

# AI vs. the Economy: A Tale of Two Outlooks

I've driven down to Silicon Valley countless times in my 29 years studying the semiconductor industry. The several-day-long trip I just finished, where I sat down with CFOs and other executives of leading chip manufacturers, was unlike any other I've experienced. That's because the AI boom that's driving the semiconductor industry is unlike any cycle I've ever seen.

I recently wrote about the [dynamics of chip cycles](#), in which dramatic imbalances for chip demand and the capacity to produce them can cause bullwhip-like swings far more volatile than those in other industries. The promise of and demand for AI computing is creating a cycle that's very different from classic cycles for PCs, memory chips and smartphones. The demand drivers are exponential this time around, based on accelerated computing and generative AI. Driving the cycle are some of the most profitable and cash-rich companies in the world. Second-tier players and sovereign nations seeking to train AI models on local data are also looking to invest in this mega cycle.

The chip sector has been by far the best performer in the first quarter of 2024, rising 29%. And yet we may still be early in what looks like an elongated cycle. When I looked into the eyes of the semiconductor CFOs I met, I detected a high level of confidence in future demand. What I took away from those meetings is that the current AI-driven cycle seems to have a secular durability, although there will likely be plenty of volatility along the way.

Many are speculating that these elevated valuations are a sign of another tech bubble. Unlike the dot-com bubble 24 years ago, which had significant funding by startup capital and debt-fueled investment against the promise of potential future growth, this boom is largely being funded out of actual cashflow from deep-pocketed tech incumbents such as Microsoft, Meta and Oracle, to name a few.

The accelerated computing required to run powerful AI models may drive demand well beyond the sought-after graphics processing units (GPUs) from Nvidia and AMD. It will also require central processing units (CPUs) to run servers in datacenters; a new



**Todd Ahlsten**

Chief Investment Officer,  
Portfolio Manager

generation of high-bandwidth memory chips; and application-specific chips to run customized AI models at tech giants like Meta, Google and Amazon.

No one can say for sure how the AI investment cycle will play out in the long run. Many past semiconductor cycles have ended in hubris and overhyped trends. But I think the secular dynamics of AI are going to be very powerful. There is an exponential amount of computing power needed in processing data, and in the training and inferencing of AI models, before they can be monetized. That could take years to build. During my several days in Silicon Valley, nobody talked about the economy, Fed interest rates or cyclical factors. AI is that much of a force of nature. While I've learned a lot during eight economic cycles, it's also important to remain dynamic, to always be learning and to evolve in the face of revolutionary change, which accelerated computing promises to bring.

## The Economy Beyond AI

In most respects, my overall outlook on the economy hasn't changed much in the first quarter. The economy so far this year has been pretty good—GDP is growing, and the job market has been relatively strong. But inflation remains stubbornly high, and the mixed bag of effects that comes from higher interest rates continues to play out. The question is: how much does AI dominate the narrative? I think the AI economy can continue to spur a massive wave of capital investment, potentially creating conditions for a bubble. But the real economy outside of AI will likely be pretty stagnant, especially in the second or third quarters, when GDP could slow down to near flat growth.

The next several months continue to hold some uncertainty. The market is off to a strong start in the first quarter. Yet, I continue to see plenty of strong crosscurrents of potential economic headwinds that could whipsaw the market. And I think that could happen if the lag effect of long and variable interest rates finally hits home and the labor market softens.

## Positioning for Economic Resilience

We believe the best way to navigate the type of economy and market we are seeing is by being very selective about the companies that earn a place in our concentrated portfolios.

Gaining exposure to AI through technology and semiconductors gives us the opportunity to grow as these companies expand their business, driving the AI economy. We look for quality companies with AI exposure trading at reasonable prices, as well as wide-moat, durable and less economically sensitive companies outside. What does that look like? In our flagship Core Equity portfolio, our top two holdings are Microsoft (MSFT) and Alphabet (GOOGL), and we have semiconductor positions in Nvidia (NVDA), Applied Materials (AMAT) and Micron (MU). Other holdings - like Salesforce (CRM), Oracle (ORCL), Intuit (INTU) and Adobe (ADBE) - have a revenue sturdiness that we believe can remain resilient during a downturn.

Defensively, we aim to protect against the potential economic slowdowns and uncertainties with economically resilient businesses that can outperform in this environment. We seek opportunities in companies that offer high recurring revenue and durability in down markets, such as auto-parts retailer AutoZone (AZO), food distributor Sysco (SYY), discount retailer Costco (COST), paint manufacturer Sherwin

Williams (SHW) and residential recycler Waste Management (WM). We think financial exchanges like CME Group (CME) and Intercontinental Exchange (ICE) can also do well during periods of volatility. We also like solid life sciences companies such as Danaher (DHR) and Thermo Fisher Scientific (TMO) that not only offer steady revenue growth but service a life-science industry that could experience a cyclical recovery.

While the prospect of a tech bubble certainly could be real, the success these businesses have experienced is contributing to ever-widening moats and sustained earnings growth that can continue to propel these stocks forward. And on the other hand, we are awaiting the pressure valve on the economy to release from the impact of higher rates.

One of the privileges of being asset managers based in the Bay Area is our close proximity to Silicon Valley, where we can witness the evolution firsthand. Right now, this is a very special time in that corner of the economy. ■

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