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# MORAN QUARTERLY ECONOMIC COMMENTARY

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# ECONOMIC COMMENTARY


## Executive Summary

The 2023 market dynamics revolve around the dominance of large-cap tech stocks, attributed to two triggers: the Silicon Valley Bank crisis and the rise of Artificial Intelligence. Over-specialization in tech and venture capital sectors led to a banking crisis for Silicon Valley Bank amid a tech slowdown and rising interest rates. The situation rapidly escalated into a modern-day bank run, culminating in a swift FDIC intervention after a staggering $42 billion in deposits was withdrawn in one day. This crisis propelled investors towards the relative stability of the Big 7 tech companies. Concurrently, ChatGPT's success propelled AI into mainstream discussions, leading investors to view the Big 7 as the optimal investment avenue for this emerging trend. This skewed market, echoing the late 90s tech bubble, raises caution. Parallels are drawn to the dot-com era due to high valuations, a tight labor market, and an inverted yield curve. However, on a brighter note, the current tech titans are far more profitable and stable than the fledgling companies of the dot-com crash. Navigating these unpredictable conditions requires vigilance and flexibility, focusing on aligning your investment choices with financial goals and risk tolerance, despite unresolved banking issues and AI's uncertain future.


## 2023...How Did We Get Here?

As discussed in our most recent newsletter, 2023 has been an unconventional year. Not to rehash the points, but the 17% stock market price return this year, as gauged by the S&P500, has been powered solely by valuation expansion. In fact, overall corporate earnings have declined in 2023, bringing about a form of “earnings recession.” The robust 32% upswing in the NASDAQ and the 17% rally in the S&P500 didn't occur in isolation, nor did they transpire merely as a recovery from a subpar previous year. The 2023 rally has been primarily driven by large-cap technology and discretionary stocks - with the top seven mega-cap stocks monopolizing nearly 100% of market returns this year. This lopsided market landscape can be traced back to two key catalysts: the Silicon Valley Bank debacle and the rise of Artificial Intelligence into mainstream prominence. It is informative to explore each. In addition, witnessing such a bifurcated market — where the 'Big 7' significantly outperforms the remaining 493 —naturally leads us to question if we have seen this movie before. Have we seen such a dream or theme enrapture the markets before? Indeed, we have. Around 23 years ago, the fervor surrounding the Internet's transformative potential sparked a similar NASDAQ surge. The situations are not identical, but they carry insightful similarities and stark differences.

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## Silicon Valley Bank Crisis

Silicon Valley Bank imploded in March 2023 taking First Republic and Signature Bank down with it. SVB, a California-based bank, had essentially put all its eggs in one basket, focusing its business model on the technology and venture capital sectors, along with their employees. However, when these industries faced a challenging 2022 due to a post-Covid tech slowdown and IPO decline coupled with recession fears, SVB saw an exodus of deposits. Smaller and medium-sized public and private tech companies experienced a slowdown from their previous high levels, and layoffs ensued. Compounding the issue, SVB's management decided to invest its surplus cash in long-term treasury securities because the deposit base had grown at such a rate that loans could not be extended quickly enough. The rapid rise in interest rates since 2020 hit the bank's investment book hard, as the principal value of a bond decreases when rates increase. This situation led to mounting unrealized losses, jeopardizing solvency ratios. In March, when SVB's significant deposit outflow became apparent, Peter Thiel and Bill Ackman rang the alarm bell and encouraged all depositors to pull their assets from SVB. $42 billion of deposits left in a 24-hour period. Had the FDIC delayed its intervention by just one day, an additional $100 billion was poised to be withdrawn. It was a modern-day bank run. In the days following the takeover, the number of Google searches for "FDIC insurance" and "bank crisis" surged.

From a market perspective, the kneejerk response to the uncertainty arising from the failure of these three banks was for investors to retreat to familiar and safe territories, namely the "Big 7" (Apple, Amazon, Tesla, Nvidia, Microsoft, Google, Meta). In retrospect, the market pattern was rather predictable: sell bank stocks, economically sensitive stocks, and small-cap stocks, while flocking to the perceived safety net provided by the Big 7. This shift was reason #1 for the rotation into the Nasdaq and Big 7.

## ChatGPT & Artificial Intelligence

Reason #2 for the market's pivot was the breakout success of ChatGPT. While artificial intelligence (AI) has been a known concept for years, its potential was suddenly propelled into the limelight in November 2022 with the launch of OpenAI's mobile app, ChatGPT. This AI model can understand and respond to human dialogue quickly and with great sophistication. Users can instruct ChatGPT to perform a wide array of tasks, from composing poetry to generating code. With over 100 million global accounts, ChatGPT became part of everyday conversation. Its impact was amplified when '60 Minutes' ran a special on AI on April 16th, igniting widespread interest.

