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MARKETS IN FOCUS

AI Insights

Market rotation and the next phase of the AI trade

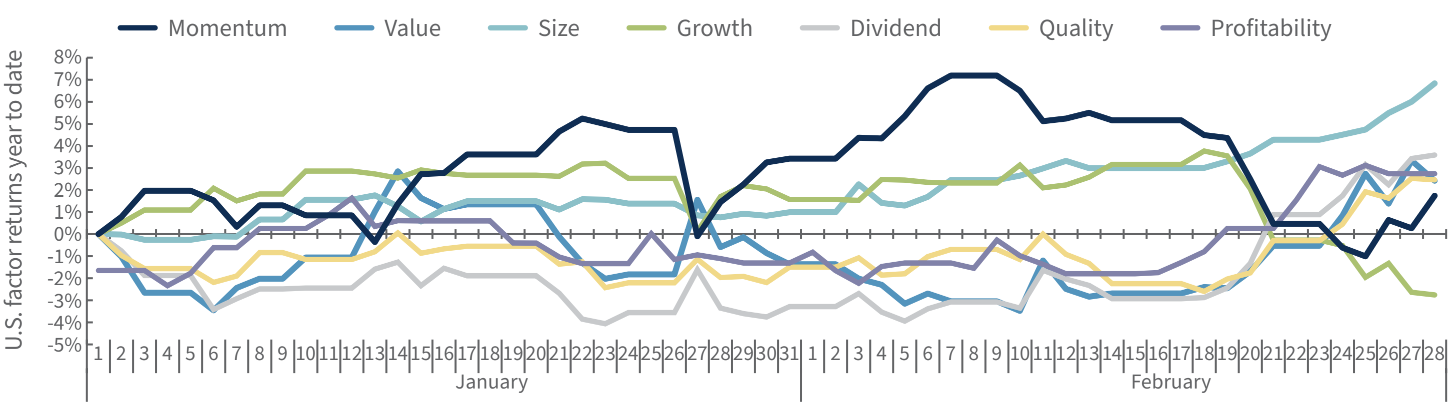
By Matt Orton, CFA, and Joey Del Guercio

Since the beginning of the current bull market in October 2022, the market has scaled numerous walls of worry, thanks largely to the resiliency of the tech giants. These leaders not only benefitted from strong underlying fundamentals, but also from the tailwinds of artificial intelligence (AI), which supercharged top-line growth. And it was the extraordinarily high top-line growth from this cohort that helped to assuage concerns over high valuations and index concentration.

While the path has largely been up and to the right, we've seen fits and starts of a rotation away from the AI trade, none of which coalesced into a sustainable trade – that is, until the DeepSeek drama took shape.[1] The biggest outperformers in 2024 and year to date underperformed meaningfully on Jan. 27, 2025 on news that DeepSeek, a small Chinese company, was able to train a competitive large language model (LLM) at a fraction of the cost of what domestic AI pioneers have been spending. Markets sold first and asked questions later. While many AI-related stocks have traded meaningfully lower since then, the broader market has continued to scale the wall of worry, primarily driven by an increase in breadth. We believe this market could continue to push higher from here, but investors will need to be more selective to outperform.

Momentum faltering while safety factors pick up steam and smaller companies build on strength

U.S. factor returns year to date



Source: Bloomberg, as of 2/28/2025. Factor returns cover all equities in the U.S. market tracked by Bloomberg and represent the top quintile of returns within each factor less the bottom quintile of returns.

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of Feb. 28, 2025.

Questions around concentration

This ongoing market rotation has understandably reignited concerns around market concentration. Index concentration has been rising for many years, but the advent of AI exacerbated it and brought the major indices to a level of concentration previously unseen.

Zooming out, the S&P 500 Index maintains approximately a 31% weight in the Magnificent Seven. This includes the quintessential consensus AI beneficiary – NVIDIA – and the big four hyperscalers: Amazon, Alphabet, Meta, and Microsoft. In addition to the Magnificent Seven composing one-third of the entire S&P 500, the top of the index looks even more fragile when you consider how incestuous the Magnificent Seven are: About 42% of NVIDIA's revenues are from the Magnificent Seven, with approximately 19% coming from Microsoft alone.

This does not mean the Magnificent Seven should be avoided. This time around, the concentration is backed by fundamentals as these companies are deservingly as large as they are. Most of the Magnificent Seven constituents have fortress balance sheets with minimal debt and ample cash while generating hundreds of billions in free cash flow per year. And despite their size, they broadly continue to grow. While concentration has likely peaked, it is more a feature and not a bug of the current market. That said, we believe investors should consider looking for opportunities to lean into the rotation that is taking place within the market, especially given some lingering uncertainties for the largest companies in the AI trade.

