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GAM Expert Highlights the Technology Sector's Resilience as we embark on the Road towards a Multi-Polarized World

Wendy Chen, Senior Investment Analyst at GAM Investments presented a fascinating Workshop at the Hubbis Singapore Investment Forum on November 1. She highlighted how nothing has really changed in the realm of US-China relations, which for decades have been challenging, but the constant throughout has been competition and, surprisingly, collaboration. But that is changing as countries and people appear ready to sacrifice growth and low-cost supply chains for safety and national security concerns, leading to a far more multipolar world. She explained how as a result, the US is in a trillion-dollar-plus transition cycle as AI gains sway and as technological innovation and manufacturing are re-shored amid geopolitical turbulence. She later analysed China in transition, wondering if, when, and how the rebound might happen to raise the market from its five-year valuation lows. On that point, she concluded that the Chinese government has massive financial firepower and the private sector is the key to growth resurgence and huge investment potential; both need to fire their big guns, but neither is doing so as yet. And she discussed the potential beneficiaries of these trends amidst the ongoing US-China rivalry and re-shoring, such as India, Vietnam, The Philippines, Mexico, and others.

This is a review of her talk, which should be read in combination with the excellent and very detailed slide show she offered delegates (View the PDF of these slides by clicking HERE.)

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WENDY CHEN
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US-China relations – critical to risk management

Wendy began by noting the critical importance of US-China relations for Asian investors in their risk management. She explained that, actually, for decades, the dynamics between the two superpowers have been characterised by quite measured responses and restrained actions, both in trade and diplomatic aspects, avoiding dangerous conflicts or rhetoric, especially vital as both as nuclear superpowers.

She highlighted that in response to a trend of diversification by its trading partners (such as "China+1" or "China+n"), China is also pursuing a China+One approach to 'friendshore' export network supply chains and manufacturing in response in response to actual or potential sanctions against China, including in the broad field of technology and innovation.

A significant focus has been on the semiconductor sector, with the US imposing sanctions on advanced AI chips to/from China, causing short-term disruptions in Chinese tech advancement. In fact, the sanction has caused China's AI capacity to lag 2-3 years behind lagging behind that of the US peers like OpenAI. US chipmakers, such as Nvidia, have attempted to navigate these sanctions by producing exportable lower-capacity chips for China. However, US regulators have sought to close these loopholes with new rounds of sanctions. In response, chipmakers further tailor their chips to comply with renewed regulations, as no one can give up a market as massive as China. Such a game of offense and defense in this prolonged chip war, is just like the competition status between China and US impacting Nvidia's stock price.

Balance has maintained for decades

Wendy then explained that while China has been working hard on AI for some time, she reckons that China's AI capacity now is 2-3 years lagging behind that of the US.

She observed that the reality is that US-China relations are more difficult to assess than the public might assume and that underlying all this is a constant vacillation between friendliness and commercial enmity. In the public's eyes, each serves as the imaginary villain, whereas behind the scenes, there is perhaps less conflict than appears on the surface. This situation has for decades allowed both sides to focus on their domestic issues, maintaining a balance between security and economic development.

The (more defensive) winds of change

However, Wendy observed that there is a clear shift occurring where security considerations are taking precedence, even if unintended, as both not only the US and China, but also the EU, Japan, and other major economies are recognising the importance of targeting each other from a security and political agenda perspective.

This phenomenon also pertains to the relationships between Japan and Europe with China. Wendy concluded that it signals a shift from the globalization trend since the end of the Cold War, towards a multipolar or fragmented world where safety and national security considerations are becoming more critical than cost-efficiency and production considerations.

The US in Transition

Wendy said this leads her to the assertion that the dominance of the United States is being challenged by a more fragmented global order. Nevertheless, she is very confident that the US will thrive – after all over the past decade alone, the S&P 500 has already delivered annualised returns of 13%, outperforming Europe, Japan, and other regions.

She said believed the tech advancement of the US would help should maintain its resilience in a more fragmented and more 'protected' world. Her reasoning was that the slowing globalisation trend means reduced reliance on global supply chains and makes cost-cutting and scaling production more challenging. Therefore, organic growth, often driven by disruptive technology, becomes increasingly crucial in fostering growth.

Technology's resilience in the 'new' multipolar world

This, Wendy explained, brings her directly to the central theme of the presentation: tech sector resilience in the face of multi-polarisation. She observed that the resilience of the technology sector in such a fragmented world can be attributed to its ability to drive growth through disruptive technologies and innovation, even in an era of reduced globalisation.

She highlighted how despite numerous concerns including inflation, higher rates, and possible recession in the US (now less of a worry, at least for the moment), US technology stocks had hugely outperformed the market. It's the first time in decades we see valuation multiples rise despite an increase in yields. Tech giants like Microsoft and Google, among others, now make up a quarter of the S&P 500 index, a significant change from decades ago.

The AI rollercoaster

Wendy then pointed to the remarkable prominence of AI this year, especially the shift toward more consumer-friendly AI interfaces like ChatGPT and Bard, leading to increased adoption and surging interest, so much so that any stocks with an AI bent or intent have generally surged in value. But she said that building the necessary infrastructure, including acquiring chips, remains a prerequisite for meaningful AI integration and trading. That is why GPU and chipset providers have been the primary beneficiaries of the AI hype, while sectors like enterprise software, considered less direct beneficiaries, have been less buoyed as yet by the AI trend.

