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CIO NOTE

IS THE AI NARRATIVE SHIFTING? SEPARATING NOISE FROM REALITY

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What Happened

NASDAQ futures fell by ~3.5% overnight, driven by a sharp sell-off across the artificial intelligence (AI) equity universe. This abrupt turn in market sentiment has been driven by evidence that the gap between the U.S. and China in developing AI technology might not be as wide as generally assumed, and that efficient and highly competitive large language models (LLM) can be produced, replicated and commercialized at much lower costs. The Chinese startup DeepSeek is at the center of this narrative shift, thanks to a new LLM that relies largely on open-source models (as opposed to increasingly expensive proprietary models developed by the likes of OpenAI and Google) and that is said to perform roughly on par with OpenAI models.

Why it Happened

This has led market participants to question the core tenets of the U.S.-centric AI bullish market: U.S. dominance and the necessity of massive capital expenditures with lack of clarity around future returns on investment (ROI). All this against the backdrop of strong outperformance by the Magnificent 7 stock group since the end of 2022 (+258%, compared to 34% for the equal-weighted S&P 500) and since the election (+18%, compared to 2% for the equal-weighted S&P 500), elevated valuations (the 12-month forward Price/Earnings [P/E] ratio for the S&P 500 and NASDAQ indexes is higher than 95% of all historical observations), and buoyant investor sentiment (especially when it relates to the AI theme).

To be clear, some cracks in the AI narrative emerged episodically last year as well, especially with respect to uncertainty about future ROI as the hyperscalers (like Meta and Alphabet) ramped up plans for AI-focused capital expenditures. And eventually, investors shrugged off short-term uncertainty to focus back on solid earnings growth and cash flow generation. And while these trends remain favorable for the broad AI ecosystem, the emergence of DeepSeek as a case study apparently challenging the structural underpinnings of the AI narrative could dent valuations and sentiment in less predictable ways.

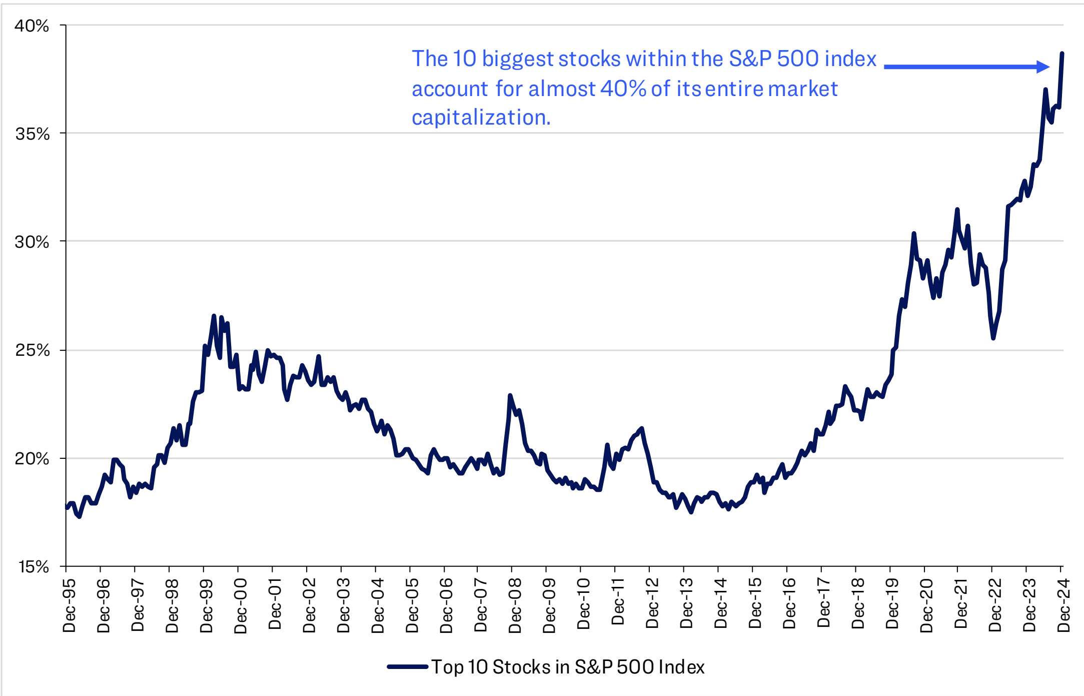
What to Expect

Firstly, it is helpful to separate noise (and there is a lot this morning) from reality. Is it true that DeepSeek was cheaper to develop than OpenAI models? Probably, but there is very little clarity around actual details, and we caution that it might not be a straightforward apples-to-apples comparison. At the same time, most experts agree that DeepSeek models perform as well as OpenAI versions, raising the risk that the development of AI technology in China might not be as far behind the U.S. as once believed, even despite U.S. curbs on exports of critical semiconductors to China.

Altogether, we view this morning's developments as a confirmation that elevated valuations and investor sentiment, while not a useful tool to predict short-term market performance, are more susceptible to surprises to market consensus. Given the centrality of the AI theme to the strong equity gains over the past two years, we expect investors to intensify their scrutiny of capital expenditure plans for the AI hyperscalers and demand more transparency from these companies on projected ROI. We continue to recommend that investors resist the temptation to react to positioning-driven market swings and remain focused on fundamentals that are still a key source of support for broad risk assets. That being said, we are mindful that narrow market concentration (Figure 1) raises the risk that a reset in equity valuations driven by the AI group could engender broad-based volatility across the stock market. As a result, being diversified within and across asset classes is crucial, as we discussed in our 2025 Outlook and January CIOP. Importantly, bond yields (which move inversely to bond prices) have declined as well in response to the equity sell-off, providing some cushion against stock losses and therefore reasserting their role within balanced portfolios as a hedge against spikes in volatility.

FIGURE 1

The U.S. equity market has become increasingly more concentrated.



Finally, we believe it is equally important to not lose sight of the big picture. In our view, AI remains a long-term megatrend that will impact the global economy, financial markets and geopolitics over the decade. As AI permeates across the economy, it could potentially increase productivity, transform the job market, change business models, and make the process of scientific research and innovation more efficient and faster. The technology could reshape the geopolitical equilibrium and represent an ongoing source of strategic decoupling between the U.S. and China. And therefore, while potentially consequential for cyclical market performance, the events overnight are unlikely to change the secular story about AI.

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