As per CIO's view, the technology sector will be one of the fastest adopters of generative AI, with further breakthrough innovations expected in the next few quarters. (UBS)

# Outlook for AI-related stocks remains positive

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**The recent performance of US technology stocks reminds investors that the AI-driven tech rally is not a one-way street. A combination of softening risk sentiment due to geopolitical uncertainties and more moderate expectations for 2024 US rate cuts after the latest US payrolls data led US information technology stocks to decline 1% last week (based on MSCI US Information Technology Index data).**

This broad gauge of the listed US tech sector has lagged the best-performing energy sector by around 13 percentage points since the end of February. Looking beyond the headlines, semiconductor stocks were particular laggards, with the MSCI US Semiconductors and Semiconductor Equipment Index shedding 2.1% in the week ending 5 April.

But this softening in recent weeks follows a roughly 70% rally for the MSCI US Information Technology Index since the end of 2022, led primarily by enthusiasm for and application of artificial intelligence (AI). With the first-quarter reporting season fast approaching, this recent underperformance does not alter our positive view around AI-related stocks and the three main reasons for this constructive view:

**Broadening demand trends.** AI demand in 2023 was mostly led by AI GPU computing and the hyperscaling of big tech customers, with some initial signs of broader AI demand from customers and the wider segment. While big tech continues to aggressively spend on AI, we now see clearer signs of AI demand becoming more ubiquitous. For instance, during the recent GPU Technology Conference, a major semi maker highlighted how sovereign entities and major countries are becoming key sources of incremental demand, especially from markets like the Middle East, Sweden, Singapore, Japan, and Korea. We also observed signs in the first quarter of demand broadening beyond GPU computing into other beneficiaries like custom chips, software, data centers, and memory.

**New revolutionary products.** The first quarter of 2024 saw the launch of fresh AI applications across chips and text-to-video platforms, as well as the further application of generative AI products into software engineering. Given our view that the technology sector will be one of the fastest adopters of generative AI, we expect more such breakthrough innovations in the next few quarters.

**Increasing adoption**. According to the US Census Bureau's recent Business Trends and Outlook Survey that tracks AI adoption across 1.2 million firms in the US, between 5.4% and 9% of firms are already using some form of AI as of the first quarter. This compares to between 3.7% and 4.5% reporting AI application in the third quarter of last year. Participants' responses suggest this share could rise to between 6.6% and 12% of surveyed firms over the next six months. Digging into the details shows that firms in IT and professional services are leading the adoption of AI, with a low- to mid-teen share of firms already employing it and potential for a strong increase expected over the next few months.

At the other end of the spectrum, the construction and agriculture industries are lagging, which does not surprise us given our view that it will likely take some time for tangible use cases to emerge. By segment, the survey also highlighted cloud and internet companies and motion picture and sound recording companies as some of the early adopters. Increasing future adoption should continue to support strong spending on AI infrastructure and potentially increased monetization, in our view.

So, with robust AI fundamentals, our expectations of 18% year-over-year earnings growth for global tech in 2024 (MSCI AC World Information Technology Index), and a reasonable 12-month forward price-to-earnings ratio of around 27x, we stay positive on global tech and companies in the AI value chain in particular. Our free cash flow analysis suggests the top six tech companies globally by market cap are likely to generate a combined USD 480bn of free cash flows this year and USD 560bn next year. Based on their current combined market capitalization of USD 13 trillion, this suggests the largest technology firms trade at around 27x this year's free cash flows and 23x next year's. For comparison, many global markets trade between 30x and 50x their 2024 free cash flows.

We remain positive on the broader AI theme. In our view, the semiconductor and software industries offer the best opportunities for investors over the course of this year. For investors seeking exposure to AI's possible gains but concerned about the risks of further near-term consolidation, we see scope for structured strategies as a way to manage tech exposure as part of a well-diversified investment portfolio.

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