

Bright Prospects Podcast: Episode 3 – Transcript

SARAH HUDSON: Hello everyone and welcome to the Bright Prospects Podcast. I'm Sarah Hudson, Portfolio Specialist on MSIM's International Equity Team. And I'm once again joined by Alex GABRIELE, PM for Global Stars. Alex is recently back from a research trip to China, so today we get a chance to hear some of the latest musings following that trip. And having had a sneak peak at some of his notes. I know that means we'll cover topics like the AI ecosystem and how the trip's influenced his views there. What we might be able to learn from the way China works a bit closer to home. And of course, ultimately, potential investment implications for portfolios. So with that, shall we get stuck in?

ALEX GABRIELE: Sounds good.

SARAH HUDSON: Great. So maybe let's start with I guess what struck me most from your reflections on the trip, which is the real sense of opportunity you came back with. I know we talked on a previous podcast about the sort of cynical optimism. And I definitely see that optimism coming through in some of your comments. I think you wrote that you felt it was really refreshing to meet companies, where there was a genuine possibility of earnings and share prices growing two or three-fold over the next five years. And I'd say that's maybe contrasted quite a lot with a market currently focused on a relatively small group of mega cap winners. So perhaps you could tell us what gave you that confidence and what the characteristics of some of these companies are.

ALEX GABRIELE: Yeah. I mean what was sort of interesting is -- so I went to China for a week, which I do every year, more or less, in the spring. And it's always sort of fascinating to see the progress that they've made between one year and the next, and how things evolve on the ground. But among other things, met a load of robotics businesses and autonomous driving companies and some of the AI ecosystem in China, and it's just striking that the valuations for those businesses are much lower. And in many ways, the environment perhaps is -- there's a sort of more visible pathway to some of the dream being realized. I mean just taking the car thing, you know, you drive from Shanghai Airport into Shanghai Downtown, and it's crazy to see how the Chinese EV companies, the electric vehicle companies, have completely wiped out pretty much everybody else. Just going along the road, maybe -- I don't know. It's not scientific, but I guess 85% of the vehicles on the road are Chinese EVs. And only five or six years ago it wasn't like that. You know, most of these cars, you watch how these taxi drivers are driving and they have these level two-plus automated assistance. So one of the cabs I took, the guy literally just put in the destination. He went up onto the freeway that goes through Shanghai, and the car more or less drove itself 80% of the way there. And you sort of see like there's thousands of these cars on the street. You look around, they've all got LiDAR embedded in them. It's just sort of fascinating to see the scale and the progress and how quickly they just execute on stuff. So when you see stuff like that and you just look at the valuation of some of these businesses, sure, there's

tons of problems with China, not least of all the competition regulation. There's all sorts of issues. But in terms of the pure engineering progress and product development on the ground, and then the scale of the opportunity, it's just quite exciting, honestly. And you see real progress moving from one thing to the next. It's not just prototypes. There's tons of stuff physically being deployed in the real world. So that was sort of what -- I mean, it sounds silly, but we're used to looking at all these absolutely mega cap businesses with punchy valuations to match, or at least punchy market caps, even if the valuation optically isn't that bad. And you slightly lose sense of the scale. You know you can't really see all the chips that they're making, or you can't really see in the same way all of the deployment of all of these LLMs, how much of it is really happening. But the numbers you're seeing on the sheet of paper are huge. And that's a bit different to some of these -- as I said, the trip to China was just -- there's lots of these businesses where the potential for these numbers to be huge is there and you can actually sort of see it in real life.

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SARAH HUDSON: Fascinating. I think our sustainability focused colleagues will also be thrilled to hear about the takeover of the EVs. So perhaps you touched on it a little bit there but I feel like it wouldn't be a discussion without everyone's favourite topic, obviously, AI.

I think I saw the stat that semis and hardware were up over 120% over the last year, which I guess shows you where that focus has been maybe on those bottlenecks. And I know you've been talking about how you think that's increasing in importance, and also that the supply constraints may be what's the limiting factor here.

