Investment Views

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BUTTERFIELD

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The Data Centre Backlash is Here

- AI infrastructure spending has been a key driver of markets
- But there is now a backlash against data centres
- This may slow, but not stop, the date centre buildout

Artificial Intelligence has been a key driver of the strong returns in global equity markets over the past three years. At times, it has been hard to find much else to write about. Regular readers will have often seen us discuss the wide range of physical infrastructure that sits behind the AI tools such as ChatGPT, Claude, and Gemini. Much of this investment focusses on data centres, where the semiconductors and other technology powering the AI revolution are housed. Modern data centres are highly complex buildings requiring state-of-the-art facilities and a lot of reliable power. All this technology hardware generates heat, so cooling technology like air conditioning and liquid cooling are key to stop the systems from overheating.

To put the scale of these projects into context, it helps to look at a specific example. Elon Musk's flagship AI data centre project is called Colossus and is based in Memphis. The site covers around 100 acres, which is equivalent to roughly 75 football pitches. The data centre will contain around one million specialist computer chips.

Its planned power supply is 1.2 gigawatts, which is comparable to 20% of London's average power consumption. The first phase of this project was on an abandoned industrial site which was previously an Electrolux factory.

Projects like this help explain why the US is the clear leader in AI models. The US has the land, favourable regulatory backdrop, cheap natural gas, entrepreneurial spirit, and deep capital markets to help fund these developments. The opposition to such projects, however, is mounting.

From a public relations perspective, the messaging around AI in the US has been terrible. The idea that people will see their utility bills rise due to data centres, and then the risk that AI will come and take your job, is not a message conducive to building public support. Polling by Pew Research Center shows that 52% of Americans feel more concerned than excited about the increased use of AI in daily life, whereas only 9% feel more excited than concerned. There are also worries around the safety of AI, particularly in cybercrime and warfare.

The Governor of Pennsylvania has recently signed an executive order demanding that data centre developers comply with stricter requirements. The Governor justified this by explaining that "over the past year, I've listened to the people of Pennsylvania – and I've heard directly from many residents across our Commonwealth who are concerned about what data centre development could mean for our communities, our environment, and our utility bills". He went on to say that "these are some of the biggest companies in the world — they can afford to be good neighbours, follow the rules, and do this right."

It is notable that this backlash cuts across the political divide. The Republican Governor of Texas has recently placed a temporary halt on new data centre connections to the state power grid, while also

52%

The number of Americans who feel more concerned than excited about AI in daily life.

demanding audits over concerns about the strain on electricity and water resources. President Trump has also waded into the debate in characteristic fashion, writing on social media: “the only reason that communities throughout the USA should not want Data Centers is if they want to end up being backwards and poor. If they want to be successful and rich, with far lower taxes and jobs all over the place, let Data Reign.’

US stocks linked to the data centre buildout have come under a bit of pressure in recent months, but this followed strong gains over recent years. The political backdrop is heightened due to the upcoming midterm elections in November, but given public opinion there is a chance this backlash persists. However, this is likely to slow rather stop the current data centre buildout. America is a big place with states competing with each other to encourage economic activity. Companies will need to mitigate the negative consequences such as higher energy prices. This is likely to mean more investment in bringing their own power sources or contributions to improving the local grid infrastructure. Given that the AI investment boom continues, we have used this as an opportunity to add to our exposure in industrial stocks.

Resilient Global Growth Keeps Pressure on Bonds

- Energy prices and fiscal deficits are an issue
- There are a lot of bonds being issued
- Credit spreads have been stable

August delivered another volatile month for global fixed income, although headline moves concealed a fragmenting story underneath. Global economic data was generally stronger, but regional divergence widened: Europe and China improved, while key releases from the US and Japan softened. Renewed energy pressures also kept inflation firmly in focus. The 10-year US Treasury yield finished August close to where it began, at around 4.75%.

The US provided the clearest example of the competing forces facing bond markets. July non-farm payrolls, released in August, fell by 23,000, with previous months revised lower. Retail sales also declined, while July CPI rose just 0.1% month-on-month. These releases initially reduced expectations for further Federal Reserve tightening, but the broader growth picture was not weak enough to remove inflation concerns. Overall, the month produced a softer US macro pulse even as global data surprised more positively.

Energy increasingly complicated that outlook. Short-dated US inflation expectations rose again as oil prices strengthened. Brent crude finished August above $90 per barrel, while WTI ended

around $86. More importantly, diesel prices continued to rise as limited global refining capacity struggled to meet demand. US diesel crack spreads briefly exceeded $100 per barrel amid reduced Russian and Middle Eastern refinery output and low distillate inventories. This matters because diesel feeds directly into freight, agriculture and industrial costs, increasing the risk that higher energy prices filter more broadly through the economy.

The Treasury market also continued to wrestle with fiscal concerns. Large deficits, heavy borrowing and higher energy prices pushed the 30-year Treasury yield to 5.34%. Its highest level since 2007. Treasury Secretary Scott Bessent subsequently announced an increase in planned liquidity-support buybacks across longer maturities. Long yields initially fell following the announcement, highlighting how sensitive markets have become to Treasury supply, refinancing requirements and the term premium demanded by investors.

Attention shifted back towards the Federal Reserve late in the month. July PCE inflation remained well above the Fed's 2% objective, while Fed Chair Kevin Warsh used his Jackson Hole speech to reinforce the central bank's commitment to controlling inflation. Markets responded by increasing expectations of another rate hike, pushing 2-year Treasury yields higher. The rise in shorter-dated yields reflected growing expectations that the Federal Reserve may need to keep policy tighter for longer.

