



Insigneo Weekly Dispatch

The Picks and Shovels of Artificial Intelligence in the Context of the Current Market Backdrop

Investing in Artificial Intelligence beyond the Magnificent 7, while keeping the overall equity market in perspective.

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TV commercials have a way of capturing our imagination. The sight and sound of a Coke or Pepsi being poured into glass full of perfectly shaped ice cubes has a way of making us crave one. But some commercials also have an amazing way of encapsulating an industry changing idea in a single phrase. Case in point is a Salesforce commercial currently playing on TV. In it, Matthew McConaughey, dressed as a cowboy from the Wild West says: “If AI is the Wild West, does that make data the new gold?” The commercial then goes on to read: “Your data is your data. Your data is not our product”. But that opening line really makes you think: “...is data the new gold?” The market has been focused on a handful of companies as a way to invest in the AI revolution. Granted, these companies will undoubtedly be big beneficiaries of Artificial Intelligence. However, what about other companies, like the data management and analytic companies dealing directly with the AI “gold”?

Gold went through many ups and downs in the days of the Gold Rush in the American West. However, the people that were the most successful during this time were the ones providing the picks and shovels to mine said gold. The same could prove true for the current “information” or “data” rush, where the value of information could ebb and flow, but the companies

providing the tools to manage it could be the winners in the end.

The 800-pound gorillas in the room, mainly Google, Meta, and Amazon, are sure to rule the data gathering and analytics jungle. However, the ecosystem is large enough for other players to flourish. Companies like Salesforce (CRM) and Snowflake (SNOW) operate in cloud-based data management end markets, with highly scalable business models that have the potential to revolutionize what is becoming known as the “Data-Cloud” industry. Salesforce is better known to investors, and as a result, has seen its stock move meaningfully higher. However, lesser-known Snowflake could play catch up and may present an attractive opportunity for investors with long-term investment horizons and a high tolerance for risk, looking to get exposure to the AI revolution.

As we said before, the market has been focused on a handful of companies when it comes to investing in AI. Chipmakers like Nvidia have seen their stocks meaningfully appreciate over the past year. But these large chipmakers are also not alone in their ecosystems. Chips need to be designed and machines are needed to physically produce them. Two companies that could dominate the chip-design industry are Cadence Design Systems (CDNS) and Synopsys Inc. (SNPS). These two companies comprise a meaningful portion of this end market, giving them tremendous scale and pricing power. In fact, Synopsys recently acquired Ansys, further reducing the number of players in this space. I had the pleasure of meeting with Ansys’ management on multiple occasions over the years and believe that its recent acquisition will provide Synopsys with an

important competitive advantage in this industry. A third “pick and shovel maker” that had been largely forgotten until recently is Netherlands-based ASML Holding (ASML). The company is a maker of the machines needed to make the chips manufactured by AI hardware suppliers like Nvidia. It stands to reason that if the chip makers are going to benefit from AI, so should the companies that enable the manufacturing of these chips. But as recently as 10 days ago, ASML traded near \$700 per share. This changed after the company reported quarterly earnings though, after management stated that orders for its products had tripled from the previous quarter. The stock now trades near \$870 but could once again prove attractive if it retreats in a general market pullback. To this point, we believe that the market could again give investors the opportunity to invest in some of these appreciated stocks, as we would not be surprised if a healthy market pullback materializes sooner rather than later.

As of the time of this writing, the S&P 500 is currently trading at 4,894. Earlier in the year, Wall Street’s consensus price target for this market for the end of 2024 stood near 4,850, adjusting upwards to 4,875 over the past week. That is not to say that Wall Street strategists are always right. Coming into 2023, most strategists envisioned the S&P 500 ending lower at the end of the year. But it does give a sense of where the market stands in relation to consensus expectations. Some of the biggest bulls on the Street, like Goldman Sachs, have price targets in the 5,100 range. On the other hand, some of the biggest bears on the Street, like J.P. Morgan, have targets at 4,200. That is a 20% difference between both ends of the range. Looking at where the market currently stands in

relation to that range, we find ourselves approximately 4.2% from the top and approximately 14.2% from the bottom. If I was gambling man and some were to ask me to place a bet with 4% upside and 14% downside, not knowing the probabilities involved, I would most likely decline that bet. As we know though, the market is not that simple, and again, strategists' expectations can be wrong.

Our own, in-house views have the S&P 500 moving up to the 5,000 range if the Fed achieves a soft landing yet moving down to the 3,600 range if the Fed cannot stick the landing and we get a recession instead. Based on our own internal probabilities of recession versus no recession, two weeks ago we calculated an expected return for the market of -6.5% for 2024. By definition, expected return is a moving target depending on where you are standing at a particular point in time. Two weeks later, our expected return for the market drifted lower, to the -8% range. Even if the probability of a soft landing might have increased a bit, our expected return has not improved, as the market is quickly pricing in this event with near certainty.

However, having seen many financial institutions report quarterly earnings over the past few weeks, we are seeing a trend of increased credit card usage by consumers as post-pandemic savings are decreasing, coupled with increased delinquencies on these credit card payments. Granted, we are coming from a low-base where liquidity was high and credit card usage was relatively low, but data points like this one are worth monitoring, given that a weaker than

expected employment picture could weaken the consumer and quickly turn a soft landing into a recession.

To be very clear, we are not encouraging investors to sell out for the market and run for the hills. **We believe that keeping a long-term investment perspective is the key to investment success. We are simply pointing out two things, both of which revolve around the concept of prudence. First, regardless of which camp we find ourselves in, whether we believe in a soft landing or a recession, statistically speaking, the expected return of the market is currently skewed to the downside.** As such, exercising prudence is important. For example, an investor could consider purchasing put options that are attractively priced, given that the market appears complacent that its move higher is going to continue. Buying put options is like buying insurance: you hope that you do not need to use them and that your investment keeps growing as the market continues higher, but if it does not, you have some downside protection. **Second, do not chase stocks higher at their current levels.** Many stocks, particularly those in the Technology sector, have had dizzying moves higher over the past year. Many of these are great companies. However, a great company is not always a good stock. This is where growth potential and valuation come into play.

As with many of the Artificial Intelligence companies we mentioned before, the prospect of earnings growth is meaningful and very enticing. The question is how much do we want to pay for this growth potential. To be clear, we find the

potential for many of these stocks highly attractive. However, market expectations have pushed these names meaningfully higher. Considering this, coupled with the possibility of a pullback in the general market, we would not chase these stocks higher at this time and would wait for better entry points to purchase these investments. Having a list of attractive investment ideas ready for the right opportunity is a fruitful investment practice. We believe that the picks and shovels of the AI boom could be a great place to start. ■



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