ALEX GABRIELE: Yeah. So that's the interesting thing about it. The interesting thing is -- we're focused on the bottlenecks, but really in particular, availability of these cutting edge EUV machines -- because ASML just can't really make any more of them. And capacity at TSMC to make the high-end chips is really flattening out this cycle a little bit. So if you just imagine a parallel world where there was unlimited capacity in these machines and at TSMC, you might have had a bigger, sharper boom. It's hard to imagine a sharper boom, but a sharper boom and we might already be in a bust. But because there's all this supply constraint across various different bottlenecks in the system, it does feel somewhat like the whole so-called cycle, bubble, whatever you want to call it, has been flattened a little bit. The shape of it's flattened. And it sort of feels like the pacing of that flattening is really determined, ultimately, by ASML and TSMC. And you can see it indirectly because one of the only places where there was any real capacity where these machines weren't working at full pace was Intel. And so it made total sense for people to go into Intel to try and repurpose some of that stuff, some of that capacity to feed the AI beast. But it's not as though NVIDIA is holding back. You know, NVIDIA is selling as many chips as it possibly can, as quickly as it possibly can. The only thing that's slowing them down is TSMC and the capacity of these machines. And that, by the way, is true for everybody, not just NVIDIA.

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So now that the only place with spare capacity was probably Intel, and that is slowly being unlocked, and you're seeing that with some of these deals. there was a deal today announced with Google as an example, to manufacture some of these high-end chips. So there just aren't enough of them, and that's delaying -- because we have all these narratives out there about is this a bubble, is it going to burst, et cetera, et cetera. But it's all sort of been -- it's been squigged. It's been flattened by these bottlenecks.

SARAH HUDSON: That's an interesting take. I think quite contrary, as you say, to this discussion around bubbles. I'm interested in the comment you made right at the beginning just about China, how efficient the speed and scale of some of the development, obviously, when you were talking about just that deployment of the EVs. So more broadly, you also talked about how in China they address challenges through investment and construction and engineering. And so I guess from an economic perspective, what lessons do you think we should take from China's approach to development and innovation? And what could we learn over here?

ALEX GABRIELE: Well, it's funny. I sort of think China is what happens when the engineers have the car keys. And most of the West is what happens when the lawyers have the car keys. Simplistically, if all you have is a hammer, everything is a nail. I think I'm paraphrasing some saying. But in China, the way they seem to approach things is they build their way out of problems. They see things as engineering challenges, and it's more like we will manufacture at scale, at precision. We'll build housing. We'll build this. We'll build that. And you see from the number of STEM students they have in China, which is probably -- I think it's something like ten-fold, the number of STEM science and math students there are in the U.S. every year. Their focus is very much an engineer's mindset of how to run a country. And so if you start from there, you end up with this huge investment in building your way out of problems. Whereas we sort of in the West have more of a lawyer's mindset where all problems ultimately turn into a policy of litigation rather than the policy of construction. And so I think for this kind of industrial innovation -- actually, in a funny kind of way, the Chinese might be slightly better off than us. And you see the politicians sort of squirming around for ideas, right, because you can't really write a law, not easily -- it's not easy to legislate innovation. In fact, it's sort of the opposite is true. You need to get out the way of innovation. But that isn't their tendency. The tendency is to try and legislate. And so you sort of see how those two lenses of running the show of who has the car keys probably influence quite a lot how the progress in these areas evolves. The scale of deployment of -- the Chinese are going after this isn't going to be quite as good as the leading edge AI models or the leading systems, but we're going to be so much cheaper than everybody else and all this stuff is going to be an open platform that we will win eventually. Because everybody that's not America or China, economically, they'll end up picking us. And by the way, that's the sort of Android versus IOS argument. Being the open platform that is free or cheap generally wins over everywhere, other than the high end. So it sort of feels like they're using that playbook in robotics and in AI and in EVs and in batteries and in all sorts of areas. And they are effectively building their way out of their own economic situation. Now, whether or not that works, who knows? I'm not a qualified economist to answer that question. But I just find it curious that that lawyer versus engineer mindset -- it's a way of visualizing a different approach to problem solving.

