CIO would consider using any near-term consolidation in tech and semiconductors as an opportunity to build exposure. (UBS)

What AI chip demand signals for tech exposure

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US tech and semiconductor stocks retreated on Tuesday ahead of closely-watched earnings from Nvidia. The top global semiconductor company by market capitalization delivered a strong beat on third-quarter earnings and guided for a solid fourth quarter ahead.

The firm also indicated that sales to China would fall significantly due to the Biden administration's export curbs targeting advanced AI chips.

The broader decline for tech on Tuesday ended a five-day winning streak for the sector. But a measure of consolidation after recent sector outperformance is not surprising, and the Nasdaq is still up 10% so far in November alone. We see several reasons to stay positioned in tech:

AI will remain a driver of growth in demand for semiconductors into 2025. Without taking any single name views, we see a positive outlook for the broad global semiconductor sector, which we think could record more than 50% profit growth in 2024 and strong momentum into 2025. On the back of recent earnings, we see upside risks to our AI infrastructure spending forecast, which currently stands at 38% compound annual growth rate (CAGR) during 2022–2027, on sustained AI training and inference demand.

Software and platform AI beneficiaries have more room to run, in our view. US tech earnings likely grew by an above-consensus 11% in the third quarter, and we expect the sector to sustain low-double-digit growth in 2024. As applications for AI expand to more industries, we expect more stocks within the tech sector to benefit, with software and internet stocks particularly well positioned to monetize their investment in AI. The relative scarcity of AI capacity in the cloud is already helping drive revenue growth for platform cloud operators and expected sustained end-user demand for these non-commoditized AI services in the coming quarters.

Tech also offers exposure to quality, our key style preference in a late-cycle environment. The US tech sector is one area in which investors can find quality companies in relative abundance, with a leading return on invested capital (ROIC) at 19% over the past 12 months, above the other 10 US equity sectors. US tech sector balance sheets are also the strongest, with a net debt-to-EBITDA ratio of just 0.5 times. The recurring nature of many software companies' revenue makes cash flows for these businesses somewhat annuity-like, which means many of these firms are akin to "enterprise staples."

So we would consider using any near-term consolidation in tech and semiconductors as an opportunity to build exposure. We continue to like the software segment in particular given its defensiveness and our anticipation of broadening AI demand. We also expect companies that deliver enabling technologies and those that deliver storage, transmission, protection, and analysis of digital data to benefit from the rise of AI. Some of the highest returns in equity markets over the decade ahead, in our view, may come from companies that harness new tech to grow markets, dislodge incumbents, or slash costs. Successfully identifying these "leaders from disruption", including AI beneficiaries, may be critical to boosting long-term portfolio return potential.

For more details on these ideas and more, click here for our **Year Ahead 2024: A new world.**

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