The dot-com bubble vs. the AI bubble: The match

Introduction

After an exceptional year in 2023, major US technology stocks are reaching new heights, thanks notably to the artificial intelligence (AI) hype. Are we reliving a phenomenon similar to that of the Internet bubble of the 2000s?

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In 2023, the "Magnificent 7" (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla) recorded gains ranging from 50 to 240%. These 7 large-cap companies alone accounted for over 60% of the S&P 500's growth over the past year. Although some of them have been lagging in recent weeks (e.g., Tesla), 2024 has got off to a flying start for the big tech stocks. A stock like Nvidia, for example, has seen its market capitalisation rise by $650 billion since January 1 of this year.

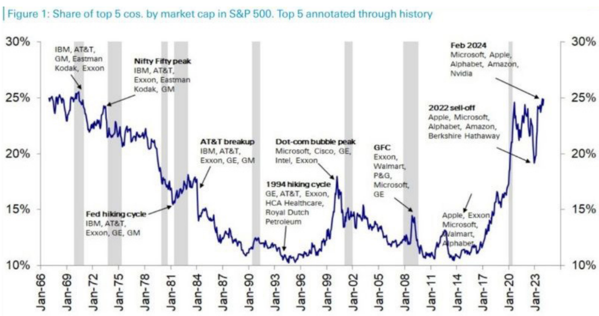
The dominance of these stocks on the US and global stock markets has an air of déjà vu of a time when technology stocks soared before facing a dramatic correction.

2024, the new 2000?

I. The risks of market concentration

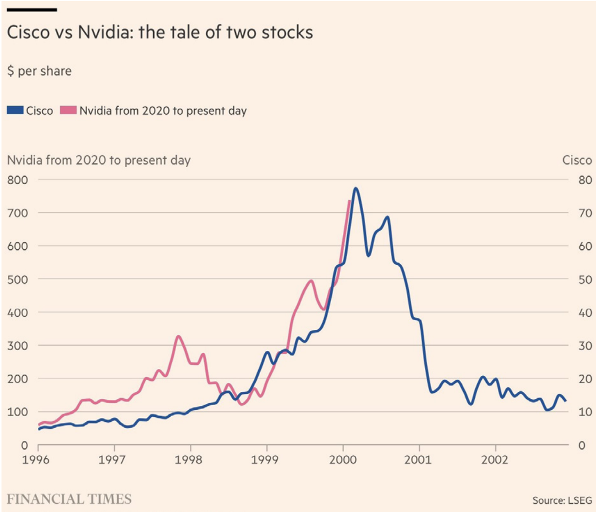
By the end of the 90s, Internet stocks had become a must-have. For many investors, the Nasdaq was poised to replace the S&P 500 and the Dow Jones as the benchmark for US equities. Even if Internet stocks reached sky-high P/E multiples (or even no multiple at all, as many companies were losing money), most investors justified these valuations by projecting very high growth rates for many years to come. These projections turned out to be far too optimistic.

Almost 25 years later, history seems to be repeating itself. The rise of artificial intelligence suggests massive spending on servers, semiconductors and "platforms" such as Meta. However, the phenomenon of market concentration in this field is even more pronounced today than it was at the beginning of the century. Whereas the 5 largest stocks in the index represented 18% of the S&P 500 in the early 2000s, the "top 5" now account for 25% of the index, an all-time high.



Source: DB

This extreme concentration poses a significant downside risk for the S&P 500 index. As a reminder, major Internet stocks such as Cisco System and Intel had failed to meet market expectations in terms of earnings growth rates. These disappointments led to a sharp fall in the share prices of these stocks, and consequently to a very sharp decline in the S&P 500. Many investors now fear that any disappointment on a stock such as Nvidia could send the whole market tumbling. The parallels between the AI chip leader today and Cisco's stock market behaviour at the time are striking (see chart below).



Source: FT

II. The risk of disappointment

Since ChatGPT-3.5 was made public by Open AI in November 2022, the Magnificent 7 have been seen by investors as the sole beneficiaries of the AI revolution, not only because of their ability to attract talent, but also because of their financial power, which enables them to make huge R&D investments in their AI branches. This is an important difference from the dot-com bubble of the 2000s, when it was not just large caps that were riding the ".com" wave; indeed, numerous IPOs of internet stocks had broadened the spectrum of available investment opportunities.

While some AI-related stocks have the potential to deliver a growth rate in line with current market expectations, history tells us that most will not. As explained in a recent article by Research Associates, picking future AI winners is the equivalent of investing in Amazon, Apple and ADP in early 2000. These three stocks were the only ones among the 40 biggest names in the technology sector at the turn of the century to record double-digit performances over the following 23 years.

And the history of financial bubbles tends to repeat itself. As was the case during the Internet boom, financial markets tend to pay very high valuation multiples for companies that seem best positioned to benefit from the new technological revolution. On the other hand, markets tend to overestimate the ability of these companies to deliver on earnings growth expectations.

