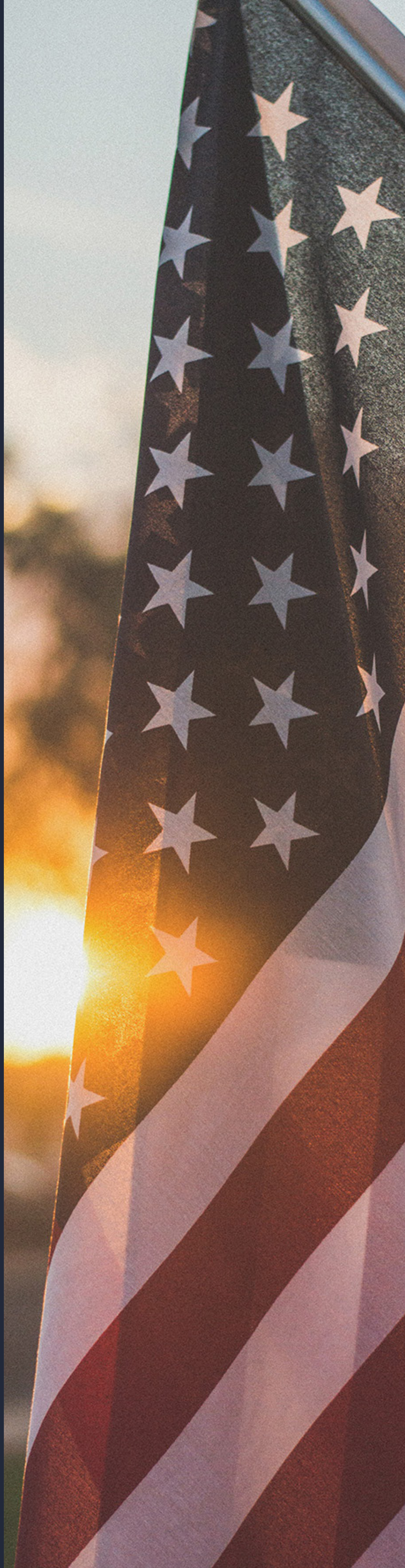
CIO Outlook - Q2 2025

From TINA to TIA

There is an Alternative (to US Stocks)



From Dr Dan Appleby CIO (Listed Investments)

Will US exceptionalism – or a dominant US stock market – continue in 2025? That was the key question for investors as this year began given that the S&P 500 has trounced both developed and emerging stock markets since the Global Financial Crisis (GFC). And after a two-year streak of 20%+ returns for the S&P 500 ending in 2024 on an Artificial Intelligence (AI)-fuelled boom, President Trump was expected to add further fuel to the US stock market's fire by cutting taxes and slashing regulation.

Referring to the post-GFC period again, the phrase 'There Is No Alternative (TINA)' was used to support the idea of buying equities to achieve sufficient returns. This was due to the low, or even negative, interest rates on offer from bonds and cash. There are parallels to US exceptionalism and TINA. Indeed, TINA was increasingly applied as a rationale for buying US equities at the expense of other stock markets as the mega-cap technology companies drove returns.

Then barely a week into Trump's second term came a rather sudden jolt to the TINA narrative. China had arrived with its own version of an AI chatbot that rivalled the popular ChatGPT. Suddenly, the significant sums being invested into AI infrastructure, most of it heading Nvidia's way, was thrown into doubt. Meanwhile, geopolitical developments also sparked a rethink in Europe regarding its dependency on the US military.

Both events have brought into question whether we are at the end of US exceptionalism. Or rather than TINA, investors are beginning to see that There Is an Alternative (TIA) to US equities in the shape of European and Emerging Market stocks.

