The Way We See It

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Is AI the panacea for labour productivity and higher sustainable growth in the US ?

A brief update report which serves to review the recent market development and to offer our outlook for the rest of the year and beyond.

Review of Developments
- Global Economies

On growth dynamics, recently-released data continued to show significant growth divergences amongst key economies.

Again, on the relatively stronger side of the ledger, recent estimates of Q1 2024 GDP show that the U.S. economy remains the strongest amongst the largest industrialised nations in G7. Both households and government spending remain solid. Capital expenditures also showed signs of picking up. The only unexpected macroeconomic risk in the U.S. relates to the fragility of regional and smaller banks, as well as the recent and additional write-down of loans made to the commercial office and hotel sectors.

On the relatively weaker end of the growth spectrum, while the latest economic indicators of Eurozone and China continued to confirm a sluggish trend, at least it appears that the Eurozone has bottomed.

In the case of China, despite a number of

expansionary measures implemented by the government, the latest economic picture remains somewhat slow. Whether Chinese leaders at the National People's Congress, which is held in March, will surprise with much larger expansionary packages is yet to be seen. Odds of a positive surprise remain low.

On the global inflation front, while headline and core inflation indicators continued to show a decelerating annual trend, wages growth remain high and labour shortages still dominate in many developed countries. In addition, energy prices have bounced back up recently. As a result, central bankers in the OECD bloc remain reluctant to cut rates immediately.

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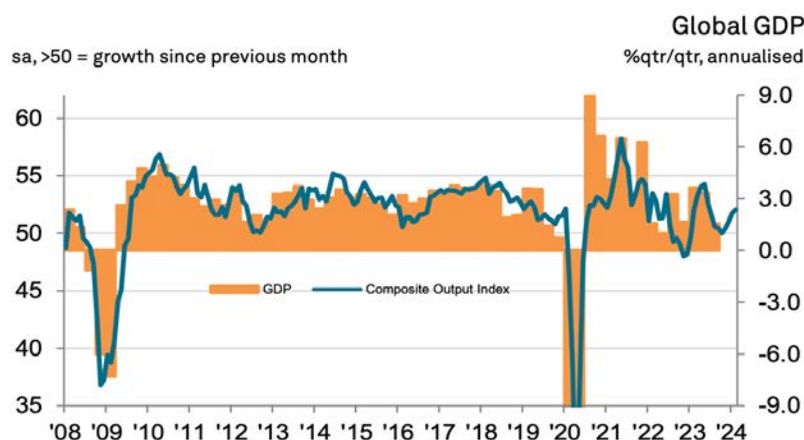
As Far as the US Fed is concerned, the key message from the forthcoming FOMC, scheduled in mid-March, is expected to emphasise the need to keep cash rates high for a while longer, particularly when the U.S. domestic economy continued to grow solidly. This is based on their thinking that the road to achieving an annual 2% core inflation rate remains uncertain. Having said that, the Fed's Board appears be in unison on the scope for cutting rates about 2-3 times, starting in H2. In the month of February, all other major OECD central banks remained on hold.

Finally, global geopolitical risks remain high: Russia and Ukraine, Gaza and Israel, plus geopolitical and trade tensions beyond semiconductor chips between the U.S. and its partners, against China.

J.P.Morgan Global Composite PMI™



Source: J.P.Morgan, S&P Global Market Intelligence

- Global Markets

The month of February saw a continuation of strong buying of equities around the world. The hot areas of focus continued to include U.S. AI- and Semiconductor-related stocks. China also had a strong bounce from very oversold levels. Many global equity indices in the Developed Markets bloc made all time highs, led by the S&P 500 and Nasdaq, followed by the Japanese Nikkei.

Similar to previous months, it was reported that both fundamental and quant-driven investors were moderate buyers of stocks. The former were positively motivated by the better-than-expected US corporate results, solid economic growth and a continuing fall in all inflation indicators, as well as prospects of the Fed and other G20 countries to cut rates this year. The second type of buyers of the rally was driven by the positive momentum of stock prices and falling volatility. This trend was established since early November to date.

Both fundamental and systematic investors continued to be buyers of risky assets.

