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Summary Points

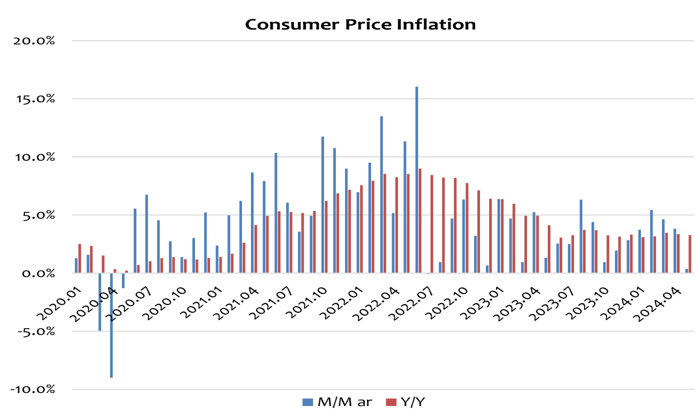
- A handful of super large cap Tech stocks, led by Nvidia, continue to drive stock prices higher.
- There are reasons to be very cautious regarding the AI excitement that involves business between a small number of very large companies.
- Continued strength in employment growth, a lagging indicator, makes it likely that the Fed will cut interest rates only once this year, if at all.
- By 2025 employment could very possibly be declining and the Fed may aggressively cut rates as economic growth stalls.
- Stocks are in a secular Bull Market, but cyclical risk remains elevated with valuations stretched. We expect good buying opportunities will come with lower stock prices.
- The year-ahead outlook for gold and gold miners looks positive.

Year-to-date, the S&P 500 is up 14%, with most of those gains coming from a small number of very highly valued stocks, with the AI story continuing to be the dominant theme. At the center of this trend is Nvidia, which sells the advanced graphic chips used for AI training and "inference," which is when a trained model draws new conclusions to make a prediction or solve a task. Nvidia has been selling billions of dollars of chips mostly to a handful of very large buyers including Microsoft, Alphabet, and Meta. Nvidia's stock is up 9% in the past week, 42% in the past month, and 173% this year. Furthermore, Nvidia alone accounts for 5% of that 14% return for the S&P 500. The top ten companies account for a full 10% of the index return with the remaining 490 companies contributing only 4%.

The frenzy of chip buying reflects a speculative belief that AI will create huge new revenue streams that justifies huge new capital spending. There is not a whole lot of evidence of that yet. For one thing, the performance of older proprietary AI models, like Chat GPT, have begun to slow and newer models, even "open source" models like Meta's are catching up. If all models compress into similar performance, it would imply that AI models could become a commodity with commodity pricing. This would be a problem as already the developers of AI systems mostly have very high costs and very little in the way of revenues. For example, the Wall Street Journal recently reported that the industry spent $50 billion on chips from Nvidia to train AI in 2023, but that spending corresponded to only $3 billion in revenues. At the end of the day, users of AI systems will have to find enough value in those systems so that they are willing to pay enough to cover the enormous costs of building and training the systems. That day may someday come, but not necessarily soon. The systems make frequent errors and appear to be more suitable as a tool for professionals, as opposed to being a replacement of professionals. One other issue to keep in mind: When Nvidia sells chips to Microsoft, Google, etc., Nvidia immediately recognizes the revenue on its income statement. In contrast, the cost of buying the chips and other hardware can be capitalized and depreciated over years. As a result, current earnings are likely overstated if these systems don't produce the future demand now expected. Similar to the Internet in the year 2000, there are likely to be amazing developments to AI over the next twenty years. However, the explosion of interest and the spending on chips over the past year and a half has many of the earmarks of FOMO (fear of missing out). Even seasoned business managers feel compelled to react to new trends when they catch the public and media imagination. Often in these cases, the stocks go beyond the real.

