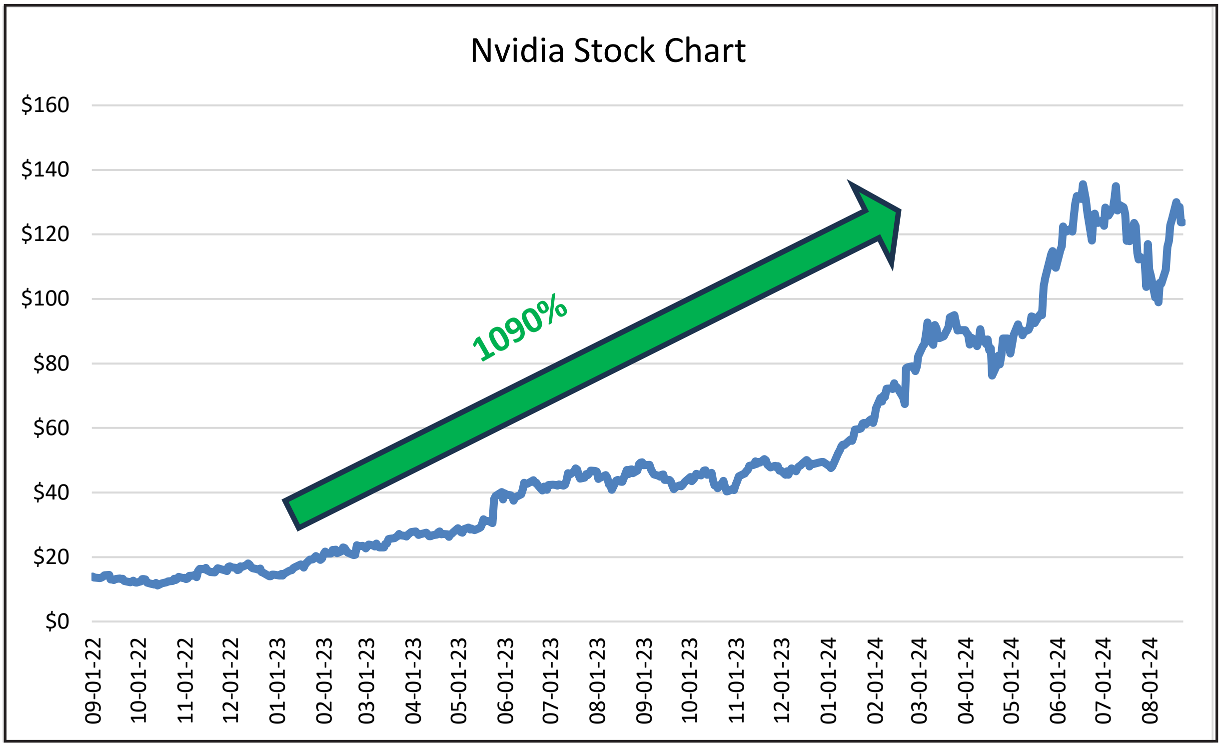
Portfolio Positioning

As we expect the North American economies to slow down, we continue to concentrate our long investments in our strongest conviction ideas and spend an increasing amount of time looking for shorts. As we said last month, we believe it will be easier going forward for the next 2-3 years to make money on the short side of the portfolio as the stock market phases into a "bear market". Our gross long and net exposure are low.

As the July employment data shows, the Canadian economy is not progressing well. Indeed, the number of jobs fell by a net 2,800 jobs in July despite the government sector alone creating 41,000 jobs. This indicates just how substantial the contraction in the private sector is. This net job contraction is also despite the population increasing by 125,000 individuals over the same period. Not only is the private sector shrinking despite a large increase in population, but wages are also up 5% year over year. These numbers suggest a potential risk of stagflation (weak economy + high inflation) which is probably the worst outcome for our economy and the stock market.

The AI Bubble?

