HSBC Asset Management

AI trade wobble

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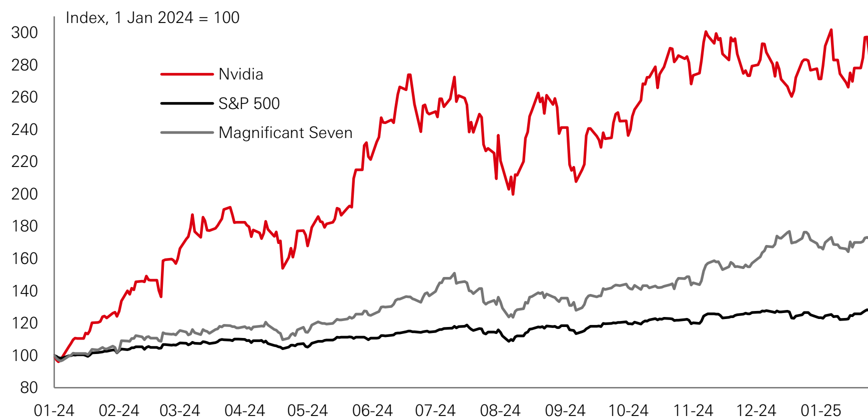
A new threat to US tech dominance

The release of an AI model, R1, by Chinese company DeepSeek has injected significant uncertainty over the future of the global AI business model. The development of a low-cost alternative to Western models that uses less sophisticated GPU chips but with comparable ability, implies the possibility of increased global competition in the sector. Barriers to entry in a market currently dominated by the "Magnificent Seven" and other US tech giants may now be lower.

Unsurprisingly, the initial market reaction to the news has been negative for US tech names, with Nvidia – a market leader in high-end semiconductors used to power AI – significantly underperforming (figure 1). Markets regained some lost ground yesterday.

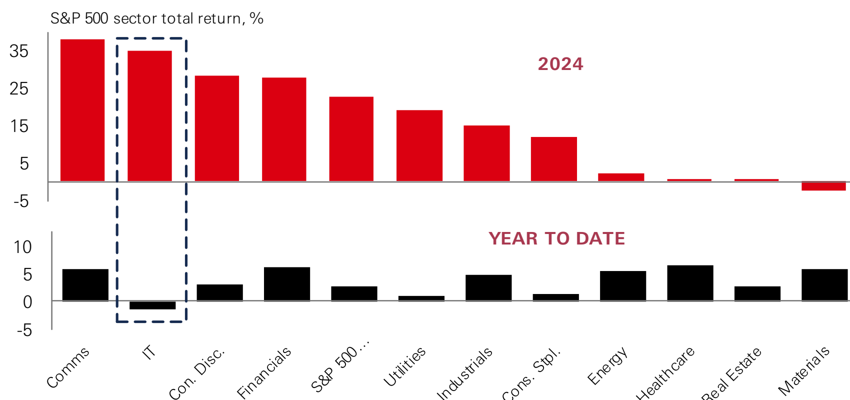
Figure 1: US equity market performance



Source: Bloomberg, HSBC AM as of 29 January 2025. Past performance does not predict future returns.

The latest wobble in US tech leaves the sector as a year-to-date underperformer, having been a big winner in 2024 (figure 2), and major driver of stellar US market gains.

Figure 2: US equity sector performance



Source: Bloomberg, HSBC AM as of 29 January 2025

It's also important to note that this market selloff comes amid some broader challenges for risk assets:

Investors remain cautious regarding the elevated level of trade policy uncertainty and how this may affect future global growth, inflation, and profits. US Tech is also exposed on this front with 60% of tech sales heading to ex-US destinations.

- **Market pricing for the number of interest rate cuts in 2025 has come down** a long way from the late-summer period, with investors now expecting only 1-2 cuts this year from the Fed (figure 3). This has coincided with a pickup in global bond yields, reminding investors that the yield available on fixed income assets is generous.

