Allianz Global Investors

Allianz Global Artificial Intelligence

Monthly commentary

Investment Objective

The Fund aims at long-term capital growth by investing in the global equity markets with a focus on the evolution of artificial intelligence in accordance with the Sustainability Key Performance Indicator Strategy (Relative). In this context, the aim is to outperform the Sub-Fund's Sustainability KPI compared to Sub-Fund's benchmark to achieve the investment objective.

What Happened in August

US stocks tumbled in early August as weaker-than-expected economic data, particularly job growth, sparked fears of a recession and caused the biggest sell-off in nearly two years amid thin trading. Wall Street's "fear gauge", the CBOE Volatility Index, hit a 4-year high of 65 early in the month when stocks suffered a steep sell-off. The correction proved short-lived, however, with stocks subsequently rebounding sharply to more than recoup their earlier losses as later economic data proved more reassuring. On balance, August was a volatile month for global equities, which closed the month slightly higher. In political news, Vice President Kamala Harris secured the Democrat's nomination and continued to make ground versus Donald Trump in the opinion polls.

Recessionary fears resurfaced when the US economy added just 114,000 jobs in July, far weaker than the expected 175,000. Additionally, US job growth for the 12 months to March 2024 was revised down by 818,000. The data boosted hopes that central banks would pivot to a more dovish stance, a view that was reinforced by positive news on inflation. In July, US inflation fell below 3% for the first time since March 2021, while eurozone inflation declined to a 3-year low of 2.2%.

Oil prices eased back below USD 80 per barrel as higher-than-forecast US inventories and speculation of higher output from the Organization of the Petroleum Exporting Countries Plus (OPEC+) offset concerns over escalating tensions in the Middle East and fears of a shutdown in Libya. Gold continued to advance, breaching USD 2,500 an ounce for the first time on record. Copper initially slumped amid worries the US could fall into recession, but later recovered to end the month little changed.

From a sector perspective for global equities, as measured by the MSCI All Country World Index, performance was led by the Real Estate sector, which was helped by lower rates. The Health Care sector was another outperformer given its defensive characteristics. Conversely, the Energy and Consumer Discretionary sectors were laggards during the month.

Portfolio Review

From a sector perspective, Information Technology and Consumer Discretionary were the largest relative detractors. The Communication Services and Health Care sectors were slightly offsetting. Artificial intelligence (AI) applications was the primary detractor to performance because of stock selection headwinds and mixed earnings results. Both the AI-enabled industries and AI infrastructure generated positive absolute returns but were slightly under custom benchmark.

Contributors

Monday.com Ltd. provides a no-code and low-code cloud-based platform that allows users to easily build application and work management tools that fits their needs. Shares outperformed as the company reported better-than-expected earnings results and raised guidance, as it continues to execute well and win new customers in a choppy macro environment. We remain constructive on its growth trajectory, as the company is well positioned to help customers centralise and digitalise their workflows. Monday.com's platform has incorporated AI through Monday AI, which is a collection of AI-powered automation applications.

Social media operator Meta Platforms Inc. was among the top contributors. Shares were higher on strong quarterly earnings as advertising demand trends appeared healthy heading into H2. The infusion of AI capabilities into the company's recommendation engines and advertising tools helped drive better results. The company continues to work on new ways that generative AI can improve experiences across Facebook, Instagram, Messenger and WhatsApp – spanning search, social discovery, advertisements, messaging and more. This includes a generative AI personal assistant with robust functionality that rivals other co-pilot AI applications. We believe these new innovations can help drive greater user engagement and stickiness, as well as improvements with advertisement targeting and monetisation.

Detractors

The top relative detractor over the period was Elastic NV, which provides a cloud-based data analytics platform. Shares underperformed after the company reported mixed quarterly results. Although top-line revenue and earnings beat expectations, shares fell after management reset guidance lower because of a recent sales team reorganisation that caused sales execution slippage. Looking forward, the company's vector search offering continues to experience strong interest from customers looking to build their own generative AI solutions. This opportunity remains in the early innings and should allow Elastic NV to capitalise on the rapid adoption and development of generative AI.

Our position in electric vehicle (EV) producer Tesla Inc. was another detractor over the period. The stock fell on general softness in the EV market. Mixed earnings results from the prior month may have weighed on shares as well. Looking forward, Tesla has some of the most ambitious innovation agendas of most any public company, spanning EV, energy transition, AI and advanced robotics. We believe the company is making progress on each of these agendas in ways that can unlock significant shareholder value in the future.

New Buys and Sells

We started a position in an electronics components maker following the sharp pullback in shares. The company's advanced sensors, specialty cables and high technology power interconnect products are critical across a broad array of end markets that includes AI data centres.

Another new position is a global technology platform that focuses on creating a seamless and secure payment experience for consumers and merchants. By aggressively investing in AI technology and talent, the company aims to maintain its competitive edge in the fintech industry and continue to innovate in the digital payments space.

We exited the remaining small position in an identity and access management company, which we had been reducing, after the company reported mixed results. We were concerned the recovery was proving to be more elongated than we had hoped.

Lastly, we sold the remaining stub position in a technology conglomerate as we are concerned that the recent antitrust rulings brought regarding its search dominance and a pending antitrust suit on its advertising keyword business could prove to be a distraction.

Market Outlook

We continue to have a constructive mid- to long-term outlook for equity markets given the earnings growth potential from AI innovation and adoption over the coming years. However, we expect higher market volatility in the near term as markets digest some additional risks.

