Strategy Thoughts

May 2024

If credit spreads tell us about expectations, it seems everyone has forgotten!

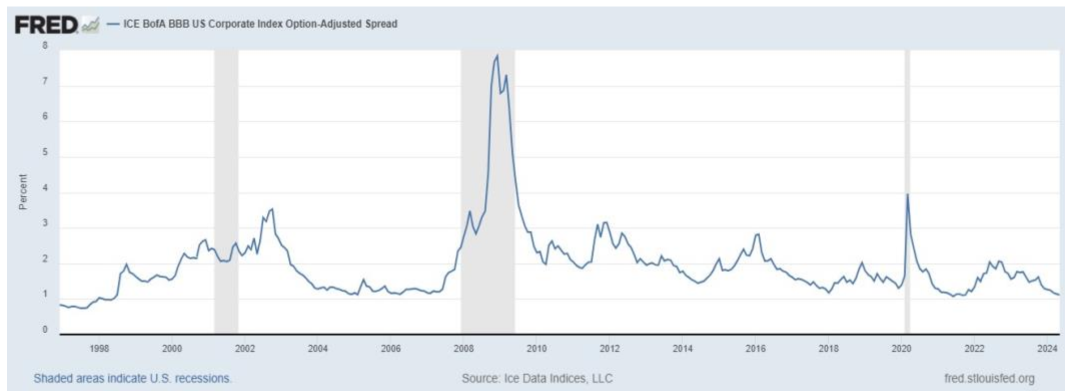
AI and Uranium

Introduction

Last edition I concluded with comments relating to how investors invariably learn valuable lessons through an investment cycle, but typically seem to forget those lesson next time around, just when they would be most valuable. Historically credit spreads, the difference in yields between high quality and low quality debt, has been a key indicator of levels of complacency, and high levels of complacency have tended to accompany important tops in markets. In this edition of Strategy Thoughts I review where credit spreads are currently and some other signs of growing complacency. I also further outline the long term optimism I continue to hold for the outlook for uranium and significance the boom in artificial intelligence has for this outlook.

Credit Spreads and Complacency

The chart below shows the difference between high yield corporate debt and treasuries. What is clear is that during recessions this spread, not surprisingly widens, however, ahead of recessions and usually close to important market peaks this spread is low, indicating that investors have little fear of default.

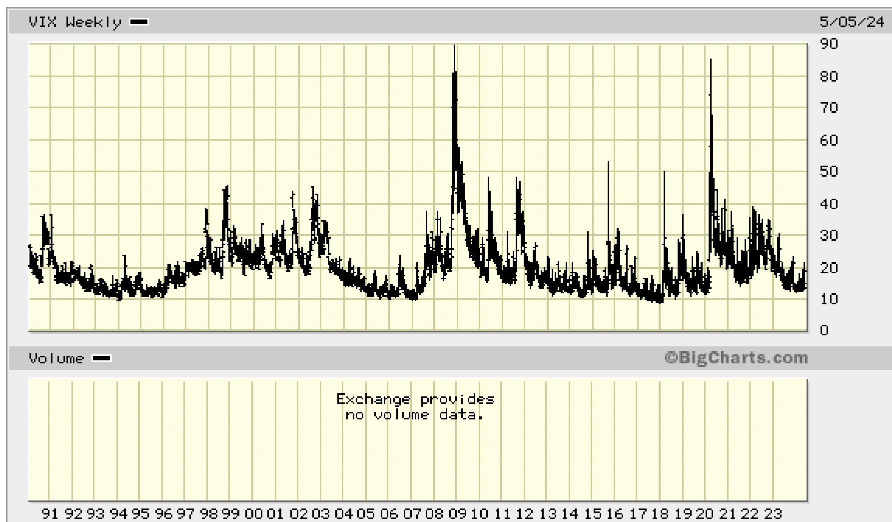


The current reading of 3.08 is the lowest it has been since June 2007, which it should be remembered was just ahead of the worst market, and economic, collapse in seven decades. This reading was also low, highlighting a lack of fear on the part of investors, ahead of the market peaks in late 2021 and late 2019. What is somewhat surprising is that this level of complacency is being seen even at a time when defaults in high yield bonds are surging. As the Reuters headline below illustrates.

> **US high yield spreads still tight despite pick-up in distress** Reuters May 3, 2024

It is not only in the bond market that complacency is rife.

