Market Commentary (continued)

The Bank of Japan raised its benchmark policy rate by 25bps to 1.0% in June, its highest level since 1995. Underlying inflation in Japan remains benign, however, and the economy is developing in line with the central bank's base assumptions. Japanese equities were the standout performer among developed markets in H1, with the Nikkei 225 Index +39% in local currency. AI beneficiaries have led the way with AI-related stocks accounting for approximately 50% of the index's market capitalization. While the share price gains have been rapid, the rally has been driven by earnings growth – the forward multiple for the TOPIX has in fact declined year to date.

The quarter was also notable for marking the beginning of Kevin Warsh's term as Chairman of the Federal Reserve. The early months of a new Fed Chair's term have often proved unkind to equity markets, and indeed with the first FOMC meeting under Chairman Warsh more hawkish than expected, the end of the quarter coincided with an increase in volatility, particularly in AI. Korea's Kospi index, perhaps the index most levered to the theme with a 60% weighting in just two stocks (SK Hynix and Samsung), is up over 100% year to date. However, half of Korea's limit down days this century have occurred this year, and 20% of them in the back half of June.

Outlook

Some of the recent AI-related volatility reflects the concentration of capex in a handful of hyperscalers, whose spending plans are being watched very closely by the market. Calling the top of such a powerful cycle requires foresight that arguably no one has. Nonetheless, there is an expectation of a continuing capex boom, and the narrowness of spreads in deep cyclicals is a sign of how much confidence remains in the theme enduring. Along with some widening of spreads in more stable parts of the market, in aggregate the market looks somewhat bifurcated between AI haves and have-nots.

The degree to which this continues comes down largely to whether the AI phenomenon is "real". At this point it looks more real than false. So far there is little hard evidence of a slowing in AI investment intent: Anthropic is likely to go public in the coming months with ARR rumored to have increased from $9 billion at the end of 2025 to $60 billion in June; Alphabet recently executed an equity raise of over $80bn on top of incremental debt financing; and Nebius, a leading neocloud provider, is entirely sold out of its available AI computing power and rushing to bring on additional capacity. Such demand is mirrored at Amazon, whose AWS segment has just raised prices for reserving its AI chips by 20%. The adoption of AI in the economy continues to grow as reflected, for example, in the rising share of businesses with a paid AI subscription. Data points such as these suggest investment appetite remains intact and reflect the shift from capital-light leadership to a capex-intensive regime.

There are, of course, risks. The irony of current market conditions is that the spenders – investing with uncertain returns – and those facing margin pressure from pricing and bottleneck squeezes have seen their share prices punished (in aggregate the so-called Magnificent 7 was down -2.5% in H1), while those benefitting from these same drivers have outperformed. Should one of the spenders signal a slowing of capex relative to expectations, the AI factor would almost certainly come under pressure. Indeed, at the beginning of July, Meta announced it would launch a cloud business. A plausible interpretation is that Meta lacks sufficient utilization for its own capacity – in other words that it has overbuilt its compute for internal requirements. Its stock rose on the news, while the semiconductor sector was widely sold off. Political opposition to data centers in the U.S. is also growing and, as November's midterms approach, we expect negative narratives around AI's impact on society and employment to garner more attention.

While share prices of AI companies will likely exhibit short-term price volatility, short-term share price movements need not signal the end of the investment cycle – indeed, we likely remain in the midst of a multi-year build-out – but it is a clear reminder to stay vigilant for possible shifts in perceptions of AI's net winners and losers. Within the theme, our direct AI exposure is concentrated in the enabling supply chain: the semiconductor equipment, specialist materials, and test franchises on which the industry relies. Positioning at the end of the quarter tilts towards "intensity" over "units" – businesses whose content grows with each step up in chip complexity, and whose high barriers and proprietary technology should sustain above-consensus earnings.

With market participation thus far relatively depressed, and valuations across non-U.S. markets still attractive relative to the U.S. (forward PE's remain at discounts to the U.S. greater than the long-term average across almost every sector), we consider the conditions for a broadening rally to be present. Geopolitical headwinds may be easing and macro indicators are improving. PMIs are recovering, global growth has been strengthening, and energy costs are dissipating. As such, earnings breadth ought to improve across a diversified range of sectors.

Given the strategy's very strong track record, the current highly attractive starting point with a still steep valuation discount for the asset class and the strong portfolio, the team recently added yet again significantly to their personal holdings in the strategy.