The widespread AI excitement that continues to this day initially kicked off in November 2022 when OpenAI launched Chat GPT, effectively bringing free generative AI services to the general public. Since then, shares of Nvidia have been on a tear and are now up more than 1000% (from November 2022) while also bringing up along with it many other "AI" themed stocks.



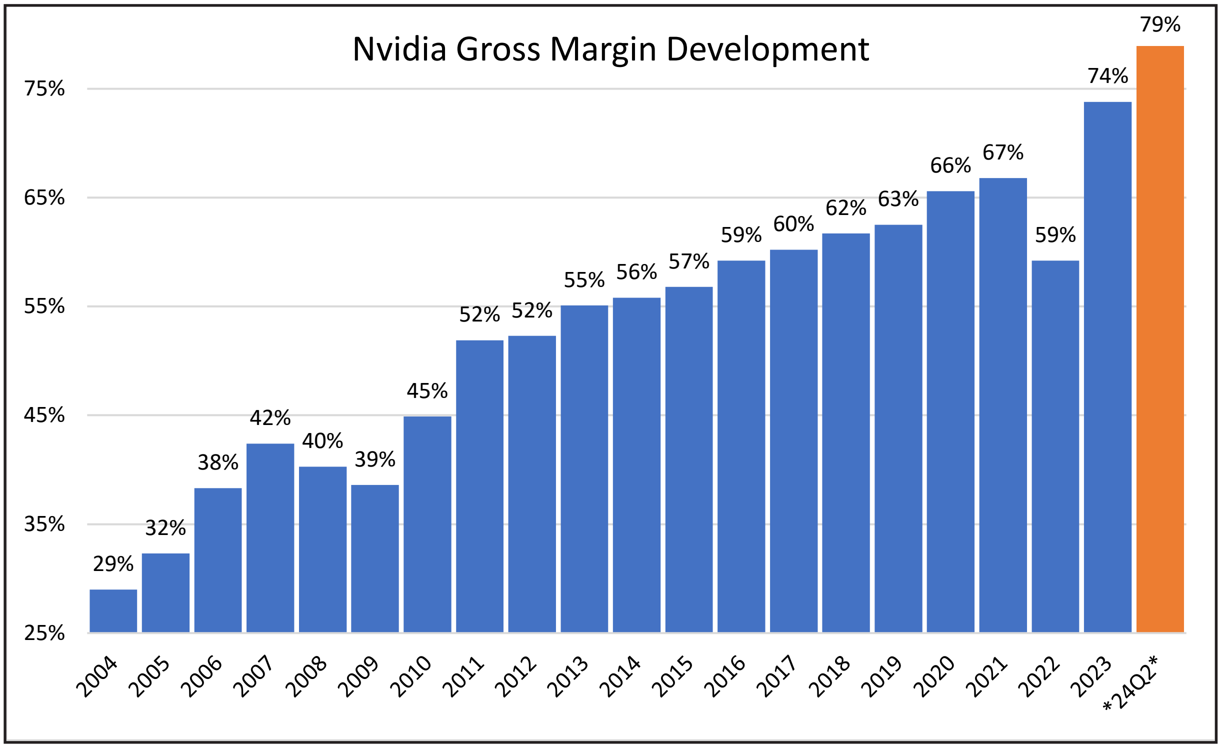
Source: Factset from September 1st 2022 to August 22nd 2024

Performance of other "AI" stocks:

Performance since November 2022							
Celestica	+382%	Meta Platforms	+372%	Broadcom	+206%	Arista Networks	+161%
Dell	+185%	Crowdstrike	+118%	AMD	+103%	TSMC	+92%
Palo Alto	+103%	SAP	+84%	Pegasystems	+88%	Micron	+87%
Amazon	+71%	Synopsys	+56%	Amphenol	+67%	Microsoft	+62%
Marvell Technology	+60%	Google	+65%	Qualcom	+38%	Apple	+53%
Texas Instruments	+18%	Accenture	+11%				

Source: Factset - as at August 23rd 2024 intraday pricing

Demand growth for Nvidia's graphics processing units (GPUs) has since then developed to extreme levels, in turn enabling the company to command strong pricing power and to become very profitable. At roughly US$40,000 a piece, the gross margins on Nvidia's GPUs are gigantic and this situation of extreme demand explains why their gross margins have expanded from around 55% in 2015 to now almost 80% as of the last quarter.



