

THE CHASE IS ON

WRITTEN BY: YOUR FIRST BANKERS TRUST TEAM



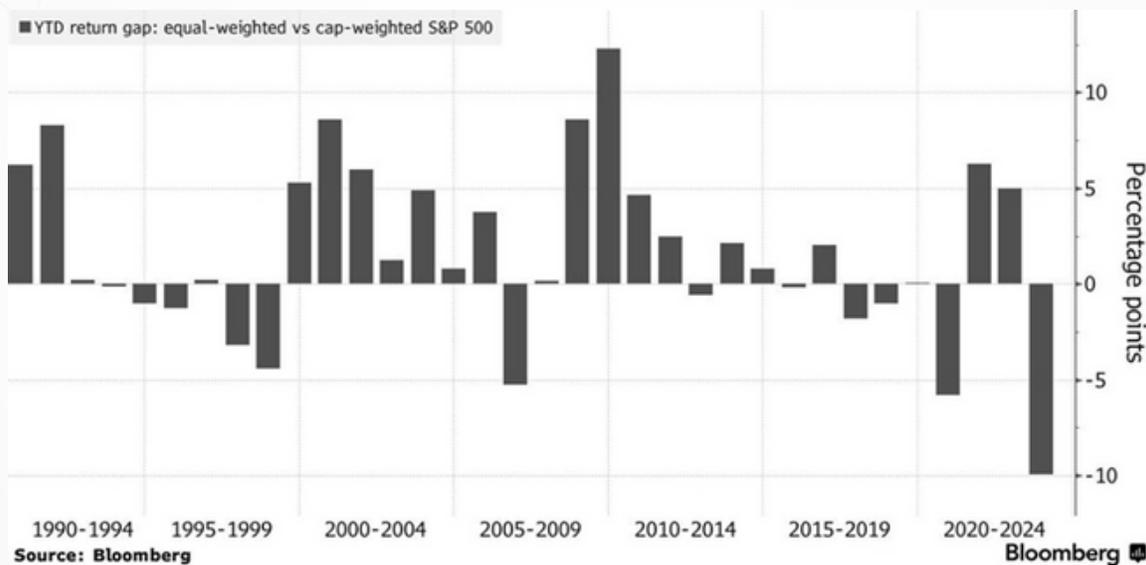
AI

FIRST BANKERS TRUST COMPANY
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If you held up a mirror to the stock market's experience in 2022, what would you see? The image would look strikingly like the inverse first half of 2023. Losses have been eliminated for many stocks and the S&P 500 sits less than 10% from all-time highs. Bear markets have been referred to as a hall of mirrors thanks to the violent bear market rallies that lead some participants to believe the worst is over, only to restart the slide again. Certainly, the haze of disinflation – is the rate of inflation coming down to due supply response or demand destruction? (hint: it is both) – can lead to confusion for bulls and bears alike.

Regardless of one's views on 2023's resilient rally, nobody can deny the fact that the bulk of the S&P 500's gains have been driven by some of the largest names in the index. In fact, until other stocks started participating in the fun in June, the spread between the market capitalization weighted S&P 500 (the commonly quoted index) and the equal weighted S&P 500 (in which each stock is given the same weighting) was the largest on record (equal weighted index data started in 1990) to start a calendar year.



What has driven the market higher and led it to be so narrowly focused? A bear would point to the bulk of the narrowness occurring after the March bank failures as evidence of money managers hiding in large technology companies as the best place to weather a storm. The bull case has been driven on excitement around Artificial Intelligence (AI).

