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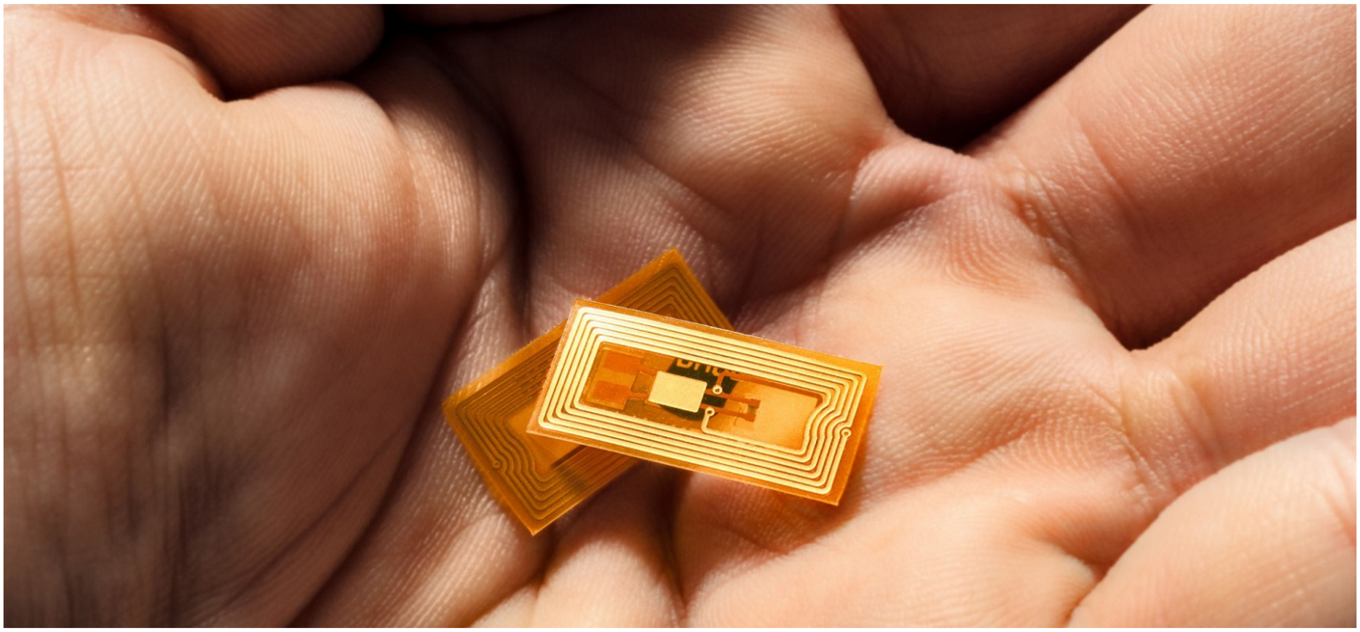

AI set to remain the key theme driving global tech stocks again this year and the rest of the decade. (UBS)

AI optimism drives US stocks to a record high

22 January 2024, 1:35 pm CET, written by UBS Editorial Team

The S&P 500 index hit a record high on 19 January, led by a rally in chipmakers and big tech firms. The Philadelphia semiconductor index rallied 4% and the Nasdaq 100 rose 2%, both closing at a record high fueled by AI optimism after upbeat outlook statements from chipmakers.

Taiwan Semiconductor Manufacturing (TSMC) sees faster adoption of AI and booming demand for high-end chips, while Meta founder and CEO Mark Zuckerberg last week indicated that the company is spending billions of dollars on AI graphics processors.

Tech stocks have remained resilient this year, led by both the semiconductor and software industries, two of our preferred industries. The Philadelphia semiconductor index is now up around 5% year-to-date, on the back of a 65% surge in 2023, while the Nasdaq 100 is up 2.9% this year after a 54%rally in 2023.

But despite the strong performance seen so far, we believe the investment case for AI and related companies, especially those in the semiconductor industry, will persist in 2024 and is in fact set to strengthen:

Strong AI demand trends. We forecast global AI revenues to grow 15x between 2022–27 from USD 28 billion to USD 420 billion. This growth is expected to be driven by particularly strong demand for AI computing and GPU chips in the next 12–18 months due to strong AI training demand and a rising share of inference (running AI applications after models have been trained).

Without taking any single-name views, recent conference call comments from TSMC (highlighting that the demand for GPU supply chain is exceeding supply) and from big tech firms (noting their increasing spend on AI chips) are reassuring. We think AI could arguably be the tech theme of the decade, as we don't see similar growth profiles elsewhere.

AI to be a key driver of the semiconductor upcycle. We turned positive on global semiconductor manufacturers in October 2023 given our view of robust and broadening AI demand, and we continue to believe that the semiconductor and software industries are well positioned to ride the AI wave. We expect both industries to post solid double-digit profit growth (50% profit growth for semiconductors and close to 20% for software) and expect operating margins of more than 30% in 2024.

The Semiconductor Industry Association's expectation of double-digit sales growth of semiconductor chips due to improving end-market demand in AI, PCs, and smartphones supports our view of improving demand.

High valuations are justified. Semis could re-rate. Global semiconductors are trading at a premium of about 25% versus their 5-year average. In our view, this premium is justified given the significant evolution of semiconductors over the past five years with exposure to many mega-trends and strong pricing power. More importantly, semiconductors are trading at a reasonable 22x forward price-to-earnings ratio (P/E), considering our forecast for 50% profit growth. This is a 10–15% discount to global tech (around 25x forward P/E and expected earnings growth of 16% in 2024).

We anticipate the semiconductor cycle to accelerate through 2024 with sequential improvement in utilization rates. For instance, we expect semiconductor foundry utilization rates to rebound strongly from around 70% in the first quarter to 85–90% by the fourth quarter of 2024.

Also, in the last three upcycles, semiconductor share prices rallied for 2.5 to 3 years. Given our view of strong demand trends and the solid performance in this cycle, we think semiconductor stocks have more room to run.

So, with AI set to remain the key theme driving global tech stocks again this year and the rest of the decade, we maintain our preference for the semiconductor and software sectors and see opportunities in those involved in memory and AI edge-computing. Overall, we like the US tech sector, which aligns with our quality tilt and offers exposure to compelling disruptive trends.

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