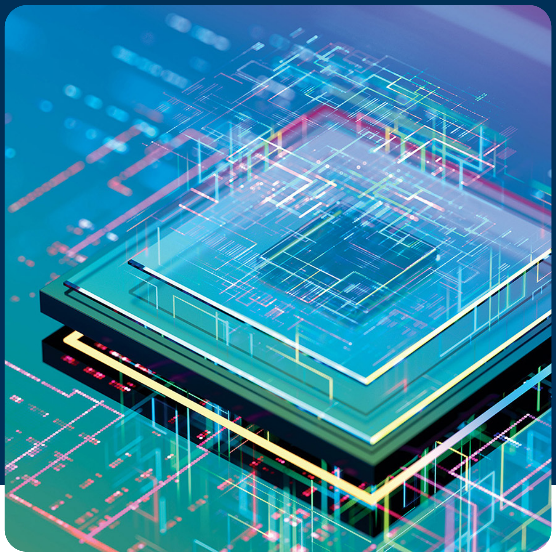
AI and the tech boom: Is it 1996 or 1999?



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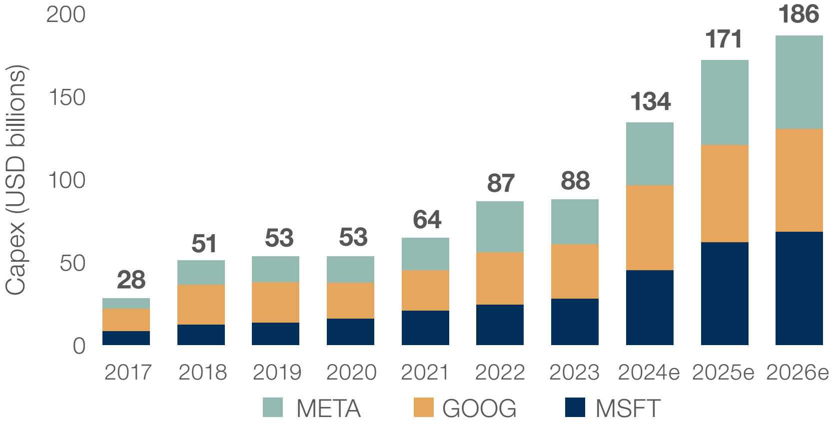
ChatGPT was released in late 2022 and almost immediately ignited a capex surge reminiscent of the late-1990s. Spending by the top three hyper-scalers had increased steadily from 2017 but then rose by a significant 53% in 2024 with the trio forecasting a 27% increase in 2025 (**Figure 1**). Similar to the internet boom, capex is soaring even though it is unclear when there will be a return to the massive amounts of capital being invested.

Figure 1: Capital expenditures by the big three hyper-scalers (USD bn)



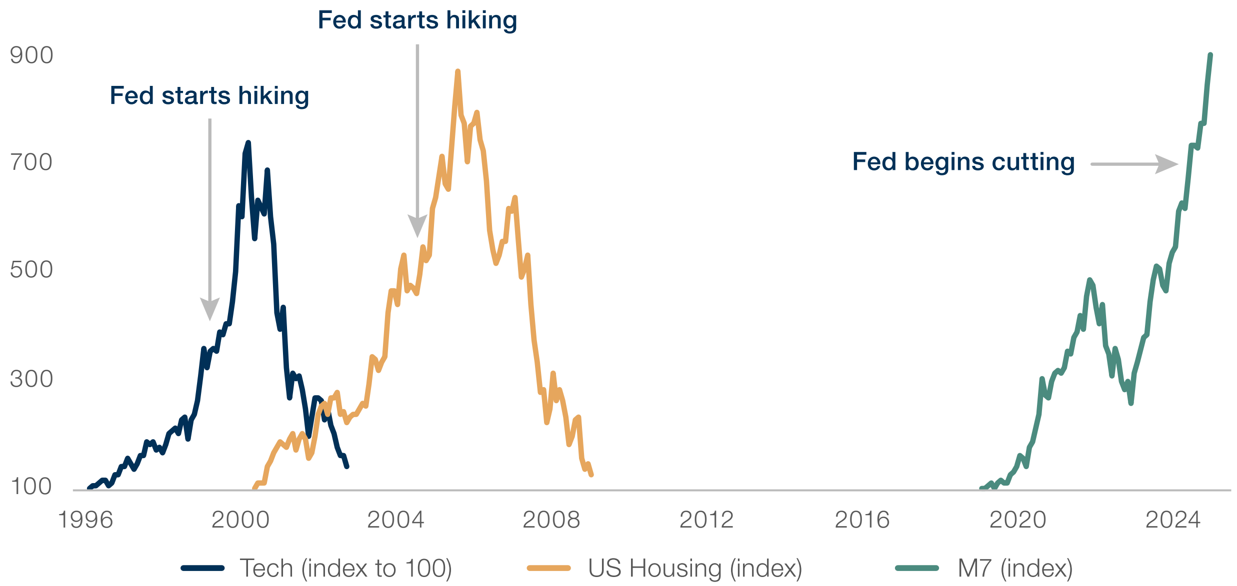
Source: Bloomberg, as of December 1, 2024.