The VIX index is also at a very low level;

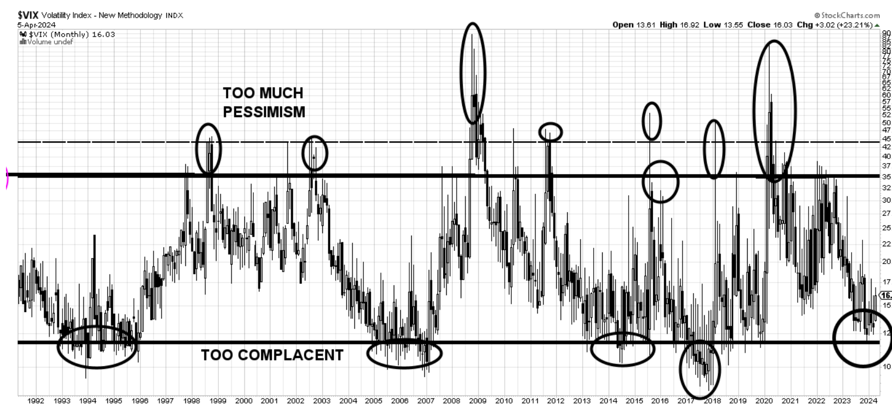


It is not quite as low as it was ahead of the GFC, but it is low, and the preceding peaks of volatility over the last four years since the COVID recession spike, have been getting lower and lower.

A similar concern was raised by JP Morgan Asset Management a few weeks ago;

JPMAM's Gimber: Market complacency is making me uncomfortable

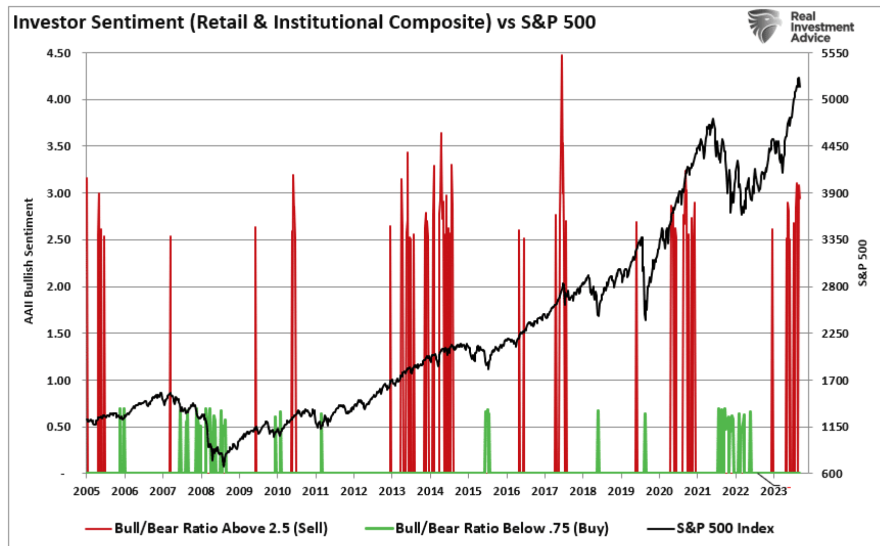
Investors should beware of double-digit earnings growth expectations when bond markets are pricing in a cooling economy, says JP Morgan Asset Management global market strategist Hugh Gimber.



At the same time, a strategist at Ned Davis research commented on MarketWatch that low levels of implied volatility readings on bond, equity and currency markets, could leave markets vulnerable.

In a further sign of heightened expectations, and reduced fear, the Conference Board released the results of their survey of investor expectations. Each month they ask whether investors expect the market to be higher, flat or lower over the next year. At the end of March 49.7% expected stocks to rise. Not surprisingly this was close to double the percentage who expected a rise at the lows two years ago, and almost three times the percentage who expected a rise in 2009, at the end of the GFC bear market. Remarkably, at the peak of the market ahead of the GFC the similar reading was a high 47.7% but not as high as was recorded two months ago.

Given that result from the Conference Board it is perhaps not that surprising that the ratio of Bulls to Bears in the American Association of Individual Investors is as high as it is and has been for a number of months.



Recession?

A year ago there was a widely held expectation that the Fed tightening, that had begun the previous year, was almost certain to cause a recession, as CNN wrote on 2nd July 2023;

> **New York CNN —**
> Economists, investors and the Federal Reserve have sounded alarm bells for months that a recession could come later this year. But a growing chorus of experts believe a downturn might not happen until early next year.
>
> Here are some of those recent calls:
>
> - Bank of America CEO Brian Moynihan told CNN on Tuesday that he believes the US economy could tip into a recession early next year, rather than this year like he originally predicted.
> - Vanguard economists wrote in their mid-year outlook that they see a high probability of recession, and the "odds have risen that it could be delayed from 2023 to 2024."
> - JPMorgan Chase economists said in a note last week that there could be a "synchronized global downturn sometime in 2024."
>
> Delaying recession predictions isn't anything new. Investors and economists last year predicted that the US could enter a recession in early 2023, after the Fed set out on its aggressive interest rate hiking campaign to tame inflation. As the economy proved more resilient than expected, and the US has avoided recession so far, the case for a 2023 recession has been crumbling. Bets have accordingly started to move further out.

