Quant insight

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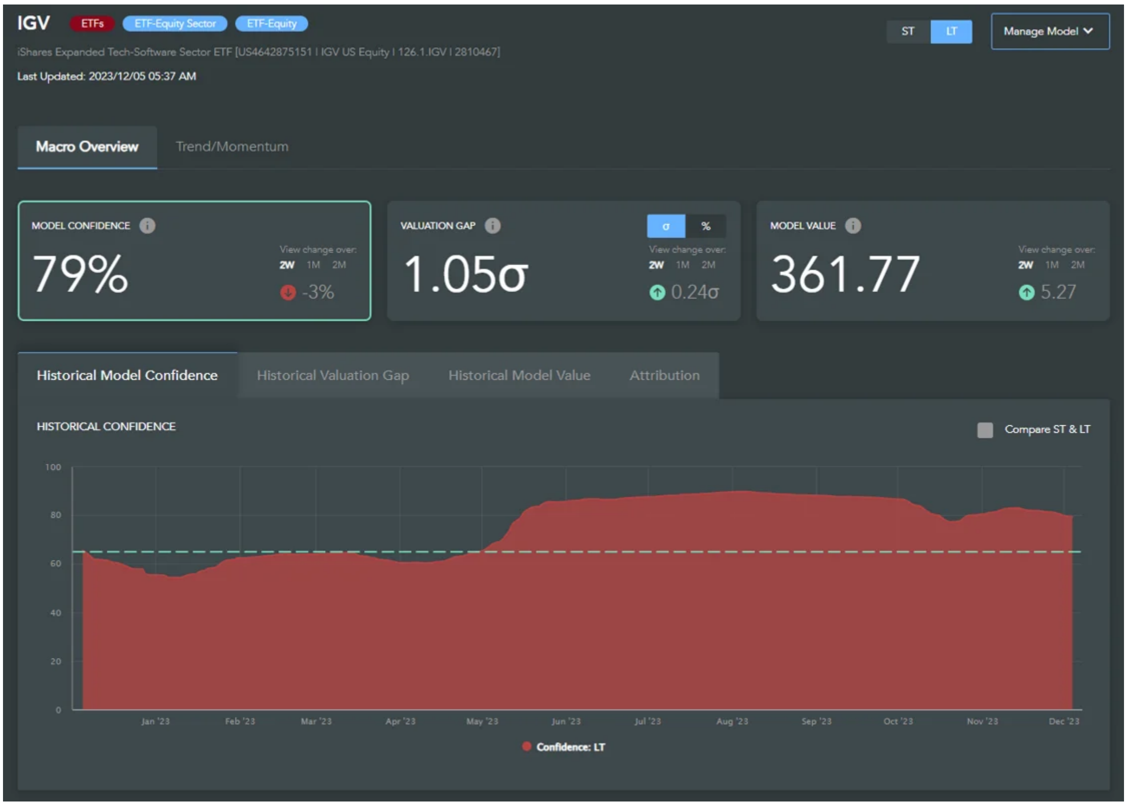
Finessing the second wave of the AI revolution

Nvidia is the poster child of the AI trade but despite a 200% plus gain in 2023, it appears to have lost some momentum. In contrast, software names have had a strong run - the sector has rallied almost 20% since the October lows.

There is a narrative that the AI revolution is evolving. The early winners (chip makers) are giving way to a new set of beneficiaries - the software companies that will help develop the necessary infrastructure.

On Qi, IGV (the iShares ETF tracking Expanded Tech Software) is in regime with a strong valuation story. Outright, versus semiconductors (SOXX) and versus the broader market (SPY) it screens as rich versus prevailing macro conditions.

