Perspectives Podcast
“Investment Trends in Focus: AI Is Driving Global Markets”
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Ashley Lester
Welcome listeners to MSCI's Quarterly Investment Trends In Focus Discussion. I'm Ashley Lester, the Chief Research and Development Officer at MSCI, and I'm joined again by my friend and agent provocateur, Axel Kilian, Chief Client Officer here at MSCI. Axel, welcome.

Axel Kilian
It's a great pleasure to be here with you, Ashley.

Ashley Lester
Axel, you and I have been talking for a few quarters now, and most of our conversations basically revolve around two axes, geopolitics and technology. And there's only one technology that counts these days, AI. We've had a pretty memorable second quarter. Heads of state removed a major conflict in the Middle East, starting, stopping, starting again. Oils topped $100 a barrel, then it didn't, then it did again. And yet equity markets are way up on where we were when we last talked three months ago, driven by AI euphoria. So for now, I think if we think of these two tectonic forces or these two major forces as being geopolitics and technology, and they've got an ongoing war, which I guess is the metaphor for the day, the battle of the second quarter has been comprehensively won by technology, at least according to markets. I've got one little fact that I'll introduce about that and then hand over to you.
Two industry groups, tech hardware and semiconductors, together those guys were less than a fifth of the index on January 1, at the start of this year. By the middle of the year, they had contributed nearly 90% of all of the gains in global equity markets. So markets are all in on technology and specifically on the hardware that's powering the AI revolution. This quarter then, we'll talk through the issues in public equity markets, what happened. We'll go into that in a bit more detail. What do these AI IPOs mean for equity indexes and passive investors? What does the AI revolution mean to private markets? And we'll look at the risks on the horizon.
But to get started, I'll ask you, Axel, how should we spend our time today? Or to put it differently, in your meetings with the world's top investors, what do they want to talk about? What are they most worried about? Is it the concentration they're already in or is it the concentration that's going to hit via the wave of IPOs?

Axel Kilian
Ashley, honestly, it's both and they are connected. So you mentioned clients benchmark to the ACWI or MSCI USA. They're running enormous bets on AI infrastructure. CMEs, tech hardware, and it's whether they signed up for it or not. That's the anxiety number one. Number two is the IPO wave layered on top. So institutional clients wants to know, “Am I about to get forced into SpaceX,

Anthropic, OpenAI's index inclusion? And at what price will that happen?” So that methodology question has come up explicitly by name in a bunch of my client conversations. And there's a generational split I keep noticing. Clients who live through 2000 are much more attuned to the concentration risk than newer allocators who've only ever known an AI bull market. So you mentioned the ACWI being up 11.5% through June. I thought this is a broad-based rally, but when we look at the breakdown, it really wasn't. Can you walk us through what actually drove those returns and why that matters?

Ashley Lester
Roughly speaking, there's only one key theme that's driving equity market returns this year, and that is AI. And we can use that theme to look across many different dimensions of how people normally think about equity markets. I mentioned in the introduction one. So, often investors, when they think about equity markets, try to pull them apart by industries. And as I mentioned, if you look at gains in equity markets by industry groups, overwhelmingly the gains in equity markets have been accounted for by hardware that relates to the AI revolution, IT hardware and semiconductors in particular. So that sectoral lens is one way of thinking about concentration in markets and thinking about the way in which AI is driving markets. By the way, there is a downside on the sectoral lens as well, which is that software, which traditionally has been pretty closely correlated with hardware, has obviously had a very difficult first half. And that's because as the AI revolution has progressed, we've seen that investors have come to worry that traditional software business models are going to be drastically undermined by the progress of the AI revolution. And so we're now in a very unusual historical context whereby the dispersion between software and hardware is enormous. Two groups that normally track each other quite closely, that both go up at the same time, both go down at the same time, instead there's over 50 percentage points of dispersion between them. One's going drastically up and one's going significantly down, but they're both driven by the same thing. And much of the market's time is spent worrying, what's the next industry to be disrupted by AI?
So that's a sectoral lens on what's driving equity markets, but we can take some of the other lenses as well and see this same AI theme. If we take a regional lens, we see that emerging markets have done great through the first half of the year. That's interesting. Emerging markets are normally thought to be a diversifier to what's going on in developed markets. But in fact, emerging markets themselves are very largely driven by just a small handful of stocks that are very heavily exposed to AI. In particular, Samsung and SK Hynix, the semiconductor manufacturers in Korea, TSMC in Taiwan. And so we see enormous concentration in emerging markets reflecting just a small set of names that are heavily involved in AI-related hardware. So what seems like an interesting regional dispersion is actually just another reflection of AI. And then if we look at countries, we see the same thing. Here's a fun fact that not a single investor I've spoken to has guessed. What was the world's top-performing developed market country in the first half of the year? Do you want to hazard a guess, Axel?

