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EP 197 | From Invisible Hand to Heavy Hand: Government Stakes, AI, and the Shifting CapEx Cycle in U.S. Markets

[00:00] Rob Campbell: Coming up: a conversation with U.S. Equity Portfolio Manager Grayson Witcher, all about the intersection of policy, innovation, and the current CapEx cycle. We discuss how government involvement—from funding early research to shaping defense innovation—intersects with today's surge in corporate investment and what that means for investors navigating today's environment. Stay tuned for insights on where the invisible hand meets the heavy hand of public spending, along with some examples of where Grayson and our U.S. team are seeing opportunities today.

[00:36] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:51] Rob Campbell: Grayson, welcome back to the podcast.

Grayson Witcher: Thanks, Rob. It's great to be here again.

Rob Campbell: Here's something that maybe not all of our listeners know about you. When you were fresh out of school and starting your investment career, you didn't start on the equity side. You were on a different part of the capital structure. You started as a credit analyst.

[1:08] Grayson Witcher: It seems like a long time ago in a different world, but in many ways, it's actually pretty similar. When I switched to the equity side, you're speaking with management teams, you're doing cash flow models, you're trying to understand themes out there, you're trying to understand how the cash flows of a company are going to shift over time, and understand the risks in a business. It's the last stage that is a little bit different, where you know what you need to know about the business itself. Then you have to determine which part you're going to invest in. Is it going to be the corporate bonds? Are you going to invest in equity in that part of the capital structure? So, while it seems like it's vastly different in many ways, if you do real in-depth credit research or equity research, a lot of the stages are the same. The transition was relatively easy. That was a great background and a really good way to understand risk better, I think.

[1:59] Rob Campbell: I can imagine. And those who listen to the podcast will know that we had our global credit portfolio manager, Brian Carney, on the podcast recently. I think he summarized current conditions in credit markets as being both "convergent and complacent." That was his assessment. You mentioned that they're not terribly different. I'm curious whether you agree with Brian and whether that extends to equity markets as well.

[2:20] Grayson Witcher: I don't think Brian knows what he's talking about. No, I'm just kidding. I agree with Brian. Credit spreads are tight when you look at the market. Certainly, I follow it a lot less closely than Brian does these

days, but I still keep tabs on it. When you look at investment-grade spreads, for example—or as I'm sure he's mentioned many times—they are on the tight end of things. High-yield spreads are also on the tight end of things, indicating you don't have to pay a big premium to get people to buy debt. So that generally means that people aren't pricing in a whole lot of risk. They're willing to take on that risk for a lower yield. One thing that's kind of interesting is that we seem to be at a bit of an inflection point. So while credit spreads are quite low and people seem quite complacent, it seems that we might be in a new era of higher capital spending, which impacts both equities and fixed income. When you look at what's happening in the world right now, there's a bunch of themes that seem to lead to higher capital spending, which is kind of unique. The last decades has really been a period of lowering capital spending, just-in-time delivery, so you have less inventory in your system.

[3:27] Rob Campbell: There have been people and prognosticators talking about buybacks and how that is the opposite of investment and how we should have more investment. It sounds like that's shifted.

[3:36] Grayson Witcher: You're exactly right. And you think about what are some of the things that are happening now? Well, artificial intelligence or AI—of course, that's enormous amounts of spending that you're seeing. You're seeing nationalization or reshoring of assets, or you're building semiconductor fabs in the States, or you're building auto plants. Spending on space—you're seeing SpaceX or Amazon building rockets or building satellites to feed these internet networks. Self-driving vehicles are expensive. You're going to have a fleet of Waymo cars that drive you around San Francisco or Austin and that's going to cost a ton of money. We're unfortunately seeing a lot more defense spending in the world now. So, you're seeing a number of those big capital projects that are starting to take a lot of money and a lot of capital for bondholders and equity holders. I guess the real question over the next five or ten years is going to be: is the return going to be there? You get a pretty good initial return, which is why people do it. The first couple of data centers you build or AI data centers you build are great. People are excited. You can capitalize on that somehow and make money off it by selling subscriptions if you're ChatGPT or Anthropic. But the question is more: well, that's great for the first ten or twenty or thirty billion dollars. But if you spend four hundred billion dollars next year between the big companies, and then you spend four hundred billion or five hundred billion the next year, and then the next year, are you going to get a ten percent or twenty percent return on that capital? Or is that going to start to diminish quickly? We've seen that in the past, which is a typical cycle. In 2001, for example, there was a massive amount of fiber that was laid down or wireless telecom networks that were put in place. It turned out that there was too much, at least for that time. Same thing with 2005 through 2009 with housing. A lot of people were buying a second home just to sit empty in Florida to speculate on housing prices, and it turned out that wasn't really needed. That was a disaster after that. The combination of complacency and capital spending right now—that's unique in environments. So we have to figure out if we're going to start seeing diminishing returns in some of those markets.

