Morgan Stanley

WEALTH MANAGEMENT

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The Paradox of a Placid Market Amid Semi-Euphoria

Despite war in the Middle East, elevated energy prices, inflation fears and a more hawkish Federal Reserve, the S&P 500 Index's 11.0% year-to-date total return appears unremarkable given solid US economic growth and corporate earnings upside. Beneath the surface, however, recent narrow market leadership is more glaring. Indeed, approximately 80% of S&P 500 performance attribution is derived from just three industries, which happen to also be among the most volatile historically: semiconductors, IT hardware and AI power.

These industries have benefited from improving earnings revisions and pricing power given their direct leverage to "first order" data center capex trends, upside guidance from Magnificent Seven (Mag 7) spending and accelerating subscription-revenue run rates from large-language-model (LLM) providers. Seemingly insatiable demand and supply bottlenecks have led to long-term agreements and robust order books, and in turn to a call for secular growth in these traditionally cyclical industries.

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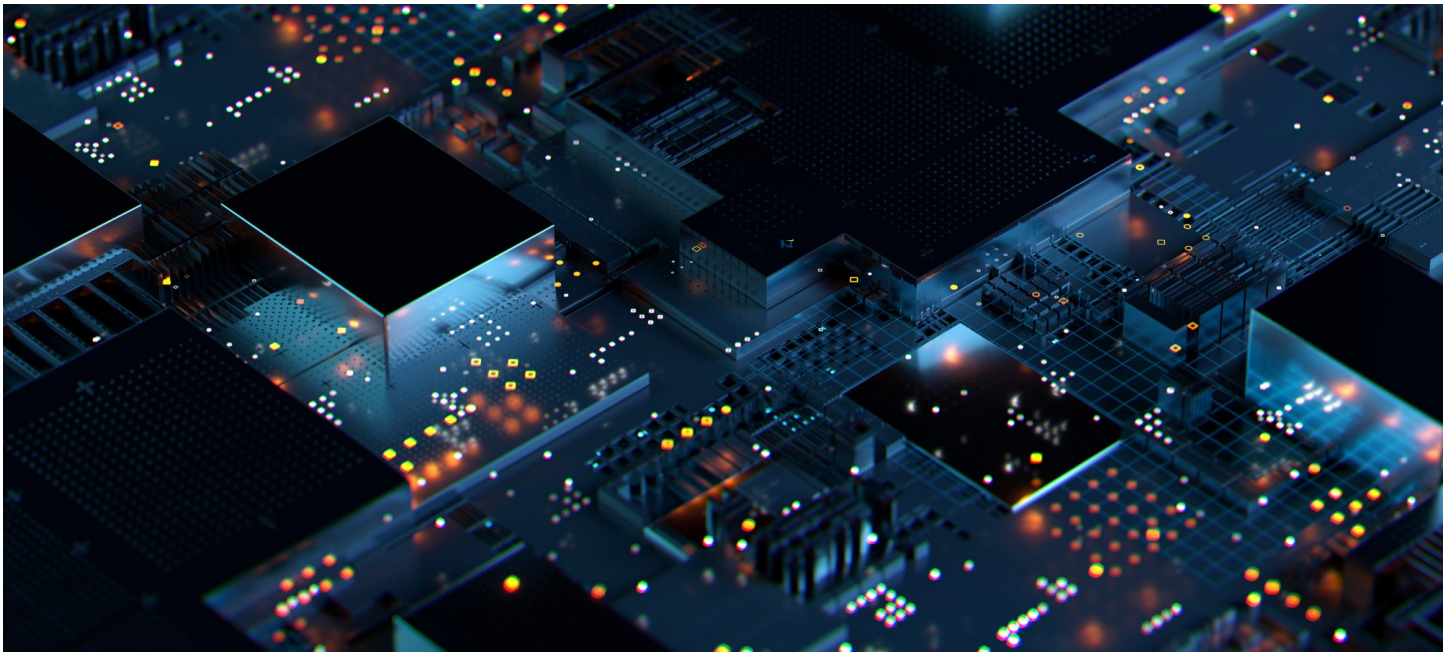

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To put the upside surprise in the rate of spending in context, a year ago, sell-side estimates reflected expectations for 2026 hyperscaler capex of $350 billion. Today, it's tracking closer to $750 billion, and Morgan Stanley & Co. Research analysts forecast more than $1 trillion in 2027. As a result, consensus earnings forecasts for companies levered to AI infrastructure (represented by the MS & Co. IED AI Tech Beneficiaries basket) have been revised higher by an average of 80% for the year to date. However, we are keen on when the focus will swing back to the second derivative rate of change and sustainability into 2028 and beyond.