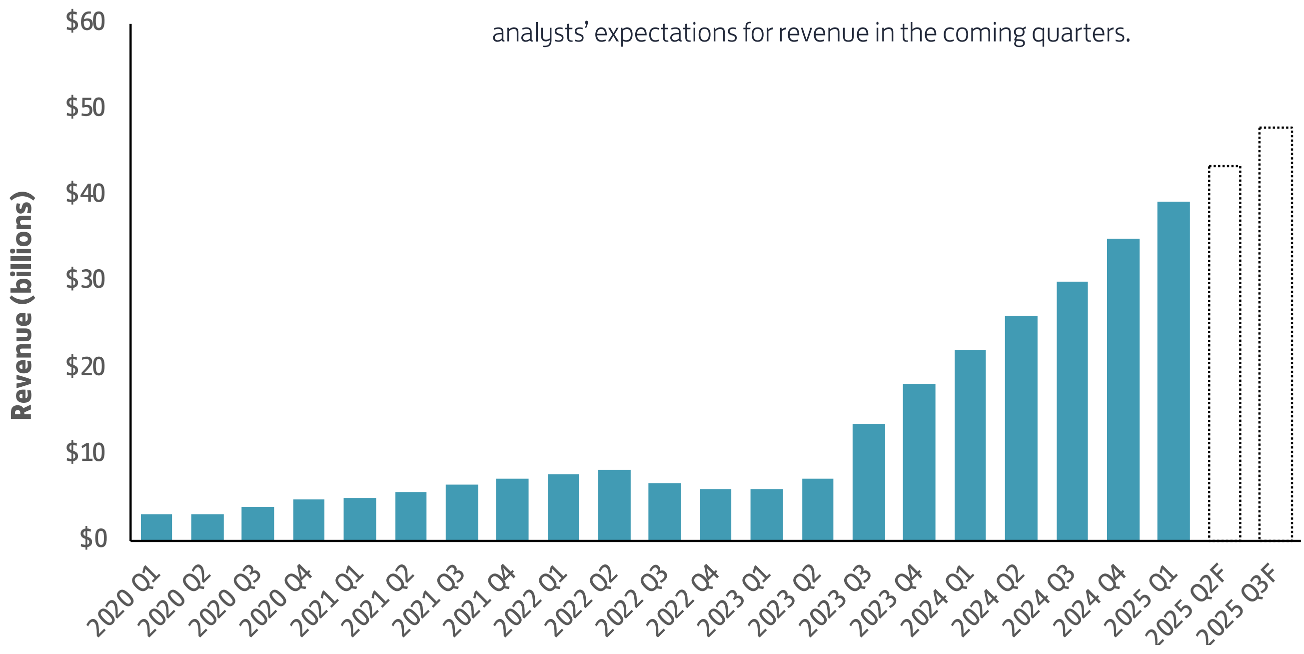
The DeepSeek Moment

Just as Sputnik — the first satellite launched into space in 1957 — shocked the US into accelerating its space program, the release of a powerful large language model by the Chinese company DeepSeek in January stunned the tech industry by rivalling OpenAI's ChatGPT. It marked an abrupt 'Sputnik moment' for artificial intelligence, challenging the prevailing assumption that America's OpenAI was leading the AI race.

There are always many reasons why a stock market may move up or down. However, the turn in the 2022 bear market for US stocks coincided with the first release of OpenAI's ChatGPT. UBS estimated that ChatGPT reached 100 million monthly active users just two months after its December launch. For reference, it took TikTok about nine months to reach this same user base.

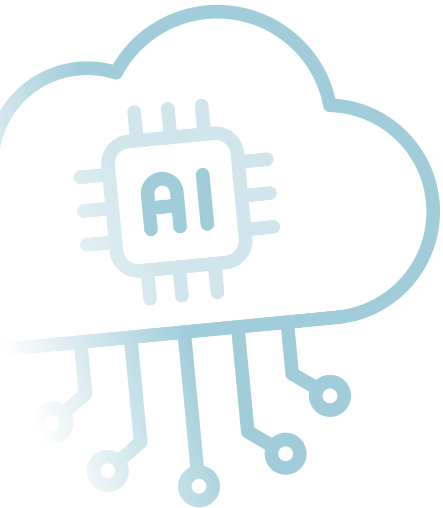
This excitement over AI not only helped the Nasdaq rise over 70% from December 2022 to where it is today but also propelled Nvidia into the limelight as the enabler of this technology. Its quarterly revenue exploded from $5.9 billion in the fourth quarter of 2022 to $39.3 billion last quarter (Figure 1). Nvidia was now not seen as just developing graphics processing units (GPUs) for high-end gaming computers, but a company that was selling GPUs to the likes of OpenAI to kit out data centres that are being used to run AI software.

Figure 1: Nvidia's quarterly revenue hit an inflection point in early 2023 when AI chatbots were released to the public. The dashed bars show analysts' expectations for revenue in the coming quarters.