[5:44] Rob Campbell: Not too long ago, I think it was a study from MIT that came out claiming that ninety-five percent of companies, so far at least, are seeing no returns from generative AI. I think even Sam Altman was speaking recently just about concerns on exactly that topic of return on investment, at least in the shorter term. What sort of signs would you look for to see whether that return is coming through or if it isn't? Because certainly there are pockets of the market that have climbed in terms of equity prices. From my perspective, there's a big assumption that, yeah, these returns are substantial and they're coming and they're enduring.

[6:18] Grayson Witcher: Often in these real bull markets, you tend to get a couple of things. One, there's just such desperation to kind of take part in it that you tend to get overbidding of assets in many ways. You hear

stories of some of the big tech companies, big hyperscalers, and others who are so desperate for data centers and for power that they're basically talking to everybody that they can in North America that might be able to provide some power. Sometimes when that happens, you get a conflicting message because you hear that there's so much demand for these assets, but it's hard to tell that—oh, maybe the demand is actually the same person asking twenty different people if they can provide power for this facility or if they can build a data center, and they don't need twenty different facilities. They just need maybe two right now, but they're just trying to figure out: well, who's going to be the fastest to build one that we want? And then we'll go with those two and then we'll kind of scrap the rest of them.

[7:13] Rob Campbell: This is like the OpenTable problem. You can no longer just book ten different restaurants and then pick once you're there. You're not going to sit at ten different tables at once.

[7:21] Grayson Witcher: Exactly. So that's one of them. And then it's going to be a question as well of utilization. I think early on, we saw some feedback on some of the early AI that it was kind of neat, but it got to a plateau reasonably early. So, people were using it at work, for example. I'm thinking of some kind of Microsoft properties like Copilot. Initially, people were excited about it, wanted to use it and saw it had all these kinds of neat features—it could summarize meetings and it could take notes for you, write emails and these kinds of things. Then I think it faded a little bit before it improved and got to the next phase where people found new ways to use it. So, I think that will be the kind of leapfrogging situation we see going forward too. We'll have to watch that to see whether people find it useful or just fascinating, where, yeah, I can write haikus and I can do fun stuff like that. But it's not actually saving you a ton of money. You can ask a ton of questions. In our job, we do a bunch of research, as you are well aware. It can be helpful to have AI act a bit like an analyst and do some work for you in the background. You can ask it to research competitors in this industry or who's grown over the past several years. So I think it'll be a question of seeing how useful it is for some of those and whether a lot of those are necessary or they're just fun to do at the time. And it doesn't really change your workflow three or four years from now. So watching workflow and how companies change their workflow, I think will be important over the next several years.

[8:49] Rob Campbell: You spend a lot of time speaking to management teams, assessing management teams. I presume in every conversation, the manager is going to claim how transformative AI has been for their business. Are there genuine use cases within the portfolio that you've seen that are like, "Oh yeah, this is a step function change with respect to that return on the investment?" Are we still early to really evaluate that?

[9:08] Grayson Witcher: It's going to be a little bit like software and internet was twenty years ago, where at first you're not really sure how to use it. There may be these phases where it takes you a while to figure out how to use this new technology. With AI, there are a bunch, and there are a number in our portfolio that are pretty interesting. What we've tried to do is find ways to benefit from AI without really trying to bet on one winner, one type of technology that's going to be a win-or-lose technology. You've heard this from us a number of times. It's really trying to hedge our bets a little bit, benefit from the theme with a bit less risk. I'll give you a few examples on how we're trying to diversify our beneficiaries on AI. One is Amphenol. This is a company that makes interconnects, which are the wires that connect many devices. Part of the thesis with this is that they can benefit from AI or digitization of the electrification of the world. Whether it's your car has a fancy infotainment system or windows that have power to go up or down or even have power that if you put your finger in it, they'll stop like a garage door and they won't crush your finger if you're pushing the up button. So, just all these different additions