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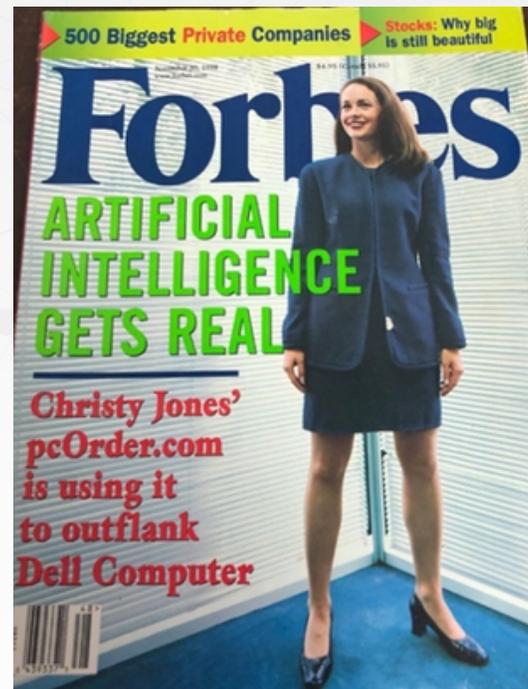
Iterations of AI have been with us for decades, but most of the applications have been mathematically oriented. Companies in every industry use algorithms to help them analyze and predict business indicators and even train the algorithms to improve themselves with each new data point. The explosive excitement now driving sentiment and technology stock prices higher is more oriented around text, or generative AI, powered by what are called Large Language Models (LLMs). The believed leader in the space is OpenAI and their product, ChatGPT. In January of this year, Microsoft invested another \$10 billion in OpenAI to continue their partnership, bolstering the hype around the release of ChatGPT to the public late last year.

ChatGPT has generated a ton of buzz and its feats are quite impressive. The technology can generate lengthy, human-like answers to prompts by the user. The excitement has proliferated: from consumer searches for the technology to mobile App downloads to corporate partnerships and of course into the stock market: an index (Indxx AI Big Data Index) that invests in stocks allegedly involved in artificial intelligence is up almost 40% this year through the end of June. Some stocks within the index have more than doubled since the beginning of the year. Semiconductors will be heavily used to both power LLMs and develop new platforms, and semiconductor stocks that have as little as 5% of revenue exposure to AI are up as much as 50%.

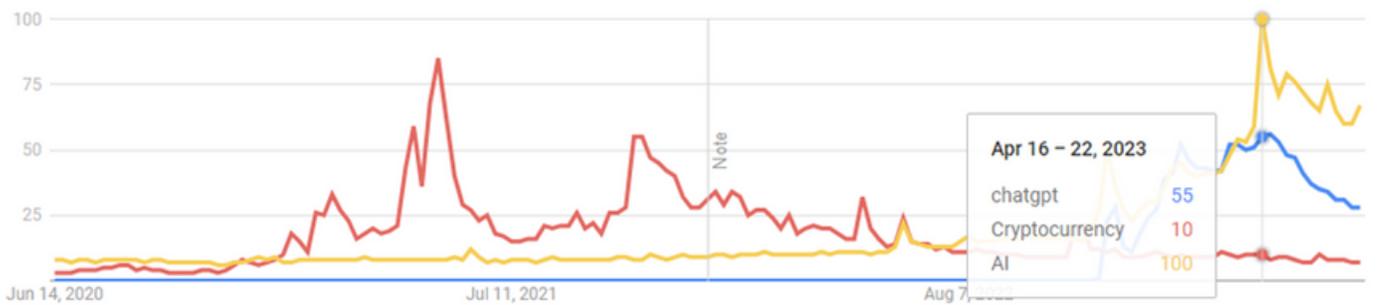
Business think tanks such as McKinsey have trotted out the economic value add of generative AI to be as high as \$4 trillion. Wall Street firms such as Goldman Sachs have suggested 25% of jobs could be replaced by generative AI.

You get the point. It's a bonanza in prognostications, salesmanship, and greed. Companies have changed their names to incorporate AI to see their stock prices soar. Per usual, we've been here before. In fact, incredibly recently: cryptocurrencies and blockchain technology merely two years ago. But it is important to remember that history merely rhymes, not repeats. From our perspective, the use cases are much easier to envision than esoteric data security needs for blockchain technology or whatever ends up being the use case for Bitcoin (digital gold?). The consumer side of generative AI could become a Google competitor, supplementing or replacing the search function and crossing what was once believed to be an uncrossable moat (please note Google has already rolled out their competitive offering, Bard). Companies could implement AI to improve customer service experience or bolster productivity of data scientists. Legal firms could use generative AI to drastically speed up research. The list goes on and on.

