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Zooming In: Episode 3 – Opportunities in AI beyond the 'Magnificent 7'
Willem Sels and Mark McDonald

Willem:

Welcome, everyone, to the third episode of our Zooming In series, where today we are going to talk about Artificial Intelligence. And of course, AI has been the buzzword of markets over the last number of months. And that has helped our overweight on technology, quite on US and global equities. So, so far, so good. But of course, there has been quite a significant run-up in valuations and those have become a little bit more volatile over the last few weeks.

So to discuss what's next for AI, I'm here with Mark McDonald, who is Head of Data Science and Analytics at HSBC Global Research.

And today we will discuss with Mark what is the outlook for AI demand and profits. Whether current technology valuations are warranted and what companies outside of the Magnificent 7 can benefit from the AI phenomenon.

So Mark, thank you very much for joining.

Willem:

And if I may start with the question around the macro side, the IMF reckons that AI will boost global economic GDP growth by up to 0.8% on an annual basis, and McKinsey has calculated that it may lift productivity by 1%, whilst productivity growth is actually only 1% currently. So this looks quite considerable. And gain in productivity is obviously quiteet positive, especially as it can also capthat inflation pressures.

So, Mark, do you think those numbers are realistic?

Mark:

Well, there are millions of tasks that can be done more efficiently using AI than without. So when you aggregate this up to the level of an entire economy, I think it's very plausible that we could see a significant productivity boost from this technology.

However, when it comes to estimating specific numbers that final estimate can be hugely sensitive to the assumptions made. And given that forecasters, some forecasters at least will have incentives to over-estimate this potential growth number, it's worth taking the specific numbers with a pinch of salt.

Now, one thing that seems quite likely from previous waves of disruptive technology innovation is that the market is likely to overestimate how quickly the benefits are likely to be realised, whilst perhaps underestimating the full scale of the ultimate impact. So we may well end up going through a period of disillusionment before GenAI technology ultimately changes the world beyond all recognition.

Willem:

So in other words Mark, innovation doesn't go in a straight line. There is a risk that the markets get a little bit overexcited in the short term but the longer term potential is enormous. And I would agree with that. But let's try to define the benefits of AI. Where exactly does this productivity growth really come from?

Mark:

Shortly after ChatGPT was released, I was talking to someone who commented, "it seems like a cool technology, but what's it really for?" Now the reason they couldn't immediately identify the killer use case for GenAI is that it's for everything. In other words, these AI models are general purpose technologies.

In essence, I think there are productivity benefits to be realised all across the economy. And rather than a small number of stunning productivity improvements, I believe we'll actually see a larger impact from the millions of small and often rather mundane improvements which will aggregate up to a significant productivity boost.

Now, in reality, the productivity improvements will only be realised by changing working practices. And there's an awful lot of inertia in many institutions. As such, the productivity benefits will be distributed not just widely, but also unevenly. And some companies will find ways to use AI technology well; others will do so badly or not at all. So it's going to be important for investors to find ways of tracking which companies are doing this well, as these companies are likely to outperform. And really these companies where AI will lead to outperformance, they can be from almost any sector of the economy. Some sectors such as tech and media are clearly already exposed to the AI theme. But given the broad applicability of these AI tools, the influence is likely to be felt in many other sectors, some of which might not appear immediately obvious candidates such as pharma, healthcare, financial services, and retail.

Willem:

I've heard from clients who are business owners in retail or manufacturing, for example, as well, that there are big efficiency gains that they can have, in logistics, forecasting the client demand, etc. And that's a really important thought that the benefits of AI goes well beyond the Magnificent 7; So no surprise then, that when you look at the earnings season, most companies, you know, are trying to position themselves, as beneficiaries of AI and show their credentials in that area. But where do you think it will really move the dial? And, you know, how can I find the company where AI will make that really big change to their profitability?

Mark:

Counterintuitively, the ultimate winners may not end up being those companies that immediately jump to mind as being the most exposed to the AI theme. In previous waves of disruptive tech innovation, we've seen this kind of gold-rush mentality, that leads to over-competition and over-investment.

The over-investment is often focused in infrastructure, whether that's laying too much railway track in the 1800s or too much fibre-optic cable end-consumer in the dotcom boom. And the most direct analogy to this today is likely to be the huge investment going into building and training frontier models. In those instances, the ultimate beneficiaries of the over-investment were end-consumers, who benefited through lower costs. Similarly, the intense competition amongst providers of frontier AI models may end up benefiting the consumers of AI services. Eventually, we'll be able to identify the companies which are doing a good job of implementing AI through their formal reported numbers. These companies will see increased revenues, lower costs, improved margins, and so on. However, it's too early to see that at the

moment, and as such, investors are likely to have to use more alternative datasets in order to identify these potential winners.

Willem:

Another related topic, of course, is the digital architecture that is needed to support that AI growth story. For example, data centres, which have been a very popular focus in the area of real estate and continue to be one of our focus areas as well. Electricity consumption, of course, will pick up sharply as well, and that can lead to more demand for electricity company services. But also of course have an impact on the net zero transition. So a lot to think about. But infrastructure Mark, if it is not sufficiently available could be a bottleneck. Correct?

Mark:

Well, I think there are several potential bottlenecks for integrating AI into business processes. One of the trickiest bottlenecks is the necessity for companies to actually change working practices in order to practically integrate AI into their operations.

Making the best use of these new AI tools may well require retraining of staff and this will also take time. Another potential bottleneck is the rapidly changing regulatory landscape. Companies, particularly those in highly regulated industries, are likely to make only tentative progress until the regulatory environment is clearer.

And, as you say, another important bottleneck is the energy and advanced chips needed to train and serve these models. To be able to provide the energy necessary, it's likely that there will have to be significant investments in energy infrastructure.

This could actually be quite positive for companies in the Utilities and Industrial sectors. Another illustration of how the AI theme can play out in many sectors.

Willem:

So Mark let's be really practical. What's the best approach for investors in this AI theme? Magnificent 7 have benefited a lot and will continue to benefit but valuations have already risen. So are those valuations warranted? Or should investors, on the other hand, switch to other sectors? So are you better off with direct exposure to AI companies or indirect exposure?

Mark:

The Magnificent 7 and other big tech companies are clearly the area where this AI theme is manifesting most strongly now. And, as such, investors who wish to be invested in the AI theme will need to have exposure to these companies. However, given that everyone is analysing these companies through the same AI lens, it's going to be challenging to achieve outperformance there – even if the AI theme continues to drive good performance for these stocks.

So a more promising area to find alpha may be to identify the companies outside of the obvious sectors, which are likely to do a good job of integrating AI. In other words, this could be quite a promising environment for active investment.

Willem:

I completely agree with that. And our strategy is to diversify our sector exposure. And that of course also applies to the AI theme. We try to pick the winners of innovation in all sectors. And in a way, in my view, that's a search for quality, a search for companies

that are well positioned for the future, which is, of course, digital. And also remember, of course, that, this is not just a US thematic, there are opportunities in this area to tap into this theme in other areas of the world as well.

Thank you very much, Mark, for sharing all of your insights.

And thank you all for watching.