

Beyond the volatility: Why the AI story is stronger than ever

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Vik Heerah (VH), Chief Marketing Officer at Polar Capital, talks to Alastair Unwin (AU), Partner, Polar Capital Global Technology Team.

Q: VH: Starting with the macro, inflation has remained persistent, putting pressure on interest rates. We have seen government bond yields spike. This is not typically a helpful backdrop for equities. What are the implications for technology stocks?

A: AU: You are quite right, Vik, the macro environment has become a bit more challenging in the past few weeks and months. You have seen upward pressure on bond yields, with UK, French, German and Japanese yields at multi-year highs. If we move over to the US, we have had persistent inflation or pots of inflation being quite sticky. We have a new Fed Chair who has sounded a bit more hawkish and the market is now pricing some rate hikes at the upcoming meetings, although that number swings around quite a lot depending on the data. We have seen some interventions in the Treasury market from Secretary Bessent and in the foreign exchange market we have seen some big moves in FX, like the yen.

As a result, it has become a more difficult or a more challenging, choppy kind of macro backdrop for equities and for all risk assets. Does that matter for the tech sector and particularly for the AI story? I think there's a case to say that with hyperscaler capital expenditure (capex) at \$800bn this year going to \$1.3trn next year, according to NVIDIA, that the cost of capital as an input to the AI story has become a more significant factor.

You have also got the issuance from the hyperscalers themselves, which is going to run at something around \$250bn this year, up to \$400bn next year as a way to fund some of that AI investment, so it is definitely an input to the story. Where I think it is maybe not the be all and end all that some investors are worried about is that the AI story keeps getting better. We have seen fantastic and accelerating model progress, even with the launch of GPT-6 Astra, which is a great model. We have seen fantastic models from Anthropic. We have seen really strong open-weight models. It feels like AI progress is accelerating.

So while we are keeping a very close eye on the macro and it's definitely bringing crosscurrents to our story and the AI equity story, I think for now, it does not seem to be bad enough to offset or more than offset the sort of excitement we and other investors feel for the AI story. This is at a time when you are seeing despite, or maybe because of, all this supply of new compute, demand is still running ahead of that. That is a reflection, we think, of the enormous progress AI has made.

Q: VH: We have seen some volatility over the summer with the AI-related stocks, but that is against the backdrop of NVIDIA beating expectations yet again, as one example. How has your view on the AI story changed: has your conviction wavered in any way?

A: AU: The fundamentals remain very, very strong for the AI story and NVIDIA is a very good example. You have seen the fifth quarter of accelerating revenue growth, now growing more than 100%. The company guided to 70% revenue growth next year, in an unusual move for them, and said it could be as high as 100% if they were not supply constrained. That obviously has implications not just for their estimates but also for the whole supply chain, so the fundamentals remain very strong and that has been true more broadly. We have talked about model progress accelerating with the launch of new models – AI adoption has been extremely strong. If you go back all the way to February, that was the moment, at least according to Open Router, a company that provides model routing services, that at which agentic demand for tokens overtook human demand. Since then, agentic demand since February this year is up 14 fold. Human demand is no slouch either, up about 2.8 times, so we have just seen an explosion in demand. If you look at web traffic, it was May when agentic web traffic overtook human traffic.

That was expected to happen sometime next year. If you roll this forward at the current rate, in five years' time, there could be a thousand times more agentic traffic than human traffic. It's a massive AI adoption, which has also – crucially – been reflected in revenue. We follow Exponential View, and they have put together some numbers to suggest that overall AI revenue, deduplicating the various different parts, is maybe running at \$230bn at the moment, up three and a half times in the past 12 months, so really just very good fundamentals in AI. Why then have we seen such volatility if the fundamentals are so strong?

I think that is best looked at as a momentum unwind, as the first half of the year saw some very strong returns. Then you have seasonality – positioning became very one sided. You certainly had some pockets of speculative excess with retail investors' use of options and levered DRAM ETFs and all that kind of stuff. And some of that, we think has now washed out. We have seen a very sharp drawdown in momentum – tech momentum has almost halved from June highs. We have seen net leverage for hedge funds getting back to the first percentile on a 12-month lookback. We have seen something of a cleaning out and I suppose a reset and some of that speculative excess being washed out of the market while the fundamentals remain very strong.

Q: VH: There have been a lot of comments around the levels of capital expenditure by the hyperscalers. The numbers are phenomenal, to be fair, but can that generate a return on the investment over time? What's your view on that? How do you respond to that concern?

A: AU: The return question is extremely interesting and there are multiple facets to it for the hyperscalers. One thing we always note at the outset of these questions is it should tell us something when the smartest companies in the world are investing so aggressively in this technology about what they think the future path of it is.

We would take that as a massive vote of confidence in the future monetisation of AI. The bull case is that you are already seeing returns. You have seen aggregate cloud revenue growth accelerate from 39% in Q1 to 48% in Q2. At enormous scale, you have seen record additions of net new ARR (annual recurring revenue) dollars and you have seen decent margins. You have seen very strong pricing of compute in the neo cloud market. If you go back about 12 months, people were pricing deals at maybe \$10m or \$11m per megawatt per year. They are now being priced at \$16- 25m – so compute has been repriced. The clearing price has been reset up because models are more capable, and you can do so much more with that compute versus what you could do 12 months ago. So in that sense, the returns are very strong for hyperscalers. You might even say there's a case they are underearning because most of their business is priced at the old rates and the prevailing spot rates are much higher. There is certainly a bull case that the return on investment (ROI) is going to be very strong. That said, there's also a bear case, and the bear case suggests that this capex is not wholly about this being an enormous new market, although we and the hyperscalers clearly think it is. There is a defensive element to this capex. For all of the new markets that were created, these companies all have very large, very profitable businesses that are to some degree at threat, or at least potentially at threat from AI, whether that is a search business, a social networking business, their existing cloud business, or even an e-commerce business.

