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Hi everyone and welcome back to FYI, the four-year innovation podcast. I'm Michael Cromer, a product marketing manager here at Arc. On today's episode of FYI, we will be featuring last week's episode of In the Know, a monthly video series in which Arc CEO and CIO, Kathy Wood, discusses fiscal policy, monetary policy, economic and market indicators, and innovation. On this specific episode, Kathy Wood weighs in on artificial intelligence, bitcoin, Fed policy, electric vehicles, the discrepancy between GDP and GDI, bankruptcies, and the chairman and Chinese economies. Please enjoy. Greetings everyone. This is Employment Friday. I'm Kathy Wood from Arc Invest and this is going to be a little bit of a quicker dive into what has gone on in the last month because I'm going to a wedding and it happens to be very early in the afternoon. So please bear with me. It's going to be quick but to the point. So fiscal policy. As usual, we'll go through fiscal policy, monetary policy, economic indicators, market indicators, and then a little bit about innovation and particularly some of the nuances in the equity markets around innovation today. So fiscal policy to start. We are heading into the election year campaign season and so what that means is we're probably going to experience gridlock, which is a good thing. It means there will be little to royal the markets, we think, during the next year from a fiscal policy point of view. So that's good.
Monetary policy. We still have the Fed, interestingly, not mentioning money supply at all. Money supply is down roughly 5% on a year-over-year basis. Haven't heard a word out of the Fed on it. Maybe you have, but I haven't. It is still very focused on inflation and employment. Now employment, we had so many indicators in the last week or so that there was something for everyone, bulls and bears. So today we got the non-farm payroll. It was below expectations at 209,000. Expectations were 230. But the important point was downward revisions, 110,000 jobs revised
away over the last few months. So that made this quite a weak report from an employment point of view. But if you looked at average hourly earnings, they were a little better than expected. The Fed may not have liked that. And average work week was a little better than expected. So those probably all netted out to something a little weaker, not a lot weaker than expected.
Now we got all kinds of indicators. We got the ADP on Wednesday employment, which was almost 500,000. And of course, that roiled the market. In today's report, household employment, as you know, we focus on that because it captures more of the small businesses that are very important at turning points in terms of a leading indicator. Last month, those jobs were down, negative, 310,000. But this month, they bounced back, not all the way, but 273. In the report today, temporary employment was very weak, very, very weak. I rarely see it that week. So I took note

of that. And we also got the job openings report this week. And the number of job openings dropped by about 500,000. So again, as I said, something for everyone, including the Fed. The Fed seems to want to pay attention to the stronger numbers. So that is the employment side. On the inflation side, we see a year ago, the commodity prices started falling pretty precipitously. And so now we're coming up against the comparison against that drop. So commodity prices, which had been down
on a year-over-year basis by 20% to 30% are now down roughly 12%. So again, we're comparing against
declines last year. Now, if you look at the Bloomberg Commodity Price Index, it is still in a down trend. So that is a leading indicator for inflation. The PPI reported this past month was up 1.1% on a year-over-year basis. So the Fed has a 2% target on a year-over-year basis. We've got two leading indicators that are well below that commodity prices. And the PPI up only 1.1. If you look at the retail sales deflator, this is a number you kind of have to back into, and not many people pay attention to it. But it does belong to the retail sales report, which is a little more goods-oriented than services-oriented. But that is up only 0.2% on a year-over-year basis. And that is a consumer inflation measure. We do have the CPI. The last print was 0.1% month-to-month, so very good, well-behaved month-to-month, but still up 4% on a year-over-year basis. Now, this next month, so for June, and this report I think will be out next week, the comparison against a year ago was month-to-month, the CPI from May to June a year ago went up 1.2%.