Axel Kilian
Netherlands.

Ashley Lester

Well done. We might have talked before. And why was it Netherlands?

Axel Kilian
No, ASML.

Ashley Lester
Exactly. Yet another AI-related hardware manufacturer. So country lenses also reflect enormous concentration in single cap AI-related hardware manufacturing stocks. Lastly, we can look at a factor lens, which generally gives a really different take on what's moving markets. In a pretty bull market like we've been seeing, normally it's profitable stocks that tend to go up a lot. In fact, the most profitable stocks have not done especially well over the first half of the year. The stocks that have really been doing well over the first half of the year are momentum stocks. That is stocks that have been doing well for the last year basically. And why is it all in momentum? Because the market is pricing AI hardware, and so that's what's driving the market up. So whether you take a regional lens, a sector lens, a country lens, or a factor lens, all of those lenses on equity markets say the same thing, which is the market is pricing AI.

Axel Kilian
Well, what I can tell you, it's been an incredibly challenging quarter for active managers. So with all the dynamics you described, unless you had a systematic overweight to tech and semis this year, almost certainly underperformed and most likely badly. So this is what we have seen. It was very tough. This was a regime where traditional stock picking was nearly impossible unless you were in these two sectors. So what comes up frequently is the '99, 2000 comparison. The nuance I have to add is, and the data backs these up, earnings this time are real. It's not [inaudible] but the concentration patterns feel very similar and clients who remember that era are watching that very closely.
So the question I keep coming back from earlier discussions, so if this reverses, does everything come down together or just the semis and AI names while the rest of the market just sits there? So to make the comparison with 2000, telecoms and tech fell 50%-plus, but old economy was only down 10% to 15%.

Ashley Lester
Yeah, I think this is a really interesting question, and this sectoral lens on it is one way to help investors think through the problems that they face. But to start with your initial point, you're quite right, when just a handful of stocks concentrated in just a couple of industry groups are on a tear like this, in the end, while they continue on a tear, if you're underweight those stocks, then there's no real way to make up for that exposure elsewhere in the portfolio. You will underperform the broad market. So that's kind of fact one. It's almost impossible to avoid at the moment. I find it helpful to think about two sets of stocks here. There's stocks that are hedges in some sense, in the sense that they're actually negatively correlated with AI, and so they would go up if the AI bubble were to burst.
And then there's stocks that are just diversifiers, that are more or less orthogonal. And if you think about that, the most orthogonal stocks at the moment where you don't lose directly if you're in them and the market keeps going up, but you shouldn't lose too directly if the market were to reverse, those are the least cyclical stocks, perhaps not surprisingly. So the stocks which show least correlation with semiconductors are in things like REITs, real estate investment trusts, in utilities,

interestingly. For a little while, utilities were a big story that was looking increasingly connected to AI actually, but that's come off the boil. And so stocks like utilities and REITs are probably places where if you want equity exposure and you are worried that the AI engine is going to go into reverse, those types of non-cyclical stocks are probably the best place in terms of what would suffer least through a reversal, while not hurting too much if the AI thing keeps ongoing.

Axel Kilian
Ashley, I think we need to talk about the mega cap IPO wave.

Ashley Lester
Indeed.

Axel Kilian
So SpaceX came to market at a $1.75 trillion valuation, one of the biggest in history. Anthropic and OpenAI are reportedly next. So clients are really asking whether they'll be forced into these names by index inclusion, potentially at or near the top of the valuation. What does MSCI's research actually say about the risk here?

