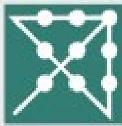

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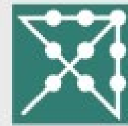

October 1, 2024

Morning Briefing

On Labor, AI & Election Uncertainty

Check out the accompanying chart collection.

Executive Summary: If AI proves to be as transformative as many expect, its adoption has barely gotten off the ground. As AI proliferates—accelerating the productivity growth that's central to our Roaring 2020s scenario—will it mean mass layoffs? Eric examines the labor market and the drivers of tech investment, concluding that most workers are not at risk of losing their jobs or bargaining power over employers. … The Fed's new easing cycle removes a big source of uncertainty for corporate decision makers. But election uncertainty is keeping them cautious, according to research by the Fed and The Conference Board. That uncertainty will soon be over.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

US Economy I: Labor & AI. In our base-case Roaring 2020s economic scenario, technological investment drives innovation and increased productivity growth. The results include wage growth that beats the rate of inflation, expanding corporate profit margins, and a briskly growing economy.

But what sparks investment in innovation? And if AI proves to be all that the forward earnings per share of AI enabling companies suggest it will, are widescale job losses likely?

Let's answer those questions by examining the drivers of the technological boom, and how it may manifest as tech and non-tech companies alike adopt it:

(1) *Fewer workers, more tech*. Tight labor markets are correlated with higher productivity growth (*Fig. 1*). When available workers do not match the skills that a company needs, they shell out cash for technologies that augment their current employees' productivity. This investment is often in the form of spending on software as a service (SaaS) or capex. Plenty of US companies—large and small—rely on renting cloud computing or AI from large tech companies. Others invest in data centers, software, and R&D.

These aren't your grandfather's capital spending plans. SaaS is akin to a monthly or annual rental. Software and R&D often require less manpower and borrowing upfront than traditional capex such as building a new manufacturing plant. So the technological investment used to enhance worker productivity in today’s labor market is less reliant on financing and therefore not hampered by higher interest rates. It makes sense that high-tech investment continued to thrive even as rates were ratcheted up and labor was scarce (*Fig. 2*). It’s also notable that intellectual property now represents a larger share of GDP (5.5%) than nonresidential equipment investment (5.2%) or residential investment (4.1%) as of Q2 (*Fig. 3*).

For non-tech companies, SaaS is easily accessible and upgrades happen instantaneously. That creates hyperscalability for the companies providing those technological services. The upshot is productivity growth can happen much quicker (*Fig. 4*).

(2) *Demographics*. A record 48% of Americans aged 65 and older are not in the labor force (*Fig. 5*). That’s up from less than 40% a decade ago. The wave of early retirements during the pandemic reduced the supply of workers, leading to a yawning gap between the demand and supply of labor (*Fig. 6*). Of course, unemployment remained relatively high despite proliferous job openings, creating a kink in the downward sloping Beveridge Curve (*Fig. 7*). We suspect that job openings’ descent “down and to the right” of the Beveridge Curve will be prevented by forces similar to those that rendered the model inadequate during the pandemic. In other words, we do not see a risk of surging unemployment without a crisis first materializing.

Workers continue to beat inflation with higher wages, suggesting that they still hold bargaining power over their employers and that their productivity is growing. In our opinion, most workers facing persistent unemployment (i.e., teens, those with less than a high school degree, new labor market entrants, etc.) largely lack the skills needed in today’s job markets. Thus, job openings may not fall much relative to the number of unemployed workers (*Fig. 8*). Rapidly declining immigration across the US’s southwest border, if it continues, may remove pressure on some of the groups struggling to find a job right now.

(3) *Fiscal*. Fiscal stimulus, of course, can jumpstart technological advancement. The Infrastructure Investment and Jobs Act (IIJA), Inflation Reduction Act (IRA), and CHIPS Act provided both funding and tax incentives for public and private manufacturing construction. Manufacturing structures have surged more than twofold to nearly $150 billion (saar) in real GDP (*Fig. 9*). These largely represent the construction of semiconductor chip fabrication plants, or “fabs.” Other forms of private nonresidential construction have also increased

since the IIJA was signed into law in November 2021.