Source: Bloomberg

Then the DeepSeek moment arrived which led to an almost $600 billion fall in the valuation of Nvidia when markets opened on the 27th January. It marked the biggest ever daily drop in a company's valuation. DeepSeek claimed to have created a model that was just as good as OpenAI's but at a much lower cost and with much fewer Nvidia GPUs.

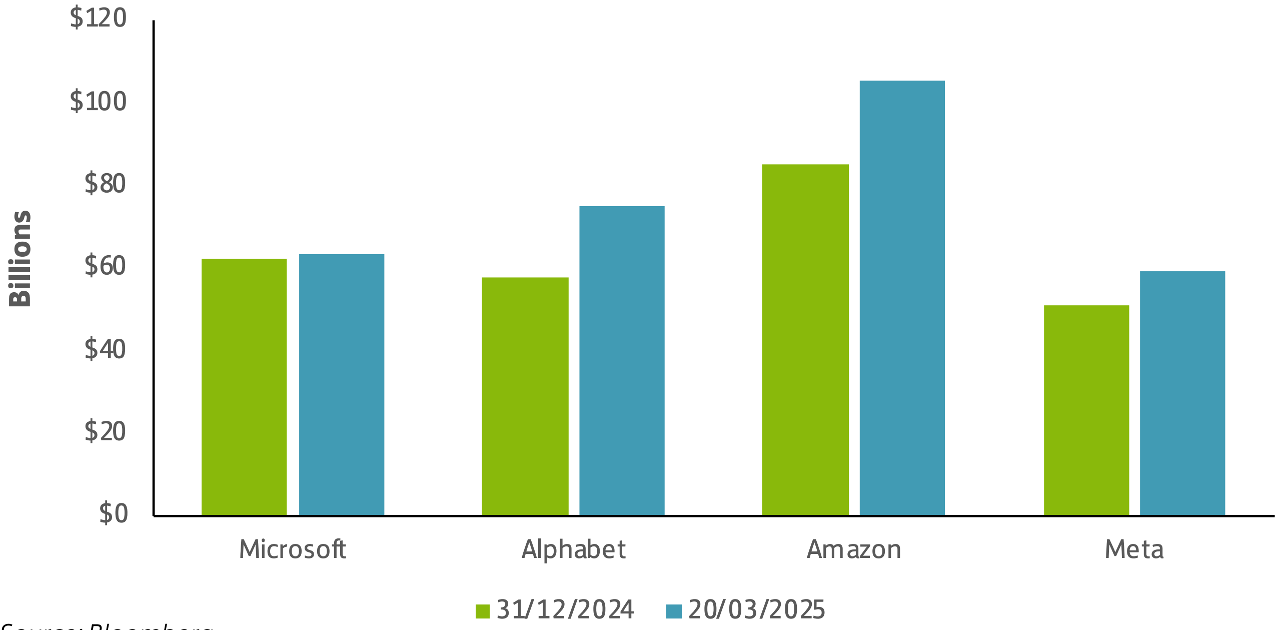


There does appear to be breakthrough innovations with DeepSeek's model. They optimised what is referred to as a Mixture of Experts (MoE) algorithm. MoE operates in the same way as a human brain by only activating specific areas depending on the task, such as language interpretation or visual perception. It means that fewer GPUs are required to run DeepSeek's chatbot as only part of the model most relevant for solving the prompt is loaded into the memory of the GPUs, resulting in fewer being required. DeepSeek also removed any human-in-the-loop element during the training of its model and relied on a process of distillation – using other highly trained models, such as ChatGPT, to train its own model. Further speculation arose around how DeepSeek may have used more GPUs than claimed due to the export constraints on Nvidia's most powerful GPUs into China.

A key aspect of this revelation is that DeepSeek's model was just about as good as OpenAI's, but not better. Furthermore, OpenAI have said that there is evidence to suggest its own models were used in the distillation process such that DeepSeek could not have achieved what it has without the more powerful and plentiful GPUs that OpenAI has at its disposal. Yet, Nvidia's valuation has not recovered from the DeepSeek moment. Therefore, the question remains: is Nvidia as critical to the AI race as once thought?

