Is Nvidia really the ‘most important stock’ on the planet?

Nvidia’s staggering growth and surging share price is drawing comparisons to previous bubbles. How should investors approach this mania?

Goldman Sachs called it “the most important stock on planet Earth.” Veteran tech-analyst Dan Ives of US research firm Wedbush called it “probably the most important earnings that we’ve seen from any company in the market for the last five years.”

Whatever hyperbolic phrase you prefer, it’s fair to say that there was just a little bit riding on the December quarter earnings result from artificial intelligence chipmaker Nvidia.

Bubbles are generally popped by rising bond yields. We’re not there yet. David Rowe

Thank goodness then that it delivered – and how.

December quarter revenue more than tripled to $US22.1 billion ($33.7 billion), while earnings came in about 12 per cent ahead of market consensus as demand for Nvidia’s AI chips surged. Companies such as Amazon, Meta Platforms (owner of Facebook), Microsoft and Alphabet (owner of Google), which are rushing to invest in AI hardware and surf this boom, account for nearly 40 per cent of Nvidia’s revenue.

Just as important, Nvidia also said revenue in the current March quarter would come in at $US24 billion, better than the $US22 billion expected by Wall Street analysts. Taken together, the December quarter result and the March quarter guidance give investors’ confidence that the AI hype is starting to translate into serious dollars.

Nvidia shares surged 10 per cent in after-market trade. If those gains stick when Wall Street opens on Thursday night it will take Nvidia's year-to-date share price gain to 48 per cent, meaning the company's market capitalisation has increased by about $US600 million to $US1.8 trillion.

This is stunning growth, and of course helps explain the broader rally on Wall Street since the start of November. While the so-called Magnificent Seven tech stocks are correctly credited with driving the S&P 500 higher, Nvidia's stunning gains mean it has become the most magnificent of all.

But can a stock like this really keep running? Or is this AI rally starting to get into bubble territory?

The speed with which Nvidia and its fellow six tech stocks has risen has naturally given rise to much commentary on comparisons between this AI bubble and previous bubbles, such as the dotcom boom/bust between 1998 and 2000.

Bubble-in-waiting

Bank of America's Michael Hartnett says that on many measures, this is more a bubble-in-waiting. While the Magnificent Seven's price gain of 139 per cent is approaching the Roaring 20s bubble of the 1920s, and the Nifty Fifty bubble of the1970s (where prices rose 153 per cent), this bubble is still a fair way behind the dotcom period (gain of 192 per cent) and even the pandemic-era FAANG bubble (gain of 229 per cent).

And yes, the Magnificent Seven are expensive, trading around 45 times earnings as a group, while Nvidia is around 30 times. But the FAANG stocks – comprising Facebook, Amazon, Apple, Netflix, and Google – peaked at 60 times, and the Nasdaq100 peaked at a staggering 205 times during the dotcom boom.

If this is a bubble – or at least a baby bubble – then perhaps the most important question is what could pop it.

Hartnett looks to interest rates: in 12 of the 14 bubbles he has studied, dating back to the South Sea Company bubble of the 1720s, bond yields were rising as the bubble peaked and popped. Bond yields have risen markedly since the AI bubble started in late 2022 with the release of ChatGPT, but Harnett says real interest rates – currently sitting around 2 percent – need to rise to between 2.5 per cent and 3 per cent to "end AI and Magnificent Seven mania".

The other possibility is Nvidia, and other AI leaders fall victim to their own incredible growth, as Vantage Point chief investment officer Nick Ferres points out.

"NVIDIA has a clear edge or advantage over its competitors. We also have no doubt that the euphoric positive speculative feedback loop behind the AI mania could push valuation multiples beyond what seems remotely plausible," he says.

"However, if returns on capital and profit margins are extremely high, other companies will enter the market to compete. That is how capitalism works."

That's happening. AI chip supply is increasing and the likes of OpenAI and Meta Platforms are looking to build their own AI chips. But demand remains strong, and how quickly others can catch Nvidia is obviously not clear.

Ferres also quotes billionaire George Soros, who said, “every bubble has two components: an underlying trend that prevails and a misconception relating to that trend.”

When it comes to AI, the fundamentals are clear – surging demand and, for now at least, limited supply. The challenge for investors, then, is determining whether there’s a related misconception, such as whether a company like Nvidia deserves a multiple that prices in endless growth, or whether the monetisation that sustains demand for chips flows as naturally as expected.

Reference: Australian Financial Review. Article by James Thomson published Feb 22, 2024.