Of course, generative AI could be little more than a fad or false promises. If you squint hard enough at the Forbes magazine cover to the right, you can see the article about Artificial Intelligence is from 1998. IBM's artificial intelligence product, Watson, splashed on the scene in 2011 with a win in Jeopardy and commercialization in 2013. Suffice it to say, Watson's commercial efforts have disappointed. There are already indications that consumers are losing interest in ChatGPT at the margin (see below).



And the current iterations have very serious obstacles at the moment: generative AI applications often lie (industry terminology is “hallucinate”) when they don’t know an answer and can be manipulated by the user to change an objectively correct answer into something incorrect. Furthermore, companies will have to do significant legwork to ensure their data is private before inviting in LLMs.



Despite sounding cautious, we’re very open-minded to generative AI being a world-changing technological breakthrough. But the chase is on, and valuations have exploded to levels fraught with risk. The chase manifests itself beyond the stock market as well: capital investment will pour into the space. With greater capital investment comes an increasing likelihood of lower returns on invested capital, potentially compounding downside if valuations drop. Furthermore, one has to at least ponder whether a pull forward in demand is occurring and the potential for a glut to follow. Our final question focuses on the large cap stocks getting all the love from investors: if this is truly world changing, why would the benefits only accrue to today’s titans? Most groundbreaking technologies disrupt incumbents.

WHAT DOES THIS MEAN FOR PORTFOLIOS?

“Markets can remain irrational longer than you can remain solvent.” This famous quote by John Maynard Keynes is often trotted out when the market moves in mysterious or confusing ways. We think a little more nuance is appropriate given the market’s continuous effort to be a discounting mechanism: different players play different games. The market may be continuously discounting, but it does so in emotional ways, swinging from euphoria to despair. We tend to think this stage of the chase is getting euphoric. But that’s not to say those chasing can’t push these stocks higher: continued jumps in earnings expectations will be used to justify any valuation. Those playing this game could see further gains. Or, if earnings disappoint or valuations sobriety sets in soon, devastating losses (please review the chart appendix for some examples). Participating in the chase is a game some choose to play, fraught with high risk and overall low probabilities. Remember, the market is an emotional creature, and it is difficult to know when sobriety will set in. First Bankers Trust clients can rest assured we will stay true to our philosophy of investing in high quality companies that pay growing dividends, a time-tested strategy with a track record of strong returns and lower volatility.

While euphoria rapidly returns to the stock market, the bond market has had some moments of joy and gloom but has largely remained subdued after a historically bad 2022. At the time of this writing, yields along the entire Treasury curve sit above or close to 4%, a key marker we noted in our last newsletter as a reasonable entry point for adding duration. With the U.S. government’s spending problem despite full employment, one cannot rule out yields going higher from here if supply overwhelms demand. But, near term inflation numbers will remain restrained until next year and growth risks are rising as the labor market shows some cracks. We honestly don’t know if these labor market fissures will turn into earthquakes, but the long and variable lags of interest rate increases lurk just as the stock market is now convinced a recession won’t happen. This presents a dilemma for bond investors, and we don’t think it is unreasonable to expect the trading range for bonds to widen on both the upside and downside in coming months. Nevertheless, 4% should beat inflation (in the near term), keep the housing market in check, and provide sufficient cushion against price loss if rates surprise a little higher to the upside.

