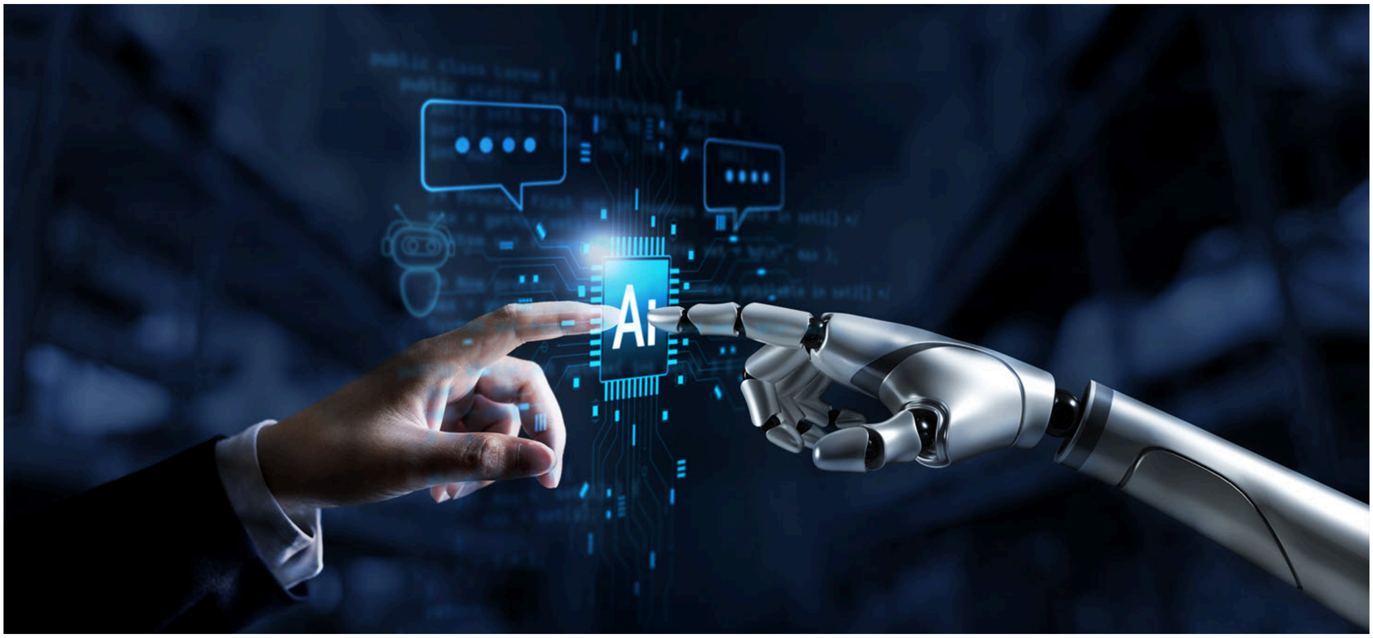

(Shutterstock)

AI theme remains intact but risks remain

04 February 2025, 3:55 pm MYT, written by UBS Editorial Team

Although the initial scare from the emergence of a low-cost Chinese AI model appears to be fading, related uncertainties could still return. With other sources of risk also looming on the horizon, the recent market volatility serves as a reminder of the importance of a diversified portfolio with an appropriate amount of active management. We think the recent tech correction was overdone and recommend taking advantage of extreme volatility through structures and buying the dip in quality AI stocks.

Revelations of the cost-effectiveness of Chinese AI model DeepSeek have whipsawed tech stocks over the last 10 days. The VIX equity volatility index jumped from around 14 to an intraday peak of 22.5 before receding to around 16/17. The Nasdaq fell as much as 3.6% in two sessions before recovering 1.6% in the subsequent three sessions. Markets appeared to be startled after becoming accustomed to resilient US growth and a structurally positive AI story. We think this episode serves as a warning of volatility to come with tariffs arriving and more US policy uncertainty looming.

But investors should remember that in every selloff, opportunities might also emerge. This is therefore a good occasion to reiterate some key messages about managing portfolios during such periods of elevated volatility and uncertainty.

Relying on your core. The recent bout of volatility illustrates the logic behind using a "core" component to gird portfolios against the risk of uncertainty and volatility disrupting investors' financial goals. We believe that this "core" should be a portfolio diversified effectively across asset classes, geographies, and sectors, and left alone to grow consistently for the long term. Combining asset classes with different drivers and uncorrelated returns tends to lead to smoother growth, smaller drawdowns, and faster recoveries. This approach can also help investors pursue tactical opportunities with greater confidence. With various event risks potentially producing further episodes of elevated volatility—geopolitics and climate change adding to tariffs and US policy risk—over the next few months, investors should use volatility and elevated yields to build out their "core."

But volatility also favors active management. To complement a strong "core", we would also add a level of tactical finetuning to meet the investment needs of the day. Active investing tends to be critical in volatile and uncertain periods, less developed markets, assets with less liquidity like small caps, or in thematic investing. In particular, periods of investor risk aversion, when accompanied by high market volatility and elevated uncertainty tend to favor active management, more judicious security selection, and harnessing volatility to generate additional portfolio income. With the DeepSeek concerns still simmering in the background, investors should be prepared to act on any outsized market movements, especially in the tech space.

AI theme remains intact. We think the recent market correction was overdone and recommend taking advantage of extreme volatility through structures and buying the dip in quality AI stocks. Initial 4Q2024 earnings releases from the major tech firms indicate that AI fundamentals such as capex and adoption trends remain solid. We expect the Big 4's combined capex for 2025 to grow around 25% year-on-year (y/y) despite the emergence of low-cost AI models like DeepSeek. The key counterpoint here is that the lower cost of AI adoption is likely to increase its usage—to the point of sustaining profit growth of 18% y/y for global tech in 2025.

Given the lack of clarity on the full set of implications of a lower cost of training AI models, it is worth considering a bear case. In this scenario, low-cost models like DeepSeek proliferate, resulting in potentially lower training and inference costs. Here, we would still expect AI training demand to be supported by robust volume growth, driven by increasing contributions from tier-2 platforms, enterprises, and emerging market customers, as well as from Big Tech on high-cost frontier models. In such a scenario we would expect profit margins for the AI compute industry to fall from 50% in 2024 to 35% in 2029. With AI compute stocks currently trading in line with the S&P 500, we still see these offering a fair risk-reward tradeoff even in the bear case.

Nothing in this document constitutes legal or tax advice. UBS and its employees do not provide legal or tax advice. This document may not be redistributed or reproduced in whole or in part without the prior written permission of UBS. To the extent permitted by the law, neither UBS, nor any of it its directors, officers, employees or agents accepts or assumes any liability, responsibility or duty of care for any consequences, including any loss or damage, of you or anyone else acting, or refraining to act, in reliance on the information contained in this document or for any decision based on it.

Additional Disclaimer relevant to Credit Suisse Wealth Management: Except as otherwise specified herein and/or depending on the local entity from which you are receiving this document, this document is distributed by UBS Switzerland AG, authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA). Your personal data will be processed in accordance with the Credit Suisse privacy statement accessible at your domicile through the official Credit Suisse website https://www.credit-suisse.com. In order to provide you with marketing materials concerning our products and services, UBS Group AG and its subsidiaries may process your basic personal data (i.e. contact details such as name, e-mail address) until you notify us that you no longer wish to receive them. You can optout from receiving these materials at any time by informing your Relationship Manager.

Please visit https://www.ubs.com/global/en/wealth-management/insights/chief-investment-office/marketing-material-disclaimer.html to read the full legal disclaimer applicable to this document.