Investment Strategy
April 2024

The market continued its relentless push upwards during the first quarter of 2024 on the back of a small group of stocks that capture the "Artificial Intelligence (AI)" euphoria. This rally has reignited rampant speculation as random crypto coins surge, insolvent stocks jump higher, and even well-known companies compete to say "AI" as many times as possible during their quarterly conference calls. Although we believe the AI bubble is largely without substance, true believers are still faced with the massive power demand these models require which is already stressing electric grids around the world. The need to rapidly deploy new power plants will only further inflame inflationary pressures in the U.S. economy, making the Federal Reserve's job increasingly difficult. Meanwhile, full-time employment declined over the last six months[1] and a steady stream of large corporate layoff announcements continued in 2024. The carnage in the commercial property market is piling up and delinquency rates among non-prime borrowers are surging. This creates a very confusing and treacherous world for investors. We believe resource stocks and select international companies currently offer the most appealing investment opportunities. Most notably, gold prices have jumped to a new all-time high while gold mining stocks continue to trade for very attractive valuations.

The performance of the S&P 500 was dominated by the "Magnificent 7"[2] last year as this group collectively increased their market capitalization by over $5 trillion. This concentration has continued in 2024, but the outperformance has become even more narrow as three of the former leaders have "fallen off the wagon". During 2024, Tesla's stock is down sharply, Apple has performed poorly, and Google drifted sideways until a sharp rally late in the quarter[3]. This has left the four remaining stocks to carry the load with NVIDIA adding $1.1 trillion in market cap just this year! Many other highly speculative investments have joined the party over the past few months. The recent market behavior has been reminiscent of 2021, although certainly not as broad based in its absurdity. The euphoria has been driven by the potential wonders of "A.I." and the belief it will bring about important technological advancements to mankind.

The current iteration of "artificial intelligence" was sparked by the release of ChatGPT-4 a year ago. ChatGPT is a large language model that excels at providing written answers to questions or queries. ChatGPT is impressive in its ability to spit out a detailed answer that appears well researched. Unfortunately, ChatGPT has been hyped as a "General AI" that is thinking, discovering, and generating original thought. Such an AI would be truly

[1] The Fed's household survey shows that full time employment is down by 1.78 million since November.
[2] Apple, Amazon, NVIDIA, Microsoft, Google, Meta/Facebook, Tesla
[3] Tesla declined 29.2%, Apple declined 11%, and Google gained 8% after a sharp rally at the end of the quarter.

historic, but that is not what is being created. Large language models (LLMs) intake massive amounts of data and use it to essentially predict a string of words that sound relevant. Often, the LLM will simply spit out copyrighted material from a human writer as if it was its own. LLMs are mimicry machines that can be highly convincing, but they have no ability to solve the world's problems. The models have also been found to be inaccurate. In one famous example, an LLM was asked to write a law brief and the model simply made-up previous cases out of thin air[4]. The inability to trust the accuracy of LLMs effectively disqualifies the technology from any critical tasks. We have yet to see a use for an LLM during the past year that has a clear pathway to substantial long-term profitability. Venture-capital firm Sequoia recently provided some prospective as they estimated that the AI industry spent $50 billion on NVIDIA chips in 2023, but only brought in $3 billion in revenue.[5]

While we are skeptical of many of the grand claims made by the promoters of LLMs, the industry has another glaring problem even if some of these dreams do come to fruition. These models process massive volumes of data which require a considerable amount of electricity to train and operate. As a result, electric grids across the developed world are being stressed and utilities are scrambling to build new generation facilities[6]. It is estimated that a new data center opens every 3 days somewhere in the world. Data centers supporting LLMs use nearly 7 times more power than a normal data center during the training phase and roughly 3.5 times more while in operation. PJM Interconnection, a wholesale power market across 13 Midwest and Northeast states, projected the region would need to add enough additional power for two New York Cities by 2029. This physical reality brings into question the economic viability for many potential uses of LLMs. This is also creating inflationary pressures in the developed world which significantly increases the difficulty of the Federal Reserve's job.

The Fed hiked interest rates aggressively in 2022 and 2023 to control the burst of inflation that emerged following COVID. While price increases have certainly slowed, the goal was to get inflation back to their 2% annual target. During their March meeting, the Fed quietly gave up on this goal and admitted that inflation of 3-4% per year would have to be good enough. If inflation runs at 4% per year for 10 years, U.S. citizens will lose nearly half of their purchasing power in dollar terms (-48%). This scenario would be devastating for recent retirees that are living off their investment portfolios. Triggered by the Fed's admission in late March, commodities have been up strongly with gold up 7.3%, oil gaining 4.8%, and copper jumping 4.2% over just the past two weeks.

[4] Mata v Avianca is the case we are referring to. However, there have been several other examples.
[5] AI Ascent 2024 published March 26, 2024 on Sequoia's website
[6] Natural gas, coal, or nuclear are required because data centers require consistent power. Solar and Wind won't work.

The price of gold deserves the most attention because it has forcefully broken out to a new all-time high price[7]. Gold has continued to rally into April with the metal seemingly gaining 1% per day. With higher inflation becoming accepted policy, governments and citizens around the world are beginning to diversify their stores of value away from U.S. Treasuries and other dollar denominated bonds. With no other paper currency in the world capable of the job, unfriendly governments are stockpiling things like gold, oil, copper, and other critical inputs while regular citizens are left with fewer choices such as gold, silver, and precious stones. We believe the best place to have gold is in the ground itself through the ownership of gold mining companies. Since the last major gold cycle peaked in 2013, gold mining companies have been forced to become financially disciplined, pay down debt, and completely stop developing any new mines. Most of the mining industry is now lean and highly profitable because they can extract the metal for roughly $1,100-1,400 an ounce compared to current prices around $2,300. Interestingly, most gold mining stocks are down 30-50% from their highs of two years ago when gold was trading around $2,000. With gold now 15% higher than those levels, we believe mining stocks are a considerable bargain at current prices.

The bottom line is the LLM bubble has been surprisingly forceful in the face of uninspiring applications and highly questionable economics. The tech rally is now showing signs of exhaustion with even NVIDIA going sideways over the past month. Investors would be wise to remember that markets driven by speculative momentum generally don't end gracefully. Conversely, markets are starting to recognize that the world is quickly running up against physical limitations when it comes to oil, copper, electricity, and other important inputs. At the same time, the world has amassed levels of debt we have never seen before in history. With supply problems emerging and governments printing money without restraint, it is likely that commodity prices will be pushed higher in the years ahead (triggering inflation). When looking out over the next ten years, investors need to focus on maintaining purchasing power. This is best achieved by a portfolio of high-quality companies trading for low valuations reinforced with companies that produce critical commodities or control important physical assets. Incredibly, these are the cheapest assets in the market today.

Sincerely,

Keating Investment Counselors, Inc

[7] It's been reaching new all-time highs in the other major currencies for the past 6-12 months.

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