Ashley Lester
Okay. I think this is a really hot topic for many investors, both retail investors and institutional investors, particularly investors who are passively invested in funds that replicate indexes such as those calculated by MSCI. Now, there was a lot of publicity before the SpaceX IPO for a number of index providers who were either thinking about changing their methodology or did change their methodology to reflect from their own perspective the best way of reflecting the SpaceX IPO. But at MSCI, we never had to discuss that. We have a very well-established rules-based methodology for what to do when a very large-cap IPO hits the market. MAT methodology has been rules-based and consistent since 2007. And it is that after 10 days of trading, we include the stock in line with the normal methodology with which we include any stock, which is at its free float adjusted market cap.
Now, let's think about this free-float adjusted market cap because it's really important that investors understand this. A lot of discussion of indexes refers to them as market cap weighted indexes, which for most purposes is good enough. And so when investors read that there is, for instance, a $1.75 trillion new company hitting the market, they not unreasonably tend to assume that MSCI's indexes or whatever other indexes they might be invested in, will involve them buying shares in that new IPO proportional to that $1.75 trillion contribution to the overall market cap of the equity market. Just for context, ACWI's market cap is very roughly about $100 trillion. And so if one were to say, “Well, okay, we'll include SpaceX at a $2 trillion valuation,” close enough, it would be about 2% of your money going into SpaceX, which is not an enormous amount because equity markets are huge, but quite a lot.
In fact, that is not what happens typically for IPOs. Because when an IPO comes to market, most of the stocks in the company that's new to the market are still tightly held by the original investors in the private company. Elon Musk cannot sell most of his SpaceX shares, and most of the other founders of SpaceX or early investors in SpaceX also cannot sell their shares for some protracted period of time. So when SpaceX came to market, we had to assess the free float of SpaceX. How much of it was actually available for investors to buy? Because our job is to represent on behalf of investors the total market in which they can actually invest.

Now, SpaceX only has a free float of about 8% of its total market cap. And so if we start with, say, just to make the numbers easy, let's pretend it's a $1 trillion of valuation, 8% of $1 trillion is $80 billion, which makes SpaceX in terms of its overall contribution to the market ... Multiply up by whatever SpaceX's actual market cap is at the moment, but makes SpaceX's overall contribution to the market, even at, say, $2 trillion, that'd be $160 billion. Don't get me wrong, that's a good-sized company, but it's a drop in the bucket of $100 trillion of equity markets.
SpaceX's approximate index weights at the moment are on the order of about 10 to 15 basis points of MSCI USA and on the order of 7 or 8 basis points of MSCI ACWI. So investors are not buying a lot of SpaceX or being forced to buy a lot of SpaceX at the moment. As more free float comes available, as shareholders are unlocked and they're able to sell their shares, investors in passive index replicating products will end up buying more of SpaceX, but only as that free float becomes available.

Axel Kilian
The SpaceX experience has been a real education for clients who bought into the hype in the first days after the IPO. And a $28 trillion TAM story was of course everywhere pre-IPO. Now the stock is trading below its IPO price, and the next test is coming on August 4th. They will report earnings and I think this will trigger the first unlock, and this is 20% of the market cap. So on the methodology topic, the fact that MSCI didn't change anything comes up in client conversations as a mark of credibility. So people noticed that a boring and consistent approach turns out to be the right one.

Ashley Lester
I think that's right. I think boring and consistent is what passive investors want. Passive investors, or indeed anyone who follows an index, what they want is a boring and consistent approach that reflects the investible market. Now, that said, I totally ignored the second part of your question, so let's just deal with that quickly. We do have some experience of what has happened in the past to stocks that come to market that are big and that have high-valuation multiples, and that certainly describes SpaceX. In the past, stocks that have those two characteristics jointly that come to market via an IPO, typically significantly trail the market over a long period after their IPO. Roughly speaking, that cohort trails the broad market over the following five years by about 20% in the US and by about 30% in other developed markets. And so the outlook historically for large-cap high-valuation multiple stocks, whether it's SpaceX or whether it might be Anthropic or OpenAI coming forward, the historical experience of stocks like that has not been strong over the following five years.

Axel Kilian
So we covered, I think the public market side of the AI story, but it splits in an interesting way once you go into private markets. It's truly fascinating, you mentioned it, AI affects them in completely opposite way depending on where you sit as an investor. So venture is having a moment with SpaceX listing and Anthropic on the way, but buyout, especially software is getting written down. What are the MSCI data showing here?

