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TechGPT: Addressing AI and tech laggards

Information technology

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- We introduce a new series covering the technology sector called "TechGPT," where we address the most frequently asked questions we get from investors on technology and related topics.
- Our readers are encouraged to regularly send questions for us to address in upcoming publications. Key debates around AI, positioning in tech, and laggard opportunities are discussed in this inaugural edition.
- In summary, we don't believe the AI trend is a bubble but advise investors to be selective on AI-related stocks after the strong year-to-date rally. From a positioning point of view, we recently closed our self-help theme as we see better risk-reward in mid-cycle industries (software, internet) and tech laggards.

Unsplash, UBS as of 2023

Our view

Tech stocks rebounded by 25–30% in 1H23, reversing most of the losses witnessed in 2022. The turnaround has been powered by the rising popularity of generative AI, which has taken the world by storm. Anyone can now approach a chatbot to ask whatever questions are on their mind. In the same spirit, we introduce our "TechGPT" publication, where we answer the most frequently asked questions from investors on technology and related topics. In this inaugural edition, we address five major questions around AI, opportunities in tech, and preview upcoming results. Our readers are encouraged to regularly send in questions for us to address in our upcoming publications.

Is AI a bubble?

We do not think the AI trend is a bubble. First, AI, or generative AI, has clear use cases for consumers and enterprises alike, distinguishing it from previously hyped tech trends like 3D printing that failed to take off in a big way. Popular consumer generative AI tools, like ChatGPT and Midjourney, have already sparked an enterprise rush to build or incorporate AI functions across a wide range of businesses and services. Moreover, we see artificial intelligence as a "horizontal" technology that will have important use cases across a number of applications and industries, such as knowledge services (including the TMT sector) and financial services.

Second, the adoption of generative AI has been rapid and consumer-led. ChatGPT built up a million users within a week of its launch last November, and now has more than 200 million. This is a far faster uptake than prior technological innovations. Even the smartphone—now ubiquitous around the world—took several years to pick up momentum. In addition, most previous technological innovations, including personal computers and the internet, were adopted by businesses before consumers.

Third, AI is fueling growth for a 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 at a 20% CAGR to reach USD 90bn by 2025. Given the relatively early monetization

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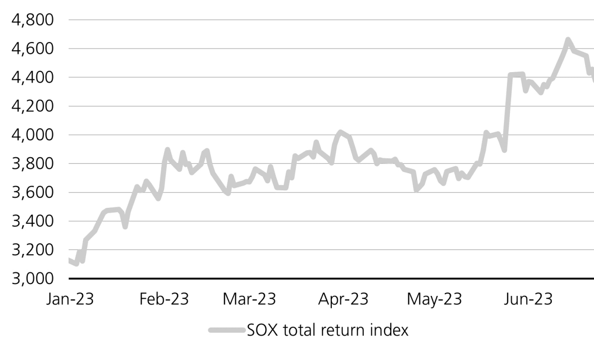
stage of generative AI, we estimate that the segment accounted for 10% of the broader addressable AI market in 2020, predominantly from enterprise and consumer subscriptions, which we expect to grow from less than USD 1bn revenues today to around USD 18–20bn by 2025. Our estimate may prove to be conservative; the growth opportunity could be even higher if generative AI improvements (in terms of computing power, machine learning, and deep learning capabilities), availability of talent, enterprise adoption, spending from governments, and incentives are stronger than expected.

That being said, we see a near-term risk of consolidation for AI-related stocks after the strong year-to-date rally and are now more selective on AI-related stocks.

What can bring AI down?
While we do not think AI trend is a bubble, we see the risk of a 10–15% reset lower for AI-related stocks in near term. In fact, the semiconductor industry, which has been a key beneficiary of AI's rising popularity, is down 5% (as seen in Fig. 1 for SOX index) from its recent peak. We expect volatility to stay high in the near term.