Investors are paying close attention to the potential for slower US economic growth given later timing of interest rate cuts and recent softer employment numbers and consumer spending trends. A closer race in the upcoming US elections may also add to volatility, especially around geopolitics and global supply chain. An unwind of the Japanese yen carry trade recently introduced additional volatility, although concerns have subsided as most expect the Bank of Japan (BoJ) to be slow with future rate hikes if needed. Overall, corporate earnings have been relatively resilient, as most companies reported better-than-expected earnings and revenues for Q2. Amid the volatility, we are opportunistically looking to upgrade select names and add to our highest conviction ideas to better position the portfolio for improved performance.

Since inflation is now moving towards the US Federal Reserve's (Fed's) target of 2% and employment conditions have moderated, the central bank is now in a more comfortable spot to normalise policy. From the most recent Jackson Hole Economic Symposium meeting in August, Fed Chair Jerome Powell indicated that the future direction of monetary policy is for interest rate cuts starting in September after a period of tight financial conditions. The timing and pace of such cuts will still depend on upcoming economic data. The market is now pricing in a 25 basis points (bps) cut for the upcoming September meeting, followed by additional 25 bps cuts at remaining meetings in 2024. An easier monetary backdrop should be constructive for the economy to regain its footing, but it may take time for effects to take hold. While markets may see some volatility in the US elections, we remain optimistic in the resiliency of the US economy, corporate earnings growth and AI adoption in the years ahead.

Separately, a key characteristic of the equity market strength over the past year is that returns have been concentrated among a handful of large technology companies. Coming into 2024, investors were worried over the risk of recession, timing of interest rate cuts and geopolitical tensions, so preferred larger caps, higher quality stocks. Also, the large technology giants were the early beneficiaries of this first phase of AI given their large infrastructure investments and data-driven business models that could quickly capitalise on generative AI. However, we believe some caution is warranted when mega-cap technology earnings begin to slow, compared to other sectors as interest rates moderate and the market broadens out more.

As for what's next in the ongoing generative AI innovation wave, we expect the robust capital investments in "Phase 1" AI infrastructure to continue and the industry to enter the "Phase 2" AI applications wave that leverages this infrastructure to develop new generative AI capabilities in software to drive greater value and automation opportunities. We are also seeing early signs of "Phase 3" AI-enabled industries demonstrating effective use of generative AI. Many companies outside of the Technology sector are increasing investments in generative AI to train one's own industry-specific model on its proprietary data or knowledge to compete better and innovate in the future. A backdrop of emerging AI beneficiaries under-appreciated for their potential creates a significant opportunity for alpha generation in the years ahead.

AI infrastructure: The developments around generative AI and large language models further demonstrate that the demand backdrop for AI infrastructure companies should remain strong given the computing requirements for training complex AI models and subsequent inference needed for edge intelligence. More companies are now motivated to build out their own domain-specific generative AI capabilities through continuous training and refinement. As these launch for broad-based use, demand should also expand to networking and storage infrastructure to support the explosive growth in new AI workloads. Investment also appears to be expanding to smaller cloud providers, governments and corporations in more countries around the world, which should be supportive of the ongoing build-out of critical AI infrastructure in the coming years.

AI applications: A new wave of AI applications is emerging that infuse generative AI capabilities into their software to drive greater value and create more monetisation opportunities. Today's general purpose AI models were trained on the internet, and they cannot respond to questions based on proprietary knowledge or data housed privately within an organisation. Many internet and software companies have a wealth of proprietary data sets and workflows to train AI models that can result in a new era of more intelligent applications and systems, opening up many new opportunities for monetisation and value.

AI-enabled industries: AI is helping to reinvent digital transformation, introducing new generative AI possibilities that can significantly boost productivity and reduce costs. As more processes go digital, the opportunity for AI to react to new information or unexpected changes can revolutionise every industry. Many companies in AI-enabled industries are increasing investments in generative AI to train one's own industry-specific model on its proprietary content or knowledge to compete better and innovate in the future. We are witnessing an increasing number of companies across Automotive, Consumer, Health Care and Finance sectors leveraging proprietary datasets that could yield differentiated AI models and applications which are difficult to replicate and can handle tasks better than general purpose AI. We believe this is just the tip of the iceberg as companies become more comfortable with AI's potential to drive greater efficiencies and automation across every part of their business.

Overall, we continue to believe we are at the very early stages of massive disruptive change brought about by advances in – and the deployment of – AI. We believe these changes will drive meaningful growth for companies that can take advantage and drive disruption within their respective industries. Our view is that the compounding effect from AI disruption will create massive opportunities for innovative companies across every sector. Stockpicking will be essential to capturing the benefits of this opportunity, especially in an environment characterised by disruption and change. As we have done since the launch of the Fund, we remain focused on identifying the companies that leverage AI to deliver the most shareholder value creation over the long term. Compared to the technology innovation ahead of us, humanity is still on day one of our journey through the AI revolution.

All data are sourced from Bloomberg and Allianz Global Investors as of 31 August 2024 unless otherwise stated.

Allianz Global Investors and Voya Investment Management have entered into a long-term strategic partnership, and as such, as of 25 July 2022, the investment team transferred to Voya Investment Management. This did not materially change the composition of the team, the investment philosophy nor the investment process. Management Company: [Allianz Global Investors GmbH or other AGI entity]. Delegated Manager: Voya Investment Management Co. LLC ("Voya IM").