Source: Factset

Examples of this extreme demand includes announcements from the world's big tech companies (Microsoft, META, Amazon, Alphabet, and Elon Musk's companies) for massive capital investments dedicated to AI projects with the hope of getting the lead in generative AI:

"Tesla will spend around $10 billion this year in combined training and inference AI"

Elon Musk tweet; 2024.04.28

Google's spending on artificial intelligence is projected to exceed $100 billion and "the total cost to get to full AI will be nothing short of astronomical"

Demis Hassabis, CEO of Google DeepMind[1]

"Meta anticipates full year 2024 capital expenditure will be in the range of $37 billion to $40 billion." Also, "we currently expect significant capex growth in 2025 as we invest to support our AI research and our product development efforts"

Meta 2024Q2 earnings call

"Microsoft's capital expenditure for the entire fiscal year ending June 2024 will increase approximately 50% YoY to more than $50 billion"

Forbes[2]

1 Inc.com : Google could spend 100 billion going all in on ai

2 Forbes.com : Big tech Q1 earnings: AI capex increases as AI-related gains continue

To further make the point about Nvidia's strong pricing power at the moment, the world's big tech companies have also each expressed on their latest earnings call that they would rather **over invest** at any price today than risk being behind and losing to competitors in terms of AI capabilities:

"The reality right now is that while we're investing a significant amount in the AI space and in infrastructure, we would like to have more capacity than we already have today. I mean we have a lot of demand right now. And I think it's going to be a very, very large business for us"

Amazon 2024Q2 earnings call

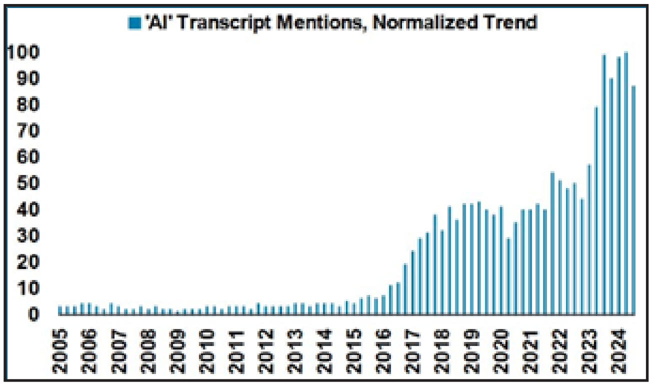
"When you go through a curve like this, risk of underinvesting is dramatically greater than risk of overinvesting"

Google 2024Q2 earnings call

"I'd rather risk building capacity before it is needed rather than too late given the long lead times for spinning up new inference projects"

