AI: THE BUILD-OUT AND THE WEALTH EFFECT

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While the US economy is exposed to the vagaries of various wars, be it trade, military or culture, it has not hurt its global economic leadership. At this pivotal juncture of technological change, private investment into the US economy is powering growth at a time when most other countries are increasingly reliant on government investment. Furthermore, this private investment is having positive knock-on effects including foreign capital inflow, growth in household wealth fuelled consumption, and demand for US goods and services. While these secondary effects are migrating to other economies, the US economy is clearly the biggest winner.

Economic data would make it appear that current US growth is reasonably well diversified across business and consumers, i.e. capital investment and household consumption. While on the surface this is true, there is an important inter-related dynamic at play. Capital investment is unquestionably being driven by the AI-related data centre build-out (DCBO) which has resulted in demand for commodities, manufactured goods, building trades as well as a range of other services. However, with overall employment and population growth relatively tame, consumer spending is commensurately being powered by the growth in household wealth primarily related to equity market appreciation largely related to expectations surrounding AI.

The relatively narrow scope of economic growth around AI has had a variety of market impacts that are notable and, in some cases expected, while in others not so much. Financial services have benefitted enormously from the financing activity surrounding the DCBO as well as from market trading activity. Bond market offerings in both public and private markets have been enormous as hyperscalers and related companies have demonstrated an insatiable need for financing, having used up their once hefty cash reserves. Software and other professional service companies deemed vulnerable to AI have had their valuations slashed as investors grapple with the risk associated with competition from AI-powered in-house solutions and third-party upstarts. For now, it is hard to believe that markets are appropriately accounting for what the AI impact to general business bottom lines will ultimately be … that is still likely to come.

While markets have been keen to reward the so-called AI winners and their complements (banks, real estate, electricity, etc.) and punish the conversely labelled AI losers (now "old economy" services), consumer-related sectors have been largely ignored. The other area of notable market attention has been commodities – specifically oil and gold for different, but related reasons. In the case of oil, the trajectory of the US-Iran conflict has resulted in higher energy prices and commensurate oil stock gains. In the case of gold, many believe that the uncertainty over US foreign policy (as well as other policies) coupled with rising sovereign debt levels has driven more investors towards the sanctuary of gold, resulting in higher spot gold prices and gold stock gains.

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We anticipate that DCBO activity will continue for some time yet. The AI labs, infrastructure companies and hyper-scalers are all projecting further investment spending into next year which should keep economic growth expanding steadily. But there are headwinds and risks. Constraints on inputs to the DCBO such as chips, electricity and trades will likely slow deployment of capital. There is also growing opposition to data centres because of environmental, inflation (electricity and water prices), taxation, safety and security, amongst other concerns that could stall activity in certain jurisdictions. Perhaps, the greatest risk to the DCBO however, relate to the ultimate use of AI, what kind of data centre capacity will be needed, and who will provide it. The use of AI in the future holds much uncertainty, while the magnitude of investment is slightly more certain - a significant risk surrounds the intersection of the two.

While capital markets have become increasingly geared to AI, we believe traditional risk factors are still relevant. Relatively low bond yields have been conducive to the historical equity market returns over the last few years. However, it would be difficult to ignore the recent rise in bond yields and the risk they imply for equity markets. Overall equity earnings have been healthy, which would suggest a level of market resilience. But higher bond yields imply higher financing costs including mortgage rates (alongside higher gas prices) which pose a headwind for households and broader economic risk. Although inflation is hovering above the central banks' targets of 2%, the rise in longer-term yields is less about rising long-term inflation expectations, but more about the rise in real yields. Higher monetary policy rates (the Fed, ECB and BoE have all raised rates to slow inflation), poor sovereign finances (high debt and deficits to GDP) everywhere that have resulted in large government bond supply, and unprecedented corporate issuance on the back of the DCBO have combined to pressure longer-term real and nominal bond yields. A further rise in bond yields is clearly a risk for equity markets. Notably, corporate bonds, which have historically been a good leading indicator for problems in equity markets have not been flashing orange or yellow, except for the riskiest credits which now appear to be flashing red.

Markets have delivered excellent returns over the last few years, much of it on the back of AI and the investment it has spurred. And the potential for massive productivity benefits, albeit at the risk of significant employment dislocation are likely ahead. There are clearly risks that the DCBO and future AI usage portend, but on balance we think investors should stay the course with a well-diversified approach to investing their wealth. Our portfolios are being managed to navigate the technological changes and the relative risk and rewards across capital markets.

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