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It is too early to argue for a big negative impact on AI capex spend and chip demand, and the wider US tech sector

But with DeepSeek potentially challenging the market dominance of US megacap tech firms, we think it makes sense to be cautious on the sector

We think there is a possibility that market performance "broadens" and "deepens" away from megacap tech in 2025

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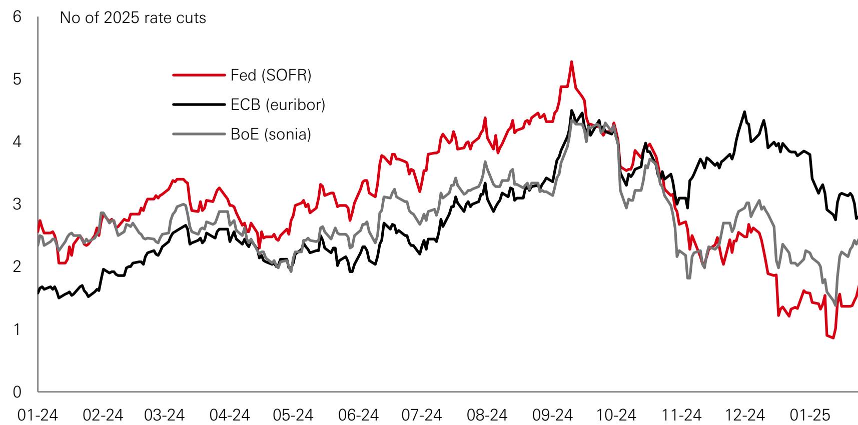
- Following two years of stellar gains for US stocks, **market valuations look increasingly stretched**. The 12-month forward price-earnings ratio of the NASDAQ is currently at around 29x, well above the last 10-year average of 24.6x. This is particularly important in a backdrop of higher-for-longer interest rates, and where super-normal profits are no longer guaranteed.

Figure 3: Market pricing of 2025 rate cuts



Source: Bloomberg, HSBC AM as of 29 January 2025

An evolution, not a revolution

It's early days to draw definitive conclusions about how this development will impact the tech sector, the future of AI, and investment markets in 2025. Our equity specialists have made the following observations:

- This represents an **evolution and not a revolution**. Because of the restrictions on US chip exports to China, DeepSeek has focussed on software innovation and clever techniques to improve the efficiency of the models they have developed.
- The fact that DeepSeek has made this open source will enable other model builders to incorporate the technology. This should reduce the cost of AI inference (the process by which an AI model produces predictions or conclusions) and therefore drive quicker and faster adoption of AI. **This is the Jevons' Paradox in action**: cheaper and more efficient AI tools could create an explosion in demand.
- So **it is too early to argue for a big negative impact on AI capex spend and chip demand, and the wider US tech sector. The software sector is likely to benefit** as a result of lower cost inference too. Upcoming earnings announcement from AI hyper-scalers such as Microsoft, Alphabet, Meta, Amazon, and Oracle will be important to monitor on this front.

Investment views: A gradual broadening out in investment markets

In our Investment Outlook for 2025, "Spinning Around", a key theme was that investment market performance could "broaden out" into other sectors, rather than remain heavily concentrated in US mega-cap technology. We argued that a lot of the names in the tech sector looked expensive, reflecting much good news, and were "priced for perfection". Key risks included investors underestimating the threat of new competition, and overestimating the return on invested capital, especially as capital spend intensifies.

With DeepSeek potentially challenging the market dominance of US mega-cap tech firms, **we think it makes sense for investors to be a bit more cautious on the sector**. The wider adoption of AI can still maintain strong demand for AI related services and infrastructure. But the recent news adds some extra uncertainty ahead of important tech profits announcements.

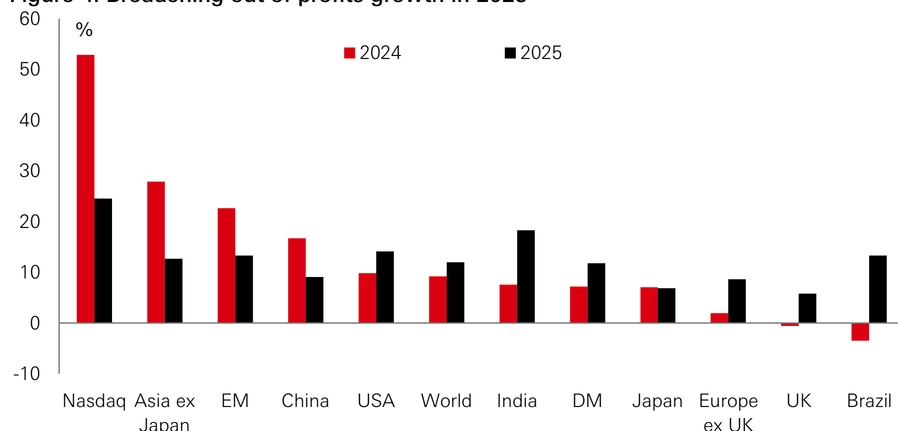
Greater profits uncertainty, elevated valuations, and some cooling of US GDP can have knock-on effects for wider stock markets dynamics. The notion of **"US exceptionalism" is a consensus assumption among investors**. But recent events could force a re-assessment of risk and return. Even encouraging investors to think again about how equity allocations should evolve during 2025.