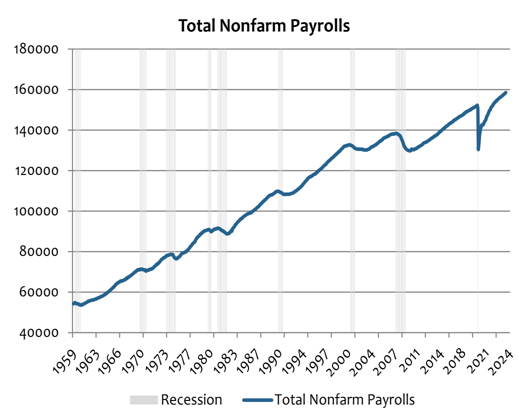
Whereas six rate cuts were expected early in the year, the Fed is now expected to cut interest rates once at most in 2024. Next year may be different. By law, the Federal Reserve has two mandates: Achieve maximum employment and keep prices stable. The inflation rate has dropped sharply from 9.1% in mid-2022 to 3.3% in May 2024, but that's still quite a bit away from the target of 2%. And there were surprisingly strong month-to-month inflation reports in February to April this year. These sticky numbers encourage the Fed to keep interest rates high to ensure that spending and inflation continue to trend lower. At the same time, employment has grown an average of 248,000 per month during the first five months of 2024, compared to an average of 251,000 per month in 2023. No material sign of a slowdown. These two facts, given the Fed mandate, make it seem unnecessary for the Fed to cut rates. The problem is that these two sets of data are lagging indicators, meaning they tell us more about past conditions than what is coming.

Chart 1



Source: Federal Reserve

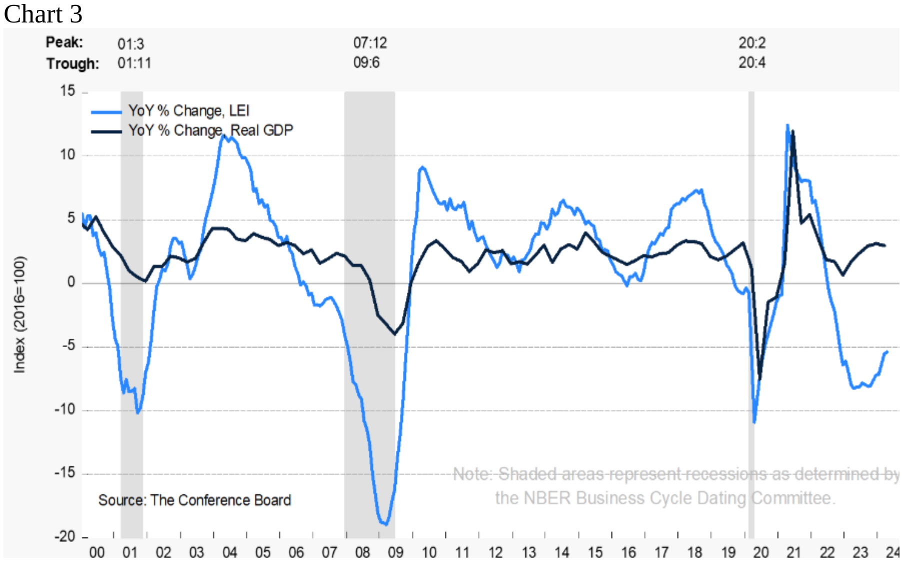
Chart 2



Source: Federal Reserve

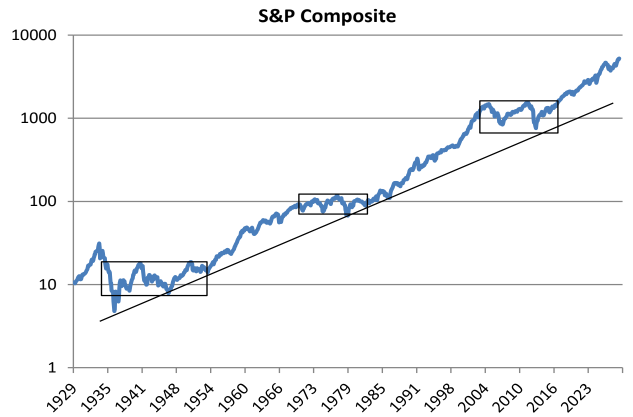
In contrast to employment growth and inflation, many data sets that tend to lead the economy are still indicating a contraction in growth ahead. As we have written in the past, the yield curve—meaning the spread between short-term and long-term interest rates, turned negative in November 2022. This is one of the most reliable indicators of future business activity. Similarly, another forward looking indicator, the ISM Manufacturing Purchasing Managers Index, also went into contraction territory that same month. And as seen in Chart 3 below, the Conference Board's Leading Economic Index is in negative territory. While the Conference Board is not forecasting a recession, they do see real growth falling to under 1% for the second and third quarters of 2024. If growth does indeed slow to below 1% and the unemployment rate, now 4.0%, continues to tick up from the 2023 low of 3.4%, the Fed will likely be cutting short-term interest rates next year.