Since then expectations for a recession, given that one has not clearly started yet, have slipped further to the point that the vast majority now no longer fear any recession at all;

> **The U.S. economy and stocks have likely dodged a recession: El-Erian** Morningstar 5 May
>
> **US jobs fall short of expectations at 175,000 but risk of recession reduces** Investmentweek.co.uk 3 May

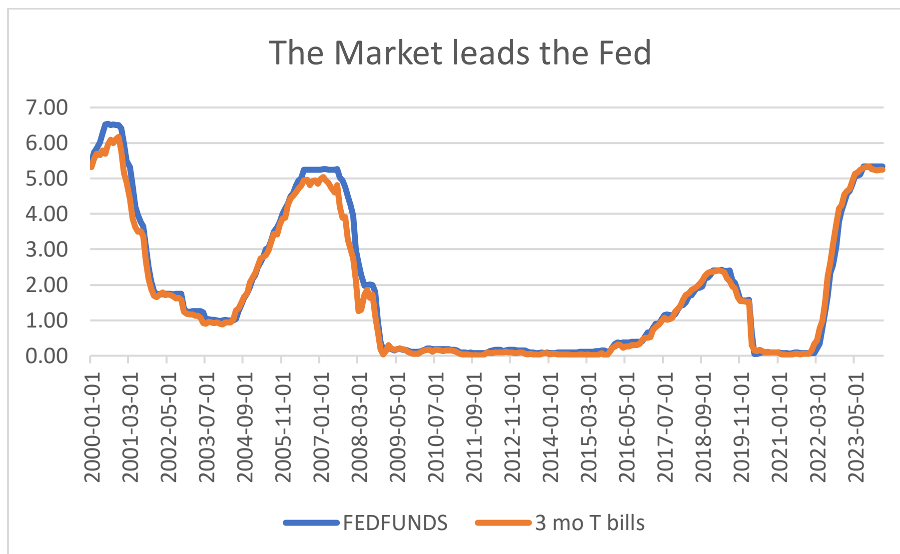
Despite these protestations to the contrary, a number of historically successful indicators point to an imminent recession. Bond market guru, Jeffrey Gundlach, has pointed out many times that whenever the US unemployment rate has risen above its longer term (36 month) moving average a recession has always already started or been about to begin. The latest data shows the rate is rising, and has been for

a while, and is now within a tiny fraction of that longer term moving average. Any further rise, or even a sideways move in that rate over coming months, would trigger this indicator.

Just because the previously widely anticipated recession has not yet begun it in no way indicates that it has been avoided, and the now prevalent relaxed attitude that it has is yet another indication of the broad based complacency currently priced into markets.

What leads what in interest rate markets?

There is still a widely held view that it is the Federal Reserve that drives interest rates and that the Fed will somehow be able to do something to avoid a recession. I have written at length over the last few months that investors should be careful what they wish for as buying after the first cut in interest rates has not been a particularly successful strategy, largely due to the fact that the reason for the cut has already been widely anticipated… a slowing economy. It is in fact the market, not the Fed that drives short term rates, as the chart below shows. It is a little difficult to see, but Fed Funds rate only starts to be reduced after the three month treasury bill yield has stated to fall.



The three month treasury yield is currently at 5.4%, a little higher than it was one year ago, and a little higher than it was at the start of this year.

Uranium

I first mentioned uranium as an attractive long term investment at the beginning of this year and I described how my interest had originally been aroused some years earlier after reading 'Apocalypse

Never'. That book outlined how in the pursuit of averting any climate disaster nuclear had to be part of the solution, not the problem. I showed the very long term chart of the Global X Uranium ETF, URA.

Back then I suggested that URA may be on the verge of a very long term breakout. Since then URA has been consolidating around the $30 level that was its original breakout high in 2021. What is encouraging is that volume has remained high and the fundamental story only continues to get better, particularly now as the AI boom has emerged.

The poster child of the AI revolution that is apparently underway is undoubtedly semiconductor chip maker; Invidia.

In the sixteen months from October 2022 the share price of Invidia rose close to ten fold and moved it from relative obscurity to becoming one of the very largest companies, as measured by market capitalisation, in the world.