Tech leadership is fully committed to AI because they rightly view it as a highly disruptive, general-purpose technology that will be the key driver of their free cash flow (FCF) over the next decade. The tech titans realize they face an existential risk in that falling behind in the AI race means their market leadership is likely to atrophy and they could ultimately go the way of Kodak and Blockbuster. That is, their choice is to spend massively, and to some extent recklessly, or risk fading into obscurity.

Although there are many similarities between this situation and the internet boom, there are three reasons why we believe it is not yet 1999.

First, investment booms typically last longer than two years (for example, seven years for the internet and six years for housing in the prologue to 2007). Second, the Fed is currently cutting interest rates, ensuring liquidity remains plentiful. By contrast, the internet and housing booms ended nine months and three years, respectively, after the Fed began hiking (**Figure 2**). Finally, President-elect Trump has adopted a staggeringly pro-tech stance, surrounding himself with triumphant entrepreneurs and announcing a swarm of policies that may provide a stalwart tailwind for the tech sector, we believe at least through 2025 and likely well beyond.

Figure 2: The AI boom is unlikely to end until the Fed pivots away from easing and begins to hike aggressively



Source: Bloomberg

Tech's critical role in the new administration's "Global Economic Reordering"

There is much uncertainty regarding policies and personnel after January 20th. However, Trump has repeatedly emphasized tech leadership, economic strength, and that "We have to win." To encourage tech sector innovation and economic dynamism, we expect the new government to implement moderate tax cuts and aggressive tariff hikes, as well as to scale back antitrust. However, deregulation and cutting red tape are probably the most critical policy issues for tech in our view.

Which subsectors within tech could be the most impacted? We believe AI models and semiconductor fabs are clearly core, followed by fast-tracking the buildout of data centers, natural gas permitting and encouraging small nuclear reactors. Other sub-sectors that appear promising include defense-tech (e.g., satellites, drones, and robotics), fintech and crypto. The latter is highly controversial, and we are agnostic on its overall potential to benefit society. However, a 180-degree policy flip has occurred and hundreds of startups are diving in, so watch this space.

Will a small number of tech titans continue to dominate?

Over the last decade, a few tech behemoths have experienced exponential growth in their FCF, market cap, power, and influence. Their continued dominance will depend on two developments. First, antitrust, which had been essentially dormant in the decades prior to 2021. However, the Biden administration aggressively cranked up the volume and currently 43% of the S&P 500 is under antitrust investigation[1]. This enforcement blast reflects a view that big tech has grown more by acquisition and erecting unfair barriers than by innovation and superior products.[2] We expect the Trump administration to dial back antitrust enforcement significantly, which means M&A activity is likely to rebound sharply. However, the perception that tech is too powerful is widespread and the content moderation policies of social media are thoroughly reviled within the GOP.