Chart 3



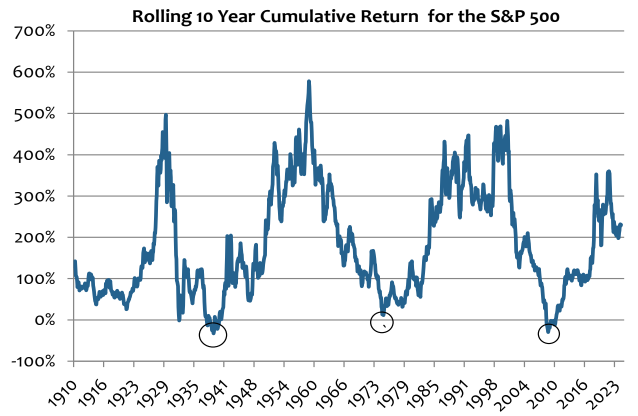
Despite cyclical headwinds facing the economy and U.S. stock market, investors should keep a long view. From our perspective, we are in a long-term secular Bull Market. As seen in Chart 4 below, we are now in the third secular Bull Market over the past 100 years. There have been three major periods of cyclical decline and stock market correction, with the last bottom having been in 2009. As seen in Chart 5, these secular Bull Markets haven't ended until the market achieves a cumulative 10 year rolling return of about 500% or more. As of May 2024, we're at a 230% cumulative return—still further to go. What accounted for these big secular trends you may ask? The first period of stagnation reflects the 1929 stock market collapse and the Great Depression, followed by the secular recovery after WW2. The second period of stagnation reflected the decline of the dollar's value when President Richard Nixon decided to de-link the dollar from gold, which was followed by the Arab oil embargo of 1973 and a big inflation. This was followed by a bull period thanks to the Paul Volker Federal Reserve and "tight money," as well as President Reagan's deregulation and tax cuts. The third period of stagnation came after the tech bubble burst in March 2000 and was followed by the popping of the real estate bubble in 2008. All of these secular periods had shorter cyclical ups-and-downs within them.