Credit markets remained considerably calmer. US high-yield spreads tightened to roughly 265 basis points by the end of August, leaving them close to historically tight levels. Investment-grade spreads also remained compressed despite heavy new issuance. At current spread levels, the attraction of credit increasingly comes from absolute yield and carry rather than expectations of significant further spread compression.

5.34%

The amount large deficits, heavy borrowing and higher energy prices pushed the 30-year Treasury yield to.

Outside the US, Europe produced some of the stronger macroeconomic surprises. The eurozone composite PMI improved, while manufacturing activity rose to its strongest level in more than four years. Government bonds nevertheless remained under pressure from inflation and fiscal concerns, with the German 10-year Bund yield briefly reaching new highs. UK gilts also remained weak as inflation and government borrowing concerns kept term premia elevated.

Japan experienced an even more striking repricing. Second-quarter growth slowed, but persistent inflation and expectations of further Bank of Japan tightening pushed the 10-year JGB yield to almost 3%. Its highest level in three decades. Currency markets reflected the divergence: the yen was the weakest-performing G10 currency during August, while the Australian dollar was the strongest, helped by firmer risk sentiment, commodities and expectations of comparatively tighter Australian monetary policy.

China remained mixed but showed improvement towards month-end. The official manufacturing PMI rose to 49.8 in August, moving closer to the 50 level separating contraction from expansion. Earlier data still showed weakness in retail spending, investment and property, but the better August survey helped support the broader global macro picture. Together with firmer European data, China helped offset weaker releases from the US and Japan, leaving the overall global macro data pulse somewhat stronger during the month.

August reinforced the difficult balance facing fixed-income investors. Growth has not weakened enough globally to remove inflation concerns, while energy, fiscal deficits and government bond supply continue to exert upward pressure on yields. However, higher starting yields provide more income, tight but stable credit spreads continue to reward risk taking, and falling volatility suggests markets are absorbing uncertainty more comfortably. The path for rates is likely to remain volatile, but the medium-term return potential of high-quality fixed income continues to improve.

Earnings Higher and Valuation Multiples Lower

- Equities rallied in August, led by cyclicals
- Higher interest rates are a headwind for valuations
- Japanese stocks have been outperforming

August was a positive month for global equities, which returned 2.6% in US dollar terms and 2.0% in sterling terms. Cyclical sectors like Energy, Materials and Financials led the way, while Utilities, Industrials and the Consumer sectors lagged. Higher bond yields have been a theme this summer, and these moves are impacting different sectors of the stock market in various ways. The Financials sector is benefitting from higher rates, while they are a headwind for the Utilities sector.

Higher bond yields are also a headwind for equity valuation multiples. Stock markets can be thought of as earnings (profits) multiplied by the number that investors are prepared to pay for those earnings. Investors were prepared to pay 22x earnings at the start of the year, but that number has fallen close to 19x now. Earnings have been very strong, but on a valuation basis, the market has got a bit cheaper.

There have been a number of contributors to the declining valuation, including AI-related uncertainty and scepticism about the durability of recent earnings strength. Higher interest rates have also been a factor. This makes intuitive sense. If investors can earn higher yields on bonds, then the valuation multiple that investors will be prepared to pay for owning stocks is lower. Thankfully, earnings have been so strong that the increase in profits this year has been higher than the fall in the valuation multiple.

7.8%

The amount Japanese equities outperformed global equities by.

One region of the world that has seen particularly strong equity markets this year is Japan. Japanese equities returned 20.9% in the first eight months of the year, outperforming global equities by 7.8%. Japanese equities were out in the wilderness for years after the bursting of the Japanese equity bubble in 1990. A moribund economy and stock market was the catalyst for a policy push, starting in 2012, to bring economic and stock market growth back to Japan. This ended the long running underperformance versus other developed markets outside of the US.

The Japanese yen has long been an important consideration for global investors in Japanese markets. The yen has been weak over the last 5 years as interest rates in Japan have gone up by far less than elsewhere. This has been helpful for Japanese exporters (their products become cheaper), but international investors have given up some of their gains due to currency weakness. Recent yen weakness has got the attention of policy makers in the US and Japan. The US Treasury has looked to support the yen by selling some euros and buying yen. Meanwhile, the probability of further rate hikes in Japan have increased.

Higher interest rates (bond yields) in Japan have been supportive for the financial sector there. The sector returned 41% in the first eight months of the year. The gains have been broad based across Banks, Financials Services, and Insurance. Japanese banks in particular have performed well, returning close to 50% in US dollar terms. Higher interest rates in 2022 caused some challenges for financial stocks in the US and Europe, however, stocks in Japan have been benefitting.

We have held more exposure to Japanese equities than our benchmarks in recent years, so this has been helpful for portfolios. Exiting decades of weak growth has been a beneficial tailwind to corporate earnings, while a drive to improve corporate governance has also made progress. For example, companies have been returning more money to shareholders by buying back their shares and this helps optimise company balance sheets. Themes like this provide helpful diversification in portfolios as they are not simply a function of global growth and AI investment, which has become so dominant in global markets.

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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	FIXED INCOME (MODEST UNDERWEIGHT)	ALTERNATIVES (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION SHORT DURATION HIGH YIELD
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY REAL ESTATE	INDUSTRIALS

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