As I have mentioned in recent editions of Strategy Thoughts I think the era of the so called 'Magnificent Seven' leading tech companies may already be over and the bubble associated with the future of AI may have burst. However, even if expectations around AI, as manifested in the extreme valuations of companies associated with AI, may have been extrapolating hope far too far into the future and got far too far ahead of themselves, AI is undoubtedly here to stay and is set to grow. The implications of this for an already stretched power grid are far reaching.

Artificial Intelligence is very power hungry, far more so than simple search engines. This was highlighted recently by Scientific American Magazine, that wrote:

> "that if you were to fully turn Google's search engine into something like ChatGPT, and everyone used it that way—so you would have nine billion chatbot interactions instead of nine billion regular searches per day—then the energy use of Google would spike. Google would need as much power as Ireland just to run its search engine."

Last year the Wall Street journal wrote;

> Elon Musk is predicting U.S. consumption of electricity will triple by around 2045. "I can't emphasize enough: we need more electricity however much electricity you think you need, more than that is needed." He anticipates an electricity shortage in two years that could stunt the energy-hungry development of artificial intelligence. For the past 20 years, U.S. electricity demand has grown at an average rate of 1% each year, according to a Deloitte study. PG&E expects electricity demand will rise 70% in the next 20 years, which, the California company notes, would be unprecedented. Similarly, McKinsey expects U.S. demand will double by 2050. Deloitte estimates the largest U.S. electric companies together will spend as much as $1.8 trillion by 2030.

Recently the CEO of Virginia based electric utility company Dominion Energy was quoted;

> "Economic growth, electrification, accelerating data centre expansion are driving the most significant demand growth in our company's history and they show no signs of abating,"

Further illustrating the enormous growth in energy demand from data centres the Financial Times on the 2nd May wrote;

> The International Energy Agency says that by 2026 data centres could globally consume more than 1,000 terawatt-hours of electricity, more than double 2022 levels and roughly equal to Japan's total electricity usage. The US, which is home to a third of the world's data centres, is experiencing rapidly growing electricity demand for the first time in two decades, spurred in part by the power-thirsty centres. Five-year forecasts for the growth in electricity demand in the US have nearly doubled in the past year from 2.6 per cent to 4.7 per cent, according to a report from Grid Strategies.

Given the seemingly insatiable appetite for electricity that AI data centres have it should be a concern for all electricity users that many utilities are already struggling to keep up with current demand, as the headline from NBC on 3rd May regarding the situation in Texas illustrates;

> **ERCOT Warns of Brownouts This Summer in Forecast of Power Grid Demand**
>
> While the data in the report is just a prediction, there is concern that demand will outpace the power supply this summer

Given that it is the AI revolution that is exacerbating an already tight electricity market it is perhaps not surprising that leading Tech entrepreneurs believe they know what the solution may be.

On 5th May The Telegraph ran the headline;

> # Silicon Valley finds its silver bullet in a desperate race for energy
>
> Tech giants bet on a nuclear revival to power the supercomputer revolution

The article included the following comments;

Mark Zuckerberg, Meta's chief executive, has assembled what is believed to be the world's biggest arsenal of Nvidia's latest AI chips. He told a podcast last month that ultimately using them all in one place could require a gigawatt of power, potentially requiring a dedicated nuclear supply. "A gigawatt [data centre] would be the size of a meaningful nuclear power plant," he said.

Zuckerberg's comparison is not simply flippant. The desperate race for energy is triggering a wave of interest in nuclear power among the world's tech barons. Venture capitalists are becoming nuclear boosters, betting that it will be the power source to keep the AI boom running.

Elon Musk has said shutting down nuclear plants is "anti-human"

It appears that Elon Musk may be getting what he wants as the shuttering of aged nuclear plants slows down and even reverses and their lives are extended.

Once Unthinkable Nuclear Plant Revival Is a Reality in US Shift

Restart of Michigan's Palisades plant could lead to more reopenings. Bloomberg 30 April

And it is not just in the US that nuclear plants are having their lives extended. As power-technology.com reported on 26th April;

IAEA clears Japanese reactor for 60-year lifetime

Following a review, unit 3 at the Mihama nuclear power plant (NPP) has been deemed fit for further operation

An opinion piece in the New York Times on 18th April illustrated the breadth of this movement to increase and extend nuclear use;

In search of that revival, representatives from more than 30 countries gathered in Brussels in March at a nuclear summit hosted by the International Atomic Energy Agency and the Belgian government. Thirty-four nations, including the United States and China, agreed "to work to fully unlock the potential of nuclear energy," including extending the lifetimes of existing reactors, building nuclear power plants and deploying advanced reactors.

