



“AI vs. Everybody”

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Dear Clients and Friends:

Since President Trump took office, there has been a pattern. The administration does something outside of the usual norms – implementing shifting tariff policies, intimidating Federal Reserve governors, taking equity positions in private companies while forcing others to share Chinese revenues, promoting a government shutdown, etc. – and we watch economists’ and market pundits’ hair catch fire as they warn of deep risks. So far, though, the economy has kept chugging along. The market tumbled in April over the “Liberation Day” tariffs but has since rebounded and then some. All the unusual policies that have alarmed mainstream economists haven’t appeared to affect U.S. key economic indicators or stock market performance.

Markets carried their strong momentum from the second quarter into the third with major indices hitting new highs. While the Artificial Intelligence trade continued to assert itself, improving market breadth added fuel to the rally with small-cap stocks finally breaking above their 2021 levels. The S&P 500 gained an additional +8%, bringing year-to-date gains to +14%. Small cap stocks rose +9% and are now up +4% this year. International stocks added +5% to their already impressive first half returns, now up +25% for the year.

The bond market was supported by the Fed’s shift back toward rate cuts. At the Jackson Hole conference in August, Fed Chair Powell struck a dovish tone, signaling concern about labor market softness and hinting at future rate cuts. In September, the Fed followed through, lowering the Fed Funds rate by a quarter percent to 4.0%. More rate cuts appear to be on the way, helping juice equity markets’ returns. The Bloomberg Aggregate Bond Index added +2% during the quarter and is up +6% in 2025.

Make no mistake though, there are two economies out there: an AI economy that is booming, and an “everything else” economy that is delivering more muted growth. Because of the performance of the Mag7 stocks and their concentration in the S&P 500, we have talked ad nauseum about AI in these quarterly letters. We will again in this one. However, it is difficult to overstate the scale of today’s AI spending boom, estimated to be 2% of U.S. GDP in 2025, and the effect it is having on certain segments of the economy.

Meanwhile, the rest of the economy is growing more slowly. Hiring has stalled. Monthly job gains have fallen from >500,000 in late 2021 to about 30,000 over the last three months. Jobs are particularly hard to come by for young people entering the workforce. Youth unemployment is at 10.5%, a level not seen in a decade, absent the pandemic. These are problems the AI boom is likely to worsen, not ease. While it takes a lot of money to build AI data centers, it doesn’t take that many workers to operate them. Consumer spending is also slowing down. Companies like Walmart and McDonald’s cite weaker demand from lower-income consumers. Confidence is also down as inflation continues to stay elevated.

The AI Spending Spree

The promise of artificial intelligence – that it will change everything from the way we look at the universe to the way we order a pizza – has been the primary driver of the S&P 500's three-year bull market. AI is seen as the next “platform” and big tech cannot risk being left behind. Because previous platforms (internet, social media, mobile) have created such dominant winners, each of America's largest companies has been willing to spend remarkable sums of money to dominate what could be the next winner-take-most market. This arms race has bolstered the U.S. economy almost by itself.

The boom has ushered in one of the costliest building sprees in world history. Close to \$400 billion, equivalent to \$1,800 per American, will be spent this year on data centers, infrastructure support, and LLM model training by these companies. The economic influence of this spending is expected to be 1% of GDP growth in the second quarter alone, outstripping consumer spending growth by tenfold. When adjusted for inflation, the money spent over the last three years on AI infrastructure is greater than the cost to build the interstate highway system over four decades.

Now, OpenAI, the owner of ChatGPT, and their CEO, Sam Altman, have begun pitching an audacious trillion-dollar investment plan to build new AI data centers around the world. He wants to scale ChatGPT to the size of Google search. OpenAI may be the hottest start-up of all time, but a trillion dollars, even in today's world, is nuts. A trillion dollars is 25% of ALL annual spending U.S. businesses do on structures (offices, factories, warehouses), equipment (machines, tools, vehicles, computers), and research and development.