So if we see the CPI up only 0.2% this month, month-to-month, then we will be dropping off a full percentage point. And that will take the year-over-year down from 4% to 3%. I know that's maybe a lot to digest right now, but it's the comparison against a very big increase last year that gets us down from 4% on a year-over-year basis, which was reported for May for the CPI, down to 3% in one month. And if per chance it's lower than 0.2%, then we will be dropping in to the 2% territory, maybe 2.8 or 2.9%. If you exclude shelter from the CPI last month, you'll see that it was up 2.2%. Now, that was the CPIX shelter, up 2.2%. Why do we pay attention to that? Shelter is the biggest lagging indicator in the CPI. And if you look at online indicators, which are day by day, you'll see that rents are beginning to fall on a year-over-year basis in many parts of the U.S., and perhaps it's flat overall for the nation. So that's pretty interesting, and there's another metric out there called trueflation. It takes into account 10 million different data readings throughout the country. This is a U.S. measure. And on a year-over-year basis, it's measured daily. We can get this daily. You can find it online. On a year-over-year basis, it is 2.2%. So the Fed has a lot of evidence that inflation is slowing, and yet you hear out of the last meeting unanimous an increase, or it was flat in the last go-around, but that the feeling was we will be seeing further increases in the months ahead in the Fed funds rate because of inflation. So I don't know how they're getting to this unanimous vote. I think Gulsby, Austin Gulsby, who's the latest member, he's stirring the pot a little bit, but not willing to go against the chairman when it comes to the final vote. Okay, so that's inflation and employment, which is what the Fed seems to care about. And both of the metrics they use are lagging indicators, which really makes no sense to me. Our confidence that we're moving into a deflationary environment
is increasing by the month, especially because the Fed is railing against inflation when it

is already coming down quite significantly. You know, it's interesting to listen to reports like Costco's and Home Depot's Costco's basically saying, okay, we're going to have to clear inventory by cutting prices. They just come right out and say it, but the Fed's not incorporating those sorts of variables into its analysis. Now, just the backdrop, though, away from these numbers, we're seeing rising bankruptcies. And a lot of the reason for this is because a lot of businesses take loans out on a floating rate basis. In fact, those are the only kinds of loans they can get. And the rates have gone up so much. A 21-fold, if you look at the Fed funds rate in a little more than a year. And a lot of businesses just cannot afford these loans anymore. And you're seeing the same with commercial real estate, strategic defaults left, right, and center just can't put up with the interest rate increases and the empty office buildings. One of my dear friends, a doctor in one of the best parts of New York City, Madison Avenue, Midtown, she's being evicted. And so is everyone else in the building because it's only half full. And this used to be prime property. Maybe that's too New York specific, but I wouldn't be surprised to see the same thing happening in many other big cities around the world. Maybe even the smaller ones, given the regional bank issues out there. Where else would we expect to see issues having to do with this massive increase in interest rates in such a short period of time? Well, we're learning now that in the private equity world, where you see a lot of collateralized loans, that there were three trillion dollars. This is as of last August, but by that time the Fed had already been jacking interest rates up by 75 basis points at a clip. Three trillion dollars in adjustable rate unhedged loans of that sort. So I think underneath the surface out there, we're not hearing a lot about this, but that there is a lot of pain. And we also see that the KRE, which is the regional bank index, is just wallowing around where it was roughly during the regional bank crisis earlier this year. So no real recovery there either. And of course, one of the reasons is the biggest lenders to commercial real estate these days are not the big banks. They're now allowed to allocate that or allocate that much risk to commercial real estate, but the regional banks. So we believe they are in quite a bit of under some stress. And that will continue if rates continue to move up because the incentive to move to money market funds or government back funds
is only going to increase. I think when the Fed will shift its spots is when companies start responding to margin pressures, as consumers start saying we are not paying higher prices, and we're seeing that more and more Costco's report was a very good case in point. And at that point, margins will start to come down. And they've already started coming down. If you look at corporate profits, the corporate profits measure in the GDP accounts, which is it's called after tax corporate profits adjusted for IVA and CCA. Those profits have already started rolling over. So companies are already beginning to feel a little bit of heat. We think that will intensify going forward and that as a result, companies that have been hoarding labor, it had been very hard to get over a long period of time, hoarding labor are probably going to let some of those employees go. So now on to economic indicators.
It's interesting to look at the GDP revisions for the first quarter. The revision was up, I think it was from 1.3% to 2%. That's a quarter to quarter at an annual rate number. Now that's the GDP. That's gross domestic product. Now there's an identity out there, which is gross domestic product equals gross domestic income. Gross domestic product is the production of goods and services in any given period of time. Gross domestic income is what it says. It's profits and income

reported to the IRS. Those two are disagreeing with one another right now. On a year-over-year basis, I believe a real GDP, I just gave you the sequential number, which was up to 2%, but on a year-over-year basis, I think it's up 2.8%. But gross domestic income, and this is real as well, taking out inflation, is down 0.8%. We have never seen that big of a discrepancy. And if you ask me which one I trust more, it is income because you can measure that. The IRS measures it very carefully, as we all know. So really paying attention to that one. And we're also seeing leading indicators have declined 14 months in a row. Now I remember in the day when this measure of leading indicator was down for three consecutive months, the conclusion most economists would draw
is that the economy is going into a recession. Well, now we're 14 months into it. And we do believe we'll see a recession, a little bit of a harder landing, as I've mentioned on many of these. M2 down 5% on a year-over-year basis. Haven't seen that since the 1930s. And we do think velocity is starting to slow down the velocity of money, the rate at which money turns over.
