With a strong near-term visibility for tech, CIO remains bullish on the AI theme and maintain its positive view on AI semiconductors and leading cloud platforms. (UBS)

AI valuations aren’t as stretched as you might think

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The AI rally has helped drive two consecutive years of strong returns for the Nasdaq Composite, including a 28% rally last year. The Magnificent 7 group of large-cap tech stocks was responsible for more than half of the S&P 500’s gains in 2024. The Nasdaq's market capitalization now exceeds USD 32tr, with more than USD 13.5tr added in the past two years alone.

Some investors are asking if they should lock in gains now, given the strong performance and potential headline risks in 2025. While the easy gains in AI may be behind us, we believe this rally is far from over:

Expect more upward revisions from large-cap tech on AI capex spending. Last year, continued upward revisions in AI capital expenditures from the Big 4 tech companies helped keep the AI rally on track amid periodic questions over its durability. We expect the upward revisions to continue in the near term, leading us to raise our estimates for their combined capex growth to reach USD 224bn in 2024 (+51% y/y), and USD 280bn in 2025 (+25% y/y). While these updated estimates suggest Big 4 spending could match their historical peak capex intensity level (as measured by capital spending divided by sales), we believe fourth-quarter earnings results could potentially detail even larger investment plans.

Big tech firms will likely make more headway in monetizing their AI spending this year. While AI revenues are likely to again lag capex in 2025, we see evidence that AI monetization is primed to improve sharply in 2025. Cloud growth is accelerating for the leading three platforms, and a solid backlog supports AI monetization hopes. AI adoption is picking up across industries and is set to broaden in 2025, and the arrival of more clearly useful AI agents should further support return on investment (ROI). We anticipate the gap between AI capex and revenues will narrow in 2025. Companies adopting AI will use it to both increase their revenue and reduce their costs, which suggested measuring the economic value add from AI will grow in importance as a measure of monetization.

AI valuations aren't as stretched as you might think. Over the past two years, most of the gains in AI stocks have come from impressive earnings performance, not from a significant expansion in price-to-earning ratios. In fact, many AI stocks have seen their price-to-earnings multiples decrease even as their shares have risen, indicating a relatively healthier market dynamic. We anticipate this revenue-led rally will continue in the year ahead, with our forecast for robust earnings growth near 25% in 2025. While we see several positive and negative drivers that could potentially change AI's valuations, we believe strong underlying earnings growth should be enough to support solid near-term share price performance.

So with strong near-term visibility for tech, we remain bullish on the AI theme and maintain our positive view on AI semiconductors and leading cloud platforms. We remain constructive on quality large-cap AI names in particular, with strong seasonality in the first quarter another near-term driver. While it will remain essential to monitor regulatory risks (such as export controls) ahead, we believe that any significant corrections on geopolitical or regulatory developments could offer attractive buying opportunities. Underallocated investors should consider using bouts of volatility as a means of buying stocks via structured strategies or by purchasing quality AI stocks on dips. Within US equities, we rate the information technology sector as Attractive, and we expect improved breadth and wider participation in the tech rally this year.

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Original report: **Why the AI rally is likely to continue in 2025, 3 January 2025.**