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 June

Global stocks advanced over June, driven by a further rally in technology companies. US equities rallied, with the S&P 500 Index and Nasdaq Composite Index hitting fresh highs, driven by further strong gains from technology stocks. It was another strong month for growth stocks, which outperformed value ones by the largest margin in over a year, while large companies also outstripped small-cap stocks. Japanese stocks also rose slightly, while European and Chinese shares fell. Political risk re-emerged in Europe after France called a surprise election.

Economic news was mixed. Surveys of economic activity suggested that growth was stagnating in Europe and Japan and slowing in China, but US economic momentum picked up. Inflation eased in the US and UK, but central banks in these markets kept rates on hold. In contrast, Canada became the first G7 nation to cut rates, swiftly followed by the European Central Bank (ECB). The Bank of Japan (BoJ) maintained rates at 0-0.1%, but suggested it would soon start to reduce its monthly bond purchase programme.

In the commodity markets, oil prices rose modestly over the month. Brent crude hit a 4-month low on news that the Organisation of the Petroleum Exporting Countries Plus (OPEC+) was to phase out voluntary production cuts, but prices subsequently rebounded to a 7-week high, closing the month around USD 85 per barrel. Gold prices eased a little over June, but copper prices plunged to their lowest level since mid-April on growing concerns of slowing industrial demand, particularly in China.

From a sector perspective for global equities, as measured by the MSCI All Country World Index, performance was led by the Information Technology sector with performance driven by the larger cap names. The Communication Services sector was another outperformer. Conversely, the Utilities sector pulled back from a strong prior month. The Materials sectors also lagged broader markets.

Portfolio Review

During the period, the Fund underperformed on both a gross- and net-of-fees basis versus the custom benchmark (50% MSCI ACWI Index/50% MSCI World Information Technology Index). From a sector perspective, Information Technology was the largest relative detractor, as performance concentration among the mega-cap technology companies continued from the previous month. The Fund's underweight in those names represented a headwind. The Health Care sector was another detractor, while the Consumer Staples and Financial sectors were offsetting. Stock selection within the artificial intelligence-enabled (AI-enabled) industries was a key performance headwind, as our renewable energy names pulled back alongside the rest of the space due to policy uncertainty. On balance, both AI infrastructure and AI applications outperformed the custom benchmark, helped by strong earnings results and a recovery in our software-related holdings.

Contributors

The top contributor over the period was cyber security provider Palo Alto Networks Inc. Shares were higher over the period alongside peers in the cyber security space who reported strong earnings results. Looking forward, Palo Alto continues to have an industry leading network security platform and a broad range of cyber security solutions, positioning the company to consolidate market share onto its platform and penetrate adjacent markets. The company also made progress in enhancing its cost structure and product portfolio through AI, while also leveraging AI to streamline its operations. This setup should enable Palo Alto to deliver on growth, profitability and free cash flow generation.

Another contributor was a cloud-based data monitoring and analytics platform. It offers a monitoring platform that provides software engineers real-time observability across the entire technology and application stack. This platform enhances user experiences and avoids downtime through automated problem detection. Shares were higher following the company's User Conference. The company made many product announcements that were well received by investors, including a monitoring solution for large language models powered applications made available broadly. The company has an attractive growth trajectory given a large addressable market, its strong product offering, and the ongoing trend of digital transformation. It is also a beneficiary of increased AI-stack workloads. The company has also integrated generative AI into its platform, including natural language prompts to surface intelligent insights from their observability data, generate key assets like tests and post mortems and streamline incident response and remediation.

Detractors

First Solar Inc. is a vertically integrated solar manufacturer and specialises in the production of high-performance cadmium telluride (thin film) based solar photovoltaic panels. The company is implementing AI across its value chain to drive innovation, enhance efficiency and improve customer service. Shares pulled back from the previous month because of some near-term policy uncertainty and profit taking. Looking out, First Solar remains well positioned to capture the growth potential of US utility scale solar. The company will be the clearest beneficiary of the Inflation Reduction Act (IRA) guidelines for domestic content. Also, First Solar has strong visibility with orders extending through 2027 and margins being set to trend sharply higher, while the announcement of additional manufacturing capacity in the US could provide another catalyst.

Among the largest detractors on a relative basis was Nvidia Corp. Although the stock was a meaningful position in the Fund, we were underweight relative to the benchmark. The benchmark had an average allocation of 11.5% during the quarter, versus the Fund's average weight of 5.0%. Shares were higher during the period due to a combination of factors, including a follow through from the previous month's strong earnings results, positive read-throughs from other companies in the supply chain, and upward earning revisions from Wall Street analysts. For additional context during the year-to-date (YTD) period as of 30 June 2024, shares of Nvidia rose 149% and we opportunistically took profits during its rise. We still favour the holding as one piece of a diversified exposure to the AI infrastructure opportunity.

New Buys and Sells

We re-initiated a position in a cloud security company after shares reached a valuation range where the reward-to-risk ratio became more favourable. It continues to innovate its products by incorporating more AI capabilities into its offering.

Also, we started a new position in a computer technology company, which has been leveraging AI in its products for some time. Specifically, the company's cloud infrastructure segment likely reached a growth inflection. It provides services that support the growth of AI, including functionality that helps develop, train and deploy AI models.

As for complete sells, this included a design platform for video game and 3D content. Although the company retains an impressive technology foundation that should benefit in many ways from AI, recent turnover of key personnel increases the risk of continued missed execution.

We exited our position in a cloud-based data storage and analytics company, as it is entering into a period of higher investments and spending. This may put some near-term pressure on margins, and it will take some time for the company to realise revenue acceleration and margin improvement from this investment initiative.

Lastly, we sold a digital communications technology conglomerate as we have become increasingly concerned about its ability to win networking opportunities tied to AI data centre workloads. We previously moderated the position given the softening backdrop and chose to ultimately exit the remaining amount to fund other ideas.

Market Outlook

We continue to believe that the equity market recovery can extend from 2023 into 2024. Inflation has trended lower over the trailing 12 months but has moved sideways so far this year. As a result, the US Federal Reserve (Fed) likely maintains the restrictive stance by holding policy interest rates at current levels. Despite tight monetary conditions, the US economy remains healthy, as labour markets, corporate earnings and consumer spending have been resilient.

Expectations for Fed rate cuts have been lowered from six to under two, over the YTD period. Amid this backdrop, equity markets have demonstrated resilience, especially for AI and cloud infrastructure companies. From the most recent Federal Open Market Committee (FOMC) meeting, Fed Chair Jerome Powell indicated that rates likely stay elevated for the time being. As the Fed gets comfortable that inflation is moving towards its 2% target, we should see rate cuts, which are looking likely to happen closer to the latter end of 2024.

A normalised monetary policy backdrop should be conducive for economic growth to broaden. We are starting to see a broader recovery in earnings growth that encompasses sectors outside of Technology and for mid and small market capitalisation stocks. Even if there is more volatility ahead, we believe smaller companies have discounted more uncertainties, offering attractive risk rewards for longer-term investors. Lower rates should eventually ease financial conditions and help broaden the recovery as we head into 2025. These conditions should translate to better demand across various industries, easier access to capital and increased investment in high return-on-investment projects like generative AI. There are likely bumps along the way, but we remain optimistic for the rest of 2024.

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 data sets 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 30 June 2024 unless otherwise stated.

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