Building is one thing, now you must power it. Lawrence Berkeley National Laboratory predicts that by 2028, AI will require the same amount of electricity as it takes to power 22% of U.S. households. As most of that power is not yet available, these same companies are spending billions to procure and secure their expected energy demands. Billions are being spent on grid modernization, new power plant construction, and bringing decommissioned nuclear power plants back to life. There is also huge speculation in companies developing next generation nuclear. The money being spent to support AI's energy needs is equivalent to funding a new Apollo space mission every 10 months.

Given the billions and billions of dollars involved, it is easy to see how Wall Street has become enamoured with all things AI. One company's spending is another company's revenues. Since the October 2022 bear market bottom and the launch of ChatGPT, the S&P has climbed 90%, but most of these gains have come from a small group of stocks. According to JP Morgan research, the Mag7 plus another 34 AI data center ecosystem companies are responsible for 75% of those returns, 80% of earnings growth, and a staggering 90% of capital spending growth. **Per the analysis, if you exclude those AI stocks, the S&P's annual appreciation falls from a historically strong 19% to a more average 8%, showing just how concentrated the rally has become.**

There are concerns that enthusiasm for AI has turned into a bubble that increasingly echoes the mania surrounding the internet's infrastructure build-out in the late 1990s. Then, telecom companies spent hundreds of billions blanketing the country with fiber optic cables on the belief the internet's growth would be so explosive that most any investment was justified. The result was massive overbuilding that made telecom the hardest hit sector in the dot-com bust.

Outlook

To be sure, all this spending has made a plodding economy look more robust and the one-note nature of the long bull market has also made equity returns look easier than they have been. While there are many things to worry about, it appears we are still in an economic expansion and a bull equity market. There are patterns here too that we think we can see developing for economic growth and inflation.

So far, very little revenue, much less a return, has been generated from the massive investments. Without investor pressure, AI spending is not slowing down and the wind continues to be at the back of that portion of the economy. The “everything else economy” should also be able to tread water for the rest of the year. With the Fed now leaning into rate cuts, financial conditions should continue to loosen, buoying activity.

Passage of the One Big Beautiful Bill earlier this year came with several tax cuts that won’t really show up until the first quarter of 2026. Provisions related to the no tax on tips, overtime, and social security will generate larger than expected tax refunds when filing for 2025. This stimulus should invigorate consumer spending during the first half of next year. So, we see the current economy doing fine for the rest of 2025 and then getting a boost in the first half of next year before things start to slow down again later in 2026.

We see a similar pattern emerging for the inflation outlook. Given the tariff scenario, inflation has been tamer than most everyone, except the administration, has expected. Data is starting to show that companies have held prices relatively stable through front loading their imports before the tariffs kicked in and by eating the tariffs themselves since. All that’s about to change. A recent KPMG U.S. CEO Outlook survey revealed that 86% plan to start raising prices. Price increases are being planned to coincide with the larger refund checks expected, hoping consumers put up less of a fight. So, here too, inflation should stay muted the rest of the year, experience a bump in the first half of next before settling back down toward the end of 2026.

As long as earnings are growing, which they are, and both monetary and fiscal policy are on the market’s side, the status quo can continue. If markets price in deeper rate cuts, financial conditions likely ease further. Predicting when a boom turns into a bubble is notoriously hard. Many inflate for years, some never pop, others just stagnate. AI boosters insist that “this time is different.” We are concerned, but we do agree. Today’s tech giants produce far more cash than the fiber builders before them and can afford the spending they are doing. The trillions spent on semiconductors, processors, and data centers won’t be wasted. It just might take more time than currently expected to generate the corporate efficiencies and profits that will fuel even more spending and stock market gains. Our portfolios maintain exposure to AI, but we remain diversified and continue to lean into higher quality, dividend focused, and lower valuation areas of the market.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don’t hesitate to contact us. Stay safe and well.

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