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The magnitude of AI's transformative effect on our personal and business lives is still unknown, but its potential is clearly enormous. Pure play investment opportunities in AI as a standalone theme are limited. Google has imbedded AI into its search algorithms for years, as has Microsoft's Bing. Consequently, investors have gravitated towards the 'Big 7' as the most accessible and prominent means of investing in this emerging revolution, even though it's uncertain how much these companies will truly earn from incorporating AI into their products.

The real watershed moment that solidified AI's allure came at the end of May. Advanced mobile chip processor Nvidia reported their earnings and provided future earnings guidance, boasting the largest forecast increase in stock market history. Nvidia elevated its revenue projection by $4 billion, largely attributed to orders for graphics cards designed to accelerate computing and facilitate AI for the masses. On the earnings call, the CEO compared this development to the invention of the microprocessor that enabled the personal computer, characterizing it as an 'iPhone moment'.

**What is Artificial Intelligence?**

Despite its seeming novelty, artificial intelligence (AI) is far from a new concept. Coined by computer scientist John McCarthy in 1956, AI can be categorized into two types: narrow AI (specialized in specific tasks) and general AI (possessing human-like intelligence across various domains). AI can be 'trained' through supervised learning, unsupervised learning, or reinforcement learning algorithms. While it has been with us for some time, mainstream recognition of AI is just now catching the drift. AI-powered virtual assistants like Siri, Alexa, and Google Assistant, for instance, have been using natural language processing for years to comprehend and respond to user commands. Similarly, AI fuels facial recognition on Apple iPhones, aids in language translation on handheld devices, and powers chatbots in customer service. It's revolutionizing education through personalized learning experiences and even transforming healthcare treatments by enabling drug discovery and personalized medicine.

Yet, questions persist: How big will AI become? Who will benefit, and who will lose out? While it's too early for definitive answers, the surging interest is indisputable. Over 100 million ChatGPT accounts have been opened already, with over 1 million in the first five days. The ChatGPT website generates 1.8 billion visitors per month, and it is truly a global phenomenon, with 85% of its users residing outside the United States.

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We have already enjoyed many of the benefits AI brings, with more on the horizon. However, it's crucial to identify some of the potential negatives that a disruptive force like AI might usher in:

1. Job displacement: AI and automation could replace certain jobs, potentially leading to higher unemployment and economic disruption. Most vulnerable are roles involving routine manual tasks, data entry, customer service, transportation and delivery, administrative duties, manufacturing, quality control, data analysis, legal research, financial forecasting, and healthcare diagnostics.
2. Bias and fairness: Since AI learns from data, it can perpetuate and even amplify biases if the training data is prejudiced.
3. Lack of transparency: Understanding how AI decisions are made can be challenging.
4. Privacy concerns: AI relies on vast amounts of data. The collection, storage, and analysis of personal information can potentially compromise privacy rights.

**Do We Have Any Time In History Like This?**

For those of us that have been around awhile, this bifurcated market is very reminiscent of the late 90s and early 2000's—often referred to as the "dot-com bubble" or "tech wreck." During that time there was a frenzy of investment and speculation in internet-based businesses. The rapid growth of the World Wide Web and the promise of e-commerce sparked investor euphoria, prompting an influx of capital into internet startups. Investors believed that the internet would revolutionize business and that these fledgling companies would become immensely profitable. Despite many of these dot-com companies lacking profits, cash flow, and even sales, venture capitalists and retail investors poured billions into them. This inflow fueled a speculative cycle that drove stock prices to astronomical levels. The market became dominated by an "irrational exuberance," with investors prioritizing future potential over current earnings or sustainable business models. This reckless optimism, combined with high valuations, fear of missing out, and an interest rate hike by the Federal Reserve in the late 1990s to control inflation, all contributed to the 2001 recession. When the bubble burst in the early 2000, many companies went bankrupt and the Nasdaq dropped 75% from its peak by October 2002. It took almost 10 years for the Nasdaq to recover back to its prior peak.

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**Differences Between The Internet Bubble & Today**

Let's start with two of the principal differences between 2000 and today: 1) size and profitability and 2) valuation extremes. Today, companies seen as AI beneficiaries are substantial, well-established, generate significant revenue, and are highly profitable. For instance, Google generates $300 billion in sales and $120 billion in cash flow (EBITDA), supported by a strong balance sheet. Similarly, Microsoft yields $230 billion in sales amounting to $115 billion in cash flow (EBITDA). For these companies, the incorporation of AI into their offerings is simply additive, not the principal product of the firm.