Near-term performance of various asset classes

as at 29/2/2024

Asset Class	US Equities	Global Equities	GEM Equities
Index	MSCI USA	MSCI World	MSCI EM
1 month	5.37%	4.28%	4.77%
3 months	12.05%	10.77%	3.86%
YTD	7.01%	5.55%	-0.08%
FY 2023	27.10%	24.42%	10.27%

Asset Class	US Corporate	US Treasury	US Aggregate
Index	Bloomberg US Corporate	Bloomberg US Treasury	Bloomberg US Agg
1 month	-1.50%	-1.31%	-1.41%
3 months	2.59%	1.72%	2.08%
YTD	-1.67%	-1.59%	-1.68%
FY 2023	8.52%	4.05%	5.53%

Asset Class	Global Govt Bonds	Global Aggregate	Global Commodities
Index	Bloomberg Global TSY	Bloomberg Global Agg	CBR
1 month	-1.30%	-1.26%	0.98%
3 months	1.02%	1.43%	0.52%
YTD	-3.14%	-2.62%	4.26%
FY 2023	4.18%	5.71%	-5.01%

Asset Class	Asia ex Japan Equities	China Offshore	China A
Index	MSCI AC AxJ	MSCI China	MSCI China A Onshore
1 month	5.62%	8.39%	10.79%
3 months	3.41%	-5.44%	-1.69%
YTD	-0.13%	-3.11%	-0.45%
FY 2023	6.34%	-11.04%	-11.46%

Source: GOJI, MSCI, Bloomberg

In other words, the Goldilocks soft-landing backdrop together with the apparent AI bubble led investors to continue to cover shorts and/or to start reducing their pile of cash in order to re-invest in equity markets.

The whole global equity universe, in USD terms, performed well. China led in February (A-shares +10.79%, Offshore China +8.39%), boosted by short-covering and some bargain-hunting, as investors cheered the government's easing measures on both monetary and fiscal policy fronts. This helped MSCI Emerging to show a rare rise of 4.77% in the month. This was followed by the U.S., achieving all time highs on the back of a 5.37% return.

Delayed expectations of early rate cuts in the U.S. in this month strengthened the US Dollar.

Bond markets, which performed well in Q4 last year, encountered some resistance when the 10-year bond yield fell to 3.80% p.a.. On the back of a stronger-than-expected growth data in the US, bond yields continued to rise to 4.25% p.a.

The Commodities complex rose modestly, helped by a slight bounce in energy prices. Gold also rose.

The Crypto complex continued to perform very strongly, as institutional and retail investors played the momentum game and bought heavily into this asset class, following the launch of a number of ETFs.

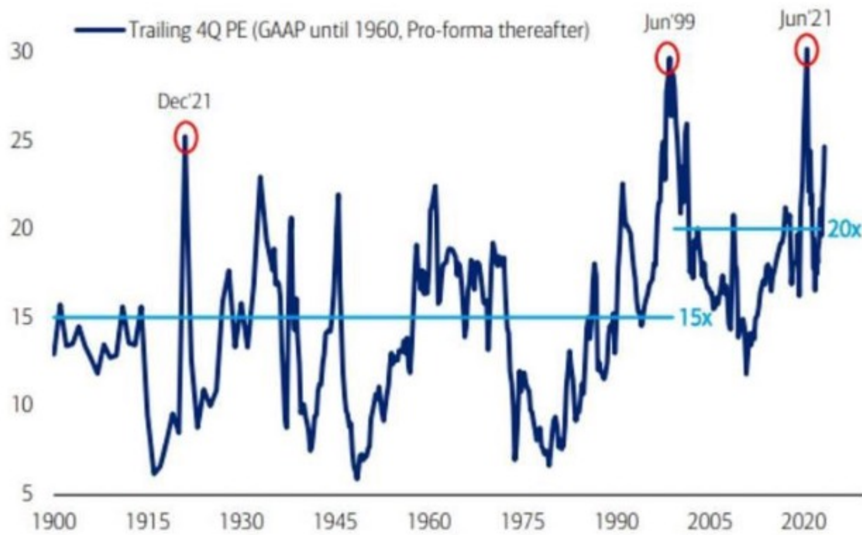
In terms of equities' investment flows and positioning, both are rising. At the end of February, both types of investors were reported to be moderately overweight.

Equity performed well in February, led by China (finally); bond saw resistance.

Market Outlook

The majority of investors (both fundamental and systematics) already appear to bullishly positioned for the continuation of a rally in G7 equities and bonds in 2024. Having said that, they can still buy a bit more in the future under the right circumstances, as their bullish positioning hasn't yet reached historical peaks. The enclosed chart illustrates the above points.

