CIO maintains an Attractive view on the health care and financial sectors, and see each as well positioned to benefit from the shift toward cash flow generation with AI. (UBS)

The market is pivoting from AI capex to cash flow generation

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Over recent weeks, a number of signals have pointed toward a shift in the market mindset toward AI. For example, Meta raised the lower end of its guidance by USD 4bn, yet its share price has declined 21% since the announcement.

Without taking single-company views, data points suggest to us that investors are now increasingly asking how companies will generate enough cash flows to pay for the trillions invested in compute infrastructure. The AI story appears to be shifting from capex to cash flows, and that warrants a shift in AI investment strategy.

The market is pivoting from AI capex to cash flow generation. The shift in market focus is especially evident among private companies, which have large amounts of compute on order but continue to lose money. Microsoft's earnings revealed that OpenAI lost USD 11.5bn in the third quarter, and other large frontier models are likely loss-making as well. These losses are currently financed by new fundraising rounds, while companies are working to monetize their AI offerings through subscriptions, API calls, advertising, lead generation, and revenue sharing. This process will take time, and not all AI companies will succeed given the intense competition and questions around price elasticity.

The next AI opportunity lies with users, not just enablers. Since the launch of ChatGPT, the market caps of the AI7—NVIDIA, Broadcom, AMD, Micron, Google, Amazon, and Microsoft—have appreciated by more than USD 10 trillion, double the size of the S&P 500's health care sector. Yet companies that use AI have not seen comparable increases in valuation. This is where we see a big potential opportunity: investing in companies that use AI to boost revenue and lower costs, increasing free cash flow. We believe return on investment (ROI) is highest in sectors like advertising, research and development, coding, and customer service.

US health care and financials offer attractive entry points. We maintain an Attractive view on the health care and financial sectors, and see each as well positioned to benefit from the shift toward cash flow generation with AI. US health care is trading at about 3% below its normal historical discount to the S&P 500, and we see three turning points in the sector: First, policy headwinds turning into tailwinds with deals on most favored nation pricing and Medicare and Medicaid deals on obesity drugs. Second, the de-stocking cycle from COVID turning into clinical catalysts for new drugs. And third, rich and vast data from patient histories to payer data turning into insights with AI. US financials also offer fertile ground, in our view, with customer history, rich market data, burgeoning capital market activity, deregulation, and a favorable rate environment driving further potential gains.

We believe that AI is real and that the ROI is tangible, but as the market mindset shifts from capex to cash flows, the greatest opportunity may lie in the companies with the clearest paths to improving profitability by using AI.

Despite potential volatility as markets assess fresh data and headlines, we maintain the view that the bull market remains intact. We recommend that investors build a clear plan, deploy excess cash, construct a strong core portfolio across equities, fixed income, and alternatives, as well as selectively hedge risks.

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