

How Magnificient is AI

Twist and turns in the Magnificent 7 have propelled the S&P 500 beyond what many investors have expected. Optimism surrounding the utility of artificial intelligence (AI) to transform businesses have led a 'gold rush' to beneficiaries of the technology. However, this has translated into a concentration to seven… or rather six stocks that have proven the profitability of AI. Yet as enthusiasm grows, valuations continue to swell, and an aversion to 'FOMO' have rational investors questioning the level of optimism baked into current share prices.

The technology sector has typically drawn the intention of investors due to its impactful innovations that help drive profitability. Today, fast is getting faster, and the cadence, scale, and efficiencies across chip makers and cloud computing platforms are making meaningful strides in evolving the capabilities for companies across all industries. These positive tailwinds have made investors reluctant to lower their expectations for AI companies.

The Mag 7 span across technology and communication services sectors, which represent more than a quarter of the S&P 500's market capitalization. This hints towards the indexes worrisome breadth but has

helped drive it's 14% year-to-date gain.

Resilient earnings and subsequent share price growth has created a self-perpetuating process of deepening market concentration as the two remain correlated. The alure of estimated earnings and management guidance have put investors in an awkward position as they tussle up between the stamina of current growth levels and how long it can be sustained. AI and cloud computing are significant parts of corporate spending, enhancing productivity and boosting revenues. As such, chip companies growing profits through strong order volumes are the biggest beneficiaries of the AI push. This has sent Nvidia's stock soaring, but is being backed by positive earnings and future forecasts.

The disconnect between the tech sector's exceptionalism with the broader market has brought into question whether current valuations for some tech stocks can be sustained by real revenue growth. Tech companies need their customer firms to be financially strong to invest in more technology. However, in July, momentum waned as earnings underwhelmed investors despite beating estimates. This has increased the fragility of valuations where even the slightest whiff of weakness or anything shy of perfection is enough to wobble share prices. Earnings expectations will continue to drive valuations, but commands profitability otherwise share price growth driven primarily by multiple expansion will start to become a headwind for the sector.

While the tech sector is prone to short-term volatility, long-term prospects do justify investor enthusiasm. Technology advancements will continue presenting new opportunities for investors and allow new players to emerge as the dynamism of what AI has to offer mean business needs are always evolving.

However, investors need to be selective with AI related tech stocks as the true winners have become harder identify. There are several factors to consider when evaluating the role of AI in a portfolio. We believe a blended approach is prudent, ensuring a portfolio has exposure to companies that can demonstrate its use of AI to drive profitability and investing in companies that have an insulated position within the market is key.

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