Understandably, all this is well received by executives at uranium mining companies;

Growing demand for power hungry AI datacenters has executives at Canadian uranium mine Cameco glowing with anticipation.

Speaking on the resources firm's Q1 2024 earnings call Tuesday, CEO Timothy Gitzel indicated the computationally intensive nature of AI workloads, and the challenges faced obtaining adequate power for the datacenters where they run, will drive up sales of uranium for use as a nuclear fuel. The register.com 1 May

Whilst uranium prices have been moving higher for the last four years it is worth noting that the URA ETF is still less than one quarter of the price it was in early 2011 ahead of the Fukushima disaster.

Gold

In early April IG indicated that retail expectations for the gold price were negative;

GOLD PRICE FORECAST – MARKET SENTIMENT

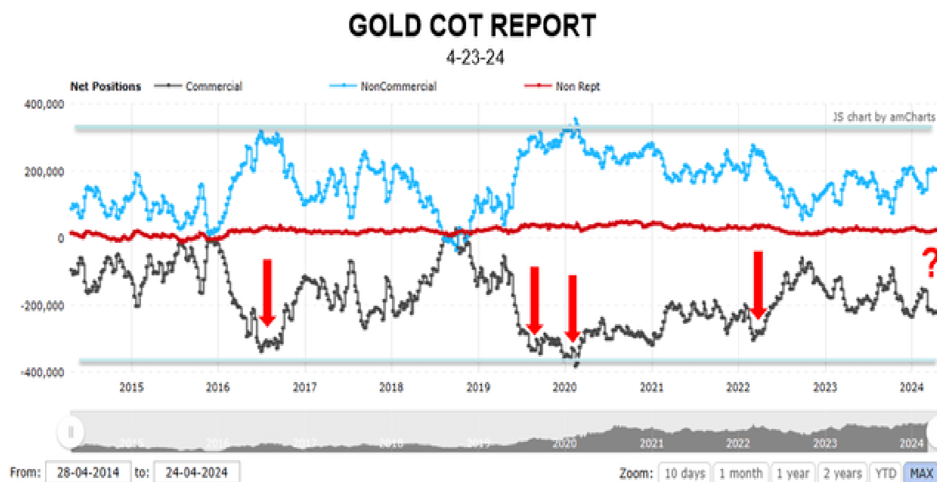
IG client data shows the retail crowd is betting against gold. Currently, 55.46% of traders hold net-short positions, resulting in a 1.25 to 1 short-to-long ratio. While this bearish positioning has remained largely unchanged since yesterday, it has increased by 6.15% from last week. Conversely, net-long positions have ticked up 4.14% since yesterday, even with a week-over-week decrease of 9.23%.

We often adopt a contrarian view of market sentiment. The predominantly bearish positioning could portend additional gains for the precious metal, meaning another all-time high could be in the cards before seeing any type of meaningful pullback.

Key Takeaway: When market sentiment leans heavily in one direction, contrarian cues can offer valuable insights. However, it's crucial to integrate these signals with thorough technical and fundamental analysis when formulating any trading strategy. IG 2 April

Since then gold has rallied further, corrected and recently started to rally again.

Historically, when non commercial traders (speculators) are bullish and commercial traders (manufacturers / miners) are bearish then gold typically falls. The reverse is also true, ie. when commercials are bullish and non commercials bearish then gold prices rally. Currently, as the chart from Seeking Alpha below shows, the diversion in opinion between the two trader groups is nothing like that seen at previous peaks in gold.



I continue to believe that the breakout in the price of gold I highlighted earlier this year has further to run.

Conclusions

Last edition I concluded with;

> Markets remain historically expensive, which almost guarantees poor long term returns, the Magnificent Seven are themselves breaking down, and important lessons and disciplines from the past are being forgotten.

This continues to be the case, as fear of a US recession have evaporated, faith in the omnipotence of the Fed remains firm and complacency about risk in markets remains high and obvious. The lesson that has been repeatedly learned throughout history is that such things should be warning sign, yet it appears the vast majority have forgotten.

Despite the fact that expensive equity markets hold little general attraction, a number of areas continue to offer the prospect of healthy real returns. Gold is one, but the market I continue to have the greatest confidence in is uranium, and, ironically, given its stock market bubble has likely already burst, it is the AI boom and associated hunger for electricity that will continue to enhance uranium's attractiveness.

Kevin Armstrong

8th May 2024

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The Expectations Game

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