light of ongoing economic data.

Federal Reserve Actions and Economic Indicators

Investors continue to scrutinize the Federal Reserve's potential actions over the remaining five Federal Open Market Committee (FOMC) meetings of the year. The Fed's reliance on economic data is evident, with recent labor market and inflation figures providing little justification for an immediate easing of monetary policy. This data even raises doubts about the necessity of any rate cuts in the near future. While Chairman Powell seems inclined to lower rates, such a decision will hinge on forthcoming economic data, specifically a decrease in inflation and a slight easing in labor market conditions, which would justify proceeding with rate cuts.

Detrimental to both equity and fixed income markets, indicators have sparked discussions of "stagflation"—a scenario characterized by high inflation and sluggish economic growth. Recently released economic data garners significant attention. The preliminary Purchasing Managers' Index (PMI) for April came in mostly below expectations, signaling a general decline in orders and a reduction in workforce numbers by many companies. This is alongside higher inflation figures and a lower-than-anticipated U.S. Gross Domestic Product (GDP) reported for the first quarter.

From a monetary-policy perspective, recent developments have reinforced expectations for just one Federal Reserve rate cut this year, with a second cut possibly not occurring until March 2025. The optimistic outlook continues to be based on expectations for Fed easing, viewing rate cuts as delayed but still forthcoming.

However, concerns about persistent inflation linger, as highlighted by an increase in both one-year and five-year inflation expectations reported in the final University of Michigan consumer sentiment report for April.

April's Turbulent Financial Market Landscape

The current rally in risk assets could be destabilized with April underscoring the ongoing threat of persistent inflation. In the context of the Federal Reserve's cautious stance on rate cuts, this inflationary pressure remains a significant concern for investors.

Throughout October, yields on U.S. government bonds consistently increased each week. Recently, the yield on the 2-year Treasury briefly surpassed 5.00%, marking its first ascent to this level since last November and achieving the highest rate since 2006. The yield on the 10-year bond concluded the month at approximately 4.67%, reflecting heightened market vigilance amidst inflation concerns and shifting expectations for monetary policy.

April proved to be a challenging month for both equity and fixed income markets. The S&P 500 Index experienced a notable decline of 4.1%, as rising bond yields put downward pressure on valuations. This downturn marked a significant setback for U.S. equity indexes, despite the strong performance reported during the first quarter. Nearly all sectors suffered losses throughout this period, with utilities being the sole exception, managing to defy the overall negative trend.

The changing interest rate environment proved especially harsh for sectors sensitive to interest rate fluctuations, such as small caps and real estate investment trusts (REITs). The Russell 2000 Index, which tracks small cap stocks, ended the month down 6.8%, while the real estate sector saw an even steeper decline of 8.4%, both lagging considerably behind the broader stock market.

Both value and growth investment styles experienced nearly identical losses. However, the top 50 stocks significantly outperformed micro-cap stocks, even though both categories ended up in the red.

The fixed income markets were also impacted by shifting rate expectations. In April, market adjustments effectively eliminated the prospect of one and a half rate cuts in the U.S. for the year, and the anticipated timing of the first cut was delayed further. This resulted in a 40-basis point increase in 2-year Treasury yields to 5.0%, and a 47 basis point rise in 10-year Treasury yields to 4.67%.

As a result, the Bloomberg U.S. Aggregate Bond Index, which provides a broad measure of the bond market, fell by 1.41%.

A Bright Earnings Season

The economic environment continues to support corporate earnings, and during the first quarter earnings season, many companies have exceeded expectations, although the benchmarks were set quite low. However, markets have been unusually unforgiving to companies failing to meet estimates, scrutinizing whether earnings could justify significant valuation increases over the past six months.

Over halfway through the reporting period, 79% of S&P 500 Index companies have surpassed profit expectations, according to Bloomberg Intelligence data. Yet, the median stock only slightly outperformed the index by less than 0.1% on the day results were announced—the smallest margin since late 2020.

According to Bloomberg, companies falling short of expectations faced severe repercussions, experiencing the harshest penalties on record since 2019, with their stocks underperforming the S&P 500 Index by a median of 3.7%.

Approaching the midpoint of the earnings season, the outlook for earnings growth has brightened. As of the latest update from FactSet, analysts now anticipate a 3.5% increase in first-quarter earnings for S&P 500 companies compared to the same quarter last year, based on results released so far and forecasts for companies yet to report.

Topic of the Month: Artificial Intelligence

As discussions intensify around the Federal Reserve's restrictive monetary policy and its implications, the debate over potential interest rate reductions in the coming months gains complexity. Despite the uncertainty surrounding monetary easing this year, one clear and indisputable trend emerges—the rapid advancement of the artificial intelligence (AI) revolution. This technological leap is reshaping industries and daily life, heralding transformative changes comparable to the most significant technological innovations in history.