need different interconnects to use them. In addition, they are now providing interconnects for NVIDIA for their racks. It's like a brain, more or less, where you see those old images of a brain that just have all of the different synapses connected together. So, they provide the wires for that. There are ways you can benefit directly. There are also companies like Texas Instruments, which makes analog chips, which are really the opposite end of the spectrum—microchips that connect the real world to the digital world. If you think about how do you get an audio signal like you or I talking into the digital world, well, you need to have an analog chip do that, and you can bring it back out so you can hear it. You need a digital chip for that. Or how do you measure temperature outside? That's another backdoor way you can benefit from AI because AI needs a lot of data, and a lot of this data is measuring things in the real world. That's been another area that has really, we think, seen an inflection point where it's allowing companies to use AI to automate stuff that they couldn't before. So, you think about the world over the last twenty or thirty years—most people can probably picture an automotive plant. These are the pictures you see of these big robots. The reason you see that mostly in the automotive industry is because it's super expensive to do, and it has to be something that you do over and over again, and you have to do it millions of times. If you're just making an electronic toothbrush or something that you're making pretty low volume, it's really hard. It costs so much money to automate it in the past, it's really not worth it. We're also investing in machine vision companies that can benefit from AI.

[11:58] Rob Campbell: And enabling a return on that investment for their customers, I suppose, if they can do it a lot more cost effectively. Grayson, I want to go back to something you said earlier, just on this notion of we're in an era of greater capital expenditure. Of course, much of it comes from the bottom up, individual companies. One thing that happened in your universe more recently was the U.S. government taking a stake in Intel, I think just about ten percent. I want to get your take on that. It borders on some of these topics of chips, of the need for spending. What's the historical perspective on the U.S. government and more state-led capitalism? It feels foreign, but I'm sure it's happened previously.

[12:39] Grayson Witcher: It does seem like a big shift. I think a lot of people, when they hear things like that, will envision countries like China, which in the last several years, President Xi in China asked big tech over there to share some of their profits for the common good. The stock market didn't really love that. Investors didn't really love that. You thought you had X dollars in profit to do something with, and it turns out you had X minus something dollars to do something with, and somebody else had the rest of it. So that wasn't great. We also envision countries like Russia, which has had a government that's been highly involved in the lives of their citizens for decades and decades. If you look back over the past hundred years, Russia hasn't really done that well, despite having unbelievable resources there compared to Canada or the U.S., for example. The U.S. or North America has gone in waves over time. I think it's not the case where there's been no government involvement ever in anything. We've been in a period of what probably characterizes privatization, less government involvement over the past thirty or forty years. You think about Reagan or Thatcher and some of these—it's generally thinking of lower involvement by the government, often lower taxes. NASA, for example—I mean, that's been a government agency that's been very successful the last number of years, a bit more privatization of that, where you've seen the government using SpaceX rockets or ULA rockets to send people to space. There have been other cases too, and it's typically been around things like bankruptcies or wars where you see more government involvement. Bankruptcies are things like the financial crisis in 2009, TARP funding where the government took stakes in Citigroup, Bank of America, AIG, and that was basically to prevent a collapse. So that's really the one area you've typically seen it in, but the government hasn't really wanted to do that. I think in the past, clearly, they don't want big industries to go bankrupt or to have a run on the bank, but they put money in to

save the system.

[14:44] Rob Campbell: I guess that's what feels different about this one. I certainly remember the financial crisis and some of the equity stakes that the government came in to take. AIG would be one example of many. I imagine in the aftermath of the Great Depression, government played a more active role in that regard too. Now, I suppose there's a case you could make that, hey, Intel is in trouble, and therefore a company that deserves quote-unquote "rescuing" by the government. But it does feel different. This feels more strategic in nature. Presumably, there are other companies that we own in the portfolio that I've seen being floated as potential other candidates where the government might be interested in a stake. I'm thinking particularly of defense companies.

