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Global X: On the Market

Chief Investment Officer Jon Maier and Head of Thematic Solutions Scott Helfstein offer their perspectives on the current investing landscape, which today can be described as AI all the time, at least in some circles. Jon and Scott put the AI wave in perspective with thoughts that go beyond software. How companies invest in AI and technologies that create new efficiencies and a potential productivity boom can be critical to understanding the state of the economy and the market. Recent capex growth and corporate earnings suggest there's reason for optimism. With so much uncertainty over the past year, investors have had viable options in fixed income for the first time in a long time. Rates at 5% have appeal, but investors must keep an eye on inflation, even as it trends in the right direction. To close it out, Jon and Scott give a nod to their favorite themes right now (and they're not just AI).

Do you view artificial intelligence (AI) as aspirational, or is it a real sea change? Much of the AI trade this year has been concentrated in a few names driving returns, how can investors find exposure to AI beyond the narrow leadership?

Maier: Sea change. I hate to start with a cliché, but with AI, this time feels different to me. First, the pace of technological advancements in AI is unprecedented, leading to greater potential for disruption. Since its launch for public use in November 2022, ChatGPT has scaled to over 500 million global users, and OpenAI expects revenue to jump from $200 million this year to $1 billion next year.[1]

Second, the significant surge in investor interest and funding in AI-related ventures indicates a strong belief in this technology's long-term potential. FOMO is real, and this "fear of missing out" can lead to innovation. Roughly one-fifth of big tech's combined acquisitions and investments since 2019 involve AI companies, and this influx of capital is fueling further innovation and accelerating the adoption of AI across industries.[2]

Third, growing awareness and understanding of AI's capabilities can lead to more pragmatic and focused approaches towards its implementation.

I think this combination of factors sets this wave of technological advancements apart from others, increasing the potential for widespread integration of AI. For investors, it's important to consider the broader AI story. Many components will play a role, including the need for greater computing power, memory and storage, business services, and cybersecurity. These tangential themes could offer investment opportunities, especially as market breadth improves.

Helfstein: An industrial sea change. First, AI is likely to be more of a commercial business-to-business (B2B) tech than consumer-focused. AI is very different than the innovations of the decade past, where consumer tech companies drew outsized returns. This innovation boom is based on corporate productivity, and those booms are typically the best types for the economy.

Second, AI might push the Tech sector to adopt a pharma model where new tech gets put through existing distribution networks. For the past 20 years, start-up biotech and medical companies either sell to larger players or they license the intellectual property. The AI situation might turn into one where AI algorithms are acquired or licensed and sold through existing distribution networks, which is where cloud companies enter the chat. They already have customer bases and sales teams ready to go.

Third, let's think about the entire AI ecosystem. Software quite possibly offers the highest growth and margin opportunity, but we can't ignore the hardware buildout. If the technology proves most valuable to companies in helping to control cost, drive efficiency, and address labor shortfalls, demand for sensing and processing capability is likely to increase. Internet of Things capabilities are the connective layers between the physical and digital worlds.

How should we think about productivity improvements going forward given enhanced capital expenditure spending?

Helfstein: Capex is the headline story from my perspective. We will see what companies do this quarter as earnings come in, but capex growth has outpaced EPS growth since the onset of Covid. What started as a operational necessity is now an economic imperative. Companies seem to get the message that investment in efficiency makes sense. And there is a lot of room for efficiency ahead. In the U.S., only 1 in 3 factories have a single fully automated process.[3] That shortfall will change, and we will see productivity enhancing technologies in places we never imagined. (Think robot waiters at restaurants.)

Productivity generally spikes during recessions when companies lay off workers, which inflates labor efficiency. I expect the productivity boom to be seen in the margins rather than productivity data, which won't tell the whole story.

Maier: Despite challenges, the current capex cycle remains robust, and I believe it has the potential to be transformative. We're in the midst of a significant shift toward enhancing productivity and a new era recognizes time as the most valuable resource. (That is, until a time machine is built, but that is a thematic discussion for another day.) With a tight labor market, tools and technologies that optimize time management are in demand. Most manufacturers recently surveyed by Deloitte plan to increase operational efficiencies over the next 12 months using new technology. Robotics and automation were top technologies favored by respondents.[4]

The future belongs to those who can adapt, innovate, and leverage these advancements to their advantage. The companies that invest wisely in this capex cycle will undoubtedly position themselves as frontrunners in this dynamic landscape. I think there's truth in what entrepreneur Peter Diamandis said: "There will be two kinds of companies at the end of this decade: those that are fully utilizing AI, and those that are out of business."[5]

Corporate earnings have been unexpectedly strong the past three quarters. What are we seeing for Q2 2023?

Helfstein: So far, so good. Companies continue to outperform mediocre expectations, and I think that trend is likely to continue. Think back to June 2022. Producer prices were increasing 18% year-over-year, but consumer prices were only rising at half that level.[6] For all the talk about companies passing price increases to customer, they actually proved a buffer and pushed them to find efficiencies. Those efficiencies did not involve firing people or cutting capex. Bears keep waiting for the profit margin collapse, but maybe the reality is slowing sales and constant margins. Expect to be surprised to the upside.