Stepping back, we credit our colleagues in MS & Co. Research who, like a good linebacker seeing around corners, foresaw three of the key inflections in the semiconductor supply chain bottleneck in the past three years—starting with graphics processing units (GPUs) in 2023–2024, then memory chips in 2025–2026 and central processing units (CPUs) in 2026. Furthermore, Stephen Byrd, MS & Co.'s global head of thematic research, led the charge on AI power two years ago, highlighting major shortfalls in electricity supply to satisfy data center compute that could only be achieved via unconventional means (i.e., not grid connection). This has unlocked strong gains in companies providing gas turbines, fuel cells and nuclear power.

We too saw opportunities to add semiconductors, hardware and power across our strategies over the past 12-plus months. However, from a process and risk management approach, we run more diversified and quality-oriented strategies, limiting our inclination to go "all-in" on just one theme or sector because it exhibits extreme momentum, especially when it is as volatile as semiconductors and IT hardware.

Identifying Excess

At times, we feel compelled to publish our views when our macro insight and portfolio convictions/positioning intersect in a way that doesn't align with prevailing market sentiment, especially during periods of extremes. Most recently in early-February, we articulated a defense of the software space. Our key conclusion was that while the market was pricing broad obsolescence for many software business models (and data-centric businesses in general), the more probable outcome was more nuanced, with dispersion likely across a spectrum of insulated vs. disrupted. Albeit with only a few months to look back, that premise has essentially played out, with the broad software index (IGV) up 12% since we published the report, with notable dispersion within the sector with constituent performance ranging from +100% to -25% (since 2/9/26).

Currently, given the extremely narrow nature of the AI spending beneficiaries, there are three key risks to the rate of change of AI spend that we are monitoring. We acknowledge that this could be early, but it is very difficult to pinpoint when the market will care about this rate-of-change deceleration:

1. **Improving equilibrium:** For more than two years, "demand constraints" has been an accurate portrayal of how massive compute orders have led to upward earnings revisions. Today, considering real time updates from companies in the supply chain, we are starting to think "deployment constraints" may more accurately depict reality. As data center construction pipelines grow, there is a natural rush to order all the compute, materials, industrial components and eventual power to support them. But data centers aren't being built overnight, and we suspect that semiconductor chips are sitting idle waiting to be deployed. At a certain point, we believe that ordering may slow as data centers become operational and chips are deployed (unlocking compute supply). While absolute levels of data center-related spending will stay high for several years, our focus remains on the rate of change, as stocks tend to discount future earnings.
2. **Domestic and/or global supply easing:** One of the key attributes of today's technological and geopolitical realignment is the phenomenon of "resource nationalism." Our Morgan Stanley Wealth Management Global Investment Office colleague Sarah Wolfe has published extensively on the topic (see her April 15 *AlphaCurrents Macro* report, "Resource Nationalism: When Security Replaces Efficiency"). The US has flexed its muscles in leading-edge semiconductors, while China has leveraged its rare earth minerals lead. Additionally, per the recent summit between President Trump and President Xi, China has reiterated its intentions to regain control of Taiwan. As we think about these crosscurrents, one potential scenario is for the US to either lean in harder to investment in domestic supply, as it has done in Arizona, or potentially to use access to high-end chip supply as leverage to try to head off a Taiwan conflict.
3. **The nature of tech itself:** While admittingly not a "tech wizard," as I reach for a phone vs a toolkit when the TV breaks, our observation is that the nature of technology changes rapidly. Much like the debate spurred by DeepSeek in early 2025, our key consideration today is the following: Will AI training, inference and agent utilization a year from now be as compute-and-power-intensive as it has been in recent years? Our guess is no; as bottlenecks are cleared, it could lead to a digestion period when hyperscalers slow capex growth to focus on free cash flow and matching compute supply with demand.

Beyond these fundamental factors, we share three more concerns from a positioning, technical and sentiment standpoint.

