Goldman Sachs Exchanges: The Markets

Why the AI-driven tech rally has legs

Sung Cho, co-head, Tech Investing for Fundamental Equity, Asset & Wealth Management, Goldman Sachs

Sam Grobart, Host

Recorded: June 8, 2023

Sam Grobart: Widespread AI adoption may be around the corner. But it's effect on stocks is already here. This is The Markets, a new series from Goldman Sachs Exchanges.

Hi, I'm Sam Grobart. Today, I'm joined by Sung Cho, co-head of tech investing for fundamental equity within Goldman Sachs Asset Management. We're going to talk about recent tech-fueled rallies in equity markets, lessons from other tech bubbles, and how all this fits into the larger economic picture.

Sung, thanks so much for joining us today.

Sung Cho: Thanks for having me, Sam.

Sam Grobart: So, taking a look back over the last month, the NASDAQ has been up about 8 percent. The S&P 500 up about 3.5 percent. How much of that rally is coming from enthusiasm for AI stocks?

Sung Cho: So, certainly, a big part of the rally, Sam, as you described has been from the enthusiasm for AI stocks. But I think it shouldn't be ignored how strong the fundamentals more broadly have been for technology.

So, about 75 percent of tech companies this earnings season beat and raised on both sales and earnings. And if you try to put that number in context, in an average quarter, about 68 percent of companies beat on sales.

Sam Grobart: Some over performance there.

Sung Cho: So, some really big out performance. And so, certainly, AI is contributing. But tech is really, really strong against the weaker macro economic backdrop. And so, AI really became a catalyst when NVIDIA reported earnings a couple weeks ago. And they literally blew the quarter out in a way that I haven't seen in a long time.

So, that really planted the flag in investors' minds that I need to start paying attention to what's going on in AI. And that's part of what really catalyzed the next leg of the rally. But really, the first part of the month it was really all about the earnings season.

Sam Grobart: Sticking on the AI topic for a moment here. How do you incorporate AI adoption into your forecasts?

Sung Cho: So, it's so early. It's a little bit of a tricky thing to do. Certainly, it's been the biggest rate of adoption on the consumer side that we've ever seen.

So, in 2006, it took Twitter nearly two years to get to one million users. If you look at a platform like Instagram, that's been extremely popular, right? When it was born in 2010, it took two and a half months to get to one million users. For ChatGPT, it took five days.

Sam Grobart: Wow.

Sung Cho: And so, this is, by far, the fastest adoption curve that we've seen on the consumer side. The question really is, you know, what happens on the enterprise side and how fast do enterprises adopt? My tech team and I, we spend the last couple weeks at a big tech conference in Boston meeting with hundreds of executives, CEOs, and CFOs of very well-known public corporations. And not a single one wasn't thinking about how they're incorporating AI into their business models.

And so, the enterprises, obviously, will be a little bit more methodical in their approach. But we think on the enterprise side, the adoption will be about as fast as we've ever seen as well.

Sam Grobart: We're sitting here, we're talking about AI. It's obviously been a huge story across all channels and media and the news. What lessons can we pull from about 20 so odd years ago when there was the tech boom and the tech bubble? What can we apply that may be relevant to the risks right now in AI?

Sung Cho: Yeah. So, I think it's way too early to be talking about bubbles with AI. It's only been a few weeks. Give it a little bit of time.

Sam Grobart: Okay, okay.

Sung Cho: But I do understand why that's happening and why you're asking the question. It's not only been the dotcom bubble but during the COVID period we saw a big boom in tech stocks. And we also saw a big decline in tech stocks. We saw the emergence of new asset classes like NFT and crypto go through its highs and lows. And so, I think it's very fresh on people's minds and a little bit of weariness around bubbles. Which is a good thing, right? You always want investors to be a little bit disciplined.

But I think the more important question is, and something that we've given a lot of thought to is, like, what is the anatomy of a bubble? And why do bubbles form? Right?

And I think there are three key ingredients. The first one is it's got to be an asset class that people don't understand and something that's fairly new. Right? So, when you don't have historical valuation ranges and parameters to be able to put on something, that you can just be open ended in how you dream about what the final stake can look like, right? And so, that's certainly one.

Number two, I think you need consensus that this is the next big thing. And I think that's always been the case with bubbles. And then the third and most important thing is really the returns have to be driven all by multiple expansion in fluff more so than earnings. And I think that's what really sets the stage for bubbles.

