# Outside the Spotlight

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*Renewed hostilities mean the US conflict with Iran remains a significant source of uncertainty. Energy markets are back on edge.*

*Despite geopolitical and consumer concerns, earnings have remained strong. But they have also benefited from the way companies account for large capital investments.*

*Businesses benefiting from AI component shortages have been highly rewarded. But many of these are historically cyclical businesses.*

*Companies perceived to be less vulnerable to AI disruption have also delivered strong performance this year.*

Artificial intelligence (AI) remained a defining theme of financial markets during the second quarter. Despite geopolitical tensions, inflation concerns, and questions about the economics of AI, equity markets recovered strongly. Investors once again rewarded businesses expected to benefit from the AI investment cycle and those believed to be less vulnerable to AI disruption.

Renewed hostilities mean the US conflict with Iran remains a significant source of uncertainty. While tensions appeared to briefly ease, energy markets are once again on edge. The greatest impact continues to be higher energy costs. Higher energy costs ripple through the economy by raising manufacturing and transportation costs. While consumers have remained remarkably resilient, prolonged pressure on household budgets will eventually weigh on the broader economy.

Despite geopolitical instability and consumer concerns, corporate earnings have remained strong. Companies continue to protect margins and profits through volume and pricing adjustments. However, earnings have also been boosted by AI's insatiable demand for capital and the way companies account for large capital investments. One company's investment becomes another company's revenue. Revenue is recognized immediately, while the company making the investment spreads the cost over many years.

The buildout of AI infrastructure also continues to create shortages of key components. Businesses benefiting from these shortages have been highly rewarded, with investors assuming today's favourable conditions will persist indefinitely. One of the latest bottlenecks has been memory. But memory has historically been among the most cyclical segments of the semiconductor industry. Demand normalizes, shortages become surpluses, and pricing power can quickly reverse. While AI is undoubtedly creating a tailwind, history suggests that cyclical industries rarely escape the forces of supply and demand.

It is not only key suppliers to the AI industry that have been rewarded. Companies perceived to be less vulnerable to AI disruption have also delivered strong performance this year. The market's rationale varies by sector, industry and company. For example, Canadian banks are seen as benefiting from regulatory barriers and deeply embedded customer relationships. Railways and pipeline companies own irreplaceable assets that would be difficult and expensive to replicate. These businesses may embrace AI to improve productivity, but their competitive positions cannot easily be replicated by technology alone.

*The intense focus on AI has left some other high-quality companies trading at valuations not seen in years.*

Outside the AI spotlight, the picture has been very different. The intense focus on AI has left some other high-quality companies trading at valuations not seen in years, if not over a decade. In many cases, earnings for these businesses have remained intact or continued to grow, while share prices have declined significantly. For years, it was difficult to justify owning many of these companies given their sky-high valuations. Many are now becoming investable again.

*Slowing economic growth and high unemployment in Canada would normally support lower interest rates. But persistent inflation is keeping any interest rate cuts on hold.*

The outlook for fixed income has been equally challenging. Slowing economic growth and high unemployment in Canada would normally support lower interest rates. But inflation persists, and renewed US-Iran hostilities threaten to accelerate it further. Balancing these competing forces is not straightforward, keeping any interest rate cuts on hold. The rise in bond yields since the war started has validated our cautious fixed income positioning. At the same time, higher yields are beginning to create more attractive opportunities. We continue to evaluate these opportunities carefully.

*Periods of narrow market leadership often create attractive opportunities elsewhere. These are the opportunities we remain focused on.*

The second quarter served as another reminder that financial markets do not always move in lockstep with underlying business fundamentals. While investors continue to reward AI-related spending and near-term earnings, periods of narrow market leadership often create attractive opportunities elsewhere. Our focus remains on navigating this environment with caution, carefully weighing potential returns against the risks involved. Rather than chasing the market's most popular themes, we continue to look for high-quality businesses where long-term fundamentals remain intact and valuations have become increasingly attractive.