CIO believes this year's strong rally in semiconductors and hardware stocks has fairly discounted the solid growth prospects in the AI infrastructure segment. (UBS)

Broadening demand points to faster AI growth

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The tech earnings season has started on a mixed note, with initial results mostly disappointing markets after the strong 25–30% rally in global tech stocks year-to-date.

CIO thinks the tone set by quarterly results over the next week will be crucial to the performance of tech stocks through the rest of the third quarter.

But while we recommend staying selective on artificial intelligence stocks after the strong year-to-date rally, we have reviewed our long-term growth model based on a reassessment of demand trends.

- Year-to-date, the combined global tech market cap has climbed by USD 6 trillion, of which—based on our bottom-up calculations and looking at the most AI-sensitive stocks and industries—we estimate AI-related stocks have contributed roughly USD 2 trillion. We don’t think AI is a bubble given clear use cases and solid long-term visibility, but recommend investors consider companies with clear monetization trends.
- There are two broad avenues for AI-related companies to generate revenues—through the infrastructure layer, and the applications and data models layer. We believe most of the AI-related spending is concentrated in the infrastructure layer given the need to build and train huge datasets. But with more signs of broadening demand, we expect the applications and models segment to emerge as the dominant force in the medium to long term. The emergence of generative AI at the end of last year and the rapid pace of innovation this year now give us more confidence about end-use cases. As a result, we expect a broadening of the AI market from the semiconductor and hardware-centric infrastructure layer to the software and internet-based applications and data models layer

- We have raised our long-term AI end-demand forecasts from 20%compound annual growth rate (CAGR) during 2020–25 to 61% CAGR during 2022–27. As a result, we now expect global AI demand to grow from USD 28bn in 2022 to USD 300bn in 2027, making AI one of the fastest-growing segments within global tech. We expect the applications and models segment of AI to deliver USD 170bn in revenues (139% CAGR), versus USD 130bn for the semiconductor and hardware-centric infrastructure segment (38% CAGR) in 2027.

We believe this year's strong rally in semiconductors and hardware stocks has fairly discounted the solid growth prospects in the AI infrastructure segment. Given the rich valuations, we are waiting for a pullback to turn positive on the segment again. Meanwhile, we think the risk-reward is more attractive for software stocks, which, in our view, are well positioned to ride the broadening AI demand trends. We see significant opportunities over the next few quarters, such as in the integration of AI “copilots” in office productivity software, rising demand for big data analytics, and AI integration in image/video and other enterprise applications.

This is consistent with our tech playbook, which calls for a switch into mid-cyclicals at the current stage of the tech cycle and a rotation away from early cyclical industries like semiconductors and hardware, which have already performed well so far in 2023.

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