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SARAH HUDSON: I can see you and I having both being scientists why that's -- I guess problem solving, hypothesis testing approach versus the art students in a room discussing would appeal. So I think I'm with you on building your way out of problems. Okay, just before we wrap we should take a step back and just think more broadly about the market. You obviously commented about the big discussion around is it a bubble. What might cause the merry-go-round to stop? I know your view is maybe this has been a bit flattened. I think there's, obviously, a lot of narrative out there about the market shrugging off geopolitics and obviously, they are making all-time highs. So keen to know where you are on the debate, what your thoughts are, what risks you're watching, and what do you think to labor my analogy too far, there's plenty more days of the fair to come?

ALEX GABRIELE: Yeah. The trillion dollar question. When does the music stop? My first comment is things seem to change very quickly. And so no insights on the longevity of the market have much validity for very long. But high level, the stuff that's doing well is relatively narrow and is generally all exposed in one way or another to AI CapEx. And that AI CapEx, up until now, has been predominantly funded by the hyperscalers. Though we are now starting to see some more funky stuff going on, whether that's weird sale and lease back or businesses like Google that have net cash balance sheets raising equity anyway. So you're starting to see -- I mean that probably means, by the way, they're going to keep spending. And now you're seeing today Meta is thinking of doing the same thing. But if they're raising equity, you're sort of coming up against the limits of what they can fund internally easily. And it might be an indication that they think there's a bit of strain in the debt markets or at least debt is relatively expensive. So it might or might not be an indication of that. There's supposition about what the management of Google are thinking. But the bottom line is most businesses that are exposed in one way or another to that huge CapEx number are doing fine. And everybody else that's exposed to the real economy is doing a lot less well.

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Maybe if you were running Google you would just raise the money now, have a bit more cash, even if you don't need to spend it. You might just think, well, if there's the possibility of some substantial chaos and changes in the interest rate environment in the next six to twelve months, it would be a prudent thing just to load up on cash and just get it now whilst the liquidity is available. And you don't have to spend it now. You can keep it for ages and just leave it for a bit, if you see what I'm saying. But you go to raise the money when it's there, we have this flood of IPOs coming, big numbers. The IPOs themselves probably can be absorbed by the cash in the system, but the cash is going to have to come from somewhere for all the rebalancing. Because a lot of these businesses are going to go straight into all sorts of indices and trackers and all sorts of stuff. So there's going to have to be some sort of movement in money, movement around to accommodate all of the stuff that tracks. And lots of these financial products now are pinned to some form of risk management of indexing. It probably means they don't have a choice in reality. And that creates a money flow issue. But it's easy to construct these crazy ideas. On the flipside, if the status quo just continues, the big guys have got tons of cash. They're very well-funded. They're going to keep spending money on data centers. And for the moment, it seems as though there is plenty of demand for tokens in the hyperscalers to process information through their various AI tools. So the status quo continues, they're just going to keep spending money. And that narrow part of the market that is exposed to that is going to do fine. And everything else is a bit more dependent on how the rest of the economy plays out. Which if you'd ask people in January, they would have told you, well particularly in the U.S., there's the World Cup coming. There was the tax credits from the One Big Beautiful Bill Act. That was supposed to be a little bit better in the lead up to the midterms because usually politicians like their voters to feel a bit better about themselves in the lead up to elections. But it's a bit unclear exactly this time around what is going on, particularly in the U.S. Europe doesn't really do very much. And Asia has got other -- there's other stuff going on out there, but we already talked a bit about China.

ALEX GABRIELE: Is there anything else you'd like to touch on there?

SARAH HUDSON: No, I don't think so. Thanks so much, Alex. Thanks for sharing your thoughts from your trip and your thoughts more generally. Look forward to speaking again on our next podcast.

ALEX GABRIELE: Thanks very much, Sarah. Thanks everybody.

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