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 July

For global equities, the big story in July was the strong rotation away from technology companies in favour of value stocks. Artificial intelligence-related (AI-related) and semiconductor stocks were particularly badly hit. There were various factors behind the technology sell-off. US inflation was slower than expected in June, boosting hopes that US rates would soon be cut; Tesla and a multinational technology conglomerate delivered disappointing earnings; Donald Trump said Taiwan, which is at the core of the global chipmaking industry, should pay for its own defence; and the Biden administration reportedly considered export curbs on semiconductor equipment companies.

As expected, central banks in the US and eurozone kept rates on hold. However, expectations of a September cut grew after US Federal Reserve (Fed) Chair Jerome Powell signalled that rates could be cut in September if inflation continues to moderate. European Central Bank (ECB) President Christine Lagarde said the decision on a possible rate cut in September was "wide open", but downplayed fears of sticky price pressures. In contrast, the Bank of Japan (BoJ) tightened monetary policy, raising rates to 0.25% and setting out plans to halve its monthly bond purchases.

Commodity prices were hit by signs of slowing growth, particularly in China. Oil prices fell, with Brent crude briefly trading below USD 80 per barrel for the first time since early June. Copper slumped to around USD 9,100 a ton, compared with a high above USD 11,000 in May. In contrast, gold prices inched higher over the month.

From a sector perspective for global equities, as measured by the MSCI All Country World Index, performance was led by the Real Estate and Utilities sectors, which were helped by lower rates. Conversely, the Communication Services and Information Technology sectors pulled back on a rotation that favoured value-oriented stocks.

Portfolio Review

During the period, the Fund underperformed on a net-of-fees basis versus the custom benchmark (50% MSCI ACWI Index/50% MSCI World Information Technology Index). From a sector perspective, Information Technology and Industrials were the largest relative detractors. The Consumer Discretionary and Health Care sectors were offsetting. AI infrastructure underperformed the custom benchmark because of policy uncertainty around additional restrictions to China on advanced semiconductor technologies. AI applications lagged the custom benchmark mostly due to stock-specific headwinds. AI-enabled industries outperformed the benchmark from strong performance among our Consumer Discretionary names.

Contributors

Our position in electric vehicle (EV) producer Tesla Inc. was the top contributor over the period. The stock rallied strongly after reporting better-than-expected Q2 delivery numbers, although mixed earnings results caused a pullback later in the period. 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.

Our underweight position in a multinational technology company was another contributor for the period. The company had an average 11.2% weight in the benchmark, while the Fund had an average weight of 3.3%. Although the company reported solid earnings results, shares underperformed after providing guidance on their intelligent cloud business that missed investors' lofty expectations.

Detractors

Our underweight position in a cell phone, computer and communications equipment giant was a relative detractor due to its significant weighting in the benchmark. The company had an average weight of 11.6% in the benchmark, while the Fund had an average weight of 1.8%. Shares outperformed on optimism of a potential device upgrade cycle given the upcoming introduction of the company's new AI features.

Another detractor was a provider of technology hardware and services. Shares underperformed alongside the AI infrastructure and semiconductor space. The company remains well positioned to leverage AI across its business to drive operational efficiencies, gain competitive advantages and offer AI-optimised products to customers that include AI server racks and AI edge devices. Its growing AI business should yield an improving profit profile and drive higher earnings over time.

New Buys and Sells

We initiated a position in a global leader in infrastructure technologies for data centres. The company has positioned itself as a key player in supporting the AI revolution, developing specialised solutions to meet the high-density computing and cooling requirements of AI workloads.

We also purchased a company pioneering in cloud-based solutions to help manage customer interactions, track sales and analyse data. The company leverages AI extensively through its platform, which integrates AI capabilities across its products.

As for complete sells, we sold our position in a provider of software products for marketing, sales and customer service as risk-reward appeared unfavourable relative to other opportunities. We also exited our stub position in a medical device company, as it recently lowered guidance and we could not get comfortable that the worst was over yet.

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 now fearful of a deeper US economic slowdown and late timing of interest rate cuts, given recent softer employment numbers, economic indicators and consumer spending trends. A closer race in the upcoming US elections is also adding to volatility, especially around geopolitics and global supply chains. An unwind of the Japanese yen carry trade has also introduced additional uncertainty. However, overall corporate earnings appear relatively resilient, as most companies reported better-than-expected earnings and revenues for Q2.

The equity market is now seeing a broad-based pullback following a strong rally in H1. Although the volatility may continue as investors look to reduce risk, this is a normal and healthy event in bull markets, as long as fundamental factors remain solid. Amid the volatility, we are opportunistically looking to upgrade select names and add to our highest conviction ideas to position the portfolio better when markets rebound.

Since inflation is now moving towards the Fed's target of 2%, the central bank is now in a more comfortable spot to normalise monetary conditions. Moderating employment conditions is also conducive for a shift to a dovish stance since the central bank has a dual mandate of maintaining price stability and full employment. Given that monetary conditions have been tight for some time, there are many tools at central banks' disposal to ease conditions. From the most recent Federal Open Market Committee (FOMC) meeting in July, Fed Chair Jerome Powell indicated a rate cut in September is probable.

An easier monetary policy backdrop should be constructive for the economy to regain its footing, but it may take time for the effects to take hold. Although conditions may be choppy ahead, we believe spending in AI infrastructure remains a top priority, more generative AI applications should move from pilot to deployment over the coming years, and more companies in AI-enabled industries are rapidly innovating with AI. Fundamental research and company selection will be key for identifying these opportunities. Further, lower rates should translate to better demand across customer segments, easier access to capital and increased investment in generative AI. There are likely bumps along the way, but we remain optimistic in the years ahead.

AI's impact on every industry is starting to take hold, and we see a growing opportunity set beyond just the Magnificent 7* and the Technology sector. ChatGPT and early use cases of generative AI have proven that these breakthroughs can greatly improve efficiency and drive a new wave of automation. We are likely at the dawn of a long-term AI investment cycle that will have significant growth implications across the value chain and in every sector of the economy.

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 that 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 July 2024 unless otherwise stated.

* Magnificent 7 refers to a group of US stocks which includes Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla.

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