And so, with AI, certainly, this is a new asset class that investors haven't considered. I think it also is uniform consensus around that this is going to be the next big thing. But, you know, the one thing that isn't true yet is that the multiples haven't expanded beyond earnings. And so, look at NVIDIA. We just talked about that earlier, right? The stock is up. Obviously, been a home run this year. But it's been driven by earnings. Earnings consensus numbers have moved up 75 percent plus in the six months.

So, you can say, yeah, it's irrational. But it's actually for good reason, right? Because the earnings are actually expanding. So, I think the recent rally around tech stocks associated with AI has legs because it's fundamentally driven. It's not really euphoric multiple expansion driven yet.

Sam Grobart: What are fund flows telling you about the AI investment and the overall bull market in tech right now?

Sung Cho: Yeah. So, if you look at the retail side of the fund flows, clearly there's a lot of enthusiasm in investing behind AI. Right? And so, if you look at the top ten thematic ETFs on the year-to-date basis, four of them are AI driven ETFs, right? And so, certainly, there's a lot of enthusiasm on the retail side.

There's also a lot of enthusiasm on the institutional side as well, right? Think about the positioning that we went into this recent period with. Investors have been fairly bearishly positioned, at least in technology. And we got this all-new catalyst in AI that's caught people a little bit off guard. And so, people have been scrambling to really try to put AI exposure on.

And when you scramble, sometimes there's not a lot of thought behind how to put that exposure on. So, we've seen creations of AI winners, AI losers' baskets. On our team, what we're trying to actually do is look at the AI loser basket and say, "What's being put in there that's being misunderstood? And that, actually, we think is going to be an AI winner?"

So, it's created some inefficiencies in the market. Obviously, any time there's an inefficiency and dispersion for the absolute wrong reasons, it creates opportunities for us. And so, we're trying to take advantage of some of those flows.

Sam Grobart: So, interest in AI-related companies has focused primarily on large cap tech companies. Do you think there's sometime room to run there? Or will investors move to smaller or mid cap AI related or tech related companies in the future?

Sung Cho: I largely think about AI investment opportunities in two large buckets. So, the first one is what I would describe as AI infrastructure. Within AI infrastructure, we think about companies like Cloud players like Amazon, Microsoft, that are providing that large language model infrastructure behind development.

Within infrastructure, I would also consider semiconductor companies that are the downstream beneficiaries of all this increased processing demand.

And then the second bucket is the applications. The first manifestation is ChatGPT. But that's really the only one that's been out there so far. There are going to be lots of other ones that are going to be developed on top of this infrastructure. We're still very, very early days in that though. And so, the reason why the rally has skewed so much more large cap is that the major infrastructure players, whether it be the Cloud or the semiconductor guys, all reside in the large cap space.

Sam Grobart: And we know who they are.

Sung Cho: Right.

Sam Grobart: It's a known quantity.

Sung Cho: Exactly. And so, that's why the rally has been fairly concentrated in the large cap stocks. But as the app ecosystem really, really starts to develop and take off, you're going to see a lot of new companies coming out in the small and mid cap space.

Sam Grobart: Investors are switching from cyclical stocks to more defensive positions. And of course, large cap tech stocks are part of that. Is that also what we're seeing here?

Sung Cho: Yeah, I think that could certainly be contributing. But I think the more important part of the story here is that tech company fundamentals continue to prove very resilient against a tough macro economic backdrop. And there's a real secular catalyst in AI that's driving earnings higher for a significant part of the universe.

I guess the short answer is even if there is a rotation back from large cap to cyclicals, it's unlikely that large cap tech starts to meaningfully underperform. Because this is not really a flow driven thing. But it's more of a structural one that's being driven by fundamentals and by higher earnings.

Sam Grobart: And last question, Sung, what are you going to be paying attention to next week?

Sung Cho: So, next week is going to be a fairly quiet week from an earnings perspective. So, really, all focus is going to be on the FOMC and what they decide to do with rates.

And so, I think the market has priced in about a 30 or 40 percent probability of a hike. I'm not a macro guy. I don't know exactly what's going to happen. But I'll certainly be an enthusiastic spectator.

Sam Grobart: Sung, this was awesome. Thanks so much.

Sung Cho: Thanks very much.

Sam Grobart: That does it for another episode of The Markets. As of June 16th, we'll be leaving the Exchanges feed. But we have our own new feed. So, subscribe to Goldman Sachs The Markets on Apple Podcasts, Spotify, or wherever you get your podcasts.

I'm Sam Grobart. Thanks so much for listening.