Chart 4



Source: Prof. Robert Schiller, Yale University, FVCM

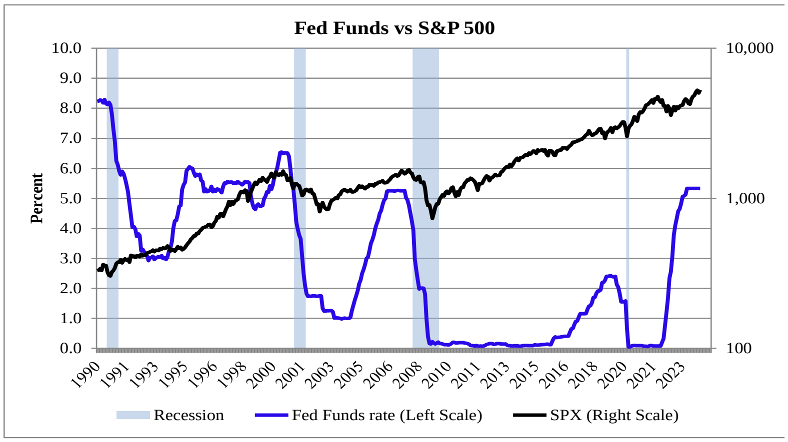
Chart 5



Source: Prof. Robert Schiller, Yale University, FVCM

As previously discussed, the leading indicators suggest that a slowdown in real economic growth lays ahead, and cuts in short-term interest rates are likely. This would be consistent with weakness in equity prices. Notice in Chart 6 that the Fed typically starts cutting rates before the onset of a recession, and cuts sharply as the recession progresses. Similarly, the S&P 500 declined through the recessions before its ultimate recovery to new highs. Drops in interest rates and stock prices go together. Therefore, it must be pointed out that this stock market cycle has been very unusual. Notice in Chart 6 that in the 1990s, 2000s, and after 2015, the Fed was raising interest rates for years and the stock market continued to rise along with interest rates. This time around has been very odd because the Fed started raising interest rates in March 2022, and instead of plowing upward as in previous periods of rising rates, in the beginning of 2022 stocks right away went into a 25% downturn. Even more odd, the stock market made a complete recovery from the October 2022 lows and no recession has yet developed. This anomalous activity has left many predicting that there will be no recession at all—the proverbial "soft landing" seen as frequently as Leprechauns. We suspect that these unusual stock market and economic trends reflect the once-per-century effects of the pandemic and the cash bulge that was created by the U.S. government. Nothing is for sure, but we've seen evidence that the legs are getting tired after that extra money and resultant spending. For example, retail sales for May came in at only +0.1%, month-to-month, which was below the 0.3% consensus but better than the -0.2% in April. Recent weakness in retail spending is part of continued evidence of slowdown by consumers.

Chart 6



Source: Federal Reserve, Factset, FVCM

Stock valuations are high, but they are particularly skewed by the Magnificent Seven and Broadcom, a big chip manufacturer being bolstered by the AI movement. Those big companies are trading at 46 times earnings, 34 times book value and 13 times sales. In contrast, the remaining companies in the S&P 500 are trading at 23 times earnings, 3.7 times book, and 4 times sales. There are high expectations built into those super large cap valuations and they may be the most vulnerable to a correction. That said, some of the developments occurring in the fields of technology are major game changers, we don't doubt it. Our issue is with the emotion and resultant high valuations that have come about. If a correction does come in the months or year ahead as we expect, long-term investors would likely do well to use the more reasonable values to take cash positions and add to their stock holdings.

After moving sideways for several years, gold has risen from about $1900 per ounce to more than $2300 per ounce over the past half year. Prices could go higher still and gold mining companies should do well. Gold is often thought of as an inflation hedge, and it is when measured in decades. However, in the shorter periods measured in years, gold is not correlated with changes in inflation. Gold is much more affected by global economic and geopolitical turbulence. Also, gold does better when interest rates are low because of the opportunity cost of not investing cash in interest bearing securities. As we've argued in this report, we see some cyclical turbulence ahead—weaker growth, stock market volatility and lower interest rates. All these factors should be tailwinds for gold. Furthermore, many central banks, particularly the Chinese central bank, have been adding to their gold reserves. Seeing what has happened to Russia and Iran, it is logical that China would want to continue to diversify its reserves. For comparison, according to the World Gold Council, the U.S. holds 8133.46 Tonnes of gold reserves, Germany has 3352.31 Tonnes of gold reserves. And gigantic China has only 2262.45 Tonnes. There is plenty of upside.

In closing, there are many near-term risks in the capital markets, but there are also many exciting opportunities. Prices have advanced too rapidly in our view, but we believe we are in a secular Bull Market and cyclical declines should be used to accumulate stocks of good companies. Technology is developing rapidly, and amazing developments lie ahead for flexible and innovated businesses of all types. The difficulty lies in the fact that business fundamentals get amplified by human emotion in the capital markets, and prices can swing excessively. Warren Buffett's famous dictum is "be fearful when others are greedy, and greedy when others are fearful." The Magnificent returns of the past 18 months have left us fearful for now, but we'll be ready to be greedy when prices are better. We're also reminded of one other famous market master. John Pierpoint Morgan said you'll go broke if you bet against the United States.