AI Optimism & China Pessimism

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Two major drivers of the global equity market this year have been Artificial Intelligence (AI) and China's slowing economic recovery. The difference in sentiment between the two is stark.

There is an exuberant buzz around the potential for revolutionary advances in AI to boost productivity, while pessimism surrounds the Chinese economy as its post-pandemic recovery runs out of steam. This stands in contrast to the beginning of the year when the reverse held true as sentiment and positioning in the Technology sector was depressed, while there was optimism that China would recover as the economy reopened. To better understand the dynamics of economies and markets, it can be helpful to frame the outlook in three parts: the long-term structural outlook, the short/medium-term cyclical outlook and specific factors such as those related to the pandemic.

Technology is supported by a number of positive longer-term themes including cloud computing, the importance of semiconductors and the power of software. However, the shorter-term outlook was looking more challenging as many Technology stocks, which benefited from the pandemic, underperformed last year as the cycle turned in favour of Value stocks. The AI revolution has reinforced the longer-term structural importance of Technology and turned around the cyclical outlook.

AI has existed in various forms since the Second World War but generative AI and Large Language Models have been thrust into the spotlight since the success of OpenAI's hugely popular ChatGPT product. The speed with which ChatGPT has gone mainstream is quite remarkable and for good reason given its ability to generate coherent and contextually appropriate responses to a wide array of questions.

There is of course a lot of uncertainty but early estimates of the potential of AI are striking. Goldman Sachs estimates that broad improvements in workforce efficiency could add almost 1.5% to US labour productivity. As with any new technology, a key question is how can it be applied and monetised in the real world. This is something that, for example, blockchain has struggled to answer. However, the potential use cases are exploding across sectors such that a recent research paper (Eloundou et al. 2023) concluded that AI could affect 80% of the US workforce in some form.

The near-term constraint on AI is computing power and we have already seen substantial upgrades to revenue and earnings revisions for Nvidia, which is at the forefront of semiconductor development to support the necessary computing power. Microsoft is another major beneficiary having already started to embed AI in their software with clear routes to monetisation.

Turning back to China, the longer-term structural case is challenging. The property sector has been an outsized driver of growth over recent decades with the developer financing model and lower-tier cities under pressure. Authorities have previously used the sector to boost growth but appear reluctant to do so now and seem to be managing a multi-year slowdown. Furthermore, the liberalisation of the private sector, which helped drive productivity growth in China over the last thirty years, has become more challenging as the state has been playing a more assertive role.

On the positive side, the reopening in China has boosted consumption in the service sector, with retail sales up strongly this year. Domestic travel has also picked up significantly. The US economy saw a powerful post-Covid recovery driven by consumers flush with cash from supportive fiscal policy and pent-up demand. The situation in China is very different as households received much less support and, with sentiment impaired from policy missteps, the economy has been scarred.

With recent weak data out of China and Chinese equities severely out of favour, there are increasing calls for stimulus to help support the recovery. Policymakers appear to be moving in this direction but small cuts to interest rates are unlikely to move the needle. China is suffering from a liquidity trap where deflationary pressures are building and demand needs supporting. Local governments are indebted, but government debt remains low and targeted stimulus is likely later this year.

Long Artificial Intelligence and short China has been the trade of year so far. This is supported by a range of longer-term structural factors. However, the nature of markets is such that short-term sentiment can get stretched too far and a more meaningful China stimulus is a risk for investors leaning too aggressively into the long AI and short China trade into the second half of the year.