Bull Stays Long Until SPX Trailing PE >25x
- S&P 500 trailing Q4 P/E

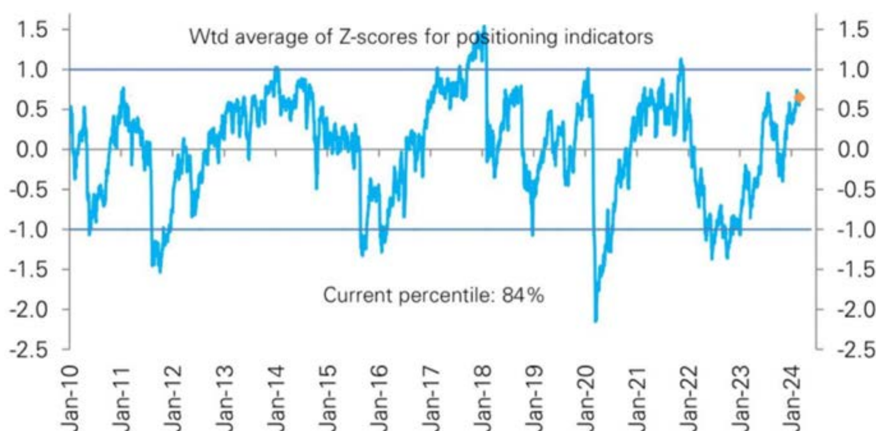


Source: BofA Global Research

Their bullishness is based, firstly, on the soft-landing economic scenario (slowing growth and falling inflation); secondly, corporate earnings recovery; and finally, the commencement of the monetary easing phase in the U.S. and other developed nations in H2 of this year.

Soft-landing scenario dominates; hard-landing scenario is off.

Consolidated Equity Positioning



Source: Deutsche Bank Asset Allocation

Discretionary vs Systematic Equity Positioning

*Wtd average of Z-scores for positioning indicators, weights based on explanatory power in regression of equity performance on indicators

Source: Deutsche Bank Asset Allocation

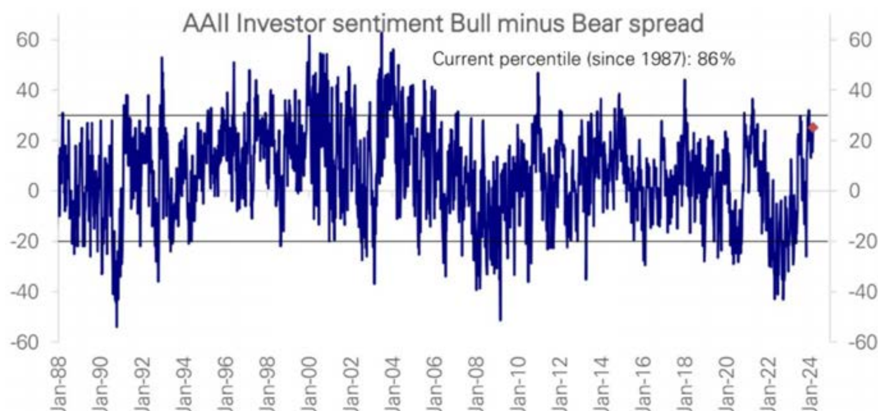
Greed overshadows Fear; FOMO continues.

Consequently, both institutional and retail fundamental investors' risk appetite has been increasing significantly, thus continuing to lift the CNN Fear and Greed index to "Greed / Extreme Greed" levels. The strong positive momentum in equity and bond markets has encouraged both fundamentally- and quant-driven investors to take risk and buy aggressively. The fear of making losses continued to be played down significantly.

Fear & Greed Index
- What emotion is driving the market now?

Source: CNN Business
Last update Mar 12 at 6:30:00 PM ET

Investor Sentiment
- Investor bull minus bear spread



Data as of 24 January 2024
Source: Barron's, Haver Analytics, Deutsche Bank Asset Allocation

As outlined in our report last month, GOJI's own fundamental research continues to point to a scenario where growth is expected to be stronger in H1, and that inflation may make a surprise return. Hence, we only expect a modest easing of monetary policy of the U.S. Fed towards the end of the year. The European Central Bank, the ECB, is most likely to cut rates first, since its economy is so much weaker than that of the U.S.

Expect ECB to cut rates first.

As a result, our view is more prudent in the next few months. In summary, we believe that there is a better entry point for long term risk asset investors.

The Way We See It
- Global Markets and Investment Thematics

As we discussed previously, to be a contrarian investor, i.e. adopting a more prudent investment stance at present, is definitely not a popular thing to do. Again, we, at GOJI, wish to stress that we do not propose a different view to the market consensus just for the sake of being contrarian.

As outlined in our Global Investment Outlook for 2024 and in the two sections above, it is our belief that both fundamental and quant-driven investors have priced in, positioned for and are prepared to pay up for a best case scenario of slowing but not

recessionary growth, falling inflation and lower interest rates. A Goldilocks scenario.

As a result, based on our perspective of stronger than consensus growth, more sticky inflation and interest rates, plus an overvalued US equity market, our strategy recommends to stay modestly underweight risky assets and overweight cash and low-beta quality assets.

No-landing scenario (persistent inflation) is creeping in.