Fig. 1: Despite rising AI popularity, we expect further near-term volatility for semiconductors
SOX YTD total return (%)



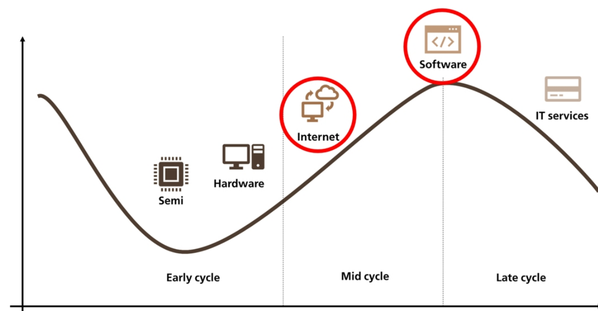
Source: Factset, UBS as of June 2023

While we do not expect a meaningful correction, increased volatility in the near term could be driven by various factors: **First, valuations** are elevated, with AI-related stocks trading at around 30–40x price-to-earnings, significantly above the broader tech average of 25x. While we agree that AI-related stocks deserve a premium versus the broader market, we believe select stocks have run ahead of fundamentals and are at risk of correction. **Second, increased regulation**: Unlike other tech innovations, governments across the world appear keen to introduce AI regulations at a relatively early stage of adoption, particularly when it comes to security, ethics, and the impact on jobs. That said, we do not expect excessive hurdles as governments seek to avoid stifling AI-related innovation; **Third, supply bottlenecks**: We believe an extended shortage of chips (mostly GPUs) and the lack of talent pose near-term risks to AI adoption, which may weigh on revenues; **Fourth, increased competition**: Given the pace of innovation, we see more entrants in the AI space (there are already more than 10 generative AI-related unicorns), which could intensify competition and cap margins for key AI players.

Still, we believe a potential correction in the mid-teens for AI-related stocks will provide investors with an opportunity to revisit AI technologies, given the structurally increasing long-term adoption in both consumer and enterprise applications and double-digit growth rates per year.

Where are the opportunities in tech?
We recently turned defensive in our tech positioning and closed our self-help theme to lock in profits after the strong absolute performance. Looking ahead, we now see two near-term opportunities.

Fig. 2: Our tech playbook to navigate across the cycle



Source: UBS, as of June 2023

First, in line with our tech playbook (Fig. 2), we are transitioning from early to mid-cycle tech companies like software and internet companies. Risks for these mid-cycle stocks include potentially slower-than-expected enterprise IT spending, elevated rates, and increased competition. The second opportunity is in tech laggards where we believe the market has underappreciated near-term growth potential.

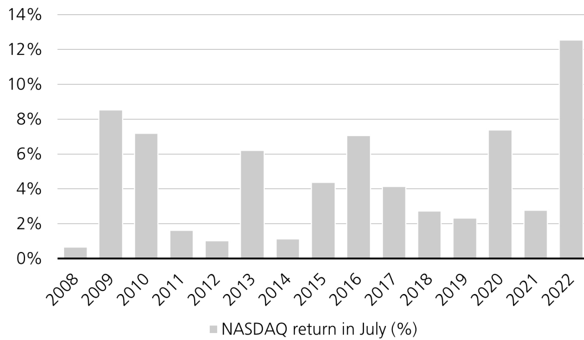
Some risks for these tech laggards include product launch delays, pricing pressure driven by increased competition and supply, regulations, and slower-than-expected adoption of AI technology and other new growth areas.

What to expect in the upcoming tech results?
It is worth highlighting that historically the 2Q reporting season has been positive for tech. In fact, the Nasdaq has reported positive gains in each of the past 15 years during the month of July (see Fig. 3). With tech results' season set to start soon, we expect a gradual pickup in growth rates after a challenging 12 months of earnings contraction. While tech earnings growth declined by almost double digits

y/y during the previous two reporting seasons in 1Q23 and 4Q22, we expect only mid-single digit declines in 2Q before tech growth turns positive in 2H23.

Fig. 3: July has been positive for tech over the last 15 years, driven by solid 2Q earnings

Nasdaq historical returns in July between 2008–22 (%)



Source: Factset, UBS as of June 2023

More than backward-looking 2Q growth, however, our focus lies primarily on guidance and management commentary around AI adoption, margin improvements, and potential risks from regulations and geopolitics. While a moderate improvement in tech growth should be taken positively, unlike previous quarterly reporting seasons, we expect upside surprises to be somewhat limited given the strong year-to-date rerating. Investors should therefore be defensive in their tech positioning. We believe structured strategies that take advantage of increased volatility like selling puts, should also be considered in the upcoming reporting season, in addition to other defensive strategies like software and tech laggards.

Appendix

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