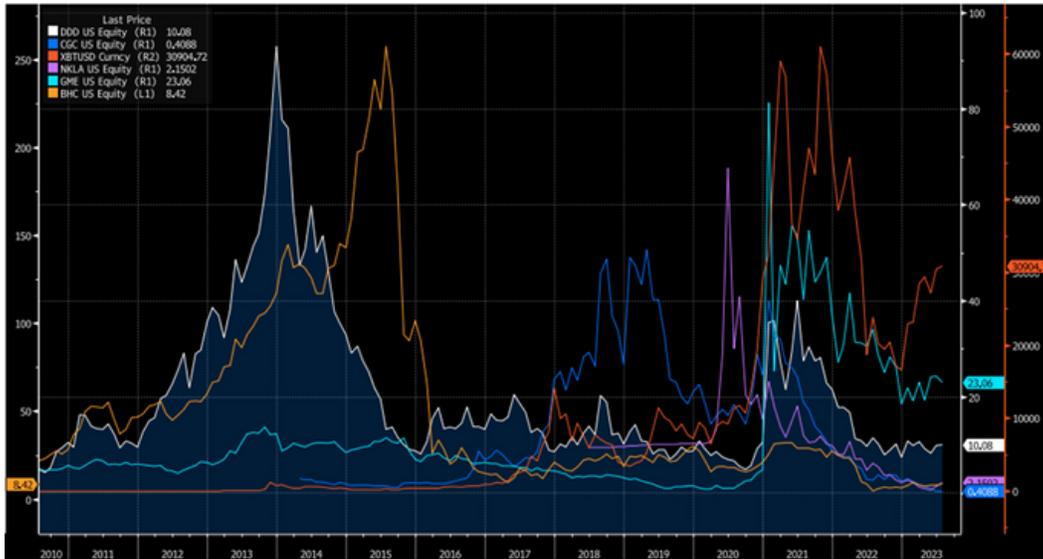
Sincerely,
Your First Bankers Trust Team



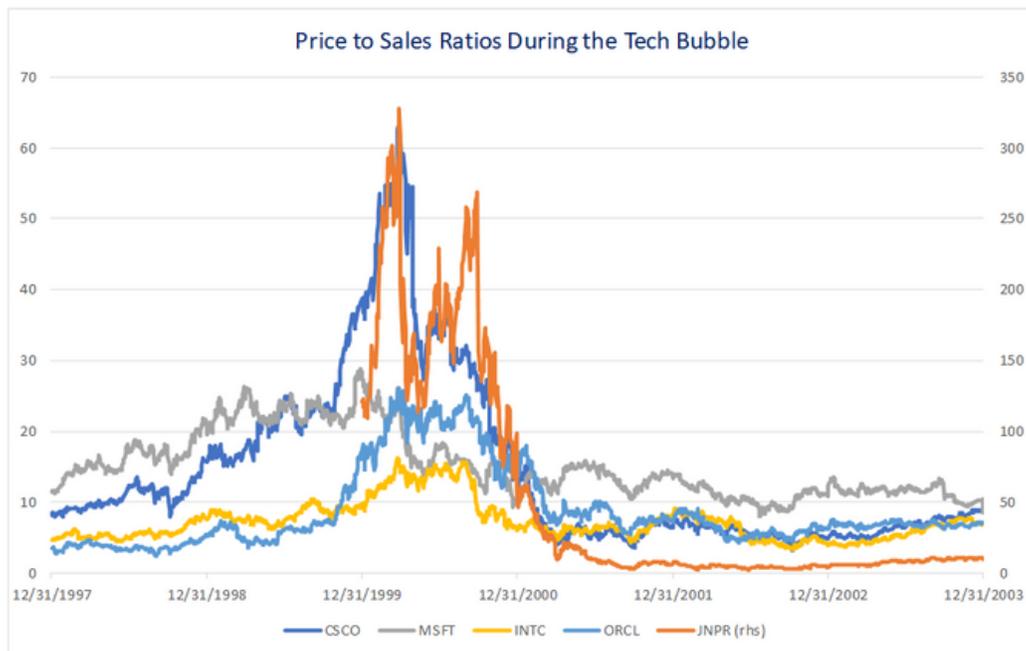
Investment products are not FDIC insured, not guaranteed by the bank, and may lose value

CHART APPENDIX

Sources: Bloomberg, First Bankers Trust Research, Fortune, Goldman Sachs, Bank of America, personalfinanceclub.com



DDD (white line): 3D Systems Corp – Remember when 3D printing was going to change manufacturing forever?
 BHC (light orange): Bausch Health (formerly Valeant Pharmaceuticals) – Valeant was an innovative pharmaceutical business model!
 No, it was just immoral market cornering and illegal sales tactics.
 CGC (darker blue): Canopy Growth Corporation – Marijuana business is going to boom!
 NKLA (purple): Nikola Corporation – Electric vehicles are the future and every manufacturer will be wildly successful! The CEO has since been convicted of fraud.
 GME (turquoise): GameStop – Get rich quick by squeezing short sellers!
 XBTUSD (dark orange): Bitcoin – a new currency outside of the banking system, an anonymous and cheaper peer-to-peer transaction outside of the payment networks, an uncorrelated financial asset, an unregulated digital gold to protect against currency debasement, a trustless transaction ledger. In all honesty, this story is still being written and we are sympathetic to the digital gold concept given the risks for citizens of emerging markets to have their currency debased. But the constant narrative and thesis shift of Bitcoin is a fascinating history and most of the narratives have been, to varying degrees, proven false.