Back in 2000, many of the companies fueling the tech boom were not profitable and often specialized in a specific sector of internet infrastructure or commerce. Even if they were profitable, they were considerably smaller than today's Big 7. The best among them, such as Cisco, a leading server and router company, had revenues of $19 billion and cash flow close to $5 billion. Meanwhile, EMC, a large data storage provider, had revenues of $8.9 billion and cash flow less than $2 billion.

Notably, the companies that littered the landscape like Webvan, Excite@Home, CDNow, 1-800-Flowers.com, Booze.com, Garden.com, eToys.com, Furniture.com, and of course fan favorite Pets.com never earned a dime of cash flow. And don't forget the high-profile fall of WorldCom, Global Crossing, and Enron. Although current valuations are high—with price-to-earnings (P/E) ratios exceeding 40x on average for the Big 7—these pale in comparison to the extreme ratios seen in the dot-com era. Back then, many companies had P/E ratios over 100x, with Cisco and EMC even peaking above 150x earnings.

**Similarities Between The Internet Bubble & Today**

While there are clear differences between the dot-com bubble of the late 90s and the market dynamics of today, striking similarities also exist. Back in the late 90s, the future impact of the internet was difficult to fully comprehend, much like the transformative potential of Artificial Intelligence today. In hindsight, the internet significantly changed the way or method in which we consume and conduct business without necessarily expanding GDP or consumer spending. AI is predicted to enhance productivity considerably, albeit possibly without creating new products or revenue streams.

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Another parallel is the state of market valuations. Today's valuations, while not as exorbitant as those in 2000, are still high. The tight labor market is another common factor, with the unemployment rate of 4.2% in the late 90s not far off from the current rate.

The inversion of the yield curve, a traditional predictor of recession, was a feature of both periods. The curve remained inverted for 13 months in 1999 and has been since April 2022. Then and now, there are debates over the relevance of this economic indicator.

A notable parallel is the Federal Reserve's actions. In the late 90s, the Fed had been increasing interest rates to keep inflation at bay, just as we've witnessed ten rate hikes since April 2022. Following the dot-com bubble, the Fed initiated a two-year cycle of rate cuts, bringing the Fed Funds rate from 6.50% down to 1%.

Finally, there are similarities in the discourse around the business cycle. During the late 90s, strategists began suggesting that real-time data from the internet had eliminated the business cycle, creating optimism for a 'soft landing'. Today, we're having a similar conversation about avoiding a recession and achieving a soft landing.

**Conclusions**

We undoubtedly find ourselves in an unusual time. We have weathered a 100-year pandemic, $10 trillion of monetary and fiscal stimulus, inflation soaring to almost 10%, Fed fund interest rates climbing from almost 0% to 5% in a year, a market correction of 25%, and close to all-time lows in unemployment. Despite constant predictions of a looming recession at the end of 2023 or early 2024, the economic downturn seems reluctant to arrive. Meanwhile, the Big 7 tech stocks in the S&P500 are up over 90% YTD, and the Nasdaq is up over 40%. In contrast, high-quality dividend stocks, as indicated by the SPDR Dividend ETF, have seen just a 1% increase year-to-date, and the Russell 1000 Value index has barely risen by 6%. With recent economic datapoints coming out clearly better than expected—CPI, jobless claims, payrolls, productivity, shipping, confidence—the odds of a meaningful recession have declined substantially. It is possible the Federal Reserve has engineered the “soft landing.” If we are heading into a new business cycle, inflation gets closer to 2-2.5%, and GDP starts expanding, then history tells us that the other cyclical, economically sensitive, and small cap stocks that have not participated in this YTD big rally should have their turn.

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We believe this will likely be the course. The market should broaden and the "other 493" will take over. And considering that the Big 7 trade at 40x forward earnings (P/E) while the 493 trade closer to 15x, there is a lot of runway for value, dividend-oriented, and economically sensitive stocks to outperform as earnings accelerate in the new cycle and valuations expand. Artificial Intelligence continues to propel valuations and captivate the market for now, but we believe, just like in the tech bubble in 2000, it doesn't last indefinitely. Eventually, sales and earnings numbers must justify these lofty valuations, bringing dreams back down to reality.

In conclusion, our team remains vigilant in monitoring the stock market's fluctuations and adjusting our strategies accordingly. We recognize the challenges presented by the current market environment, and we are committed to helping you navigate these uncertain times. Please do not hesitate to reach out to anyone on our team with any questions or concerns you may have. Our priority is to ensure that you feel informed, confident, and supported in your investment decisions. Together, we will continue to seek opportunities that align with your financial goals and risk tolerance, positioning your portfolio for long-term success.

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