JAG Growth Equity Thematic Insights: Q3 2024

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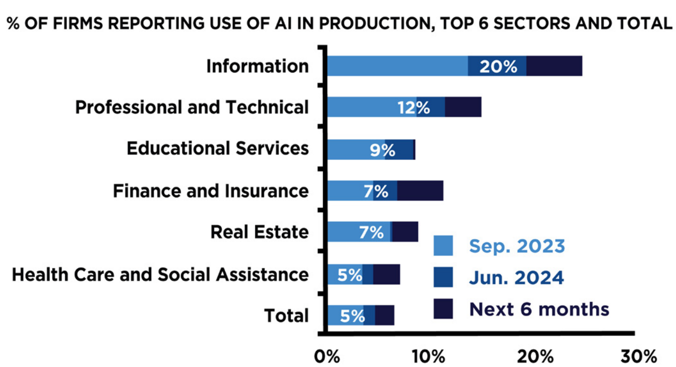
Generative AI: Q2 Takeaways and Market Dynamics

We have extensively covered Gen AI developments in our previous **Insights** pieces and Q2 earnings season commentary was consistent with our expectations. Almost all of the world's largest companies continue to prioritize AI infrastructure build out. For example, Microsoft's (MSFT) most recent quarterly capex was $19B and management noted that "cloud and AI-related spend represents nearly all of our total capital expenditures." Alphabet (GOOGL) and META (formerly Facebook) also signaled that they would maintain elevated levels of AI-related spending. We believe investments into AI will remain robust for the foreseeable future as the adoption expands outside of Tech as well.

AI Adoption Still in Very Early Stages



Source: J.P. Morgan Research, Census Business Trends and Outlook Survey

In terms of our portfolio positioning, outside of the names highlighted in our previous Insights pieces (including NVDA, AVGO, AMD, AXON), we also recently purchased NextEra Energy (NEE), the largest US utility firm and one of the world's largest renewable energy producers. Along with the company's competitive advantages such as the larger scale and a proven track record of project execution, we also believe NextEra is well-positioned to benefit from AI/data center proliferation in the US. Newer and larger data centers consume more and more power, straining the US electricity grid. Faster growing electricity demand, particularly for renewable energy, should directly translate into higher backlog and demand for NextEra.

Despite these large investments in Gen AI, monetization is still very much a question. Should companies struggle to effectively monetize their Gen AI products, there is a risk that AI capex falls sharply. We could draw a historical parallel to the dot-com era when people understood the potential transformative power of the Internet but underestimated the length of time it would take for the Internet to enable profitable business models. We believe the existing infrastructure and customer base should allow for a more rapid Gen AI adoption versus the Internet, but the questions surrounding monetization could lead to greater volatility in the near-term. Another risk we see is elevated investor expectations/valuations, as evidenced by Nvidia's earnings results. While the company handily beat expectations and continued to show very rapid data center growth, the stock has sold-off likely due to a smaller magnitude of the beat relative to recent quarters.

Weighing in on GLP-1 Winners and Losers

If you have read our previous **Insights** pieces, it should come as no surprise that we are firmly in the "GLP-1 believers" camp. The past few weeks have shed additional light on the potential winners and losers of this trend. Eli Lilly's (LLY) most recent earnings report provided further evidence that they are positioned as a key beneficiary of GLP-1's. Ongoing investments in expanding capacity for Mounjaro and Zepbound have helped the company close the gap between supply and demand. This translated into more scripts being filled for their blockbuster medicines and a $3B increase in the company's sales outlook for 2024.

Lilly also continues to make strides on demonstrating the benefits these drugs offer beyond just treating diabetes and obesity. Over a three-year period, LLY found that pre-diabetic patients who took their GLP-1 drugs had a 94% lower risk of progressing to type 2 diabetics than patients who focused on diet and exercise alone. We believe this data provides a compelling argument that tackling healthcare challenges is best done through a proactive approach. While sound in logic, this view is somewhat at odds with the current status quo across the US healthcare system where overwhelmingly patients get sick and then seek treatment in a reactive manner.

While this data is a clear win for LLY and patients who are at risk of being diagnosed with type 2 diabetes, the implications are quite opposite for other companies. We have previously hypothesized that diabetes device makers could be negatively impacted by the rise of GLP-1's and this data seems to confirm that view. As the number of people taking GLP-1's grows, this is likely to curb the rate at which these individuals progress to type 2 diabetes and have a need for products such as continuous glucose monitors or insulin pumps.

The More Discerning Consumer

There are numerous signs that consumers are becoming more selective with their spending. For example, after a huge post-COVID ramp in travel spending, companies like Airbnb (ABNB), Expedia (EXPE), and Booking.com (BKNG) reported slowing demand in their most-recent quarterly reports. Similarly, footwear and apparel brands like Lululemon (LULU), Nike (NKE), and Under Armor (UA) appear to be losing market share to more innovative competitors like Abercrombie & Fitch (ANF), Deckers (DECK), and On Holding (ONON). Fast-food restaurants and packaged foods are also experiencing slackening demand, resulting in disappointing results and guidance from McDonald's (MCD), Starbucks (SBUX), Yum! Brands (YUM), and Diageo (DEO). These food and beverage producers could be suffering from more price-conscious consumers, combined with some growing headwinds from millions of patient prescriptions to GLP-1 diabesity treatments. Overall, while we are cautious on so-called "junk food" purveyors, we generally think consumer spending habits are normalizing back to pre-COVID levels. In the process, they are revolting against brands that they perceive to be overpriced versus the value delivered.

Commercial Real Estate: Are We Nearing the Bottom?

While we have been cautious on banks and commercial real estate for over a year, there are signs that a more investable bottom could be on the horizon. Somewhat ironically, our incremental optimism is being driven by some unpleasant headlines. **As the Wall Street Journal recently reported**, banks and lenders are seizing distressed properties at the highest rate in nearly a decade. While this might seem concerning, it is a positive sign. Banks typically delay foreclosing on properties until they are confident in being able to sell the properties quickly. We believe the uptick in foreclosures implies that the overall market for commercial real estate could be in the process of stabilizing – albeit at lower prices than many property owners would prefer. If we are correct, there could be some attractive investment opportunities in the coming months.

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Disclosures

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Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/expertise without substantial reliance on non-Veteran-owned businesses.

About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm in St. Louis.

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