The Advisor

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Market Update - Second Quarter, 2024

CONVERSATIONS WE'RE HAVING – In this edition of The Advisor we extend the hottest topic of conversation we've been having this quarter.

Artificial Intelligence (AI).

There is little debate that AI has become its own macroeconomic theme, entirely. The recent boom is centered in what is called generative AI which describes machine-learning models trained to create new data. This differs from more traditional AI systems that learn to make predictions from the data they are trained on.

Generative AI in and of itself isn't a brand-new technology. What has changed is the complexity and scale of the datasets feeding the machine-learning systems which opens the door to a whole new universe of applications and use-cases. Therein lies the investor excitement that we believe is warranted.

To start, we think the current advancements in AI have the potential for sweeping societal changes analogous to such inventions as electricity, the printing press, auto assembly line, computers and the internet.

Thinking in terms of improved efficiencies and increased productivity, an example might be the fundamental changes to households with the introduction of the dishwasher, washing machine, vacuum cleaner, microwave and refrigerator.

Drawing a more commoditized comparison to AI would be oil. One barrel of oil produces refined products for numerous end-user applications, far beyond fuel for transportation, that feeds into the global economy. AI will do the same, reaching well beyond the technology sector, impacting so many different areas of our lives.

AI is a fly-wheel where data and computing power will serve as the platform to create and enhance products, services and efficiencies that have not been possible until now. The more successful the integration of AI becomes the more data and applications will be created driving the need for more infrastructure, software and computing power – and the flywheel spins faster.

Has the AI excitement created a bubble?

Our answer to that is definitely maybe, but almost certainly not, except if it has. All kidding aside, that answer depends on your definition of a bubble which historically, you'll find asset prices can fall close to 80% when bubbles burst. Let's use the internet/dot-com bubble of the late 1990's and early 2000's to draw some comparisons to the euphoria right now around AI.

What stands out to us is there were actually two coincident bubbles that served as catalysts for what we generally call the dot-com or tech bubble. The first was advancements in fiber optic technology and the second was the rise of dot-com companies with unsustainable business models. (Actually, there was a third catalyst – the Fed was tightening monetary policy but we'll focus on the first two in this conversation as a direct comparison to the AI topic.)

The first bubble was the technological advance of fiber optic cable capacity. The lifeblood of telecommunications and the internet is bandwidth, or the amount of data that can be transmitted over a connection. In the 1980's, the telecom industry began replacing copper wire with fiber cables which allowed for significantly more volume of data transmission.

Optical amplification soon followed which improved the transmission of a single data signal. But it was the breakthrough in the ability to multiply fiber optic capacity and therefore squeeze more and more data through the same fiber that fueled the growth of the internet. The revolution was underway.

The problem was the industry believed, at the time, that bandwidth was a scarce commodity and companies such as WorldCom were in full-on gold rush mode installing nearly 90 million miles of fiber cable. As it turns out, technological advances of multiplying the capacity of fiber optics exponentially increased the supply of bandwidth. What was left was an overbuilt and underused network. The bubble burst.

The second and more familiar bubble was the rise of dot-com companies with unsustainable business models. The internet opened the door to a brand-new world of efficiencies and potential for commerce. Investors, Wall Street and management alike cheered growth at all costs as long as it were a function of the internet because of course, the world had changed and skyrocket valuations, regardless of revenue, income from operations and earnings, were justified.

The problem was believing that because this revolution (the internet) connected the world in a way that was never possible before it also created infinite opportunities for "dot-com" companies. That wasn't true to the degree investors paid-up to own stocks. The bubble burst.

AI comparisons to the Tech Bubble

Two coincident bubbles, fiber optics and dot-com's, burst wiping out trillions in stock valuations during the tech bubble. However, there was one thing that wasn't destroyed and actually grew stronger despite the fiber optic and dot-com calamity – the internet. The internet wasn't a fad; it truly was a technological revolution and we believe AI is as well.

We do see some degree of risk embedded in the current AI theme as it relates to companies racing to build out infrastructure to train AI models. Much like the fiber optics story, we know that technology advancements can quickly change the rules and direction of industry. Consequently, that can lead to companies losing, going bankrupt or getting taken out by competitors as the evolution progresses. We see some infrastructure companies (like semiconductors) that appear crowded and even overvalued on certain levels that could experience a reset of valuation. But, as far as a complete bust of AI and its related integration and monetization into the world around us – we see that probability as remote.

Supporting our view is data from UBS as we revisit the AI is oil analogy from earlier. Current oil consumption in the U.S. is approximately 2% of gross domestic product (GDP). We've been using the term AI in this discussion in a very broad sense. If we focus-in on software and hardware we find they account for 3% of GDP. In our opinion, that market-cap size is not a bridge too far.

Another supporting factor behind AI's rise is today's leading companies are completely different, financially speaking, compared to the majority of dot-com companies. So much of the dot-com bust was on the back of zombie companies. Current AI breakthroughs are being led by well-established, highly successful companies that are generating very real revenue, cash flow and earnings. From that angle, this time is different.

In closing, we're in the early innings of the AI ballgame and there will be swings and misses on predicting the evolution and application of AI. There could also be leadership changes and further disruption to the field. AI stocks could selloff or a bear market ensues. But without mistake, AI's transformative power will continue to emerge and therefore change how we live and interact with the world around us which should provide tremendous opportunities for investment over the long-term.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.

Lastly, follow us on social and let's connect!

Resources and References

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