Ashley Lester
Yeah, I think it is really interesting. So in the most recent quarter for which data are available, which is the first quarter, globally buyout funds fell by about one

percentage point. In the US, they fell by about three percentage points. It's pretty unusual to have an actual negative return in private equities. Typically, there's quite a lot of smoothing of valuations in private equities, and so typically returns might be subdued for a while. But to have an actual overall fall, overall negative return is pretty unusual and it tells you something unusual is happening. Basically what was happening that was unusual was that private equity holdings in the US, that is buyout holdings in the US of software companies, fell in valuation by 7.9%. Nearly 8%.
But it was kind of inevitable that they had to do so, because as we discussed at the end of the first quarter, the SaaSpocalypse happened. There was a general revaluation in public equity markets of the business of most legacy software companies. And that's being reflected now in the substantial software holdings of buyout funds in the US, which invested heavily in software-as-a-service style companies around the pandemic and just afterwards. So tough times in buyout. The smaller but higher profile venture capital sector, on the other hand, is doing really well at the moment. Globally, that was up over 5% in the quarter. And what's really interesting is that venture capital software returns were positive in the US. So it looks like the same sector, but the returns were very unusually, very substantially negative in buyout to older holdings. And in venture, the holdings in which are typically newer, the returns were actually significantly positive. And that reflects the fact that much of the venture software investments have been made in the post-AI age.

Axel Kilian
So you said at the beginning, geopolitics lost in age one. This is the beginning of your memo. But there's one market that didn't get the memo. It's bonds. So can you walk us through what the fixed income picture is actually saying and why it matters for equities going into the second half of the year?

Ashley Lester
Yeah, you're absolutely right, Axel. We tend to spend a lot of time, as do many market commentators, on equity markets, but the largest market in the world was fixed income markets. And fixed income markets are not paid to spend a lot of time thinking about upside the way equity markets are. They're paid to spend a lot of time worrying about what might go wrong. And what's been happening to fixed income markets over the first half of the year, and particularly over Q2, is that interest rates have gone up. And just to remind listeners, interest rates going up means bond prices fall. So interest rates have gone up in a particular pattern, which is that short-term interest rates have gone up a lot. So for instance, the two-year yield has gone up about 80 basis points from its low point just before the US strikes on Iran started. So up about 80 basis points.
The 30-year point, that is very long-term interest rates, have gone up much less. They've gone up about 25 basis points. And so if you think about during a curve that describes the shape of interest rates as a function of time, what we've seen is the curve go up and get flatter. And bond market professionals call that a bear flattening. It's a bear market because as rates go up, bond prices go down. It's a flattening because it's moving up more at the short end than the long end. This is a big deal because generally speaking, when interest rates go up, particularly when real interest rates go up, that acts as a drag on equity markets, basically because equity markets are worried about the present value today of money that you'll

receive from the company in the future. With higher rates, money in the future is worth less. So higher rates should have a depressing effect on equity markets. Obviously we haven't seen that yet.
So risk number one to the bull market that we're seeing is that geopolitics fights back, and perhaps we're seeing some of that. There's renewed around hostilities. There's oil prices are higher again. If that persists, that means more inflation, more central bank, interest rate increases, and that is inevitably going to pressure equity prices in the second half of the year if that happens.

Axel Kilian
So what you've described is a market that is extraordinarily concentrated. The bond markets have not signed up on that. The equity risk premium is the first time negative since the dot-com times, and private markets are bifurcating along a single forward line. So for our clients that are hearing all that, what should they do?

Ashley Lester
So, I think clients who are actively asset allocating need to have a view on the extent to which they think that geopolitics will fight back, first and foremost. And if they are really worried about geopolitics fighting back, if they think that the Iran troubles will continue and that monetary policy will be forced to continue to tighten, that suggests a relatively cautious or conservative asset allocation. And in line with our analysis, what it also suggests is shifting out of some of the most aggressively valued segments of the market and into less cyclical stocks. But there's no free ride here, because as we've discussed, markets are very concentrated, which means that if that risk of geopolitics doesn't eventuate, there's every chance that those particular concentrated segments of the market will go on going up. And so if you do adopt that conservative allocation approach, you will feel like you're dropping behind. It's not a market where there's a free lunch.

Axel Kilian
So a lot has to go right for investors on the AI side to justify not diversifying. So from not looking back in what happened in 2000, but of course, the people who looked smart after the dot-com bubble burst were those that were taking off some chips off the table before the bubble burst. I'm not suggesting that the bubble will burst, but the concentration is probably more extreme than it was in 2000.

Ashley Lester
It is indeed now. Significantly more extreme. Well, Axel, I think we've been on quite a journey here through geopolitics, technology, IPOs. I'm not sure we've provided our listeners with any easy answers, but I hope we've helped illustrate what's been going on in this fascinating second quarter, and point to some of the key risks that investors might want to be thinking about as they make their decisions looking forward for the second half of the year. Axel, you and I will get together again in another three months and see how these risks have been playing out in the meantime.

Axel Kilian
I very much look forward to that. Thank you very much, Ashley.

Ashley Lester
Thanks as always, Axel, and thank you listeners.

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