Meta 2024Q2 earnings call

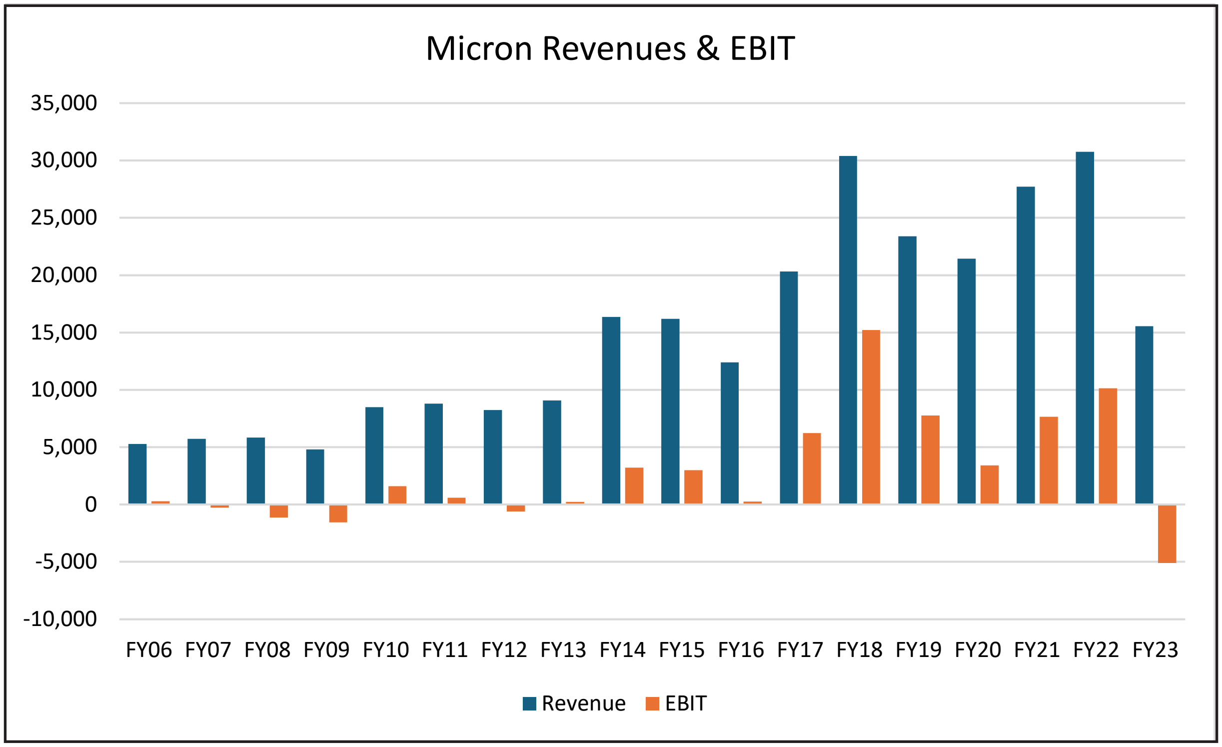
Now, it is not only the big 4 tech companies going after AI. In fact, all the big companies want a piece of it and almost all of them get asked about their AI plans on their earnings calls (see picture below). Most companies that talk their game in AI have seen their stock rewarded accordingly, in turn bringing even more intensity by most investors to pay attention to the trend on top of the media adding to the excitement. Over time, this has become an obsession to the point where most of these stocks are now discounting many years of substantial growth. In our opinion, these types of stocks are now overvalued and therefore the risk of a substantial stock price correction (50%+) when the current extreme investment cycle turns down (yes, the cycle will turn – in our opinion in 2025 or 2026).