The more than $2 trillion pace of deficit spending over the past 12 months no doubt has driven some of the economic boom (*Fig. 10*). With government outlays stabilizing at a historically high 24% of GDP and few plans from either US presidential candidate to shrink the deficit, we expect the government's vault to remain open for business (*Fig. 11*).

(4) *Nvidia*. Nvidia is expected to generate nearly $161 billion in revenues over the next year (*Fig. 12*). The chipmakers' forward profit margin has stabilized around 56%, supporting short- and long-term expected earnings growth rates of greater than 50% per year (*Fig. 13* and *Fig. 14*). Is this reminiscent of the dotcom bubble? A repeat of that scenario would depend on those earnings not being realized because demand for chips substantially weakens in the coming year.

This *Fortune* magazine article describing a recent sushi dinner among the CEOs of Nvidia, Oracle, and Tesla casts doubt on the likelihood of that outcome: "'I would describe the dinner as Oracle—me—and Elon begging Jensen for GPUs,' [Larry] Ellison recalled. 'Please take our money. Please take our money. By the way, I got dinner. No, no, take more of it. We need you to take more of our money please.'"

(5) *Retraining workers*. Researchers from the *New York Fed* collected data from its August regional business survey on how firms planned to use AI. Overall, they found roughly a quarter of services-providing firms and 16% of manufacturers use AI today. But much larger shares of both types of firms are training or retraining workers to use AI or planning to do so within the coming months. Here's are some quick highlights of their findings:

- Five percent of services firms' AI users have hired new workers to accommodate AI, while 10% have laid off workers. Most of those who were laid off had at most a high school diploma.
- Of firms planning to use AI in the future, 19% of services firms and 7% of manufacturers expect to hire new workers within the next six months because of AI. Only 12% of services firms planning to use AI and none of the manufacturers doing so plan to lay off workers within the next six months as a result of using AI.
- The large majority of workers being retrained for AI use had either some college, technical training, an associate's degree, or a bachelor's degree or higher.
- In over three-quarters of responses, businesses expected no change in wages over the next six months due to the use of AI. Among those expecting changes, more

expected increases than decreases.

AI adoption is in its early stages, particularly for small businesses. However, it seems that most workers aren't at risk of losing their jobs or their power to bargain for higher wages.

US Economy II: Removing Uncertainty. We expect interest-rate cuts to ease the debt-servicing burden on overleveraged companies among small-cap public companies, private middle-market firms with floating-rate debt, and small businesses that borrow directly from banks (*Fig. 15*). This should reaccelerate economic growth.

The Fed's easing cycle was the first step to improving businesses certainty. The presidential election will improve it even further:

(1) *Banks*. With fewer underwater commercial real-estate loans, banks will seek to grow their loan books. The latest Senior Loan Officer Opinion Survey (SLOOS) showed that few, if any, lenders tightened credit conditions this quarter (*Fig. 16*). Banks were still lending over the past couple years despite higher rates and a highly uncertain environment with respect to the business cycle (*Fig. 17*). In our outlook, loan growth will accelerate in Q4 and into next year.

Not only will manufacturers and builders have more flexibility to start new projects, but they should see more demand from customers using financing. That should buoy the ISM M-PMI after a long stretch of downbeat readings (*Fig. 18*).

(2) *Presidential election*. Anecdotes from the Fed's August 2024 *Beige Book* suggest that the presidential election has weighed on economic activity across the country and myriad sectors. Here's a rundown of what regional contacts told the Fed:

- *New York:* "With uncertainty pertaining to the presidential election ahead, many firms have put hiring plans on hold."
- *Richmond:* Ports & transportation contacts "cited high interest rates and the upcoming election as causes of uncertainty contributing to the suppressed demand." Nonfinancial services firms also said they were delaying investments in part due to election uncertainty.
- *St Louis:* "District contacts reported that slowing demand and election uncertainty are negatively impacting their business."
- *Dallas:* "The manufacturing outlook was weak with firms citing economic uncertainty, upcoming elections, high interest rates, and anemic global demand as the main

strains."

(3) *CEO confidence*. In the Q3 CEO economic outlook data series, produced by The Conference Board, fewer business leaders said they were likely to expand operations within the next six months. This data series is correlated with the y/y change in capital spending on equipment within GDP (*Fig. 19*). We suspect that improved confidence will help boost fixed investment in particular.

