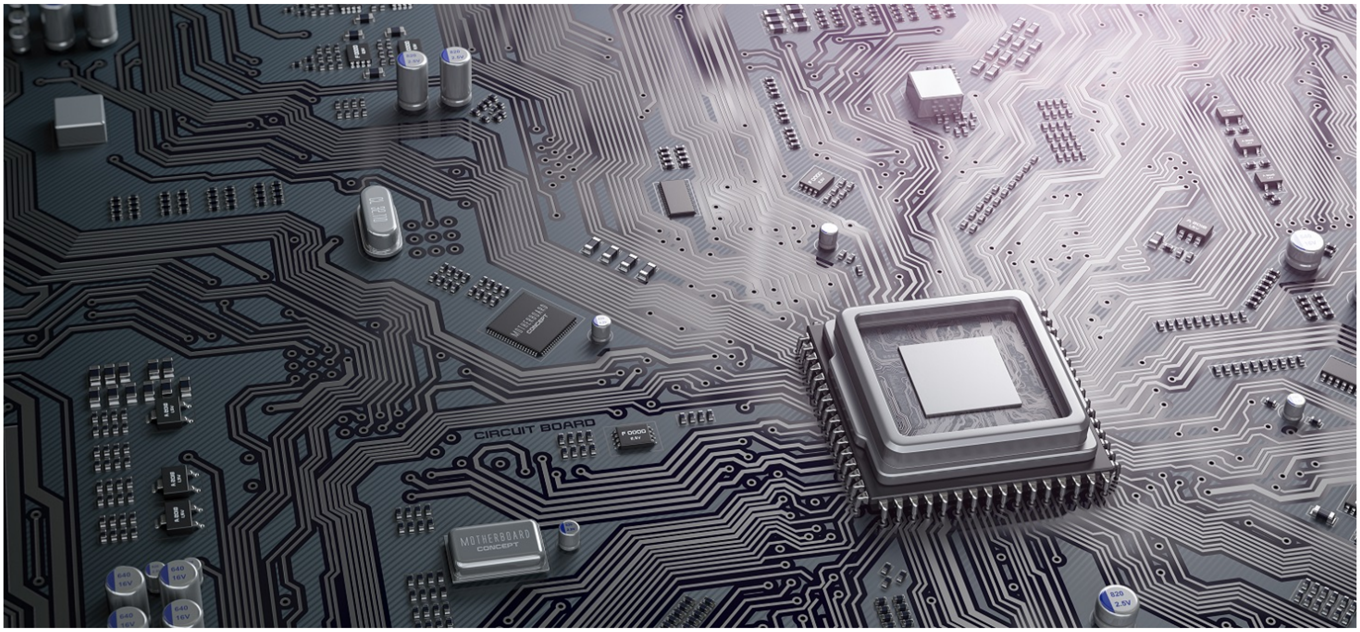

CIO recommends investors whose tech exposure has expanded well above their strategic benchmarks to consider rebalancing into more defensive parts of the tech sector and the equity market in general. (ddp)

Has the AI rally gone too far?

25 May 2023, 1:16 pm CEST, written by UBS Editorial Team

Technology stock futures have rallied, after chipmaker Nvidia forecast accelerating growth thanks to surging demand for AI processors.

The company is now forecasting revenue in the three months ending in July of USD 11bn, well above analysts' expectations for USD 7.2bn. That boosted the company's shares by around 25% in after-hours trading, contributing to a 1.6% rise in the Nasdaq 100 futures.

This year's broad tech rally has stretched valuations for the global sector in our view, with the MSCI All Country World tech sector trading on almost 24 times forecast earnings over the next 12 months—a 25% premium to the 10-year average. As a result, we advise investors whose tech exposure has expanded well above their strategic benchmarks to consider rebalancing into more defensive parts of the tech sector and the equity market in general.

But the rally in AI-related companies in particular has raised concerns that this segment is now in a bubble. While some stocks in the sector now look expensive, and we advise investors to be selective, we believe there is still plenty of growth potential in this area:

AI, or generative AI, has clear use cases both for consumers and enterprises, distinguishing it from over-hyped tech trends like 3D printing, which failed to take off in a big way. Popular consumer generative AI like ChatGPT and Midjourney have sparked an enterprise rush to build or incorporate AI tools across a wide range of businesses and services. We see artificial intelligence as a horizontal technology that will have important use cases across a number of applications and industries. In particular, we believe the impact will be disproportionately felt in the knowledge services industry including the 'telecom, media, and technology' (TMT) sector, along with financial services, whereas adoption in traditional and old economy sectors may take time.

Adoption of generative AI has been setting new records. Having been launched in late November, ChatGPT built up a million users within a week and 100 million within two months. It now has more than 200 million users. This is a far faster uptake than prior technological innovations. Even the smartphone, which is now nearly ubiquitous in developed nations, took several years to pick up momentum. In addition, most prior technological innovations were adopted by enterprises first, prior to consumers, including both personal computers and the internet.

AI is fueling growth for a wide range of companies, including semiconductors and cloud computing. The broad AI hardware and services market was nearly USD 36bn in 2020, based on IDC and Bloomberg Intelligence data. We expect the market to grow by 20% CAGR to reach USD 90bn by 2025. Given the relatively early monetization stage of conversational AI, we estimate that the segment accounted for 10% of the broader AI's addressable market in 2020, predominantly from enterprise and consumer subscriptions.

So, we don't see the AI-related rally as unsustainable. While key Asia supply chain beneficiaries have seen double-digit gains this year, and some valuations look stretched, we believe investors can find less expensive exposure further down the value chain, where revenue expectations are not yet as rich. From a broader perspective, AI, along with big data and cybersecurity, forms what we call the ABCs of technology, which we believe are foundational technologies set to accelerate over the next few years.

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Content is a product of the Chief Investment Office (CIO).

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