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The past month summed up

A slight shudder in equity markets shows investors are nervous about what the coming earnings season will tell us about the progress and prospects for the beneficiaries of Artificial Intelligence (AI). Expect more bumps on this road.

The rationale

We remain of the view that, even amid the resurgent tensions in the Gulf, the global economy is proving resilient with relatively benign conditions in the engine that is the US. The AI revolution continues to be a major factor driving growth, boosting businesses and helping support equity prices, although given the still early stages in this technological process some market turbulence should be expected. There is also uncertainty in relation to inflation where the Middle Eastern war and other factors are putting upward pressure on prices.

Once again, the question that investors are grappling with is the extent and strength of the impact AI will have on company profits and the global economy. For the moment any expectations into the future about significant efficiencies and productivity advances are founded in well-intentioned speculation. Given where we are at the moment, it is simply too early to understand how these changes will affect specific industries and companies. The potential is undoubtedly there but what will it cost and who will profit?

The focus in the here and now is on the physical investment that is going into AI projects more than the productivity potential. The titans of technology – the Googles, Microsofts and Metas – are engaged in an almost space-race like determination for each business to be a leader when this new paradigm of doing business emerges more fully. With Morgan Stanley estimating AI capital expenditure of $5.5 trillion through to 2030 (more than the US is slated to spend on defence), this is such a material sum that it's no wonder the economy is in such a highly active state. The US economy expanded at an annualised rate of about 2.1% in the first quarter this year, with capital investment (largely supporting AI) responsible for more than half the sum. In comparison the German economy grew 0.3% in the first quarter while the British expanded 0.6%.

Real returns

For the companies themselves, this isn't all about throwing money into thin air and there have been significant returns already. For example, Google's parent Alphabet predicted increased earnings on advertising honed by its AI engine's ability to target customers more effectively. Likewise, it's easy to identify immediate winners who are the recipients of this spending. Korean technology titan Samsung earlier this month reported a 1,800% jump in its profits in the second quarter on the back of huge demand for its chips, which are used for AI related activities.

However, given the scale of enthusiasm, there are also speculative investments where money has been seeking early wins long before the technology or the business model has been tested fully. SpaceX has to be the most obvious example of this. After raising $86 billion in a share sale earlier this year, more than $400 billion was wiped from its market capitalisation in a single session last month (Space related shares were the worst performers globally in June, shedding 31%).

So, what to expect? The relentless advance for the technology sector of the US economy, which is pulling the entire market upward, has been vindicated by a very strong first-quarter earnings season where profits for S&P 500 companies in aggregate surged 28% from the year before. The good news from a forward-looking perspective is that Bank of America's earnings revision ratio recently reached its highest in six months, climbing from 0.91 to 1. While the US is again leading in terms of its proportion of upgrades to downgrades, even Europe, the perpetual has-been in the global economy, is at its highest level in 34 months.

With expectations already pumped up from the first quarter and optimistic for the second, there is no doubt that this is a potentially fragile situation. Should spending or earnings miss the mark, even by a fraction, the reaction in markets is likely to be highly volatile.

Too technology focussed?

It is almost as if the entire AI theme exists independently of everything else has been going on in the world. After all, one might think that with the US continuing to bomb Iran, the Strait of Hormuz again blockaded and oil prices on the rise, that markets might take fright. Barely the case! The good news is that with the AI super cycle consuming most of the market oxygen there is scope for us to identify other themes that have significant potential, perhaps even being overlooked amid the market's technology fascination.

Over several years now we have been referring to the need in developed markets such as the US and Europe to invest in creaking infrastructure. In the US, infrastructure legislation that originated during the Biden era is still responsible for billions of dollars of investment into roads, public transport and other infrastructure projects. Even in the UK the cackhandedly managed HS2 project is an example of government seeing the need to invest to promote economic efficiency within the nation.

Secondly, the global uncertainty unleashed by Russia's invasion of Ukraine and by US/Iran conflict has also led to a huge upsurge in spending on security and defence. The recent NATO summit in Turkey included a commitment among its members to spend more than $50 billion on new procurements, and countries in Europe, both careful of a more assertive Russia and a berating from the US President, have been increasing spending over several years.

Thirdly, there's the generalised retreat from a globalised world to one where nations need to ensure their own capabilities in critical industries rather than relying on multinational supply chains. The most obvious example of this is in relation to energy were both the Ukraine war and the disruption to oil in the Middle East have prompted governments to look for ways to secure their energy needs (although massive demand from data centres on the back of the AI revolution are also leaving governments scrambling to secure more power).

Untapped potential

All of these areas already account for a number of the investments across our portfolios and are also continuing to prompt new ideas. Together they would represent a significant separate positive cycle into markets independent from the dominance of AI. However, the potential of the global economy to utilise these positive factors is somewhat challenged by threats we have identified before, particularly in relation to rising inflation and interest rates.

Unfortunately, inflationary concerns have been held hostage in the past two years by global geopolitical events. In 2025 this was due to fears that tariffs would send prices higher, particularly in the US, and in 2026 this has been almost exclusively due to the squeeze on oil supply from the Middle Eastern conflict. There are arguments that the conflicts and protectionist attitudes of the US have actually boosted the need for more defence and energy reassuring projects. But overall, were the inflationary fears to settle down, this would allow these other themes to flourish and contribute to a wider economic advance than one simply focused on the AI spending of a very few companies.

Xboxes and iPads

Of course, inflation and interest rate expectations are the key drivers of movements in fixed income. As we asserted in last month's document, whatever the status of the frequently on-off nature of the ceasefire in the Middle East, we can expect a continuing drag on oil supplies and across derivative industries that should keep inflation concerns bubbling along throughout the summer. This process has been exacerbated by huge demand from technology firms for chips that is beginning to squeeze other industries and consumer products — witness increased prices for Xbox and iPads.

Clearly, the expectation that interest rates would drop precipitously this year has now evaporated and we shall have to see whether the Federal Reserve and Bank of England follow the example of the European Central Bank and start pushing levels higher again – the new Fed Chair Kevin Warsh in his initial indications is giving the impression that he is not a pawn of the President, clambering for rate cuts in advance of this year's midterm elections, and will take action if necessary. The consequence of this is that long dated bonds still appear risky, and we are maintaining our holding at the shorter end which is less susceptible to inflation and interest rate advances.

Conclusion

Equity markets in general are delicately poised across a number of themes. But with uncertainty over the inflationary and interest rate outlook, and the bar set high both in terms of earnings and sentiment, we expect a choppy period through the summer months. We are therefore sticking with the approach of watchful balance within the equity allocation of portfolios where we of course retain exposure to the current technological zeitgeist but are acutely aware of the need to be able to adapt, and quickly at that, given how speedily events have and are likely to continue to unfold.

With bonds currently proving an ineffective counterbalance to equities we are maintaining our holding at the less-exposed shorter end. Instead, the volatility that we are experiencing remains an ideal situation for hedge fund investors to profit from the heightened dispersion of outlooks and rising uncertainty through global economy.
