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Are we facing an AI bubble?

CIO Essentials

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- The pronounced optimism in equity markets about artificial intelligence (AI) recalls the dot-com bubble that burst 25 years ago.
- But there are clear differences: Today's stock valuations of technology giants are significantly lower than those at the start of the 2000s, and profit growth is higher. This suggests little evidence of a market bubble. In addition, the Fed is likely to cut key interest rates now, whereas back then it triggered the bubble's burst by raising them.
- Exposure to AI-driven momentum in equity markets is best achieved through a broadly diversified portfolio. This is especially important given heightened political and economic risks.

Source: UBS

Until recently, investors were primarily focused on the US labor market report or the decisions of major central banks. Now, however, another event is beginning to rival the traditional highlights of the financial market calendar: the release of quarterly results by the technology company NVIDIA.

Last week, NVIDIA announced its results for the second quarter. The technology company reported revenue growth of 56% over the last 12 months. Nevertheless, the company's stock subsequently lost ground. NVIDIA now accounts for 8% of the US equity market. The "Magnificent Seven," which refers to the seven dominant US tech companies, make up 35% of the market. This underscores the optimism surrounding artificial intelligence.

For those who followed the financial markets at the turn of the millennium, this may evoke memories of the dot-com bubble. The spread of the internet at that time sparked hopes for a "new economy" characterized by high productivity gains. This led to hype around internet companies and ultimately to a speculative bubble, which burst in 2000 and resulted in massive stock market losses.

This inevitably raises the question: Are we facing an AI bubble?

Today, there are indeed parallels, but also clear differences compared to the situation 25 years ago. Individual stocks are experiencing the same meteoric price increases as the shares of the dot-com era. However, today's rally is supported by significantly higher earnings growth. The price-earnings ratio (P/E) of today's technology giants is also much lower than that of the market leaders at the peak of the dot-com bubble. In 1999, Microsoft, Cisco, Lucent, Nortel, and AOL had an average P/E ratio—based on expected earnings—of 82x. This is significantly higher than the 28x of the "Magnificent Seven" over the past 12 months. In our view, there is little to suggest that the markets are currently in a bubble.

Moreover, a typical cause of a bubble bursting is higher interest rates. During the dot-com era, the US Federal Reserve raised key interest rates by 1.75 percentage points between June 1999 and May 2000, which triggered the crash. The current monetary policy environment is very different from back then. We expect the Fed to lower key interest rates by around 1 percentage point in the coming months.

AI has the potential to fundamentally transform the economy and markets, generating growth for which investors, with broadly diversified portfolios, can participate. Those who are not yet engaged in the market can use any setbacks as an opportunity to gain exposure.

Nevertheless, the risks should not be underestimated. In 2000, investment cutbacks, overcapacity, and disappointing profits triggered a loss of confidence in the "New Economy." In the case of AI stocks, there is also a short-term risk of over-investment and misallocation. In addition, there are currently political and economic risks. This makes diversification essential to cushion any setbacks.

Good to know:
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Appendix

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