Something has got to give?

Magnificent Seven's aggregate weight in the S&P 500 since 2015

Source: Bloomberg, as of 2/28/2025.
The Magnificent Seven are Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla. This chart tracks the aggregate weight for those seven companies within the S&P 500 since 2015.
This is a not a recommendation to purchase or sell the companies or investment products mentioned herein.

The durability of AI capex

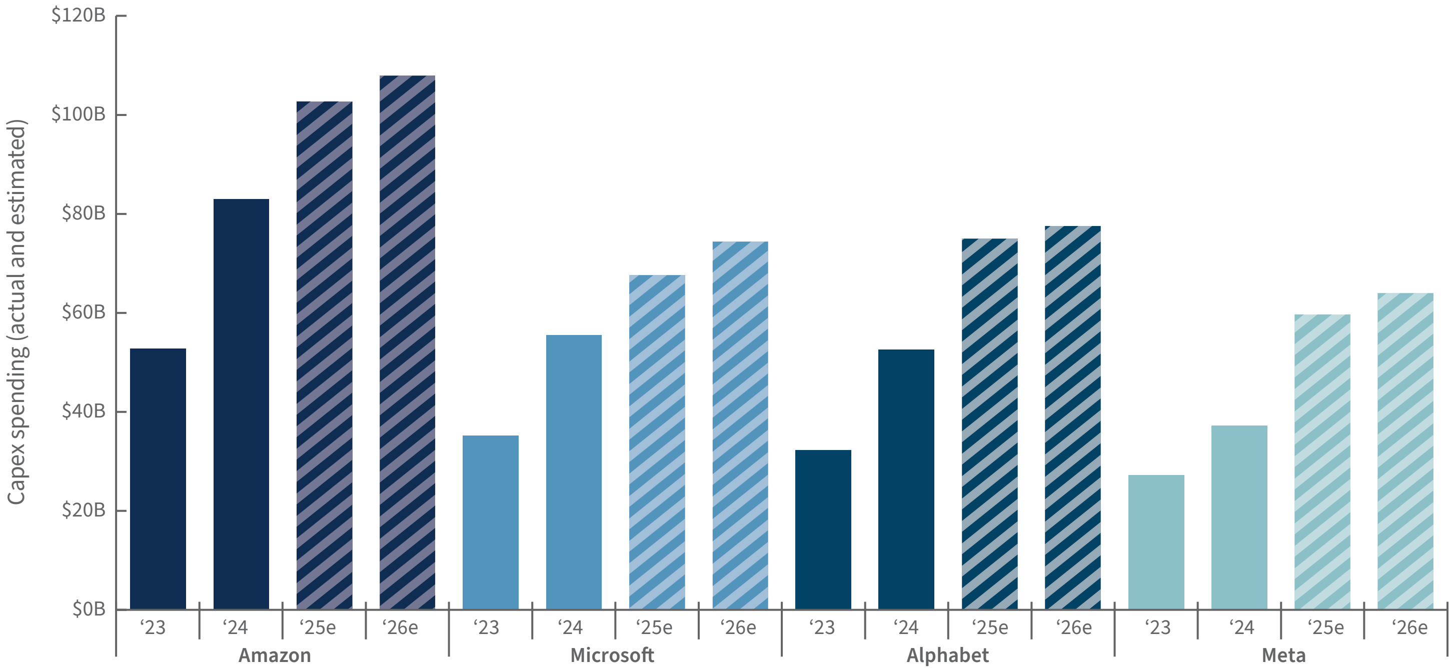
Heading into 2025, the AI trade – including semiconductors, capital expenditure (capex) beneficiaries, and the hyperscalers – was by far the most crowded trade in financial markets. Many of these companies had already doubled or even tripled in size over the course of this bull market. Valuations fully reflected the increases in capex we've seen from the hyperscalers, leaving little room for longer-term questions around the impact of DeepSeek.

It's understandable that investors sold first and asked questions later, but it's important not to understate the scale of capex that is taking place. During the fourth-quarter earnings season, all the hyperscalers met and raised their capex guidance, and one of the biggest takeaways from the earnings of the cloud providers was that their cloud segments collectively missed revenue estimates because they didn't have enough capacity to meet demand.