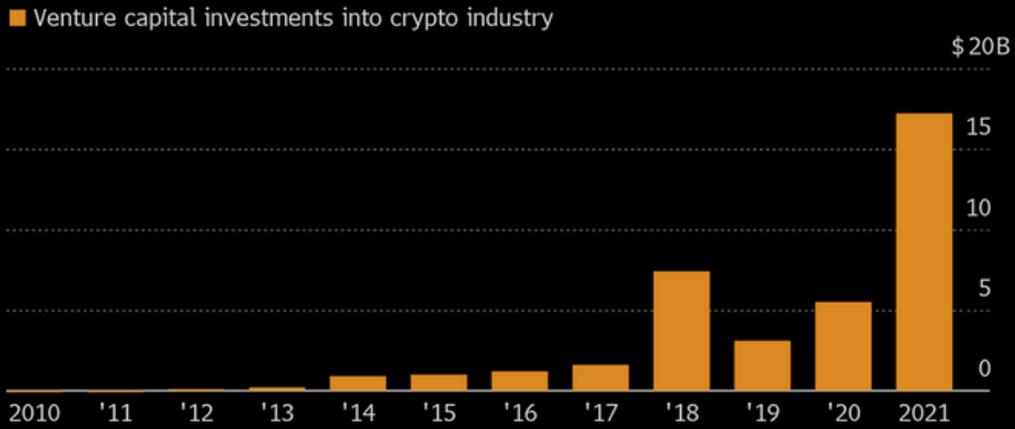


Ticker	Company	Time to Regain Peak Stock Price	Time to Regain Price 20% from Peak
CSCO	Cisco Systems Inc	Not yet	Not yet
JNPR	Juniper Networks Inc	Not yet	Not yet
MSFT	Microsoft Corp	~17 Years	~16 Years
INTC	Intel Corp	Not yet	~20 Years
ORCL	Oracle Corp	~17 Years	~14 Years

Bubbles happen in large company stocks too. Valuations don't seem as egregious for larger companies at the moment.

Gold Rush

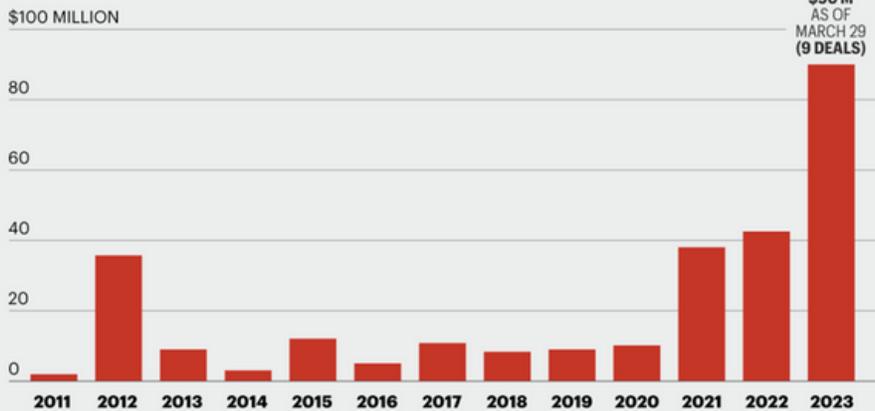
Venture capital has piled into crypto companies in 2021



