

Mountain Pacific Investment Advisers
877 Main Street, Suite 704
Boise, Idaho 83702
(208) 336-1422

William J. Palumbo
Bruce A. Reeder
Matthew M. Lindstrom
Nathan C. Oakley
Rashe L. Elliott

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For the last 18 months, the stock market has focused on the investment implications of Artificial Intelligence (AI). In 2023, the large technology companies uniquely positioned to benefit from AI, because of their market dominance—Apple, Microsoft, Amazon, NVIDIA, Google, Tesla, and Meta Platforms—increased 75.7% in value, compared to 24.2% for the S&P500 Index. These stocks, dubbed the Magnificent 7, also comprised 29% of the S&P, the largest concentration in history. Without the Mag 7, the Index increased a mere 8%.

In the first half of 2024, investors narrowed their focus slightly to the Mag 6 (Tesla declined), which had an average return of 44.7%, compared to 14.5% for the S&P500. NVIDIA increased 150% and became the most heralded technology company in the world, with a market value of \$3 trillion, joining Apple and Microsoft in that stratospheric club. The Mag 3 comprise more than 20% of the S&P500, another record, and their total market value surpasses the combined GDP of the third and fourth largest economies in the world, Germany and Japan (\$8.7 trillion). How did this happen? What does AI actually do?

AI makes it possible for computers to think, and learn, from experience, adjust to new information, and even perform human-like tasks. But how does it actually work? An AI system uses powerful processors to analyze large amounts of data using rules, or algorithms, to search for patterns or features in the data, allowing the software to learn from the data. The data is used to rewrite, or update, the software, in iteration after iteration. Graphic processing units (GPUs) provide the computing power needed for the iterative data analyses. NVIDIA designs more than 80% of the GPUs used in the datacenters where the most intensive processing takes place; its processors are then manufactured overseas by Taiwan Semiconductor. Five years ago, NVIDIA was known primarily for its video game processors! Since then, its market value has increased 30 times!

Stock market observers are comparing the AI buying frenzy to the dotcom bubble in the late 1990s, which burst in March 2000 and triggered a recession. The internet of course changed the world, just like AI will, but the stock market overshot economic reality in the late 1990s; is it doing the same thing now with AI? It's hard to see how an investor can make money buying NVIDIA at a valuation of 30 times forward revenue! The stock market is probably overshooting economic reality again. As the growth expectations for AI soar higher and higher, and more companies get on the bandwagon, the odds of disappointment are increasing. In theory the potential of AI may be unlimited, but in practice of course that will not be the case, especially among early users. After the bubble burst in 2000, for several years funds flowed out of dotcom companies and back into more traditional growth investments.

If the S&P500 is adjusted to equal-weight the size of its members, its valuation declines from 21 times to 17.5 times forward earnings. In historical terms, this is a reasonable valuation, given the level of interest rates (4.45% on the 10YR Treasury), and the willingness of the Federal Reserve to lower its short-term policy rate if inflation continues to moderate. According to the Purchasing Managers Index published by the Institute of Supply Management, the manufacturing sector has contracted for 19 of the last 20 months. The Fed will probably lower interest rates later this year.

One looming policy issue that is building in Washington is the federal deficit. In fiscal 2020 (September), federal spending soared to support the economy during the pandemic, and the deficit spiraled to over \$3 trillion (from \$1 trillion in the prior year). By 2022, as the economy recovered, the deficit receded to \$1.4 trillion, but in 2023 it increased again to \$1.7 trillion as income tax receipts declined because of inflation indexing. This fiscal year (September 2024), higher interest rates have caught up with the Treasury, and are now the fastest growing item in the budget, rising to an estimated \$870 billion, higher than defense spending. The deficit forecast is now \$1.9 trillion. Deficit spending may explain, in part, why aggressive Fed interest rate policy since March 2022 has not caused the recession predicted by so many.

Since fiscal 2018, federal spending has increased by \$1 trillion more than tax revenue, and the federal debt has increased from \$22 trillion to \$35 trillion. During this period consumer net worth (savings plus real estate, net of debt) has increased almost as fast, from \$104 trillion to \$161 trillion. In the wealthiest society in history, increasing tax revenue to support spending is more of a political problem than an economic one. This is probably why the Treasury bond market is so calm in the face of trillion-dollar deficits. The financial markets tend to focus more on economics than politics.

Has the advent of AI altered our investment approach? No, it has not. We continue to look for stocks that meet our twin criteria of consistent growth and reasonable valuation. Within this framework, we will consider AI, both as supplier and end-user, and so far the initial results have been promising.