



The past month summed up

The ramifications of the AI revolution are broadening out, with a renewed assessment of not only the winners but also increasingly the losers.

The rationale

Our core view remains the same – namely that the global economy, led by the US, remains healthy and growth is stable providing sound foundations for company profits. A demand driven resurgence in inflationary pressures, currently not in evidence, remains a bigger risk than any slowdown. The unpredictability of the US administration also means there's always the chance of some unexpected disruption, so we are mindful of overexuberance.

The factors that have been driving the economy and stock markets in recent years - the expectation that artificial intelligence (AI) will revolutionise productivity across-the-board alongside a surge in capital investment to build out the infrastructure needed to support this technology revolution - remain at the forefront. However, market attention has recently shifted focus to looking beyond AI for beneficiaries of a wider economic resurgence whilst rapidly punishing those businesses potentially rendered obsolete by the emergence of this week's latest large language model (LLM).

Return of the real economy

The winners over the past few weeks have been those companies less associated with the high-growth tech market that dominated the last couple of years. So-called value investments, companies whose merits lie in their perceived discount to underlying value and includes more traditional economically sensitive industries such as industrials manufacturing, resources and banking, have started to outperform. In contrast, so-called growth stocks, whose investment allure is based on their ability to grow fast irrespective of economic conditions such as technology-related companies, have lagged.

The best performing sectors amongst the benchmark US S&P 500 index this year have included energy shares, helped by rising oil prices as tensions in Venezuela and Iran continue to bubble, in addition to hopes of rising energy demand required to power AI infrastructure. Other beneficiaries include metals companies and industrial businesses from turbine manufacturers through to electrical cablers, again seen as dual beneficiaries of a nascent manufacturing recovery and the relentless increase in spending by the likes of Microsoft, Amazon, Meta and Alphabet.

SaaS-mageddon

Whilst the orgy of capital spending on AI has proven a boon for those companies providing the bricks and generators, it is increasingly being seen as the kiss of death to a range of businesses and industries previously seen as insulated from competition. Here the response has been decidedly brutal as markets have taken an eviscerate-first, ask questions-later approach to sectors deemed under existential threat from AI.

Software as a service (SaaS) and data businesses are seen as the principal victims, with AI models allowing non-specialists to not only code to the level of the average Stanford data-scientist but also to scrape vast oceans of global openly available data to make decisions. The current narrative goes that there is simply nothing that these companies can do to protect their business moats.

The catalyst has been the release by Claude, the leading LLM developed by Anthropic (a \$380 billion private company), of a number of specialised AI agents designed to automate large parts of legal and financial workflows. Over the course of a week or two the market embarked on an AI witch hunt, deeming industries

from insurance broking to wealth management to freight management to be doomed. Sliding share prices were at odds with the profit and sales reports given by exasperated management teams, which showed few signs of any slowdown let alone being cannibalised by AI (the earnings revision ratio for software surged last month, Bank of America data show).

With many of these companies deemed to be the winners from AI only a year ago, this provided further evidence of the challenge of understanding how a potentially disruptive technology might impact established markets. It is very possible that many of the companies whose shares have struggled recently ultimately succeed in harnessing this new technology, but we will not know for years. For now, traders have chosen to shoot first.

Making “stuff”

Outside the recent rollercoaster underlying stock markets there is evidence of the economic largesse spreading wider. The number of US jobs increased by 130,000 in January, 60,000 more than had been predicted by analysts. The unemployment rate fell to 4.3% from 4.4% the month before. Notable was the addition of 5,000 jobs in the manufacturing sector where growth had been sluggish and of 30,000 in the previously moribund construction industry. The good news was underlined in the Institute of Supply Managers manufacturing index in January which climbed to 52.6, the highest level since the middle of 2022 suggesting a three-year manufacturing recession may be on the turn.