Source: PitchBook

Bloomberg

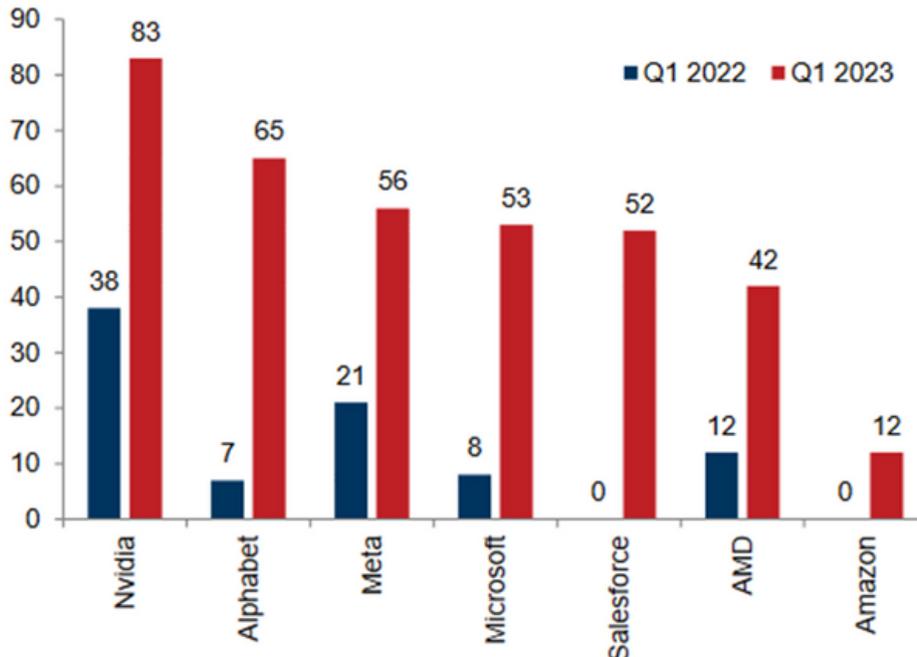
Generative AI median VC pre-money valuation



SOURCE: PITCHBOOK U.S. DATA

FORTUNE

Mentions of "AI" in selected companies' earnings calls

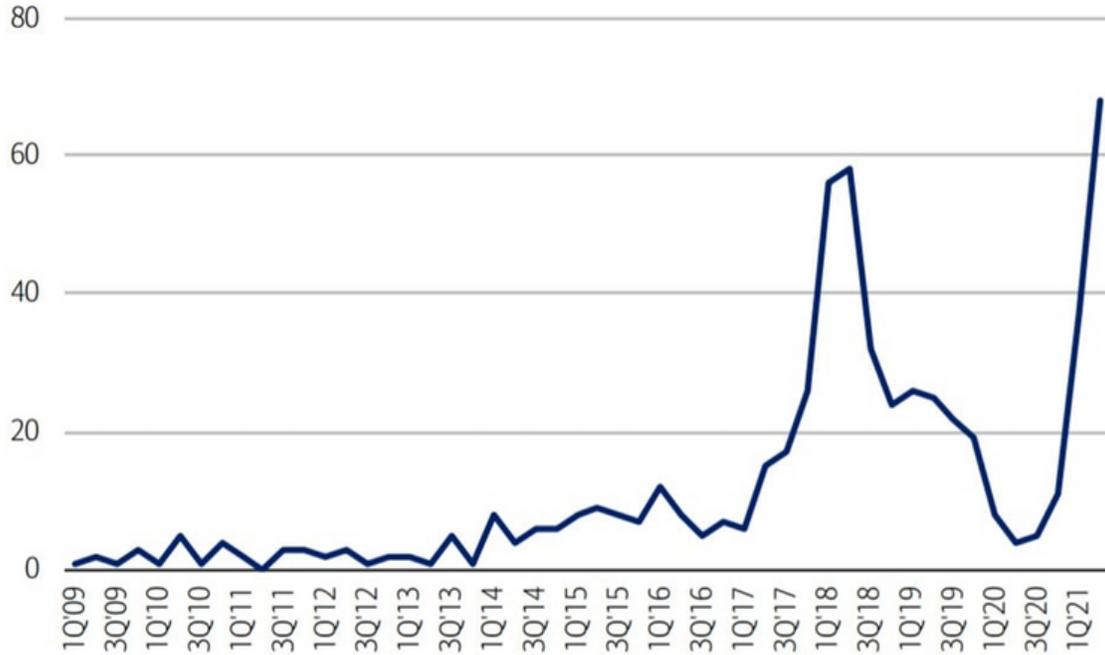


Note: Includes mentions of "AI" in analyst/journalist questions.