Source: Morgan Stanley Research

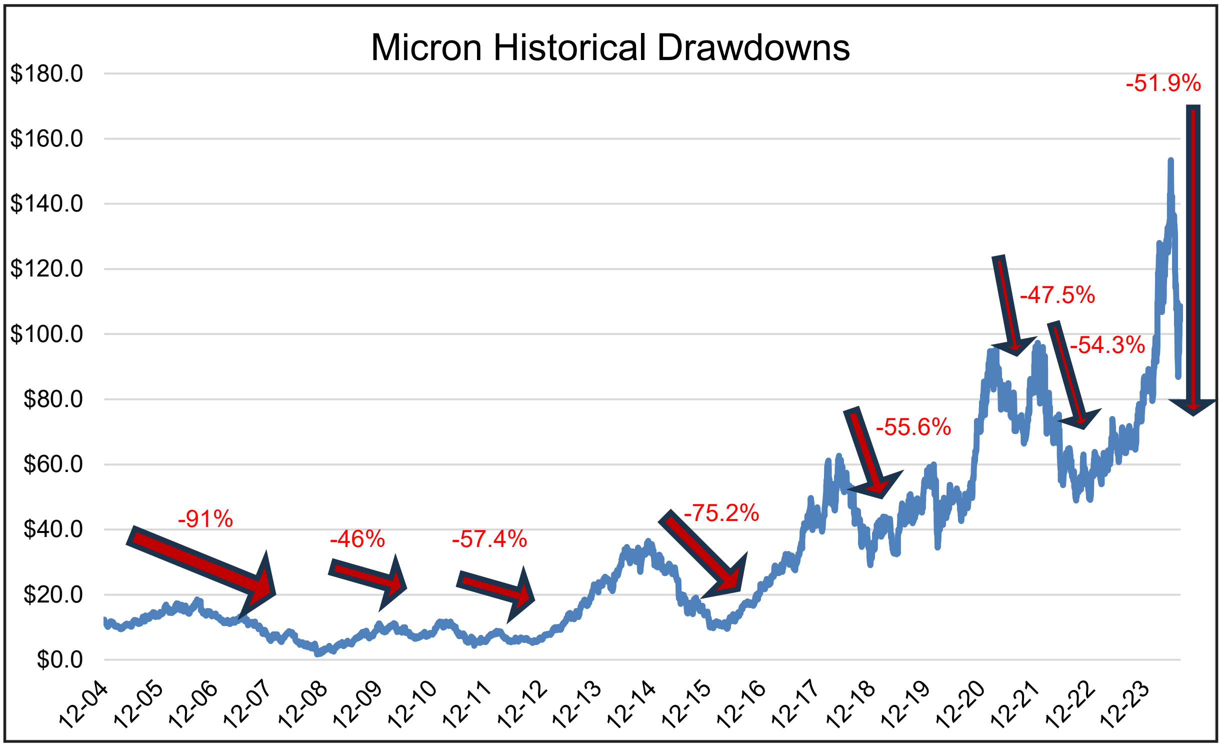
We believe this AI boom and explosion of capex investments is going to look a lot more like the boom-bust cycles that Micron has gone through over time. Businesses with capex-driven revenues, as opposed to a more predictable recurring revenue model like Microsoft, are dependent on their customers' capital investment decisions and therefore have a lower degree of predictability on top of being more cyclical. For example, take a look at the huge moves (up and down) in both the fundamentals and the share price of Micron over time (and as you will see later, the historical huge negative moves in the share price of Nvidia). Along with this high cyclicality also comes a much lower EV/EBITDA multiple of typically between 2x and 6x for Micron.

Micron (MU-US): Volatile Revenue and EBIT (in Millions):



Source: Factset - Company Filings

Micron (MU-US): Volatile Stock:



Source: Bloomberg

Micron (MU-US): Typically trades at a low 2x-6x EV/EBITDA multiple:

Source: Factset from January 1st 2005 to August 20th 2024

As for now, the AI bubble continues to rage full steam ahead and it has developed into a race between a bunch of very large profitable tech companies with no restraint on spending that are going "all-in" to hopefully win the race on any eventual AI benefit.