> "The train of AI capex is not slowing down. I believe it's just going to continue to accelerate."
>
> — Matt Orton, CFA

From $147B in 2023 to $306B in 2025, the AI arms race continues

Hyperscaler historical capex vs. forward estimates



Source: Bloomberg, as of 2/28/2025. Capital expenditures for individual companies tracked by Bloomberg
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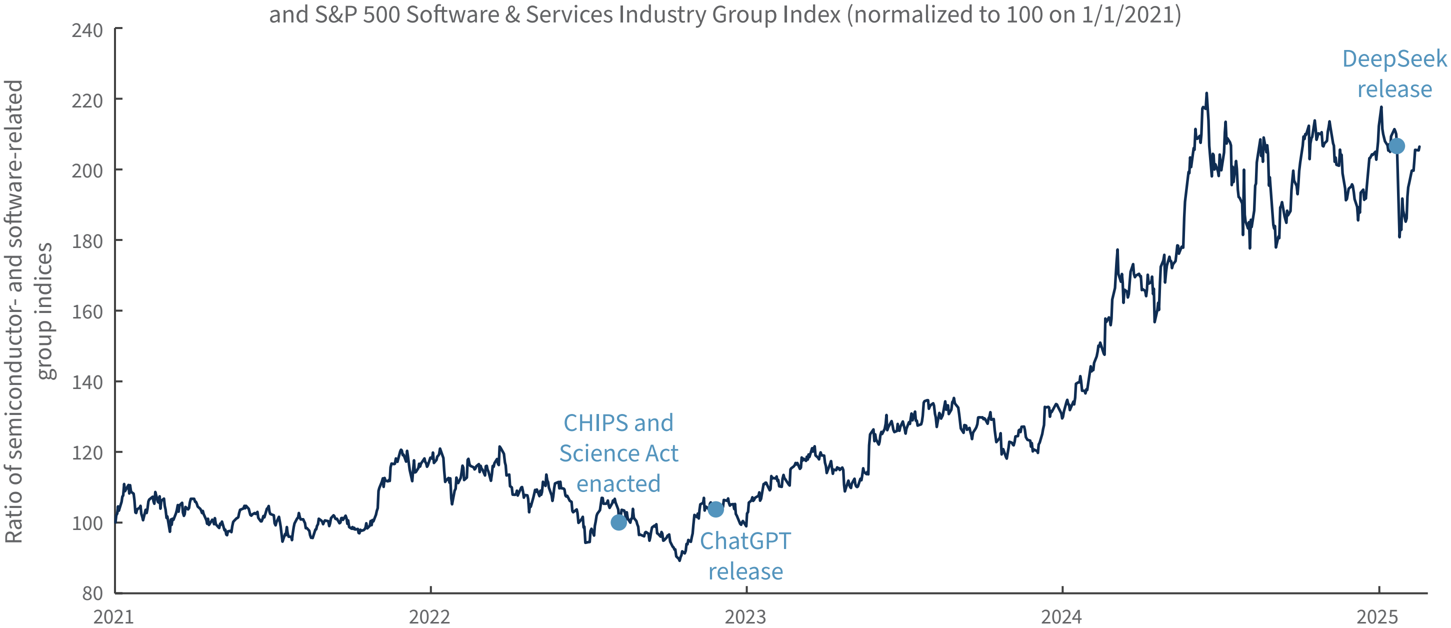
Emerging leaders

While the beneficiaries of artificial intelligence have been entirely concentrated in the infrastructure layer, new players are beginning to emerge. Going forward, we expect the market to place a premium on the actual implementors of AI. One thing DeepSeek did highlight is that the commoditization of LLMs and AI is likely to happen sooner rather than later. Naturally, software companies are in the most advantageous position to leverage AI going forward. Specifically, we believe the software companies that can best provide tooling around, streamline, automate, or even replace existing pre-AI processes with AI could be the businesses of tomorrow. This would likely advantage the software companies already most integrated with their customers given that they would sport existing moats of trust, understanding, or security clearance.

You'll likely start hearing about "agentic AI" a lot more over the coming months, which is a great example of the AI leverage that software companies are expected to be able to provide in the future. Agentic AI is the idea that a company or proficient engineer could wield multiple AI "agents," which receive initial human direction before autonomously taking on a decision, executing tasks, or solving complex problems as defined without constant human oversight. That's why we believe software is likely to be one of the most exciting places to pay attention to over the next few years.

Is the tide finally turning?