With this background one might think that there may be signs of the economy overheating – rising manufacturing activity, consumers buoyed by rising stock markets, companies throwing billions at AI, little slack in the labour market – all of this would at other times have delivered rising prices. Not so. The most recent inflationary data actually showed a drop to 2.4% in January from 2.7% in December. Core inflation, which aims to take out the most volatile elements of price increases, slipped to its lowest in nearly 5 years. As a result, bond markets imply we are flirting with Goldilocks, an economy growing sustainably and neither too hot nor too cold. US 10 year yields have fallen from 4.2% at the start of the year to about 4.05% now – lower yields on bonds generally indicate that investors don't expect inflation to rise anytime soon.

Productivity to everyone's rescue

Governments and economists spent much of the last fifteen years bemoaning the collapse in productivity; the amount of output each person produces for an economy. Here there are signs of improvement, with indications that we were able to produce more growth with fewer workers in the final months of last year. Producing more with less will help keep a lid on inflationary pressures, particularly wages, and many are theorising that this may be the first sign of AI delivering. President Trump's new choice for Chairman of the Federal Reserve, Kevin Warsh, certainly thinks so. He believes that likely productivity increases arising out of AI will allow faster economic activity without driving prices higher, setting the stage for more interest rate cuts than otherwise would have been the case.

Given the concerns about the US government hammering the Federal Reserve to cut rates faster than would be prudent and its determination to replace the relatively hawkish Fed Chairman Jay Powell with a more compliant appointee, the choice of Warsh seems to have threaded the needle of appeasing the President without upsetting investors. A former Fed governor under Obama, Warsh is seen as a more conventional, establishment figure than many other candidates.

Market participants appear happy with this state of affairs, with the Bank of America Fund Manager survey climbing to its most bullish since July 2021. Cash holdings, where money is likely to be sitting in uncertain times, are at a new record low. For our part, there are a few signs of complacency which keep us from getting over-excited. There are still plenty of risks to sentiment and with US valuations continuing to remain high it's worth lowering the risk in portfolios by looking for better value prospects around the world which have until recently been overlooked.

Still exceptional but no longer unique

US exceptionalism, the notion that the conditions and foundations of the country are so well orientated towards growth that it overshadows all else, has been much in vogue recently. Tellingly, the share of global equity markets represented by US assets climbed from about 40% to more than 65% following the financial crisis; three times the US's share of global GDP. In recent years companies have been lining up to vacate moribund European markets and instead place their listing stateside where they could better access capital and attract higher ratings for the businesses and share prices. This rationale may now be getting stretched.

Many investors recognise US stock markets are pretty expensive compared both to their history and the rest of the world, with S&P 500 index shares costing about 21 times projected future earnings compared with just 15 times for Europe's Stoxx 600 index. More impactful though in stoking demand for global assets has been a greater acknowledgement internationally of the power and importance of government spending to fire up growth, even in countries normally resistant to state profligacy. We made the point in recent notes about the German government's willingness to ramp up spending, which had led to an uptick in enthusiasm for the country's growth trajectory.

More dramatic recently has been the picture in Japan with the re-election of Sanae Takaichi, whose policies of increased targeted investment and tax cuts have underlined strengthening prospects for the world's fourth-largest economy. The stock market in Japan has risen 9% this year compared to the relatively flat performance of the S&P 500. But gains in markets aren't just limited to Japan. Among the best performing stock markets so far this year are South Korea's Kospi index, which has soared 28%, and Brazil's Bovespa which has advanced 16%. In a change to previous behaviour, investors now recognise there is plenty of potential outside of the world's largest economy.

Conclusion

The challenge for any wealth manager is to take into account the fundamentals of the investment universe while also acknowledging the unpredictability and capricious nature of markets. The ultimate destination from a change as significant as that promised by the proponents of AI suggests a level of foresight that just isn't available to investors at this stage, with the attendant fluctuations in value for many companies and sectors based on little evidence.

With markets already extended in price and valuation terms it makes sense to hold our balanced position between equities and protective assets such as bonds, gold and hedge funds. At the same time we are orientating our equities portfolio around those companies where the opportunities look most reliable, with many opportunities in the resurgent and previously overlooked economies and markets of Asia, Latin America and Japan.

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