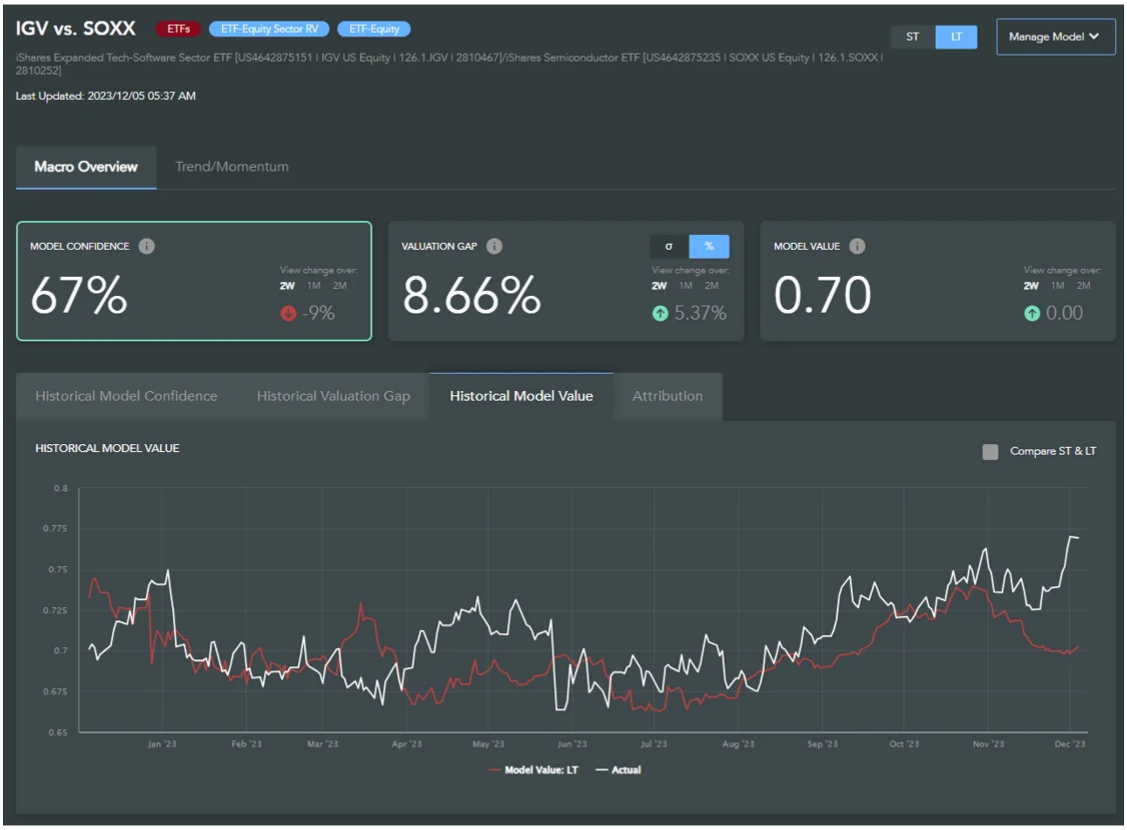
Even if you believe in a rotation in the AI winners, these do not look the optimal levels to be chasing software.



Qi's model for IGV has 79% confidence. This latest regime started at the beginning of May and confidence has been pretty stable since then.

On current patterns, the Software sector is dominated by a desire for **reflation, rate volatility to remain contained and credit spreads to tighten.** Software loves Goldilocks.

The Fair Value Gap is +1.1 standard deviations which currently translates into IGV standing 7.8% rich to overall macro conditions. In short, and from a pure macro perspective, a fair amount of good news is in the price.



The chart above shows IGV relative to semiconductors. The white line is the spot price of the IGV/SOXX ratio; the red line is Qi's macro-warranted model value for the pair.

Once again **IGV wants reflation**. Higher inflation expectations are consistent with Software outperforming Semis. The recent fall in inflation expectations are the biggest reason for the 3% fall in Qi model value over the last month.

That decline in model fair value stands in sharp contrast to the recent spate of IGV outperformance. Hence a **8.7% rich valuation** on Qi.

And finally we show Software versus the broader market by modelling the [IGV/SPY] ratio.

The desire for reflation is there again but this time other factors have worked to offset the drag from falling inflation expectations. The net result is macro momentum has eeked out a 0.9% gain on the month.

And once again, the recent rally in IGV has outstripped where aggregate macro conditions say it 'should' trade. Software screens as **6.5% rich relative to the S&P500** on Qi.

This is not to dispute the idea that the second wave of the AI revolution could provide a huge benefit to software stocks. **The AI theme is not going away in 2024**.

It is a warning that, should the mood of the market turn down, then IGV looks vulnerable from a tactical perspective. More specifically any scenario that speaks to sticky inflation, rising bond vol and wider credit spreads poses a risk.

Even bottom-up or thematic investors should know that, with Payrolls on Friday and the Fed meeting next Wednesday, the macro angle needs to be factored in.

Read the PDF

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