She also raised the question as to the level of investment required in chipsets and AI semiconductors, compared to the realistic returns that can be expected. Revenues need to be in the hundreds of billions of dollars to justify such investments. Accordingly, she said that the key to AI development moving forward is transitioning from building the AI infrastructure to utilising it and, most importantly, monetising it, which the market is now focusing on more after the initial catch-all euphoria.

Wendy observed that while there is great optimism about AI, the emphasis remains on the infrastructure side, and the true AI era will only emerge when the focus shifts to applications. She highlighted an assumption made by Sequoia that the current year's USD50 billion investments in chips and technologies will require at least USD200 billion of return in revenue in AI to make a proper return.

The crypto revival

Wendy then touched on Blockchain and digital assets, observing that the crypto cycle is seeing the convergence of utility, scalability, and regulatory clarity, helping re-rate cryptos from the lows of recent years, especially the various scandals. For example, Bitcoin is up nearly 70% this year alone. She explained that tokenisation with payments/ funds adoption was taking place, and that institutional adoption and capital inflows are helping to increase AUM and transforming crypto into a 'real' industry.

She mentioned that regulation is also evolving with the crypto proliferation. Not only did Ripple win a significant court case against the SEC, but the courts also upheld Greyscale's appeal against the SEC over allowing them to issue a Bitcoin cash ETF. From a regulatory point, her long-term thinking is that Crypto will need to be separately regulated under new laws, as traditional securities laws are not necessarily fit for purpose in the digital world.

Re-shoring in the US hurts long-term US potential

Pointing to how technology and AI innovation have been driving strong performance in the US equity market this year, she nevertheless conceded that the backdrop of the multipolar or more fragmented world and re-shoring of manufacturing and supply chains were dragging down long-term US equity market potential.

« "While there is great optimism about AI, the emphasis remains on the infrastructure side, and the true AI era will only emerge when the focus shifts to applications." »

She said that while major companies, often referred to as the "Magnificent Seven" (Apple, Google, Meta, Amazon, Nvidia, Microsoft, and Tesla), have been outperforming this year, investors are faced with challenges in capturing exposure to all of them due to valuation, geopolitical, and fundamental concerns.

The reshoring trend in the US, kick-started by the US Chip Act in August 2022 and the Inflation Reduction Act, is aimed at reducing dependence on China and boosting the US semiconductor and automotive sectors. However, reversing and reshaping the entire global supply chain requires a massive amount of capital expenditure, estimated at least $1 trillion. This scale of transformation is too large for individual companies and necessitates extensive government involvement and international collaboration.

Despite technological advances, concerns persist about the potential impact of multipolarity and reshaped supply chains on the profit margins of global-scale firms in the US. These uncertainties have deterred some investors from fully embracing US equities, and equities and remain key concerns ahead.

Will China bounce and how?

In the penultimate section of her Workshop, Wendy turned her attention to China and, to some extent, to India. She observed that while China's indices and valuations are at five-year lows, there are clear concerns ahead. Das de-risking the China supply chain away from China will mean slower FDI flows and reduced productivity spillovers.

People in China are getting older, and a smaller percentage of the population is of working age, and that trend will intensify. The real estate sector troubles are leading to deleveraging, which in turn is hitting confidence and capabilities around consumption. While GDP per capita doubled in a decade, the last part of the race toward a high-income society has been much more challenging for China.

She said that this all translates to 4 'D's of pressure on the Chinese economy that is not so encouraging – deglobalisation/re-shoring, (negative) demographics (especially compared to India, where markets have been surging), deflation (lower consumption/higher savings) and deleveraging (out of caution over the future amidst real estate and geopolitical troubles).

Can anything be done about all this?

Well, the government and the public seem hesitant to spend or stimulate the economy, resulting in inactivity. In sum, the government seems to think people still have too much savings that they could spend, and the people are waiting for more action from the government. China's high saving rate, reaching 50%, indicates that people are wary about the future. The central government has great potential fiscal resources, with debt-to-GDP of only 20% (compared to 70-80% of US/EU), and there are very tentative signs this year of a gradual inclination towards government-led economic stimulus. However, Wendy called for the government to step up this response and take more of a bazooka to the problem rather than pea shooters.

The government seems to think people still have too much savings that they could spend, and the people are waiting for more action from the government, she said. She indicated that both of them appear to be sticking to their positions, meaning no expansion in sight.

As a result, she said the key lies with the government taking top-down action in adding state leverage, while bottom-up efforts lie with the private sector – which represents 60% of national GDP, 70% of investment, and 80% of urban employment – to act as effectively to the only one that can reverse this process. But she questioned whether that is likely toIt is likely that this can only take place wholesale until the government shows more commitment to reflate as well. In short, it requires government leverage and private sector bravery combined. But the reality is that this is not yet happening.

Opportunities ahead

Noting that China's share of US imports had dropped from 22% to 16% over the past five years, Wendy closed her talk by reporting that the rest of Asia's share of exports to the US has remained stable. This suggests that other Asian markets are benefiting from China's forced retreat. There is also a trend of indirect exports through intermediary countries in Southeast Asia or the Middle East to avoid direct trade between China and the US.

Wendy highlighted India, Vietnam, and Mexico as likely beneficiaries of these supply chain shifts, allied with its demographic advantages. Other countries such as Mexico, Canada, and various Asian nations (such as Vietnam, Malaysia, and The Philippines) are also expected to benefit significantly. ■