Because of the regional bank crisis and the concerns, wait, what's going on here.
And because money is shifting from bank accounts into money market funds,
and the velocity associated with those is much, much slower. I wanted to feature some of the stronger than expected before we go into weaker than expected. Housing and autos, interestingly, delivered some surprisingly strong statistics. We see pending home sales down 21%
on a year-over-year basis. That sounds very weak, and it is. But one of the reasons is people are trapped in their existing homes by their current mortgage rates, which are very low compared to today's. And so we're seeing new home sales is where a lot of action is taking place. New home sales were up 12% month-to-month in the month of May, I believe that was. And housing starts were up to 1.6 million from 1.34 the previous month. That's an annualized number. So the new home sales are where a lot of the action seems to be going these days. Autos came in a little higher than we expected. Last month was 15, this million units at an annual rate. This month was 15.68 million units at an annual rate. What we see going on in the auto sector, this dramatic shift towards electric vehicles, we believe is starting to put pressure on the auto manufacturers.
They've reintroduced discounts. Remember, they were selling at premiums before. Reintroduced discounts. And we think they're trying to move their inventory as this consumer preference shift towards electric gathers momentum. So that could be one reason for this. The other variable that was on the stronger side was durable goods orders, non-defense capital goods orders. X aircraft is a very good indication of capital spending. And we do think two things are going on there. One is the excitement around artificial intelligence has captured consumers and businesses,
imaginations. But there's also an imperative here. If your competition embraces this new technology, which can help you increase productivity and decrease costs, you're going to be in trouble.
So a little bit of a land rush there. And also, there is the reshoring, especially from China, taking place here in the United States. So those are two of those reasons. And those are strong. But back to the leading indicators. The leading indicators are made up of 12 sub indicators.
So they are average work claims, new orders for manufacturing, ISM new orders, building permits, the S&P 500, the credit index, the yield curve, and consumer expectations as measured by the conference board. Now, those have all been negative for 15 months. And as I mentioned,

if we don't head into recession, meaning declining activity, it will be quite a big
setback for this measure of leading indicators. And may suggest that it is too
too much focused on the industrial world and not enough focused on the digital world.
That could be the case. Nonetheless, they are negative. And a lot of the regression analyses
that I see from economists are pointing towards negative GDP sometime in the second half of this
and into and some are saying through 2024. This will get the Fed to change its spots.
And the market, which had taken such a serious tumble last year, had seen this, we believe,
and has discounted a lot of this. Maybe not all. There are some investors I know
moving back into more value-oriented strategies, which are more hostage to the cycle,
figuring, oh, we're going to skip a recession. I don't think that's going to be the case.
I think that companies that are comfortable have secular growth opportunities
that are recession resistant. They won't escape a recession entirely, but recession
resistant that they will continue to be rewarded. One of the things I also wanted to focus on this
time around is the rest of the world. Germany, it seems, two negative quarters, back-to-back
recession. Germany and Europe in general are much more dependent on China than the United
States is. And we do believe that China is struggling mightily here under property and
debt, and it stands to reason. China entered the World Trade Organization around the turn
of the millennium, so around 2000, and had many, many years of double-digit growth and then high
single-digit growth. Growth covers a lot of sins or bad behavior. Bad behavior might be taking on
more debt, taking on more risk generally than companies and consumers should. And we do believe
that that is what is going on right now, that the government is grappling with this and trying
to manage it. They don't want to use too much because they're fearful of inflation expectations
and continued speculation on property. And so we think that's a real depressant on the world.
Now, going quickly through market indicators, S&P was up nicely in June, and so a lot of that,
as we've seen, has been focused on the mega tech category, what people are calling the
Magnificent Seven now. And some of them will be prime beneficiaries of this excitement about,
and we believe that the excitement is real and justified, about artificial intelligence.
But we think that there are other areas of the market besides the Magnificent Seven
that will also benefit. And I think some of our strategies were a testimony to that
in the first half of the year. Interestingly, in our broadest strategy, we have 25% in healthcare
and an over-weighting relative to the broad-based indices like the QQQs or the Nasdaq-100 as they
are called. So we're much more heavily weighted to small and mid cap. And to be able to have
outperformed the Nasdaq-100 in any of our strategies is testimony, we think, to the return
of active management. There are investors out there who do not religiously depend on
the broad-based indices, but are doing their homework and are saying and asking the question,
who is really going to benefit from this massive shift towards artificial intelligence,
which is gaining so much momentum because AI training costs are dropping 70% per year.