We can take cue from the large hyperscaler companies in Amazon, Microsoft, Alphabet and Meta, for their views on the developing AI industry. These companies are investing billions into data centres as they continue to push the boundaries of AI. Since the end of 2024 to March – pre and post the DeepSeek moment – these four companies on aggregate have increased their capital expenditure (capex) expectations for 2025 (Figure 2). On aggregate, analysts expect over $303 billion to be spent on capex by these companies alone, which has grown over 18% since before DeepSeek released their much cheaper model.

Figure 2: Capex estimates for this financial year pre-and-post DeepSeek. The hyperscaler tech companies have all increased their capex forecasts citing AI investment post-DeepSeek.



Source: Bloomberg

Not all this capex will be spent on data centres and GPUs. For example, Amazon has a significant logistics division that requires investment. Nevertheless, Andy Jassy, Amazon's CEO, stated in their earnings call on the 6th February that the "vast majority of that capex is on AI for Amazon Web Services." Nvidia's pre- and post-DeepSeek revenue forecast for financial year 2026 has also risen 3% as the CEO stated that customer demand for its new Blackwell GPU is "incredible".

Therefore, with increased spending from the Big Tech companies and incredible demand for Nvidia's most powerful GPU, why has the US market not recovered from the DeepSeek moment? The first point to note is that Nvidia's valuation on a forward price-to-earnings basis is still not exactly cheap at about 26. And there may be views that its best days of explosive growth are behind it (see Figure 1). Meanwhile, Chinese technology companies are performing very well, with the Hang Seng Tech Index up almost 31% so far this year. DeepSeek, if anything, has forced investors to reassess whether the US is the only place to gain exposure to the growing AI industry.

Then there is the AI chatbot race. Since DeepSeek, OpenAI has released new models and features that do appear to be market leading. However, there are other competitors. This prompts the question as to which company is going to win this race. Or if chatbots become commoditised, what's next? Artificial General Intelligence, and even Artificial Super Intelligence, may be the end goal whereby these models get so powerful that they can solve problems that have confounded human intelligence so far. Speculation arises, but two examples spring to mind in a Theory of Everything, so unifying relativity with quantum mechanics, or a cure for cancers.

But back to markets and it is clear that AI has landed in China. Consequently, investors are now considering stock markets outside of the US to gain exposure to the AI theme.

“This Time Is Different”

The most dangerous quote in finance. Usually, it is used to describe why a raging bull market trading at rich valuations will continue to rise. But given how Trump's second term as president has started, this quote seems apt.

Back during 2017 in Trump's first year as president, he almost used a rising stock market as a scorecard for how well he was doing. This time round, he's been quoted as saying we ‘can't really watch the stock market’ when talking about building a strong country. Tariffs have, so far, been a key factor in his strategy of building a strong country, although the stock market is deducting marks as it stands.

