**HSBC Think Wealth** CIO Exchange

Willem Sels, HSBC Bank Plc and Torsten Slok, Apollo

Willem Sels

Thank you, Torsten, for sitting down for this CIO exchange. Now, when I look at the global economy and markets as well, what has been really driving it is that AI-led investment. But for that investment to continue, obviously people need to find it useful, and there need to be productivity gains. So, what are you seeing in the companies that you invest in, in terms of earnings and productivity growth?

Torsten Slok

AI is obviously a revolutionary technology. It's having a very significant impact on consumers. It's having a very significant impact on companies. And the companies that we own at Apollo, we have invested very significantly in AI, in getting those productivity gains and in getting those increases in profit margins and also getting those increases in earnings growth. And we are beginning to see the early signs of the AI investments beginning to pay off.

That's, for example, investments in work processes; it's investments in customer services; it's also investments in, broadly speaking, compliance, legal, consulting parts; basically, trying to make companies even more efficient in our portfolio.

And of the roughly 50 companies that we own, across the board, there are early indications that we're beginning to see returns in the form of better profit margins, also higher earnings growth. And all that is something that we expect to see also over the coming quarters and years ahead. So, yes, it is on the ground and in the companies that we own – it is the expectation, and early signs are showing the case that AI is indeed beginning to pay off.

Willem Sels

Fantastic. So, that addresses one question and one concern of the markets. The other one is the funding costs. And, of course, the investments have pushed up the bond issuance together with the government bond issuance and therefore pushed up the yield curve. How concerned are you about this? Because, for now, the macro data do not say that credit standards are tightening and lending conditions are tightening. What are you seeing in the real world?

Torsten Slok

This is very, very important because all the compute that's needed to support and run AI requires a significant amount of data centres. And exactly as you're saying, and as we have been talking a lot about, you and I, namely hyperscalers, namely those who are building the data centres, they require a lot of financing. So, they're issuing a lot of bonds in public markets that are competing with government bonds. And the consequence of that is that they are now sucking dollars out of government bond curves. So, one consequence of that is that's beginning to put some upward pressure as investors put money instead into hyperscaler debt, instead of putting it into government debt.

And at the same time, we also have upward pressure on the yield curve from inflation being higher-for-longer. And we also have upward pressure from fiscal problems. Basically, governments around the world have too much debt. And that's also exerting upward pressure on the yield curve.

So, the conclusion is: there are three forces putting upward pressure on yields everywhere; namely high inflation; hyperscaler issuance that's crowding out demand for government bonds; and at the same time, the fiscal challenges are also putting upward pressure. And that means, therefore, that the funding costs are gradually moving higher, not only in the US but also in Europe.

The good news is that the returns on AI are expected to still be significantly higher, 10%, 20%, 30% in many cases. So even if you have the yield curve moving 50 basis points or 100 basis points higher, it's still not enough to slow down the US economy, because the AI returns are still expected to be higher, and therefore the spending on AI will still also be higher. So, for that reason, we could still have interest rates higher for quite an extended period and still have a very good economy because AI spending continues to be so strong.

Willem Sels

So, bond yields are already reasonably elevated, with high real yields. So, therefore, we like a strategy where we lock in those yields. But, of course, the returns are probably just going to be that bond coupon clipping, because the real yields are not going to fall, the central banks are not cutting. At the same time, the bonds are also less negatively correlated with equity. So, they are less powerful diversifiers. That means that a lot of our clients are going into alternatives to find new sources of return, new diversifiers as well. How broad-based is that flow into alternatives?

Torsten Slok

This is a very important development that we've seen over the last 6–9 months, namely that if we think about this 60–40 portfolio; 60% equities, 40% fixed income, it has been the case for many, many years that normally when stock prices went down, then interest rates would also go down, meaning bond prices would go up, and therefore there would be an inverse correlation, so that you would be hedged – if one asset class went down, then the other one would go up, and vice versa.

That has changed quite significantly because now you both have a strong economy, and at the same time you also have high upward pressure on inflation. So, that means that we've had some very significant inverse correlation where suddenly the correlation between stocks and bonds have actually started to move together.

The consequence of that is, of course, logically, that it's a good idea to diversify to other asset classes that are not in the 60–40 portfolio traditionally. And alternatives, of course, is a very obvious way to do that, both in private credit, also in private equity—go to types of assets that are not, in that case, directly related with what you're seeing in the 60–40 portfolio. And that could, for example, be asset backed finance. It could also be direct lending, especially to higher quality companies. It's important to focus on higher quality as when you have interest rates higher for longer, it needs to be companies that can pay back the higher debt servicing costs.

And in private equity that also means likewise higher quality companies, private equity strategies that generally will be and should be doing better, especially in this very unique environment we have where the correlation between what's going on in the 60–40 portfolio has reversed from what has been for a long, long time. So, from that perspective, diversifying into alternatives, is at the moment, also a good idea.

**Willem Sels**

Diversifiers to broaden the opportunity set. So, let's talk about the geographical diversification. When people think about AI and the innovators, they automatically think of the US, and there must be many beneficiaries in the US and opportunities in the US equity market. We also like North Asia, where you've seen strong earnings growth on the back of that AI innovation. But if it is something else, if it is the AI adopters that are going to see that productivity growth, you can find those around the world. So, where do we need to look? Do we still focus on the US, or do we broaden?

**Torsten Slok**

This is really important because it's obvious the US is the AI producer. And now the question becomes: they have produced a phenomenal technology. But the adoption is also happening very rapidly around the world, including, in particular, North Asia, but also in Europe, also in Canada, also in Australia. Countries around the world are adopting AI at a very rapid pace, and surveys show, indeed, that in some countries outside the US, the adoption rate has actually been faster, not only for consumers but also for corporates.

So, now the homework is for investors, and exactly for those who are looking at "where should I go?" to figure out okay well, where is it that we are seeing higher earnings growth on the back of the AI adoption.

And indeed, North Asia has been one very important region, but also in certain sectors and certain countries in Europe, we're also seeing the same. And in certain parts of, in particular, also Australia and Canada, and their economies, we've also seen sectors, especially in the service sector, where we've seen implementation that have started to show signs of improvements, and therefore of returns of the AI investment.

So, yes, ultimately it is exactly all about what you're saying namely, where are we seeing the returns begin to show up? And that is exactly telling you that there are adoptors around the world that can be benefiting. And it's not only the US producers that are benefiting, but all those that are adopting around the world are in the same race of trying to figure out how do we implement AI in the most profitable way, where we increase margins, we increase earnings growth, and we ultimately increase revenues so that we can get the most benefit out of this phenomenal technology that we've had now for the last several years.

Willem Sels

So, the opportunity set is broad, and the trend is up. Thank you very much for sharing your optimistic view and your experience from on the ground.

Torsten Slok

Thank you.