And they're coming up with good answers, we would say. This is what we do all the time,
and it's nice to have the company again, if I might say. Long-term interest rates,
they moved up from 364 today, 405, interesting. We're getting a good test here. In March,
the 10-year Treasury bond yield peaked around 4.8 to 410. Today, it's 405. In October before that,
it had a peak at 4.3. So lower highs, we were having a little bit of a test here,
and we'd be surprised to see long rates continue to move out

because of the weakness that we see evolving in the economy, and because inflation's coming down, and because it could be negative, which I think would shock a lot of people.
I was around, did a roadshow in Europe last week, and I asked the question,
how many of you here are hearing forecasters talk about deflation? Nobody. Maybe one hand went up,
and I said, I think you heard us talking about that. So no one's talking about it,
and our confidence is increasing that it will happen, that it won't be all bad.
Innovation is deflationary. I just told you, AI training costs are dropping 70% per year.
That's going to seep into many, many other costs and cause unit growth to accelerate.
The Bloomberg Commodity Price Index, it moved up 3% in the month of June, but is still in a downtrend. Should have mentioned the yield curve is still inverted. It got more inverted last month. It got to almost 110 basis points, which is the inversion it reached right before the regional bank crisis. It's come off that a bit here, but we wouldn't be surprised to see if it signaling more crises, whether they're in the commercial real estate market
or in the private equity market in a way that we don't understand right now. Bitcoin,
sort of the carbinger for crypto, up 10% good month. And of course, there is the speculation about a potential approval of a Bitcoin ETF. That got people excited.
But the other thing we'd like to reiterate is we saw Bitcoin take off from 19,000 to 30,000 when the regional bank crisis was in full force in March, April. And that told us that Bitcoin is a flight to safety currency. It's a hedge against inflation. It's a hedge against deflation.
Deflation presents counterparty risks that do not exist in the world of Bitcoin.
And we think innovation broadly is going to become a flight to safety category. We think most investors are very short innovation. They may think they have it covered with the magnificent seven as they're being called now. But we do not think they do. In fact, we think there's going to be some disruption to the magnificent seven. And we can get into that in another time. And we've mentioned chat GPT as a real risk to search and Google's entire model. And there are other risks in the what used to be called fangs are now the magnificent seven, some of which is even competition for the AI chip world. We think that autos have been a great case in point here.
The shift towards electric is happening so much more quickly than I think the auto industry first expected and auto analysts expected that that many, many investors are on guard now thinking, okay, innovation, I'm going to take it more seriously. We think that AI is going to turbo charge the speed at which these shifts take place. And so let's just talk about AI a bit.
We think there's going to be a lot of commoditization coming out of AI as you listened to Frank Downing and Will Summerlin on our last in the know foundation models could be commoditized.
And commoditization is great for companies who harness the AI that is being commoditized to increase their productivity, increase their efficiency, and lower their unit labor cost.
So so that's great. That could be a boon to the entire economy. But the companies who will really benefit disproportionately are going to be those with visionary leaders,
broad based distribution. And after those two, most importantly, proprietary data that no one else has. And so that's what we spend our time focused on as we are thinking about AI.
We think this move into the mega techs around AI has been more knee jerk. And and it will sort itself out as more and more people do the research. So with that, I'll close by saying, you know,

innovation solves problems. We've said that since the beginning of COVID. That's when I started doing these in the know videos. And I believe with the margin pressures that that corporations are going to face, they're going to have even more problems moving forward. So innovation AI, they're certainly going to make use of it. Innovation, as we saw with Bitcoin around regional bank crisis, is a flight to safety. And one of the flights to safety that investors must consider is the traditional world order being disrupted magnificently by the five major innovation platforms around which we have centered our research, multiomic sequencing, robotics, energy storage, artificial intelligence and blockchain technology,
and the convergence between and among those technologies is going to cause super exponential growth for some, but creative destruction for others. And so we believe in the next five to 10 years that investors who are short, true innovation, truly disruptive innovation,
are going to start moving more and more into that space, allocating capital to its highest and best use. So with that, I'd like to thank you and wish you a wonderful summer month in in July. And we will be talking to you again in August. Thank you.
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