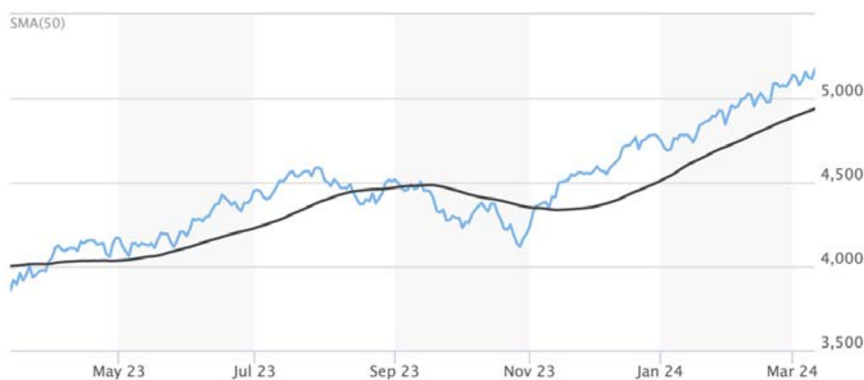
We would also suggest to build a modest exposure to commodities. Lastly, we think that the U.S. Dollar will continue to rebound in coming months against most liquid currencies.

Short-term Technical Analysis

The wave of buying re-emerged, inspired by the strong rally in U.S. equities and a bounce in China and EM a markets.

At the time of writing, US equity indices, led by AI and Semiconductor stocks, recorded all time highs. Commentators in the financial social media labelled this positive technical development the start of a new bull market.

S&P 500 Stock Price Index



Source: MarketWatch.com

As outlined earlier in our report, we believe it's more to do with crowd FOMO buying, rather than one which is based on a positive change in fundamentals. If we are right, then we could see a few more new historical highs on key tech-orientated US equity

indices. However, they may not last.

In other words, despite the semblance of a sustainable strong rally, we feel that the markets will revert back to fundamentals at some stage. This would then mean a correction, the size of which depends on how high and how euphoric the equity indices are.

Hence, our recommendation to long-term investors is not to chase this short-term rally. For those who can act based on short-term trends, some profit taking of expensive names would be a sensible tactic.

GOJI: LT investors not to chase ST rally.

Postscript

AI : The key to unlock the poor productivity trends in the US and elsewhere ?

As far as the economic implications of AI are concerned, a brief survey of the literature on this important subject reveals that economists and investment professionals appear to hold very different views. This is understandable, given how new and how fast the latest developments of Advanced AI are (ChatGPT, generative AI, and so on).

On the extreme bullish side, the house of Goldmans put forward the case that Advanced AI, if adopted by a widespread of corporates and households over a 10-year period, can raise labour productivity and real GDP by over 1.5% per annum. That is a massive boost to real economic growth, if correct!

One reason being put forward is that most displaced jobs, caused by this disruptive technology, will somehow find other employment elsewhere, based on past case studies and observations in the past century. A very big assumption, which, of course, may be wrong this time!

At the more conservative (and more bearish) end of estimates, a number of commentators argue that Advanced AI will undoubtedly benefit a small number of highly-skilled early movers, together with and their specialist components or service providers, which happen to be mostly located in the U.S. or in tech-savvy countries in Asia Pacific.

But the short- to medium-term impact (1-3 years) on the overall economy may turn out to be net negative, even for the US. The argument is that the many jobs displaced by AI are unlikely to be easily replaced by new jobs with the same pay (ie, a senior accountant or university lecturer earns much more than a restaurant waiter).

In GOJI's humble opinion, while Advanced AI will undoubtedly bring about more tangible benefits to those who create it and/or those who can afford the new more expensive electronic gadgets and services, whether this will equitably spread across the whole labour force is an uncomfortably-debated dilemma.

There is another aspect to consider, which is the wealth and enjoyment gap between the haves and the have-nots: in our opinion, the creation and adoption of Advanced AI products and services will further widen the K-curve and the Gini-coefficient, which already is at an all-time high. This may have long-term implications on the social fabric and harmony of Western capitalism.

From an investor's viewpoint, the first thing one notes is that the share price of early AI creators has already skyrocketed, and that almost every investor and trader in the world already owns them. In other words, it is a very crowded sector (the previously-known FAANG has now morphed into the Magnificent 7, and most recently, the Fabulous 4). Of course, sales and profit results of the AI leaders, notably, NVIDIA, ARM, AMD, Microsoft, TSMC, etc, have tended to exceed expectations and often upgraded.

Whether one should buy these names (or their associated companies) at current elevated prices depends very much on one's risk tolerance, and the investor's focus on valuation. If one buys them for a trade, then it is sensible to think of implementing a close stop-loss mechanism.

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