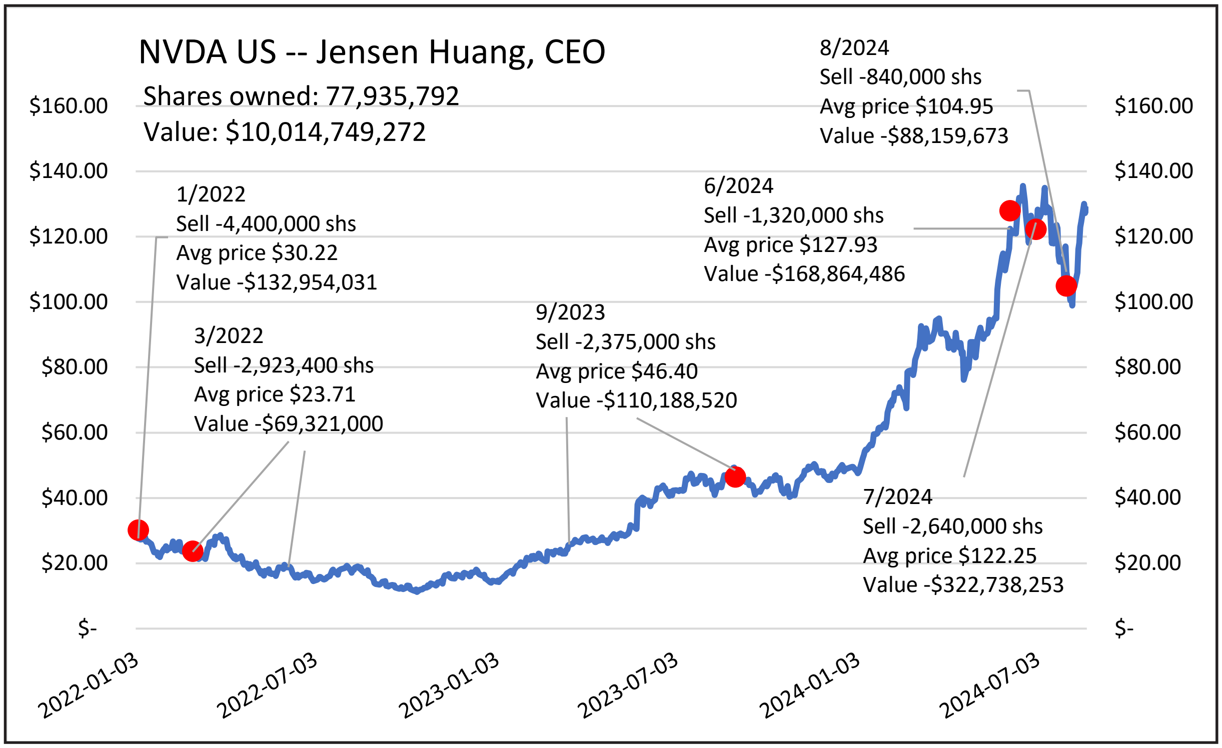
However, as Goldman Sachs explains very well in their recent report "Gen AI: Too Much Spend, Too Little Benefit", this has caused growing concerns as to whether or not all that capex being spent on AI initiatives could have little to show in terms of investment return. Concerns that the required revenue and cost efficiencies from those eventual AI benefits, if any, may prove to be too high of a price tag for the big tech companies to be able to earn adequate shareholder returns on their AI capex investments.

The current AI applications are only marginal in terms of productivity benefits, especially relative to their development costs, and we have yet to see a true "killer application" from the consumer perspective that would generate material productivity benefits and monetization opportunities. The longer this fact continues to hold, the more challenging the AI bull view will become and the more challenging it will be for the big tech companies to continue justifying their current AI capex spend levels. **This is why we anticipate a probable outcome of an eventual slowdown in AI capex spend in turn driving a triple whammy for the share price of Nvidia in terms of (1) a meaningful decline in revenues followed by (2) margin contraction and (3) downward path for the valuation multiple.**

Nvidia's growth has been impressive lately with revenues in fiscal 2025 now anticipated to grow by more than 6x vs 2022 levels and operating margins anticipated to expand from 34% to 65% over the same period. However, imagine what could happen to Nvidia's revenues and margins if as discussed, the big tech companies reassess and slowdown their AI capex plans? Nvidia's revenues could very well go down by let's say -10% instead of the recent rapid growth? Margins could contract as they lose pricing power on top of the impact from operating deleverage. Along with this, we believe it would be a reasonable outcome for the PE multiple to go down to under 30x or to similar levels last seen right before the start of the AI bubble. Therefore, we believe shares of Nvidia could easily fall by 50% or more while at the same time take the froth out of many other "AI" stocks which could very well likely – in our opinion – trigger an overall stock market correction (on top of seeing the economy going into a recession in 2025 – again in our opinion).