Defining Artificial Intelligence

AI encompasses computer systems that perform tasks typically requiring human intelligence. These systems not only automate laborious tasks, enhancing productivity, but also increasingly generate fresh ideas in business. Generative AI, a subset of AI, creates new and unique content, including text, images, video, music,

and computer code, often indistinguishable from those created by humans. AI is increasingly embedded in our economic systems at every point in the supply chain, from research and development to sales, from procurement to marketing, to after-sale analysis.

AI in Everyday Life

Although AI has captured significant attention recently, it has been integral to our lives for over a decade, providing numerous practical applications. From unlocking phones with facial recognition to interacting with virtual assistants like Siri for tasks such as making calls or checking the weather, AI has become deeply ingrained in our daily routines. AI also powers spam filters to detect unusual activity, navigation systems for faster routes, and computer opponents in games. These examples demonstrate how AI has seamlessly integrated into our lives, often without us realizing it.

Comparing AI to Earlier Transformational Innovations

AI has the potential to be as transformative as the steam engine, electricity, and the internet. However, AI's impact will be far broader, affecting decision-making, creativity, personal identity, and socialization. AI has been adopted more quickly than the steam engine and has more nuanced ethical and social implications. The internet serves as a better analogy for AI, as it seamlessly wove itself into daily life, evolved rapidly, and created similar ethical problems around privacy, surveillance, and misinformation. AI's ethical challenges are more nuanced and arguably more insidious, relating to personal privacy, surveillance, an erosion of human agency and creativity, and potentially profound effects on personal freedoms.

Transforming Industries and Driving Economic Growth

The rapid advancement of Artificial Intelligence (AI) is revolutionizing industries and driving economic growth. AI's ability to automate complex tasks has increased productivity and efficiency while spurring innovation. The public release of ChatGPT-3.5 by OpenAI in November 2022 marked a significant breakthrough, making the power of generative AI accessible to the general public and leading to its swift adoption and widespread use.

AI is being used in various industries, such as healthcare, where it analyzes medical images, assists in drug discovery, and personalizes treatment plans, and in the financial sector, where it is employed for fraud detection, risk assessment, and investment analysis. With AI's long-standing presence in our lives and recent advancements in generative AI, we are on the cusp of an accelerating transformation in how AI shapes our lives and the economy as a whole.

AI has the potential to significantly enhance productivity across various sectors by automating repetitive tasks, optimizing processes, and enabling faster decision-making. This increased productivity is expected to drive economic growth. AI serves as a new general-purpose "method of invention," potentially accelerating innovation in fields like drug discovery, education, transportation, and materials science. For instance, AI-powered drug discovery platforms can analyze vast amounts of data to identify potential drug candidates, significantly reducing the time and cost of traditional drug development processes. In the education sector, AI can personalize learning experiences, adapt to individual student needs, and provide real-time feedback, potentially improving educational outcomes. This could provide not just a one-time productivity boost but a permanent increase in productivity growth rates.

Labor Market Challenges and Opportunities

While AI is expected to boost economic growth, it may also lead to labor market disruptions. Almost 40% of global employment is exposed to AI, with advanced economies at greater risk. In these economies, about 60% of jobs are exposed to AI, with about half potentially negatively affected and the other half potentially benefiting from enhanced productivity. Emerging market and developing economies may experience less immediate AI-related disruptions but are also less prepared to seize AI's advantages, which could exacerbate the digital divide and cross-country income disparity.

Unlike previous waves of automation, which had the strongest effect on middle-skilled workers, AI displacement risks extend to higher-wage earners. However, potential AI complementarity is positively correlated with income. As we navigate this rapidly changing landscape, understanding the far-reaching implications of AI and adapting accordingly is crucial. Governments, businesses, and individuals must work together to develop strategies that minimize the negative impact of AI on the labor market while maximizing its potential for economic growth and job creation. This may include investing in education and retraining programs to help workers acquire the skills needed to thrive in an AI-driven economy, as well as implementing policies that promote the equitable distribution of AI's benefits.

Investment Opportunities in AI

Investment opportunities in AI span semiconductors, semiconductor capital equipment, electronic design automation (EDA) software, hyperscaler cloud vendors,

foundational models, infrastructure software, and application software. Companies at the forefront of AI development, such as those in the technology, healthcare, and financial sectors, are likely to benefit from the growth of this transformative technology. Investors might also favor a 'picks and shovels' approach, leaning towards the enablers of AI rather than the architects, such as suppliers of raw materials or machinery for semiconductor manufacturing, semiconductor manufacturers themselves, and those who build the surrounding hardware and software architecture for computer processors, graphics processing units, and other specialized processors.

