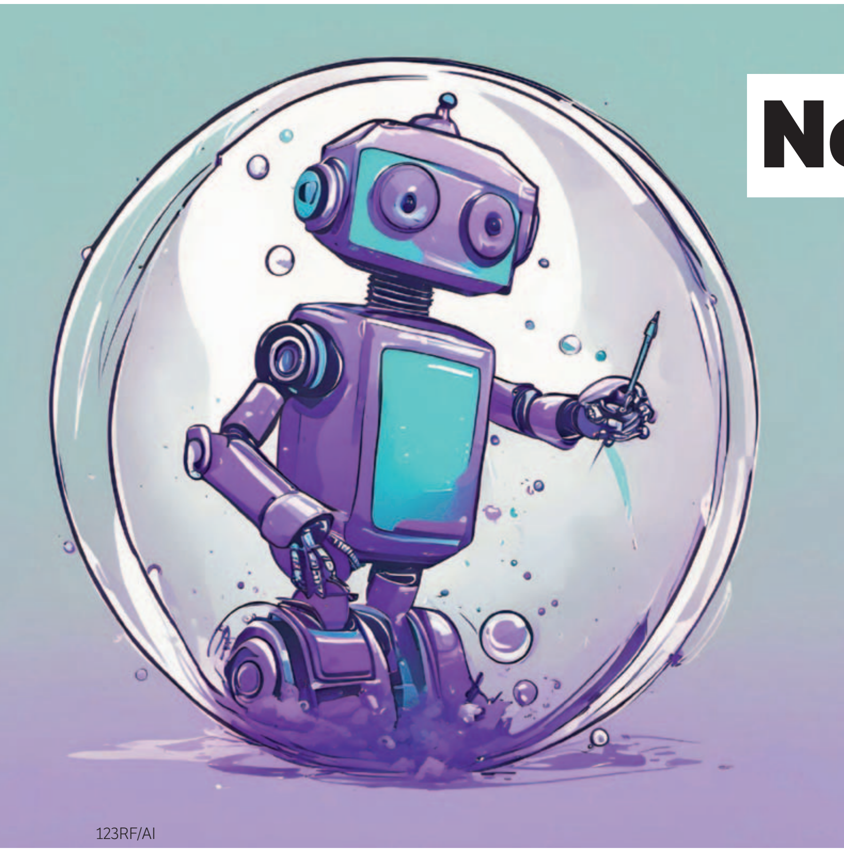
view from the Thames by Deon Gouws



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Nervous yet?

It's time to talk about the future of AI. In my column a month ago, I mentioned the debate around a possible bubble in AI stocks and when it might burst. I said it was a topic for another day. Today is that day.

"The US stock market looks very expensive right now. Nothing I've come up with is a slam-dunk explanation for the continuing high level of valuations."

This is a quote from Robert Shiller, the American academic who is credited with developing the cyclically adjusted p:e (CAPE) ratio, a widely used stock market valuation measure.

While it may look like something which the famed academic could have said in the past few weeks, the quote is from an article he wrote in The New York Times in August 2014. The S&P 500 is up more than 3½ times since then, a compound return of 12% a year over more than a decade. This just illustrates how expensive it would have been (as measured by opportunity cost) for any investor who sold out of equities based on the warnings of an expert with a Nobel prize in economics, awarded just a few months earlier for his empirical analysis of asset prices.

Fast-forward to the present day. Less than a month ago, Jeremy Grantham and Edward Chancellor co-authored a thought piece published on the website of GMO, the investment house of which Grantham was a founder, under the headline "Valuing AI: Extreme bubble, new golden era, or both".

Spoiler alert: the ultimate conclusion of this 15-page article can be found in the first paragraph: "The US stock market has now been in bubble territory for a prolonged period. Sooner or later, the bubble will burst and the price will return to its historic level."

There is not much need to read the rest of the article when you know exactly where the authors are heading. I have no idea how fast you read, but I've probably saved you at least half an hour. You're welcome.

For what it's worth, the GMO piece focused on the same CAPE ratio for US stocks that made Shiller famous. When he wrote his own bearish piece in 2014, the number was 25 (compared to a long-term average of about 18); today it stands at 40. Nervous yet?

For a completely different take, I refer you to a document published by Goldman Sachs in October last year with the headline "AI: In a bubble?" It runs to 28 pages of pretty small font (the disclaimers alone take up four pages).

That piece is more than a research report: it's a compendium of views from members of the firm as well as leading industry players. Practically every piece ends with a conclusion which ranges from cautiously optimistic to unashamedly bullish.

A firm like Goldman Sachs did not get to where it is today by being pessimistic, after all.

When is a bubble a bubble?

A much more balanced perspective comes from Howard Marks, founder and co-chair of specialist investment manager Oaktree — one of the best writers in the world of investing today. A couple of months ago, Marks wrote nearly 10,000 words under the heading "Is it a bubble?"

I would not do justice to his conclusion by trying to summarise it, so I will quote it in full: "There is no doubt that investors are applying exuberance with regard to AI. The question is whether it's irrational. Given the vast potential of AI but also the large number of enormous unknowns, I think virtually no-one can say for sure. We can theorise about whether the current enthusiasm is excessive, but we won't know until years from now whether it was. Bubbles are best identified in retrospect ."

As for positioning your portfolio in these circumstances, Marks advises caution, given the obvious uncertainties involved. "But by the same token, no-one should stay all-out and risk missing out on one of the great technological steps forward. A moderate position, applied with selectivity and prudence, seems like the best approach."

We have certainly started seeing some of the volatility that Marks warned about.

In spite of that, the S&P 500 is still trading within 3% of its peak at the time of writing. The next few months will indeed be interesting. Hold onto your seats. x

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