Moreover, a greater share of CEOs already expect to hire additional workers than reduce headcounts in the next six months. We expect this series to rebound toward even more hiring in the coming quarters (*Fig. 20*).

Calendars

US: Tues: ISM M-PMI & Price Index 47.6/53.7; JOLTS Job Openings 7.64m; Atlanta Fed GDPNow 3.1%; Bostic; Barkin; Colins; Cook. **Wed:** ADP Employment Change 124k; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Bowman; Barkin. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core CPI 1.9%.2.7%y/y; Eurozone, Germany, France, Italy, and Spain M-PMIs 44.8/40.3/44.0/49.0/50.2; Schnabel; Nagel. **Wed:** Eurozone Unemployment Rate 6.4%; Italy Unemployment Rate 6.6%; Spain Unemployment Change 181k; De Guindos; Schnabel; Lane; Elderson; Balz; Pill; Noguchi. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings impacted during the September 27 week by S&P Dow Jones Indices' quarterly rebalancing of index membership. LargeCap's forward earnings ticked down for a second straight week for the first time since December, when it fell for three straight weeks. It's now 0.3% below its record high during the September 13 week. A week earlier, LargeCap snapped its 37-week streak of record-high forward earnings, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose w/w, and is only 1.6% below its record high in early June 2022. SmallCap's tumbled 1.5% w/w to 11.2% below its mid-June 2022 record. Through the week ending September 27, LargeCap's forward earnings

has soared 18.8% from its 54-week low during the week of February 1, 2023; MidCap's is 7.1% above its 55-week low during the week of March 10, 2023; and SmallCap's is 2.8% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.0%, 14.9%), MidCap (-0.3, 16.6), and SmallCap (-9.3, 18.6).

S&P 500/400/600 Valuation (*link*): Valuations were mostly higher during the September 27 week for these three indexes but remain below their recent multi-year highs. LargeCap's forward P/E rose 0.2pt w/w to a 32-month high of 21.4 and is 1.3pts above its 14-week low of 20.1 during the August 9 week. It's also up 4.4pts from a seven-month low of 17.0 during the October 27 week and 6.3pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was steady w/w at 15.8, and is now just 0.2pt below its 27-month high of 16.0 at the end of March and up 3.5pts from a 12-month low of 12.3 at the end of October. These compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pt w/w to a 34-month high of 15.6. It's up 5.0pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 26% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 28% discount is up from a 24-year-low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Regional M-PMIs (*link*): The *Dallas* district, the fifth Fed district to release manufacturing data for September, revealed that factory activity fell modestly this month, while expectations predict increased activity six months from now. The *Kansas City* district was the fourth Fed district to release manufacturing data for September and revealed factory

activity fell moderately in September, while expectations for future activity stayed positive. The *Richmond* district, the third Fed district to release manufacturing data for September, showed activity improved a bit but remained solidly in negative territory. The *Philadelphia* Fed, the second to report, released data showing that its general activity index moved from contraction to expansion, though barely. The first to report September activity, the *New York* district, saw business activity in the state expand for the first time in nearly a year—with its general activity index moving to its highest reading since July 2021. Turning to the details in the *Dallas district*, most of the indicators contracted in September. The production index (to -3.2 from 1.6), a key measure of state manufacturing conditions, slipped into negative territory in September. Most of the other measures of manufacturing activity were also in the red: new orders (-5.2 from -4.2), capacity utilization (-7.0 from -2.5), with shipments (-7.0 from 0.8) retreating into negative territory. Meanwhile, labor market conditions revealed the employment (2.9 from -0.7) measure showed some jobs growth during the month, while hours worked (-2.5 from -2.6) held steady. Perceptions of *broader business conditions* (-9.0 from -9.7) remained negative in September, while the *company outlook* (-6.4 from -9.6) showed some improvement, though also remained negative. As for *wages and prices*, the *wages & benefits* measure (to 18.5 from 22.0) eased a bit, and was roughly in line with its historical average, while the *raw materials* price measure (18.2 from 28.2) eased, showing a 10-point drop; the *finished goods* (8.4 from 8.5) price gauge was virtually unchanged. Looking ahead, September's *future production* (35.2 from 33.7) measure posted its highest reading since early 2022, while the *future general business* activity (11.4 from 11.6) held steady.

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