1. **Crowded hedge fund positioning:** According to MS Prime Brokerage (PB) Content data, the ratio of long positions to short positions across semiconductors, IT hardware and AI power remains near the most bullish level of the past decade, leaving limited room for incremental buying. Conversely, net positioning in equities excluding these sectors is at a 10-year low. Counterintuitively, this can be read as bullish for the "market." While the AI "first order" trade is certainly crowded, overall equity exposure seems more muted.
2. **Momentum mania:** With these three groups (semiconductors, IT hardware and AI power) making up the majority of momentum baskets, the risk of rapid reversals is increased. Hedge fund exposure to long-momentum factors is near a five-year peak, only surpassed by the 2021 tech bull market, which was followed by a comprehensive bear market in 2022. Looking closer at the Morgan Stanley IED factor baskets for the year to date, one can see the significant spread between momentum/high risk factors (realized volatility and beta) and all of the other factors that contribute to our investment process—namely quality, valuation, and growth (year-to-date momentum, beta and realized volatility are up 29%, on average, versus a decline of 14%, on average, for quality, yield and growth). While this factor concentration can continue in the short term, any fundamental weakness could be compounded by an unwind of technical factors during a drawdown.
3. **Populist angst:** From a sentiment perspective, we observe that anti-AI views are bubbling up more from a populist base, per the May 19 Wall Street Journal article, "The American Rebellion Against AI Is Gaining Steam." Indeed, with elevated gas prices at the pump, a lack of affordable housing (made worse again with the recent move up in rates) and now perceived labor risks and inflation risks around AI spending itself (via power constraints), we imagine that this rhetoric will ramp up in the coming months ahead of the midterm elections, thereby acting as an additional headwind to AI spending sentiment at large.

From First to Second Gear, and the Return of the Mag 7

To be clear, we are not calling AI a bubble. We remain positive on productivity, earnings and profound positive upside likely stemming from AI over the next three, five and 10 years, as we have stated in the past (please reach out to your Financial Advisor for our prior quarterly newsletters). Instead, we feel obliged to remind investors of the cyclical nature of capex cycles, the risk of rapid rotations among perceived leaders and laggards and last, the overarching necessity of remaining diversified, quality-driven and long-term oriented in equity portfolios amid this backdrop. In that light, we continue to see "second order" AI adopters, such as financials, health care, "Rag 6" consumer platforms, and yes, select software as key long-term beneficiaries.

1. **Financials:** Banks should benefit from lower operating expenses and better underwriting due to AI adoption, while "data" businesses like exchanges, ratings agencies and brokerages appear defensible and oversold.
2. **Health care:** To date, the "hype" around AI driving drug discovery and better patient outcomes has far outpaced the stock performance. However, medtech, life sciences/diagnostics, managed care and select biopharma should be able to accelerate time to market for new drugs, improve success probability of trials and execute on value-based pricing; these options do not seem contemplated in forward earnings estimates, which have lagged the market.
3. **"Rag 6" consumer platforms:** We have previously coined the term "Rag 6" to describe scaled consumer retail platforms that operate omnichannel, retail and online, commerce. These "Rag 6" platforms will continue to press their scale advantage to deliver better value to customers. This in turn creates a flywheel that enables more data/AI investment and a wider moat. We are bullish on these companies' ability to bring AI into the "physical world" via robotics that can dramatically improve distribution centers, fulfillment and inventory management.
4. **Software:** Not all software stocks are created equal, and AI appears to be the disruptive technology that will separate the companies that truly have moats from those that have ridden the wave of SAAS adoption. Please see our April 16 Equity MAPS Quarterly Letter for more details.

Last, we were well served making the Mag 7 an overweight three years ago, as we expected a monolithic reaction to the fervor around the launch of ChatGPT. We then called for the monolith to transition to a peloton over 18 months ago and had favorable selection as the group experienced more dispersion, with our outsized program overweight to Google (at the time with a valuation of 15 times forward earnings) a key driver in 2025. We think 2027–2028 could see the return of the Mag 7 monolith phenomenon, as 1) the group continues to lead with AI monetization; 2) capital spending slows, which lifts the overhang of waning free cash flow; and 3) new AI-enabled products and opportunities emerge, with many of the group's growth segments (space, robotics, quantum and autonomous) key beneficiaries.

Conclusion

With the perspective of two decades investing, including navigating prudently through several extreme periods such as COVID, the subsequent economic reopening, the 2022 rates-cycle bear market and the varying iterations of the AI upcycle that kicked off in 2023, we believe the key consideration today is the following: Given their growing market concentration and outsized impact, do we share the same conviction across today's "first-order" AI spending leaders—including the volatile semiconductor, IT hardware, data center component and AI power companies—that we did in the Mag 7 in 2023, as that inherently higher-quality, more diversified group entered a multiyear-outperformance phase? The answer is no.

Disclosure Section

For index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Artificial Intelligence (AI) A field of study that seeks to train computers to process large amounts of unstructured information in a manner similar to human intelligence, capable of performing tasks such as learning and problem solving.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

Drawdown refers to the largest cumulative percentage decline in net asset value or the percentage decline from the highest value or net asset value (peak) to the lowest value net asset value (trough) after the peak.

Volatility This is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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