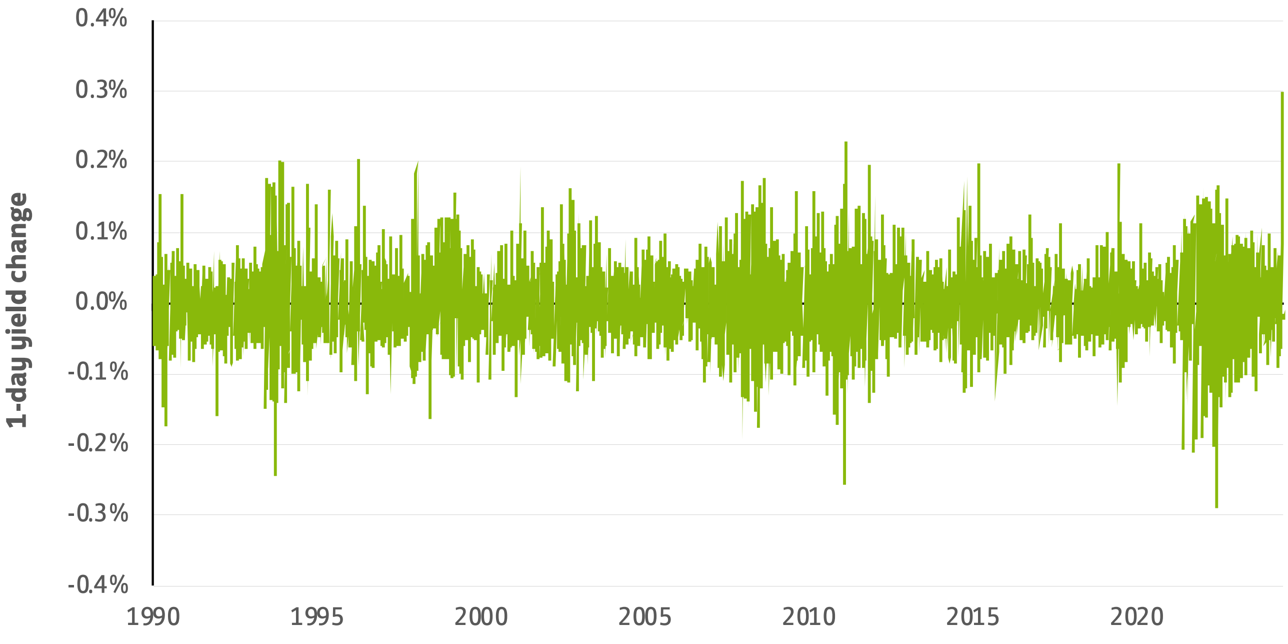
Outside of economic policy, the Trump administration has shifted significantly from traditional transatlantic alliances with Europe. In perceived alignment with Putin's Russia over Ukraine in the ongoing war, the US paused military aid and intelligence sharing with Ukraine. European leaders have stated they must be ready to support without US help in response. Furthermore, in a speech delivered by Vice President Vance at the Munich Security Conference in February, he was interpreted by officials as ‘picking a fight with Europe’ as Vance accused the continent of ‘undermining democracy,’ with this greatest threat coming from within its borders.

What this has done in Europe is galvanise politicians to move forward with or without US support, particularly when it comes to defence. Germany has been centre to this.

Led by the incoming chancellor Friedrich Merz, Germany has passed a spending bill amounting to €500 billion for infrastructure. And crucially, an additional package for defence expenditure that may exceed 1% of Germany's Gross Domestic Product (GDP) without being constrained by the "debt break", a constitutional rule that limited new borrowing. For a traditionally fiscally prudent nation, bypassing the constitution to borrow and spend more on defence is a seismic development, with thanks to the Trump administration.

As it stands, Germany's Dax Index has risen over 15% year-to-date, more than most other major stock markets and significantly more than the 3.5% decline in the S&P 500. Unsurprisingly, European defence stocks have led the charge, with the MSCI Europe Aerospace and Defence Index up 43% so far this year. But it was perhaps the move in German government bond yields that showed just how monumental this shift has been (Figure 3). Not since the reunification of the country has the 10-year German government bond yield moved as much in a single day as it did when the recent spending package was announced.

Figure 3: Daily change in the 10-year German government bond. It had its biggest one-day spike higher since the reunification when the spending and borrowing plans were announced.



Source: Bloomberg

Although interest rates spiked, Germany's debt remains one of the lowest yielding across major nations. Fiscal prudence since the GFC has resulted in a debt-to-GDP of close to 60%, which was forecast to decline to 40% over the following decades. For reference, the UK's equivalent metric is around 100% and is expected to rise to 150%. Germany doesn't have a debt problem, unlike the UK. Therefore, a rise in borrowing and spending has been seen as positive from an economic growth perspective.

Where will this dry powder be spent? Given that the US currently spends more on defence than all other North Atlantic Treaty Organization (NATO) allies combined, there is a lot of catching up to do for European members. Proposals are being drafted so that Europe's increased military spending stays within the continent, again reducing the reliance on the US. This is even more relevant as early discussions are taking place about an orderly handover if, or when, the US withdraws from NATO. It is thought that this withdrawal may stretch up to 10 years, which is a long time for markets to digest and accurately price the consequences.

Nevertheless, evidence points to a structural shift in the transatlantic alliance. Specifically for Germany, it has imported cheap Russian natural gas to power its manufacturing industries and relied on US military protection for decades. It has since re-routed gas imports to the likes of Norway and expedited the construction of liquified natural gas terminals. Alongside European allies, it now needs to enact a similar plan for its military.

