Market Commentary
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English Version

Insigneo Weekly Dispatch

# Sequels are Rarely as Good as the Original Movie

Exploring Nvidia's recent earnings report and a possible rotation in the Artificial Intelligence industry from hardware to software.

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# Sequels are Rarely as Good as the Original Movie

**Executive Summary:**

- Nvidia's third quarter earnings results, although positive, underwhelmed lofty market expectations.

- Within the technology industry, Wall Street's expectations for hardware manufacturers could be too high, relative to the software developers.

- We could be seeing a rotation out of the hardware manufacturers and into the software users of Artificial Intelligence, which could potentially create an attractive tactical investment opportunity for investors with the appropriate risk tolerance and investment horizon.

Have you ever watched the sequel to a blockbuster movie and thought "It was not bad, but nowhere near as good as the original"? They say the sequel is rarely as good as the original. That makes sense; if we absolutely loved a movie, we expect to love its sequel as well. However, our emotions sometimes get the best of us, skewing our expectations higher, leaving room for disappointment if they are not met.

This same feeling could be echoed in Nvidia's third quarter earnings results this week. The company reported sales of $35.1 billion for the quarter, compared with Wall Street's expectations of $33.3 billion, representing a 90% surge over the third quarter of last year. At the same time, the company reported earnings per share of $0.81, close to 10% higher than what the Street expected, and almost 110% higher than last year. Gross profit margins of 75% met expectations, while sales outlook for the fourth quarter of $37.5 billion slightly beat estimates. The company also announced that shipments of its new Blackwell GPU's, Graphic Processing Units, are scheduled to begin next quarter, providing some clarity to revenues over the next couple of years. In fact, the company expects demand from data centers, particularly for cloud computing from customers like Amazon, Microsoft, Meta and Alphabet, to continue to grow at a very strong pace. However, Wall Street was rather underwhelmed by these numbers, choosing to focus on the fact that the company's 75% gross profit margins could be trending down towards the 70%-72% range and that sales for the next quarter were going to rise by only $2.4 billion. If we step back and think about it, profit margins in the low 70% range, coupled with nearly $2.5 billion in sales growth over a three-month period would be amazing numbers for any company out there. But not for Nvidia…After a series of blockbuster earnings reports, Wall Street grew complacent regarding expectations for this company, where good is not good enough. It is as if the Harry Potter series would come out with a new book-turned-movie. Fans, being used to the classic series, might think it is ok, but nowhere near as good as the originals.

Granted, Nvidia is likely to remain one of the undisputed leaders in the Artificial Intelligence revolution. Wall Street recognizes that, but like a child who is not easily satiated, it is starting to look for the next toy. When it comes to Artificial Intelligence, the next toys could come in the shape of the users of AI, not just the enablers. In other words, software companies that can benefit from AI, not just the hardware companies that make the components for this technology. This theme was evident during an event that we hosted last week in Austin, Texas. At this event we hosted speakers from across the industry as well as the globe, in a series of panels discussing a broad range of topics. Although some views may have differed, something that most panelists, us included, agreed on was that we are likely to continue to see a shift in focus by Wall Street from the hardware manufacturers to the software users. As we have written in previous pieces, most of the AI hype has been focused on hardware manufacturers, specifically, companies like Nvidia, ASML, and Taiwan Semiconductors. However, as we saw with Nvidia this week, expectations for stocks in this group have also been hyped up. After Nvidia's strong earnings report, its stock bounced around most of the following day, sometimes in the red, sometimes in the green, closing the day only slightly higher. Industry leader ASML saw its stock lose 20% of its value after it reported earnings, citing the possibility of slower than expected demand. A few weeks later, after management reported a better-than-expected outlook, the stock moved up 5% for the day. When a stock is down 20% on bad news, and only up 5% on good news, that tells me that Wall Street's expectations for this stock might have been too high to begin with.

On the other side of the equation, we have the software companies that are beginning to implement AI. Companies like Palantir and

Salesforce have been Wall Street darlings over the past few quarters, outperforming peers after posting better than expected earnings. Outside of the hyper-scalers like Microsoft, Amazon, and Alphabet, these two companies have been some of the early adopters of AI, using this technology to improve their data analytics niches. However, we are seeing other software companies that are using Artificial Intelligence also start to get noticed by the market. Software companies like Snowflake, C3.ai, and Workday have seen their stocks pop as much as 20% or 30% in the days following their earnings releases. A commonality for many of these stocks going into the third quarter earnings season was low expectations from Wall Street. Many on the Street had taken a wait and see approach, wanting to get a better sense of direction regarding earnings and outlooks. Investors are now beginning to get a glimpse of their future potential. Even industrial companies like Axon Enterprise are seeing their stocks rise as they are starting to show positive results arising from the integration of Artificial intelligence into their software platforms.

We believe that this rotation from hardware into software companies is likely to continue as Artificial Intelligence becomes more entrenched in everyday life. In fact, the software technology industry, represented by the iShares Expanded Technology Software ETF had trailed the hardware technology industry, represented by the S&P 500 Technology Hardware and Equipment Industry Group Index, for most of the past three years. Not until recently has the performance of the stocks in these two industries converged, something that is likely to continue. This rotation could create an attractive tactical investment opportunity, where investors that do not want to reduce their overall exposure to the Technology sector could reduce their exposure to some of the mega-cap hardware companies and increase their exposure to relatively smaller software companies without leaving the sector.

It is important to note that we are by no means recommending that investors blindly run out and buy or sell the stocks mentioned above, as they can be highly volatile in nature and are not suitable for every investor. We encourage clients to consult with their financial advisors to determine suitability for their individual situations.

Companies like Nvidia and ASML are great franchises and will continue to be leaders in the Artificial Intelligence industry. However, investors may have gotten too comfortable with the high expectations baked into these companies' earnings. Not all sequels are bad, but in general, the original movies tend to be better. At the same time, sometimes unknown movies with low expectations can start historical film franchises, the Rocky movie series comes to mind. Could the next Rocky franchise of the Artificial Intelligence world be waiting to be discovered in the software industry?

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