The Magnificent 7

The "Magnificent 7" refers to a group of seven mega-cap companies (Amazon, Apple, Google, Meta, Microsoft, Nvidia, and Tesla), major players in the AI industry, accounting for approximately 60% of the S&P 500's total return in 2023. These companies reported aggregate earnings growth that significantly outpaced the rest of the market, supporting the overall earnings per share of the S&P 500 Index. These companies are expected to play a crucial role in shaping the future of AI and driving its adoption across various industries.

Bubble Risks

There are concerns about potential bubble risks associated with AI. The recent AI-driven tech stock rally amid a sluggish broader market suggests a potential speculative bubble forming, echoing some parallels to the late-1990s dotcom bubble. However, elevated price-to-trailing earnings ratios for some AI-exposed companies may be justified by analysts' robust earnings growth projections. If an AI bubble inflates and bursts, it would likely be a mainly U.S. phenomenon, last at least two more years, and boost the overall market in the interim, eventually resulting in significantly lower valuations and share prices for former "winners," and not undermine AI's longer-term transformative potential. An economic downturn could temporarily dampen AI enthusiasm, but monetary easing would help the bubble to reflate. Historically, excitement about prospective technologies has sometimes trumped economic weakness.

Dotcom & AI Comparisons

The AI revolution and the dotcom era share similarities in terms of transformative potential and investment hype. However, AI has a more substantial and immediate impact on industries, and its applications are more diverse and tangible compared to the early internet era. The dotcom era brought strong support for new companies, but it took time for true winners with sustainable business models to emerge, and markets suffered a reversal before the promise of the tech revolution was delivered. In 2023, AI has been framed as the innovation to change our lives, with a mixture of optimism and pessimism, ranging from hopes of a path to technological utopia to fears of human obsolescence. The environment is similar to the 1990s tech boom, where it is difficult to identify the companies that will develop the next generation of generative AI applications for end users, but those that successfully use generative AI will have extraordinary advantages.

Controversies and Challenges

AI development and adoption face controversies and challenges, such as ethical concerns (privacy, bias, job displacement), the need for regulatory frameworks and governance structures, and ensuring equitable distribution of AI benefits. Major technological change does not occur without challenges, delays, and setbacks. AI has driven speculation that it will replace millions of jobs across the economy, but it is more likely to take over repetitive, mundane tasks and free up workers to focus on more important challenges. Other challenges include de-globalization, rising geopolitical tensions, government regulation, and the technology's energy consumption and carbon footprint.

To fully harness AI's potential, priorities depend on countries' development levels, with advanced economies focusing on AI innovation and integration and developing economies prioritizing foundational infrastructural development and building a digitally skilled labor force. College-educated workers are better prepared to move from jobs at risk of displacement to high complementarity jobs, while older workers may be more vulnerable to the AI-driven transformation. For all economies, social safety nets and retraining for AI-susceptible workers are crucial to ensure inclusivity.

The complexity of generative AI, the fact that it is still in early stages, and the potential for unintended consequences raises the risk that regulation will be ineffective or impede development. Policymakers must strike a delicate balance between fostering innovation and protecting public interests. This can be achieved through collaborative efforts between governments, industry leaders, and academic experts to develop flexible, adaptable regulatory frameworks that can keep pace with the rapid advancements in AI technology.

Conclusion

April 2024 highlighted the ongoing challenges of persistent inflation and evolving monetary policy, underscoring the complex dynamics within financial markets. Despite the Federal Reserve's cautious adjustments to rate cut expectations in response to economic data, inflation remains a significant concern. Economic indicators like disappointing Purchasing Managers' Index data and a weaker-than-expected GDP report for the first quarter suggest potential stagflation, impacting both equity and fixed income markets. Notably, the rise in bond yields and the drop in the S&P 500 Index reflect the market's heightened vigilance against inflation.

Rate-sensitive sectors such as small caps and real estate investment trusts have felt the brunt of these adjustments. However, the earnings season provided a glimmer of hope, with most S&P 500 companies surpassing modest expectations, showcasing corporate resilience amid economic fluctuations. Moving forward, the trajectory of inflation and the Federal Reserve's response will be critical in shaping market dynamics. Investors and policymakers must stay flexible, ready to adapt strategies as the economic landscape evolves. The next few months will be crucial in determining whether the Fed's strategies can stabilize market sentiment and foster a sustained economic recovery.

Simultaneously, the rapid advancement of AI from automating mundane tasks to pioneering new frontiers in generative content offers vast opportunities and significant challenges. With the potential to enhance productivity, drive economic growth, and revolutionize industries, AI could have an impact comparable to transformative technologies like the steam engine and the internet. However, these opportunities also come with substantial risks, including the potential for labor market disruptions, privacy concerns, and exacerbating existing inequalities. As AI continues to evolve, it is imperative for policymakers, businesses, and individuals to cultivate an environment where technology enhances human capabilities without compromising ethical standards and social equity. Both economic uncertainties and technological innovations require careful management to harness their benefits while mitigating associated risks.

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