Source: Company data, Statista, Goldman Sachs GIR.

Exhibit 2: Number of US companies that mentioned a digital asset keyword* on an earnings call rose to 147 from 17 a year ago

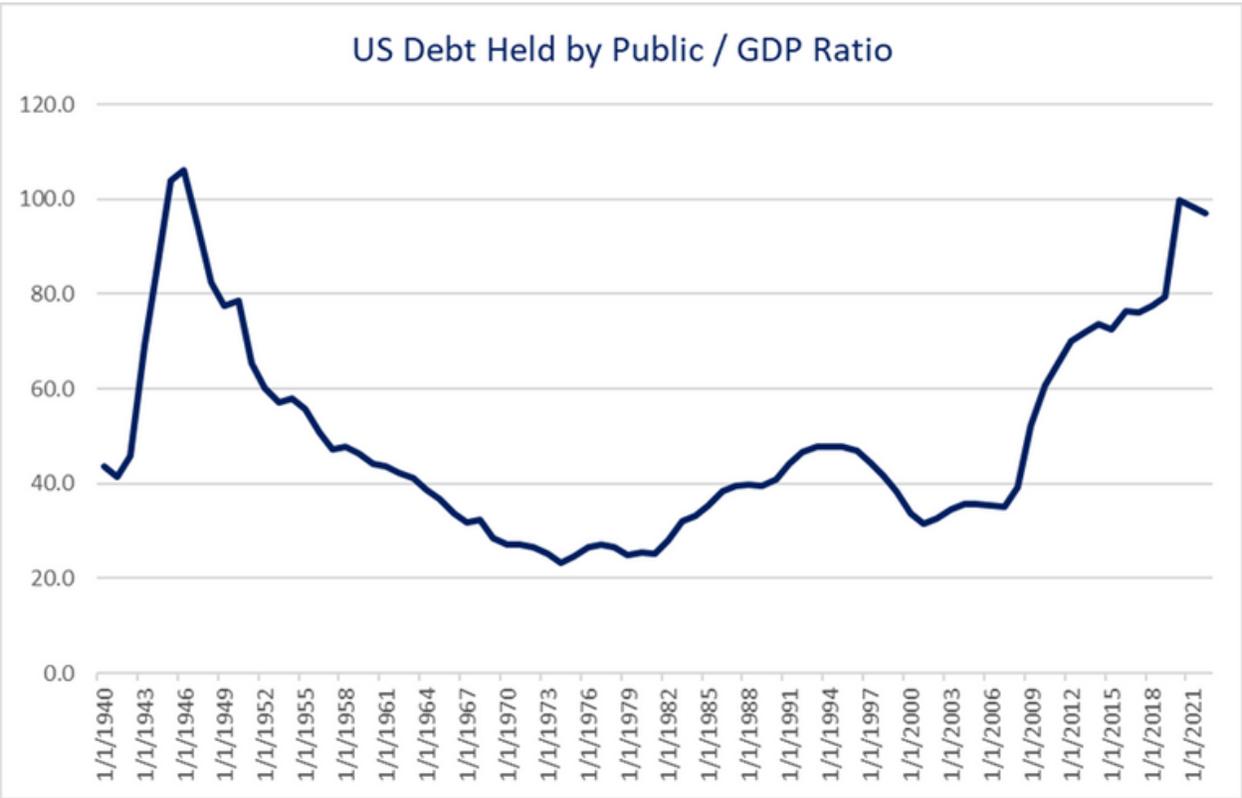
NLP analysis of earnings call transcripts of the S&P 500; avg 3,174 transcripts reviewed per quarter



Source: FactSet, BofA Global Research

*Keywords include: altcoin, bitcoin, blockchain, crypto, cryptocurrency, decentralized finance, defi, ether, ethereum, NFT, non-fungible-token
Year-over-year calculation period: 1Q'20 – 3Q'20 and 1Q'21 – 3Q'21 through 8/1/21. Note 3Q'21 not shown on chart.





Bond market at a crossroads with swelling bond supply but rapidly cooling inflation