Ratio of S&P 500 Semiconductors & Semiconductor Equipment Industry Group Index and S&P 500 Software & Services Industry Group Index (normalized to 100 on 1/1/2021)



Source: Bloomberg, as of 2/19/2025.
This is a not a recommendation to purchase or sell the companies or investment products mentioned herein.

The lessons of this rotation

Breadth is expanding, non-tech sectors are leading, and it didn't take the Magnificent Seven falling meaningfully. Tomorrow's market won't be like yesterday's; this rotation has illuminated the dangers of portfolio concentration while underscoring the importance of selectivity. The great rotation is underway as this market continues to scale the current wall of worry.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Definitions

Agentic artificial intelligence (AI) is a type of advanced AI that can act autonomously, make adaptations as it goes, and address multi-step tasks based on context and objectives with limited human supervision.

Breadth describes the relationship between the median and the mean of a market index. When a few data outliers result in a mean that is substantially larger (or smaller) than the median of the full data set, then the performance of the entire index is being driven by a "narrow" selection of companies. An index supported by "broad" market movements is one where the median is closer to the mean.

Capital expenditures, or capex, are monies used by a company to buy, improve, or maintain physical assets such as real estate, facilities, technology, or equipment, and may include new projects or investments.

ChatGPT is a generative artificial intelligence model developed by OpenAI. Generative artificial intelligence (GenAI) is a form of artificial intelligence that can create new content that includes text, audio, code, video, and images.

The CHIPS (Creating Helpful Incentives to Produce Semiconductors) and Science Act is federal legislation passed in 2022. It aims to increase investments in U.S. semiconductor manufacturing capacity, while also aiming to support the development leading-edge technologies, such as quantum computing, AI, clean energy, and nanotechnology, while also looking to create high-tech hubs that can foster a larger and more inclusive science, technology, engineering, and math (STEM) workforce.

Commoditization is the process of making a newer and less widely distributed product or service into a marketable commodity with standardized characteristics.

Concentration is a term used to describe the extent to which investments in a portfolio, group of portfolios, industry, sector, index, or particular geography or clustered in groups that share specific factors or other characteristics.

DeepSeek is a Chinese artificial intelligence startup that in January 2025 became a leading free downloadable app in the United States. This followed DeepSeek's announcement that its AI model performed as well as market-leading models, and that it was developed at a significantly lower cost. This led to a selloff of well-known U.S. technology stocks on Jan. 27, 2025.

Factor investing is an approach to investing that selects securities based on characteristics associated with higher returns. These characteristics, or factors, can be macroeconomic factors or style factors. Macroeconomic factors are focused on broad risks across asset classes and include the rate of inflation: growth in gross domestic product; and the unemployment rate. Style factors include differences in growth versus value stocks; market capitalization, and industry sector. Factor performance refers to a focus on performance of securities within a particular factor or between groups of different kinds of factors.

Forward indicators use estimates of future activity to help forecast expected financial or economic outcomes over specific periods of time. A 12-month forward indicator consists of estimates looking one year into the future.

Guidance refers statements from the managers of publicly traded companies that indicate whether they expect to realize near-term profits or losses and why.

Hyperscalers refers to the largest cloud computing providers that can provide massive amounts of computing resources and storage at enterprise scale.

Large language models (LLMs) are artificial intelligence algorithms that can recognize, summarize, translate, predict, and generate text, as well as respond to questions in a conversational manner, by massively large sets of data. Large language models learn context and meaning by tracking relationships in sequential data, such as words in a sentence.

The Magnificent Seven refers to the seven largest stocks by market capitalization in the S&P 500 Index, as of Dec. 31, 2024. Collectively they made up more than 25% of the market capitalization of the entire index. They are Alphabet, Amazon.com, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

A moat, in finance, refers to a business's ability to maintain competitive advantages in relation to its competitors and thereby to safeguard its market share and long-term profits. Investor Warren Buffett popularized the term.

Rotation describes the movement of investments in securities from one industry, sector, factor, or asset class to another as market participants react to or try to anticipate the next stage of the economic cycle.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

Wall of worry is an expression in finance used to describe stocks that manage to rise even when external factors raise questions about a capital market's ability to rise.

Indices

The S&P 500 Index measures changes in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The S&P 500 Semiconductors & Semiconductor Equipment Industry Group Index tracks the returns of S&P 500 companies that are in the semiconductors and semiconductor equipment industry group.

The S&P 500 Software & Services Industry Group Index tracks the returns of S&P 500 companies that are in the software and services industry group.

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