It could be that stock market performance "broadens" and "deepens" in 2025. If the tech sector now faces some headwinds, other stock markets sectors that have lagged behind in 2024 have a chance to catch-up. This scenario requires growth to be broadly resilient. But if delivered, left-behind cyclical stocks, as well as attractively-valued defensives, and small and mid-caps, could all recover. Figure 2 shows that market performance this year already has a flavour of this theme. For investors, it would mean that equal-weighted or more factor-balanced equity strategies could perform well versus the main indexes.

And in the tech space itself, there could be a rotation toward outperformance of mid and small-cap names where valuations have not reached stretched levels. As we have seen in the past, the winners from technological progress can change over time.

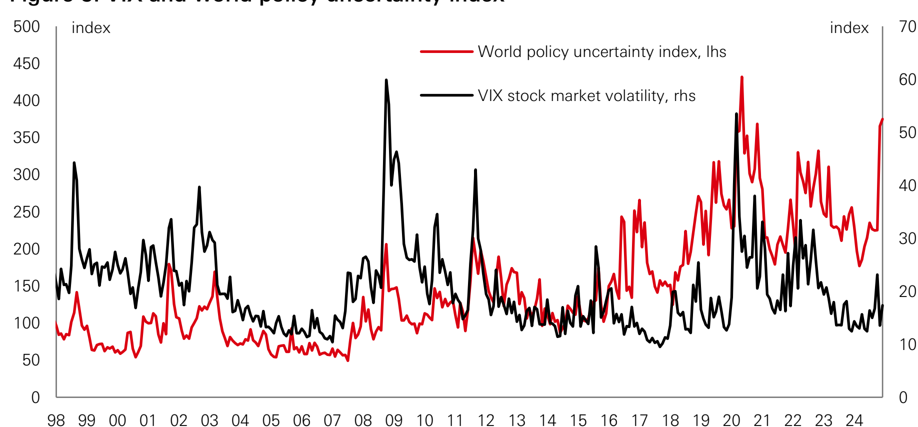
Figure 4 shows how profits growth is set to be more evenly distributed across the globe in 2025. Current projections point to country growth rates coming together more this year. This is a key pre-condition for a sustainable pattern of market broadening and deepening. Meanwhile, market valuations in many countries outside of the US look anomalously low. Good news on profits here could be 'doubly-good' news for investment returns.

Figure 4: Broadening out of profits growth in 2025



Source: Bloomberg, HSBC AM as of 29 January 2025

Figure 5: VIX and world policy uncertainty index



Source: IBES, Bloomberg, HSBC AM as of 29 January 2025

The principal risk to this theme is the sustained rise in market volatility, connected to a highly uncertain economic policy environment. Historically, more macro uncertainty goes hand-in-hand with rising stock market volatility and widening credit spreads.

But an outlook for more market volatility, alongside no recession, further rate cuts, and profits resilience remains a largely constructive mix for investment markets in 2025. And one we have described as the **"volatile Goldilocks"** in our outlook discussions with investors and analysts.

It would mean that **investors have to accept a bumpier ride in markets**. As well as the possibility that government bonds provide a less reliable portfolio hedge than in the recent past. Allocations to alternative credit (securitised credit or direct lending) or hedge funds could partly mitigate this issue. But we think it is also likely investors will have to get used to more noise in financial markets. And this builds the case for an active and opportunistic approach to investing in 2025.

For more insights from our equity specialists on generative AI and equity sectors, please see : https://www.assetmanagement.hsbc.co.uk/en/institutional-investor/news-and-insights/equity-insights-october-2024

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