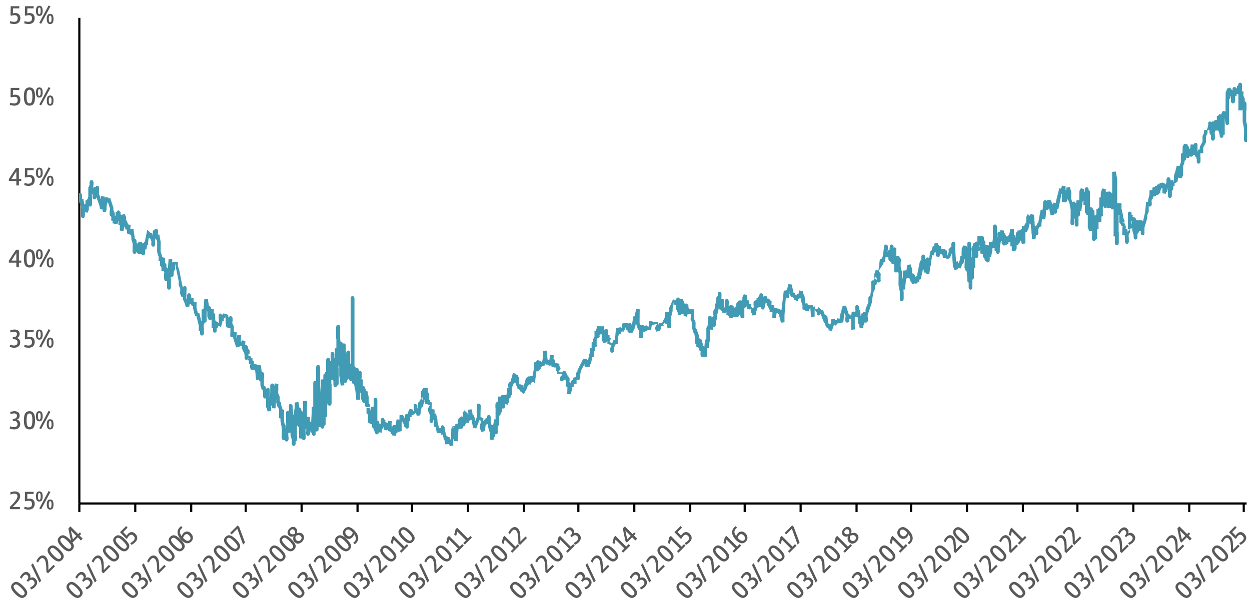
The Only Free Lunch

Diversification, said to be the only free lunch in investing, is widely attributed to Harry Markowitz, the Nobel laureate and founder of Modern Portfolio Theory. At least in the first quarter, diversification across bonds and world stocks did help reduce losses in portfolios as the S&P 500 fell.

It can be easy to overstate the significance of events in real time. Events that meant diversification was beneficial in the first quarter over simply passively investing in the S&P 500. However, it does appear that structural shifts are underway both politically and economically. Structural shifts also tend to develop over long periods of time and stock markets won't move in straight lines during the process.

As an example of a developed structural shift, there has been a focus on how big the US stock market has become relative to world stock markets. Indeed, at the turn of the year, US equites accounted for over 50% of the total of world equity market value, a trajectory that started at the turn of the GFC when that figure was only 30% (Figure 4).

Figure 4: The ratio of the US stock market capitalisation over the world stock market capitalisation.



Source: Bloomberg

A major part of this dominance – or US exceptionalism – has been due to the technology companies, such as Apple and Microsoft, and more recently Nvidia. There is no doubting their importance to world economies today. They generate so much cash and have products and services that are fundamental to many that they have almost become 'Too Big to Fail', using the quip about Big Banks during the GFC. These companies, and US equities generally, are likely to remain key allocations within a diversified portfolio.

But as we can see in the above chart, this decade-and-a-half long trend of a growing US stock market relative to the world has taken a big hit this year. There are other phases along this period where US equity dominance versus the world also reduced but then continued its march higher. After this year's sharp relative fall, we can see that over half of the world stock market is held outside of the US again.

In the short term, we should expect more volatility resulting from an erratic US president that seems determined to tariff the world. But solace for multi-asset portfolios comes from diversification as bonds now offer healthy interest rates. And for the first time in many years, there does appear to be alternatives to US stocks given the release of the German fiscal spigot and an emerging market in China that doesn't look too far behind in the AI race.

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