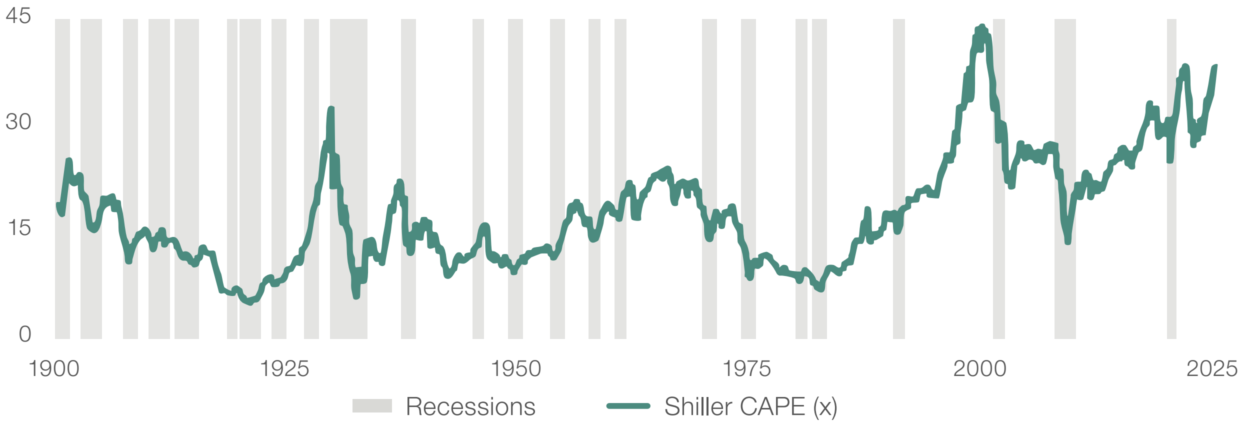
The second factor is the innovators dilemma which, by definition, comes into play during periods of rapid disruption. Few titans in 1970 (PCs) or 2000 (internet) were still there twenty-five years later. To illustrate, of the top twenty global tech companies in 2000, only three remain on the list today (MSFT, ORCL, CSCO). This begs the question: What will the 2035 list look like? One lesson from history is that it is always the case that titans rise, and titans fall, but it happens especially quickly in tech. That is, we should expect a majority of today's tech giants to fall from grace over the next decade, to be replaced by startups that are currently viewed as quirky and obscure, known only to a small number of customers and investors.

Two risks to our constructive view: Valuations and the timeline for killer apps

We believe the tech sector may continue to lead the overall equity market higher, at least through 2025. One risk to this view is valuations (**Figure 3**). While not yet as stretched as 1999, multiples are at extreme levels, as is equity market concentration and sentiment toward stocks. Further, MSCI US currently trades on a forward PE of 26x vs 15x for the rest of the world. This is a record gap and emphasizes how vulnerable today's lofty valuations are to a macro shock.

The second risk concerns how long it will take before the first AI-enabled killer apps arrive and begin producing serious free cash flow. Optimists believe this will happen during the next couple of years and will then power markets to even loftier heights. On the other hand, pessimists emphasize the experience with the internet investment boom, which ran from 1994 to 2000. In particular, massive FCF did not arrive until well after a decade, and many of the beneficiaries were recent startups rather than the firms that had stumped up all the capex. On balance, we side with the pessimists but expect it to become an issue for markets later rather than earlier.

Figure 3: U.S. equity market valuations were only higher once over the last 125 years



Source: Bloomberg, as of December 1, 2024. Shiller cyclically-adjusted PE (CAPE): Defined as price divided by earnings, where earnings here is the average over the last ten years, adjusted for inflation. It was created by Robert Shiller, Yale University. Past performance is not a guarantee of future results.

2025 Outlook: Conclusions for investors

We believe the tech sector could remain the key driver of equity markets, but with elevated volatility reflecting a number of the challenges and issues raised above. We are constructive in many areas of tech, including select hyper-scalers and semiconductor companies, as well as firms involved in data centers and electricity generation. Finally, we remain positive on equities overall, with the U.S. topping our ranking of markets, followed by Japan and the UK. We have a less favorable view on the outlook for Europe and China.

1. Source: Bloomberg, as of December 1, 2024.

2. To illustrate, GOOG has made 262 major acquisitions since 2001 (e.g., YouTube, DoubleClick, Waze, DeepMind), while MSFT has made 225 since 1986 (including Hotmail, Skype, LinkedIn, GitHub, and Activision) and META 99 since 2007 (e.g., Instagram, Oculus VR, WhatsApp).

INDEX DEFINITIONS:

MSCI US Index is a broad-based, market-capitalization-weighted equity index designed to measure the performance of the large- and mid-cap segments of the U.S. equity market. It is not possible to invest directly in an index.

S&P 500 Index is a market-capitalization-weighted index maintained by S&P Dow Jones Indices, designed to measure the performance of 500 large-cap U.S. companies representing a broad spectrum of industries. It is not possible to invest directly in an index.

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