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CIO believes durable US earnings growth, falling inflation, likely lower interest rates, and rising investment in AI will continue to create a supportive backdrop for equities. (UBS)

Supportive backdrop for equities remains

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US equities fell from record high levels on Wednesday after reports that the Biden administration is considering tougher restrictions in its efforts to prevent China from accessing advanced semiconductor technology.

According to Bloomberg, the US is considering whether to impose an export control called the foreign direct product rule (FDPR), which lets the country impose controls on foreign-made products that use American technology.

Comments from former President Donald Trump on Tuesday added to pressure on the global semiconductor sector. Trump said that Taiwan "did take about 100% of our chip business."

What do we expect?

An increase in rhetoric into the November US election could spur larger swings in geopolitically sensitive sectors and markets. The outsized impact of today's two headlines also partly reflects stretched positioning in semiconductors, in our view, which is reflected in the year-to-date performance of the SOX index (+30%), the S&P 500 software index (+14%), and the S&P 500 (+18%, but +13.6% ex-IT).

Following sharp semiconductor sector outperformance in the first half, some investors have rebalanced AI-linked semiconductor exposure into large-cap platform and profitless tech companies. However, without taking any single-stock views, we see several near-term supply chain catalysts from product launches in the months ahead that could revive semiconductor interest.

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We believe the debate around AI capex versus monetization will take center stage for AI-related firms during the second quarter earnings season, after a significant upward revision in big tech's capex during the last quarter.

Beating on profit may no longer be enough to propel strong rallies, in our view, given the high bar set for the tech sector, which already has rich valuations. Management's comments on future revenue and capex trends will likely matter more, in our view.

But while the 2025 picture is a bit less certain, we anticipate that strong sustained capex in 2024 should keep consensus estimates of 20–25%year-over-year net profit growth for global technology within reach. More broadly, while the bulk of second quarter earnings growth will likely be driven by big tech companies amid robust demand for artificial intelligence, trends are generally favorable across the S&P 500, where we expect earnings to grow 10–12% year over year, the fastest pace since the first quarter of 2022. We expect S&P 500 companies excluding the Magnificent 7 to post the first quarter of positive earnings per share (EPS) growth since 2022.

How do we invest?

We believe durable US earnings growth, falling inflation, likely lower interest rates, and rising investment in AI will continue to create a supportive backdrop for equities.

Below the index level, we recommend focusing on building long-term exposure to AI, which we expect to be a key driver of equity returns in the coming years. At present, we see particular opportunity in the enabling layer of the value chain and in vertically integrated megacaps. Within the tech supply chain, we continue to like select semi-cap equipment makers, GPU and custom chip designers, foundries, and memory makers.

We also favor quality growth stocks more broadly—those of companies with strong competitive positions and resilient earnings streams—including "Europe's Magnificent 7" and select benchmark leaders in Asia.

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Original report - **Chip concerns weigh on US stocks, 18 July 2024.**

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