[15:24] Grayson Witcher: I think you're right. It is unique. It's typically either bankruptcies or often wars will be the other one where you see the government getting involved. That's typically where you see them getting involved in critical industries. We've seen that with steel mills and coal mines during World War II or the Korean War or telecom assets in World War I. You're right, where it feels different today because we don't seem to be in an active war. It seems weird that you'd need to take ownership in some of these assets, even if you do think they're critical assets. But there does seem to be a bit of a shift. We've seen big infrastructure programs over the past eight or ten years. You've seen healthcare enlarged. Now we're seeing Intel, of course, which I guess is being billed as critical infrastructure in that it makes chips. There have been some rumors of defense companies thought of as potential targets for nationalization. I'm not really sure what the benefit of it would be for the defense industry. When we think about it, it's a pretty good setup now in the U.S. for both parties. Defense companies don't make egregious returns. The government's well aware that they're one of the only customers and certainly the biggest customer of a lot of these companies. They don't pay them enormous sums of money to do the work. It's already pretty secretive. It's not like just because they're public companies, they have to tell your enemies everything you're doing—big portions of their portfolios, they say nothing about it. It doesn't appear to be any kind of secrecy issues there. There could be some benefit. I'm not sure. Maybe if you wanted to keep stuff more out of the public eye, maybe if you didn't want to have returns on capital to be part of the equation at all. Now you have to see a lot of the spending goes through the big defense companies. Because if they're all owned by the government, you wouldn't really see any of that spending. So they could spend ten times as much as they wanted to and not tell the public about it. It does seem like that wouldn't be a great benefit in our mind moving down that path.

[17:24] Rob Campbell: In terms of your work, Grayson, looking at individual companies, and we've spoken about a few of them, what does all this mean? Uncertainty on return on investment, we haven't talked about some other big macro things that are happening with respect to rising bond yields, a weaker U.S. dollar. It all feels like this should raise the cost of capital for companies, and markets are still extraordinarily strong. Does that square for you?

[17:46] Grayson Witcher: It does seem a little bit off. I agree. It goes back to our initial conversation of complacency. There's a lot to be excited about, clearly. We've got a lot of new technologies like AI that the markets are super bullish on and feel like it could be something that changes the world. Also talking about self-driving vehicles, talking about potentially sending people to space. There are a lot of things that are exciting and could potentially change the world and perhaps get really high returns on those. But it also does seem like there are a lot of risks in these transitions. We've seen this over the last number of years where there have been a lot of false starts on different technologies that people were extremely excited about, and they'll probably pan out at

some point in the future. But that path isn't always linear when you think about Bitcoin or blockchain. You think about things like EVs, even electric vehicles. There's been great excitement and then there's periods like now where it seems like while still growing, they're much less in favor. There are even financial instruments like SPACs [Special Purpose Acquisition Companies] a few years ago that people were all too excited about and trying to buy every single company that came out that IPO'd under that format. So there have been a number of different financial or technological shifts, and not all of them have played out immediately. That's part of the challenge. And you're seeing from a macro standpoint; we don't think a lot of the underlying factors have changed all that much that could cause higher discount rates that may lead you to want to demand more compensation for taking these risks. When you think about things like inflation, while it seems like the market is a little bit less worried about it now and it's less in the headlines, a lot of the factors that drive it are still around. Think about reshoring assets. Well, that's expensive. If you already have a plant in Taiwan that makes semiconductors and you're just going to build another one to do the same thing in the U.S., well, you perhaps didn't need to do that. Or same with a big auto facility. If there was a facility in Korea that was making cars and you demand that they make them in the U.S. now, that's another facility that you spend billions of dollars on that was doing the same thing. Or for labor costs, if you want your t-shirt or your deck chair to be made in the U.S. instead of in China, the labor rates are more expensive. That's what you're going to have to deal with. So a lot of those costs are probably going to stick around. It seems like the market is not overly worried about that, at least in the short to medium term. You've seen that with rates falling down, the short end of the curve. The thirty-year end of the curve is still staying a little bit higher. So that's giving you a bit of a sense for what some people are worried about—that well, maybe the inflation and some of the changes that you're seeing out there with Fed fund rates lowering may be necessary or not necessary in the short term, but they may have implications in the long term. So that's what we're trying to balance as investors—trying to find companies that aren't overly impacted by these macro changes and that can benefit in a number of scenarios.

[21:00] Rob Campbell: For a company like Northrop Grumman, what does it mean that there might be the risk of the government taking an equity position alongside you as an investor?