Maier: I'm optimistic, and one reason why is big banks. JP Morgan, Wells Fargo, and Citi surpassed earnings expectations, mainly due to higher net interest income. Bank of America and Morgan Stanley also reported better-than-expected earnings. These banks emphasized that the consumer and the U.S. economy remain generally healthy, although there are concerning signs. Increased net charge-offs potentially indicating unrecoverable loans are worrisome as consumer debt rises. Also deposit costs are higher, affecting future net interest income. Big banks can manage increased interest rates, but regional banks are more vulnerable due to their reliance on commercial deposits. Also, compared to large banks, small banks have roughly four times more exposure to the troubled commercial real estate market, comprising 28% of their assets.[7]

Despite challenges, bank earnings overall reflect a positive outlook for the U.S. consumer and economic growth. The market environment remains difficult, but resilient consumers and a strong job market have contributed to positive sentiment.

More broadly, positive earnings surprises emerged from a lower base. Companies are more optimistic about inflation and the labor market, reducing concerns of a recession. Despite the earnings recession over the past two quarters, history says that markets tend to perform well after such downturns, especially as analysts revise their earnings projections upward. It's important to note that earnings recessions rarely, if ever, couple with a strong capex cycle, indicating that this period is different from past cycles. FactSet estimates suggest a potential third consecutive quarter of negative earnings growth in Q2, but actual reported earnings have consistently exceeded estimates by an average of 6.4% over the past decade.[8]

Fund flows into short-term fixed income remain strong given elevated rates. How do you think about that opportunity relative to other potential investments?

Maier: Investors have pretty good choices available to them these days. They can earn returns while they wait if they don't like what they see in the equity markets—5% and no risk is not a bad wading pool. In the current interest rate environment, we lean towards favoring intermediate-term Treasuries. This segment offers higher starting yields and the advantage of duration as interest rates decrease. Historically, intermediate-term bonds outperform cash following pauses in the Federal Reserve's monetary policy.[9]

A notable increase in flows towards short-term fixed income investments recently indicates a significant amount of cash held in reserve, according to data from the Investment Company Institute as of July 18, 2023. If macro conditions continue to improve, this cash could potentially be deployed into equities. A Bank of America survey showed that fund managers are already deploying cash into markets, narrowing their underweight to equities.[10]

Helfstein: In my view, 5% short rates could be a bit of a trap. The next sustained move in rates is lower, and 5% could turn into 3% pretty quick. Three times over the past 50 years money market funds had hockey stick-like inflows and then contracted by 5% or more. In each case, equities rallied 25% or more. We could be heading towards a similar situation. After a decade of low interest rates, I see why 5% money market rates have appeal. That said, investors have to keep up with inflation, and equities are the asset class with exposure to nominal growth.

What are the drivers of inflation and deflation in the economy, and which are stronger?

Helfstein: This question is one of the hardest questions out there. Put another way, do I buy commodities and real assets as an inflation hedge? Ordinarily, the answer to that question is yes. But maybe not this time. I think weakening commodities tied to weakening consumer goods demand puts the conventional wisdom in question. Real assets may be a leading source of disinflation. The economic data are pretty straightforward. Demand for goods is in decline from elevated levels, whereas demand for services is increasing. The post-Covid normalization continues. At this point in the slowing economic cycle, I think deflationary pressures are building, but I also expect a bump in the CPI data as very high readings from summer of 2022 roll off.

Maier: Inflation has been a beast and very difficult to tame, but it's slowing. Recent numbers tell an intriguing tale, particularly when it comes to producer prices, which registered their smallest year-over-year rise since August 2020.[11] The U.S. Producer Price Index was at 0.13% in June compared with 11.23% last year, which is quite a drop. It's now lower than the long-term average of 2.66%.[12]

Thanks to the downward trajectory of energy prices and the slump in used car and truck prices, inflation is trending in the right direction. However, elevated labor and housing costs continue to fuel inflationary pressures, casting some doubt on whether inflation is fully under control or simply subject to lag effects of monetary policy. I think it's crucial for investors to keep a close eye on inflation dynamics and not get too comfortable yet. Also, deflation, which is a combination of slow growth and lower prices, is a risk. A vicious deflationary cycle could prolong an economic downturn and reduce spending and productivity. It's not our base case, but if it happens, expect turbulence in the markets.

What is your favorite theme right now?

Maier: I could easily reiterate my enthusiasm for AI, Cloud, and Cybersecurity, but I after a scorching, rainy, and flood-ridden summer here in the U.S. and many regions around the world, I'm looking at Clean Energy. The importance of the electric vehicle ecosystem and renewable energy sources including solar and wind have come into sharp focus. The world has no choice but to act to with big and sustained cuts to greenhouse gas (GHG) emissions. To expedite the transition to clean energy, annual investments in all energy transition technologies must quadruple from $1.3 trillion in 2022 to an average of $5 trillion. It can't get here soon enough.

Helfstein: Either Cloud Computing or AgTech. To ride the momentum of the AI wave, think about Cloud, which is the distribution network for efficiency technologies. The Cloud theme is currently priced for 4% free cash flow growth, which seems really low given the S&P 500's historical 7–8%. AgTech is a bit contrarian. The space had a tough start to the year, but as disinflation pressure builds, a recovery is possible. Long-term, the food space needs new technology with 170,000 new mouths to feed around the world every day.

Footnotes

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