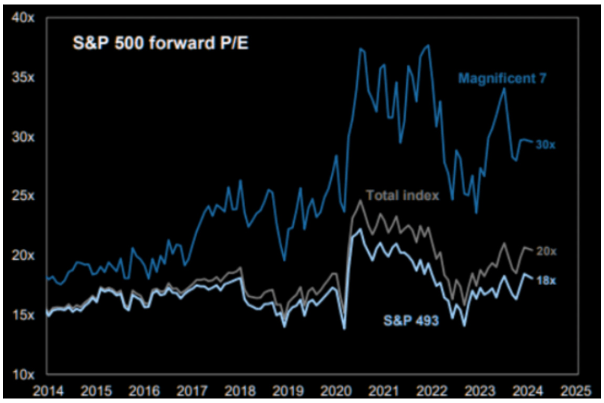
Finally, the companies that initially appear to be the leaders of a technological revolution are not necessarily those of tomorrow. In a recent article, Research Associates highlighted the example of the Smartphone. In 2000, Palm's market capitalisation was briefly worth more than that of General Motors. But in 2003, Palm Pilot was supplanted by the Blackberry, which in turn was replaced by the iPhone in 2008. Often, it's the disruptors who pay the highest price for disruption. Today, Nvidia is the most emblematic stock of the AI bubble. But it is also perhaps the one most likely to disappoint the very high expectations of investors.

How does 2024 differ from 2000?

Even if current market behaviour are in some aspects similar to that of the dot-com era, the AI bubble presents some notable differences.

I. Valuation multiples less extreme than those of 2000

One of the most marked contrasts is to be found in the valuation and structure of the market. The expected 12-month price/earnings ratio for the Magnificent 7 is 30x, a 50% premium to the rest of the market. These multiples are well below those prevailing in the dot-com era.

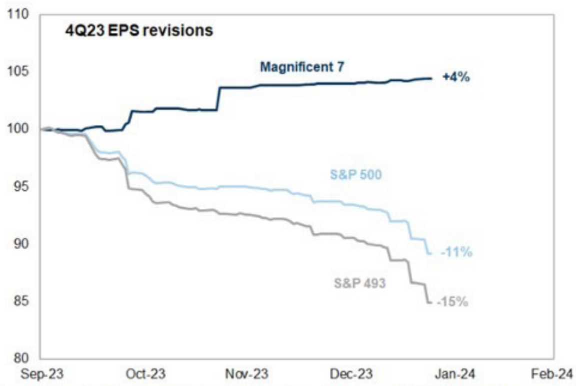


Source: Goldman

II. Valuation premiums partly justified by fundamentals

In contrast to the dot-com era, large-cap technology stocks are already highly profitable and continue to grow at a strong pace.

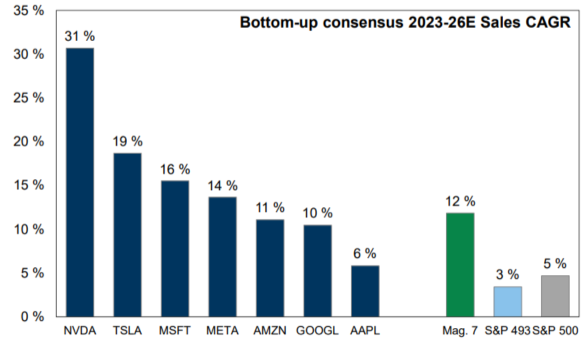
The outperformance of the Magnificent 7 since the beginning of the year is supported by earnings revisions. As the chart below shows, the Magnificent 7's earnings expectations for Q4 have been consistently revised upwards, in contrast to the rest of the market.



Source: Goldman Sachs Investment Research Division, Cormac Conners, as of 1/26/24. Past performance is not indicative of future returns.

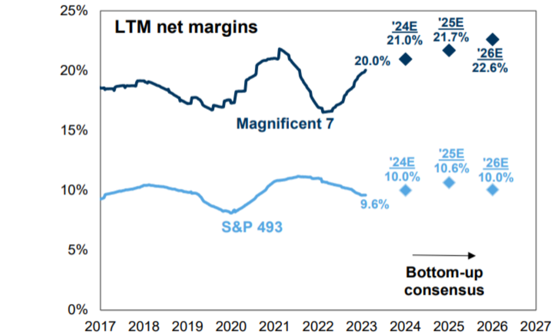
Regarding forecasts for the coming years, the market is expecting a growth rate well above the rest of the market. Expected margin levels are also well above the rest of the S&P 500.

Exhibit 5: Consensus expects the 7 to grow sales at 4x the rate of S&P 493
as of February 1, 2024



Source: Factset, Goldman Sachs Global Investment Research

Exhibit 6: The Magnificent 7 are expected to expand margins by >2 pp by 2026
as of February 1, 2024



Source: Factset, Goldman Sachs Global Investment Research

III. A shortage of supply of AI securities

Another major difference with the years 1999-2000 is capital market activity. The late 1990s saw a frenzy of IPOs, often involving companies with negative cash flows, which ultimately proved unviable.

The current cycle is in no way comparable. The Magnificent 7 attract the vast majority of AI-related investment flows, and IPOs are stable. Thus, there is no liquidity drain due to the influx of shares. There is even a reduction in the supply of shares linked to share buybacks by the Magnificent 7. For instance, in 2023, Apple bought back $77 billion worth of shares.

IV. The shifting narrative of the technology industry

In recent months, the technology sector has intensified its layoff announcements, raising doubts about their true growth momentum. However, technology companies insist that these layoffs are not linked to a deterioration in their growth prospects, but rather to the need to increase spending on artificial intelligence. The dynamic is therefore very different from the job cuts that prevailed in 2001, for example.

Conclusion

The current trajectory of the technology industry, characterised by strong growth, market concentration and speculative investment, bears some similarities to that of the dot-com bubble. However, the scarcity of AI-related stocks, strong sales growth and higher profitability levels seem to partly justify valuation premiums.

Beware, however: the risks of disappointment in terms of growth, a rise in long-term interest rates and the possible arrival of a new administration in Washington are all risks that investors should consider.

We encourage our clients to maintain moderate exposure to some of the Magnificent Seven, while considering other quality and growth stocks.

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