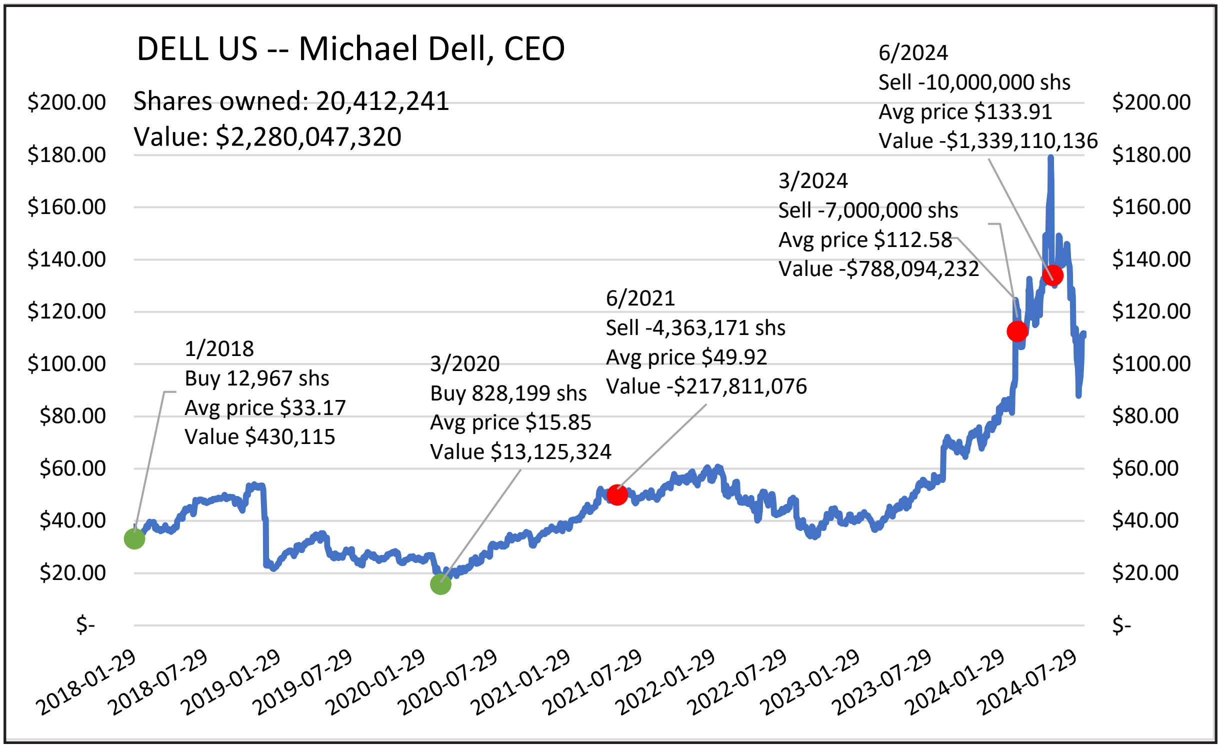
Finally, it seems we are not the only investors thinking there is downside to Nvidia and these types of stocks. For example, take a look at the insider selling activity from the CEOs of Nvidia and Dell.

