AI Opportunities
20 September 2024
Chief Investment Office (CIO)
Moneta Bank

"AI Opportunities"

Introduction:
Despite the increase in two-way share price volatility, the AI industry's rapid expansion has left many investors underexposed. Some of the largest tech companies now hold weightings comparable to those of certain national equity markets. Missing out on the potential gains these companies could deliver represents a long-term risk to private investors' wealth. Since the launch of ChatGPT, global tech (MSCI ACWI Information Technology) has outperformed global markets (MSCI ACWI) by approximately 25%.

Our Chief Investment Office (CIO) believes the AI sector remains one of the most compelling long-term investment opportunities, driven by ongoing innovation and expansion in key technology areas.

Why Now?
Despite short-term market volatility, our CIO maintains that AI will continue to be a critical driver of growth across global equity markets. The rapid advancements in AI technology, particularly in key areas such as data centers, cloud infrastructure, and semiconductors, ensure that the long-term growth potential remains robust, AI is projected to remain a crucial driver of equity market returns for years to come. Recent earnings and company updates indicate that big tech's investment in AI shows no signs of slowing, with industry leaders emphasizing the risks of spending too little rather than too much. As the AI ecosystem expands, annual capital expenditures (capex) for key enablers like semiconductors, cloud infrastructure, data centers, and power supply could reach USD 331 billion by 2027. This ongoing trend is expected to fuel robust earnings growth, particularly for companies in the enabling layer of the AI value chain. For instance, the global semiconductor industry is forecasted to see a 50% rise in earnings this year, followed by a 25% increase in 2025.

Semiconductors
Earnings reports and company updates have highlighted that big tech is not slowing down on AI spending, with industry leaders cautioning against underinvestment. Big tech's total capex is forecast to grow by 47% this year, reaching USD 218bn, and by another 16.5% in 2025, to USD 254bn. There is room for further capex increases next year as capex intensity—capex relative to sales—remains below historical peaks. Additionally, the higher-than-anticipated costs for AI computing infrastructure, particularly for next-generation AI models, suggest big tech will continue to increase spending.
These rising capex levels are a positive signal for the semiconductor industry, which already has strong order books for the upcoming quarters. Within the semiconductor space, focusing on AI logic chips and high-quality foundry stocks is recommended. On the other hand, memory chip manufacturers and chip equipment makers face greater exposure to U.S. regulatory risks.

While the semiconductor industry has shown strong earnings growth, with expectations of a 50% rise in earnings this year, our CIO notes that there may be concerns around overvaluation as demand surges for AI-related chips. However, despite some short-term pricing pressures, our long-term outlook remains optimistic, particularly for companies well-positioned in the AI ecosystem.

Megacaps

Our CIO views megacap tech companies as essential players in the AI-driven future, particularly given their financial strength and ability to continuously invest in innovation. Despite market volatility, these companies are expected to deliver sustained earnings growth, making them compelling investment options for those looking to benefit from AI monetization.

The megacap tech companies are well-positioned to thrive in the AI era due to their dominant market positions and significant investments in artificial intelligence. It is believed that "the big will get bigger" as these firms expand their AI capabilities. The increase in capex is not expected to negatively impact their ability to generate strong free cash flows. In fact, the combined free cash flow of big tech companies is projected to grow from USD 413bn this year to USD 522bn by 2025. With a combined market capitalization of approximately USD 15tr, their valuation metrics based on free cash flows are considered attractive for long-term investors, especially given the current market volatility.

Megacap tech companies are expected to deliver earnings growth of 15-20% on average over the coming quarters, driven by the increasing monetization of AI technologies.

China Internet

China's internet sector posted mixed results in the second quarter at the individual company level, as macroeconomic challenges further weighed on revenue growth. However, despite ongoing macro and geopolitical headwinds, there are resilient growth prospects in high-quality Chinese internet stocks with clear shareholder return policies and appealing valuations. The average valuation of three major Chinese internet companies is currently about 30% below the three-year historical average.

Although revenue growth faced challenges, most companies exceeded consensus profit forecasts during the recent earnings season due to a focus on cost optimization and reducing losses in new business ventures. By the end of August, average earnings for key companies in the sector were revised upward by 4%. Additionally, management teams have emphasized strong consumer AI usage and growing enterprise demand for AI testing, signaling the continued expansion of the AI ecosystem within China.

Our CIO believes high-quality Chinese internet companies with clear shareholder return policies are well-positioned to capitalize on this growing demand, offering attractive entry points for investors