[21:08] Grayson Witcher: It's tricky to know. On the surface of it, it seems like it could be somewhat dangerous just in that it appears to take out the free market dynamic where you have a stakeholder involved that may not play by all the same rules as the rest of the investors in the free market. That's been kind of a push of the U.S. and other democracies and capitalist countries over the years—that the government kind of stays away because the market knows what's best and will allocate money in the best way possible. That will typically be based on where you get returns. If there are no returns to be had, well, that often means it's not an area to invest. I think there are probably a couple areas that I'd exclude from that, that have been highly beneficial over the years. That's been things like really early-stage research. So that's something that universities do really well and the government has done really well in the past, where there's not going to be a payoff for five, ten, twenty years, but the payoff is going to be enormous. So you think about things like sequencing the genome or the internet, where the government put a bunch of money into these and the payoff was many decades down the road, but the payoff was enormous. That was an unbelievable investment and a very savvy move for the government. That's the type of things you want the government involved in, in my opinion, because private companies just don't have the time horizon to do that, even ones like Google.

[22:41] Rob Campbell: One of the best books I read over the last several years was "Chip Wars," which opened my eyes to just the role of the defense department in funding a lot of the early-stage ventures in terms of chips

and technology that are so abundant today, which I guess explains why the Intel thing makes sense. But where do defense companies like Northrop Grumman fall in that spectrum?

[23:01] Grayson Witcher: If I were in the government, it seems like you want to keep pushing on these new technologies. Certainly China's doing this, and you're seeing this more in life science companies. Waters, for example, where they're really trying to push on early-stage research in order to kind of see the benefits many years down the road from new pharmaceuticals or new life science equipment. Defense is perhaps one of those—like you say, it could be something where you get new technologies that emerge from real cutting-edge technologies that are happening in defense, and those go on to be used in commercial aerospace, for example. That's possible, and it seems like it's probably happening now. It's not clear to me that there's a huge gap missing where it's just, hey, there's not enough defense spending, they're not spending enough on cutting-edge technologies that are going to have leveraging effects in the economy ten years from now. Maybe there's something that we just don't see that the government or others are aware of that really needs and deserves a lot of spending and could benefit the economy twenty years down the road.

[24:04] Rob Campbell: We've talked a bit about risks. What's really exciting for you in the universe today? You spoke to a machine vision company that we added to the portfolio a bit earlier. Waters, another business that you've been adding to so far this year.

[24:16] Grayson Witcher: Waters is a life science company, so they make tools. These are tools that you can use in research or drug testing—liquid chromatography or mass spec equipment. One of the core uses for them, for example, is testing drugs. So white pills, the pills you might take for medicine, must have equipment for quality control. A new management team came in a few years ago, and we've been really impressed with them. CEO, CFO are both fantastic, and they've really improved the business. More recently this year, they made an acquisition. It was actually of a part of a business that we also own. So they bought part of Becton Dickinson. Becton Dickinson is a company that their core business was making needles. If you've drawn blood or something like that, you might have seen a BD symbol on the needle. So that's their historical business. But they're selling a non-core business to Waters. At first, the market didn't love the acquisition. We had a feeling that it was actually quite appealing. So we spoke with the management team a couple of times, dove into the details. My colleague, Chris, did a bunch of work on the business, understanding the technology, understanding what they were going to try and do with this technology. We really think it's going to make a real positive difference for the company. After speaking with them for a couple hours, we found that they had a clear plan on what to do with these assets. That's one of the reasons we speak with management teams. We've spoken with thousands over the years, and when you've spoken with that many, it becomes quite clear who really knows what they're talking about and who doesn't have quite the plan. When you talk with Waters, they can tell you exactly what they're going to improve with the assets they bought. "This is what can be operated better. This is how we're going to change. Here are the four things we're going to change. Here's the reason we bought these assets." How we really became more comfortable with it is it became quite clear to us that they had a great strategy, and they had a real plan for execution after buying these assets. So we added that position, and we're pretty excited about the outlook for it.

[26:19] Rob Campbell: Fantastic. Definitely lots of themes in the world, but it's great to hear that when it comes down to the core of it for us, it's about finding these businesses, speaking to the management teams, understanding how they fit from a portfolio perspective in terms of what's going on in the world. But Grayson, thank you so much for spending the time. I loved your characterization of the world of CapEx that we're in today

and the big question: what's the return on that CapEx and when will it come? Thanks so much.

Grayson Witcher: Thanks, Rob.

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