Insider selling track record of Nvidia CEO (granted these sales are a small percentage of his overall holding):



Source: Ink Research

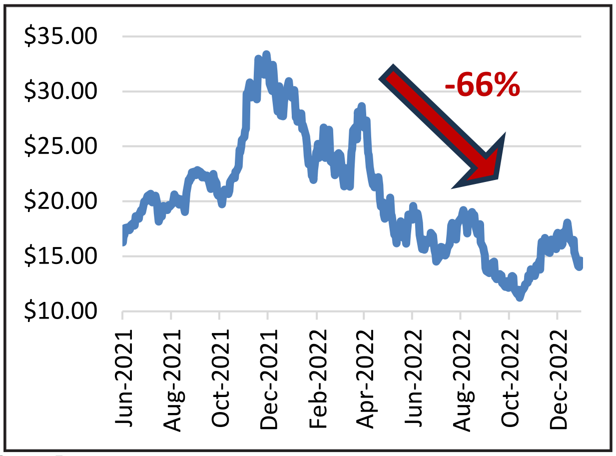
Insider selling track record of Dell CEO (Michael Dell, who has recently sold about half of his holdings):



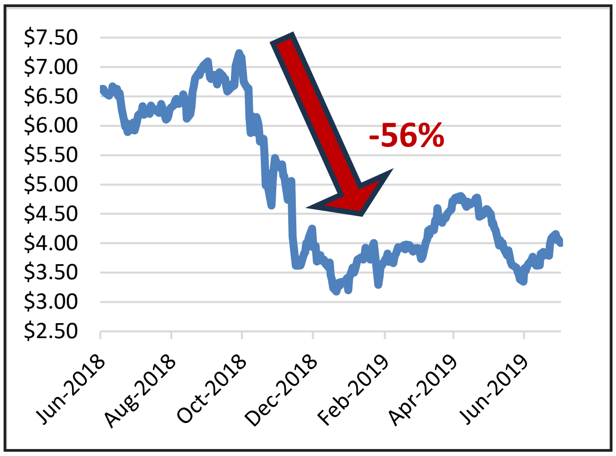
Source: Ink Research

Final Thoughts

As seen in the charts below, it has historically not been unusual for the stock of Nvidia to drawdown by more than 50% and given the risks of customer concentration, the nature of the business, and the current set of investor expectations then we see the potential for similar drawdowns as likely to reoccur again in the future – especially as the current levels of AI capex spend slows down.



Source: Factset



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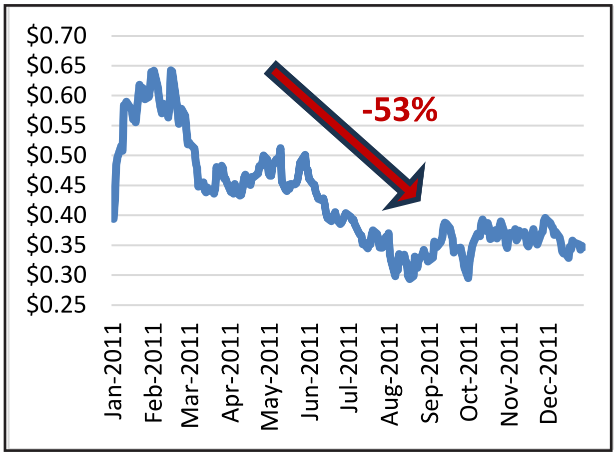

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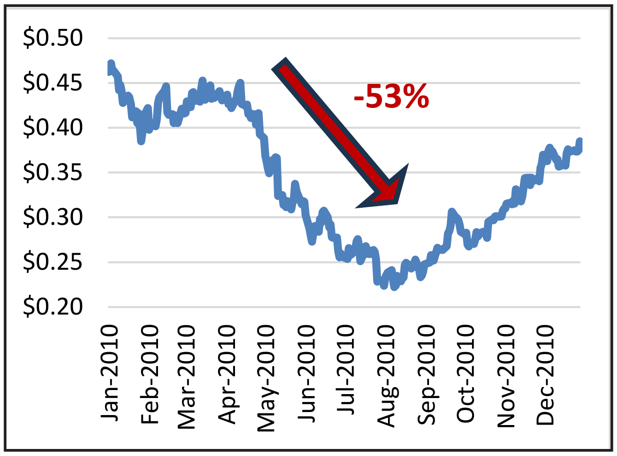

Source: Factset

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