DEAR PRUDENCE

Circular Risk

A current assessment of the U.S. equity markets is similar to the last several quarters, namely, elevated stock valuations and top-heavy concentration in a few companies, both driven by strong momentum in the artificial intelligence ("AI") narrative. Evolving trade policy remains a challenge to companies, but tariffs have not been as punitive and have generally been taken in stride by the market. The Federal Reserve cut its benchmark rate at its September meeting for the first time in 2025 and signaled two more rate cuts by the end of the year. As tariff impacts on inflation remain manageable, the Fed has turned its attention to the labor market, which has seen hiring slow considerably, yet layoffs remain limited, thus keeping the unemployment rate at 4.3%. At the same time, U.S. Q2 GDP growth was revised higher to 3.8% annualized, from 2.6% initially, driven by strong consumer spending and business investment. Each of these GDP components, however, are both influenced by what is pushing the market to new highs, the AI infrastructure build.

The seemingly circular impact on the market, economy, and deal making from AI investment has raised some concerns around potential systemic risk. As the market moves higher on AI enthusiasm and hyperscaler capital investment, consumers accumulate stock market wealth and spend more freely, economic growth is boosted from business and consumer spending, and the market moves higher on bolstered growth prospects.

- AI cloud-computing ("hyperscalers" – e.g. Microsoft, Meta, Alphabet, Amazon) and semiconductor companies (e.g. Nvidia, Broadcom) are some of the largest in the world and their impact is evident in the equity market. Per J.P. Morgan Asset Management, "AI related stocks have accounted for 75% of S&P 500 returns, 80% of earnings growth and 90% of capital spending growth since ChatGPT launched in November 2022" (JPM's AI Universe is comprised of 41 stocks across three categories – Direct AI, AI Utilities, and AI Capital Equipment)[i]. Although repetitive from prior commentaries, it must be noted that the historically high valuation and concentration of the S&P 500 have increased as the equity markets continue to grind higher. The index is trading at 22.8x forward earnings with the top ten largest companies comprising 40.4% of total market cap, as of the end of Q3. For reference, these figures were 21.5x and 39.0%, respectively, at the end of 2024[ii].

- The immense investment in AI is evident in the economy as well. Per Moody's Analytics, Americans in the top 10% of income distribution accounted for 49.2% of total consumer spending in Q2[iii]. They also own most of the "AI dominated" U.S. stock market, making them increasingly wealthier in recent years, buoying their ability and willingness to spend. Various estimates have the major hyperscalers projected to spend nearly $400 billion in capital expenditures this year with total spend surpassing $1 trillion by 2027. Like resilient consumer spending, this business investment to build out AI infrastructure is becoming a significant factor to GDP growth.

- Circular deal making, led by OpenAI and Nvidia, is also giving investors pause. For example, Nvidia sells semiconductor chips to OpenAI, Microsoft, and Oracle. Nvidia agreed to a $100 billion investment in OpenAI, its customer, and Microsoft has invested $13 billion into OpenAI, which uses Microsoft Azure cloud services. OpenAI agreed to a $300 billion cloud deal with Oracle, assumedly leading to further sales to Nvidia, and announced a partnership with AMD, a competitor to Nvidia, to buy tens of billions worth of chips, in exchange for roughly 10% of AMD's shares if certain milestones are hit. By providing vendor financing, Nvidia is arguably a financial backstop for the AI industry. As it reinvests back into the AI industry that buys its technology, this is raising bubble concerns and transparency questions, such as revenue sharing, that have yet to be disclosed.

Skepticism vs. Enthusiasm

The risk of bubble from the buildout of the AI industry is increasingly being discussed among market participants. At this point, it is reasonable to have both skepticism and enthusiasm during a technological revolution like this. From an investment perspective, history can be a useful guide as to what happens next. Markets tend to run in cycles, and periods of exuberance can lead to overinvestment and significant price swings higher over a short period. Prudence is best employed at such times. As valuations remain stretched, there is a higher risk of a pullback vs. a perpetual climb higher. Dramatic corrections are more likely in companies that are unprofitable or have excessively high valuations, yet there will be a cause for a drawdown in the broader market eventually. Owning a S&P 500 index ETF is not a diversified strategy today as it is now heavily influenced by AI investment. Owning a portfolio of actively managed stocks, with exposure to AI tailwinds but held in a concentration that aligns with your risk tolerance, is a more prudent approach. Among others, there are potential issues that could lead to less spending, thus less GDP growth, and lower aggregate earnings, bringing valuations into question.

- Despite substantial cash on hand and strong free cash flow, hyperscalers cannot spend this much perpetually. Some estimates point to negative free cash flow for 2026 at the current spending rate. Furthermore, investors will eventually require a return on investment for this spending to continue.

- Hyperscalers are depreciating their capital expenditures over five, six, or more years. If the economic life of new GPU models or servers is shorter, their earnings would be overstated, and they would be trading at much richer valuations.

- With electricity grids already under strain, the power necessary to run more data centers will likely be a key bottleneck. Some companies are signing multi-year power purchase agreements and seeking “new” energy sources, like nuclear, to secure power. Per the Department of Energy, data centers account for 4.4% of total U.S. electricity, which is estimated to reach as high as 12.0% in 2028[iv].

When comparing today with the dotcom bubble, there are some critical differences that suggest AI is not in bubble territory yet. Although valuations are stretched, this three-year bull market run has been more earnings based and led by much more substantive companies. Even if they spend beyond free cash flow generation, the hyperscalers have significant cash reserves to spend on building out data centers without overleveraging. Dotcom companies had little to no revenue, unjustified valuations, and mostly used debt to buy infrastructure. The most tangible similarity between each investment cycle is the infrastructure build. Inflated demand projections during the fiber optic cable buildout in the 1990’s led to dramatic overcapacity, creating the “dark fiber” that remained unused for several years after the bubble burst. Similarly, the goal to build as many AI-ready data centers as fast as possible may lead to a significant mismatch between capex spending today and realized revenue several years away. There’s also the possibility of infrastructure sitting unused until demand picks up, or conversely, unused because of a lack of power to do so. All of this considered, even if AI’s potential is greater than that of the internet, it is unlikely to develop without disruption. For this reason, investors must be opportunistic with a long-term view, keeping exposures in check, and staying prudent when there is exuberance.

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[i] J.P. Morgan Eye on the Market
[ii] J.P. Morgan Asset Management Guide to the Markets
[iii] Bloomberg, Moody’s Analytics
[iv] U.S. Department of Energy – Domestic Energy Usage Expected to Double or Triple by 2028