There is the degree to which these companies need to do that capex for strategic defensive reasons. They are also going to see more competition. I mean, it's ironic that the cloud market was actually a pretty small market in terms of the number of participants. You had two big players and Google as a fairly distant third. We now have a whole new type of competitor in the form of the neo clouds, which today are not that large, but they are being supported financially and technologically by NVIDIA, who do have the balance sheet and the scale and the market position to really make them into a fourth category of player or a fourth player potentially.

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So you could see a world in which the cloud market is much more competitive, even if AI as a whole is adopted very widely and the revenues may be enormous – we do not yet know that. I think one thing we are a bit concerned about, and the market is as well, is that with the exception of Google, the hyperscalers do not have their own frontier models. If you look at where the returns have accrued so far in the AI story, OpenAI and Anthropic are doing over \$100bn of run rate revenue between them already three and a bit years in. That is not a layer at the moment at which the hyperscalers are participating in a meaningful way. The question is where the eventual economic shakeout will occur – we can't know yet. In a bear scenario they are reduced – if that is the right word – to the dumb providers of compute. I am not sure that is quite how bad it will be, but there is a bear scenario there as well.

Q: VH: Now, reminiscent of the DeepSeek moment from a few years ago, we saw the launch of an open access Chinese model, Kimi K3, earlier this year. Presumably that is good for AI adoption, but does it threaten the economics of the US-based companies that you are investing in?

A: AU: This is probably the most hotly debated question in the market at the moment. The evidence is that returns to frontier intelligence so far have been very large and growing very fast. The best proof point of that is the \$100bn of revenue run rate that OpenAI and Anthropic have been able to generate. Now, the question is, does that persist in a world where you have more competitive, often Chinese open-weight or open-source models, slightly behind the frontier but very close to it. So far those models have been more or acted more like complements to the frontier models. There is a case that they become more substituted for some tasks. What we are excited about is the fact that every new generation of frontier models has opened up more economically valuable, more useful tasks. It has not been the case that you have seen cannibalisation of the old frontier and not the new frontier, so we think the market is getting much bigger at a faster rate than the old stuff is getting commoditised.

That does not necessarily have to persist forever, but given the acceleration in progress at the frontier, we think there is a good chance that continues for some time. There are massive returns to being at the frontier and those will continue. There are also some technical things around. While two models may look quite similar on a benchmark, if you are doing a long horizon task when you compound up small differences over time, there can actually be a very meaningful difference. Models like Kimi K3 are large models and they are expensive to serve. This is not quite the same price gap as we had with the original DeepSeek shock, when it really did appear to be 95% cheaper.

Here you have got to serve the models. You have to pay Kimi a 30% fee as well if you are using them at scale, so there are reasons that although the model may appear cheaper on a per token basis, it is less token efficient. It is not on the frontier and it may require more expensive human intervention. There are a whole host of reasons why, in practice, it can still make economic sense to use a frontier model. That is what is driving the growth of this market, we think, even as open-weight models are getting better all the time and are playing an increasing role in the token share.

Q: VH: We have seen a lot of change very quickly in the last few years. Looking ahead, there are new models to launch and potential IPOs coming up from Anthropic and OpenAI. What is your outlook for the next 12 months and how are you positioning the portfolio?

A: AU: We are very excited about the next 12 months, fundamentally because of that AI progress point. So long as the leading models continue to get better and open up new use cases, new economically valuable work, longer and more complex autonomous tasks, we think that they are going to continue to grow very, very quickly and play a profound role in the creation of new science, which you have started to see the opening up of brand new markets. and that is something that investors should be extremely excited about. I think if you take our AI maximalist view of the world, there will inevitably be an error endemic to all new technology cycles, volatility and pushbacks on the story counter narratives and those things are all natural and healthy. They do not feel great at the time when you are having a more difficult month rather than a better month, but those are very much part of the tech story. For us, this is the biggest market we have ever seen and the fastest-moving technology we have ever seen, and that is extremely exciting when we are thinking about returns. If you think we are going from, let's say, \$230bn of revenue, or revenue run rate, today to over \$1trn or beyond, as we think we will get to in quite short order, you need more supply and that supply in the form of models, in the form of compute, in the form of capital. All of those things come on in lumps and the return on that capital, the return on that new model is always uncertain. There is an inherent uncertainty to this industry, as with any industry scaling that you cannot avoid. You need to be diversified, you need to be liquid and you need to have an anti-hubristic approach because we cannot know all the answers in advance.

We have even seen within the sector itself massive vertical integration, which says to us that the companies themselves may not know who wins yet. You have seen the model makers building their own chips and trying to build their own cloud. You see NVIDIA building its own models. You have seen the hyperscalers trying to get into their own models and then maybe pulling back.

This is a very fluid situation but we think that the prize is very large and would encourage investors not to lose sight of the opportunity. Being mindful that over the next few weeks, we are in a tough period because seasonality into the midterms is always tough. The market, I think, on nearly every occasion, has been stronger in the 12 months following a midterm election.

There will be volatility and we need to be prepared for that. If that is something you are unable to deal with or do not want to deal with, then this probably is not the right sector for you. However, if you are willing to accept volatility being part of the story, then this is still an extremely exciting equity story.

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