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Economic and Market Outlook

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The AI Bubble Debate: Why We May Not Be in One - Yet

-At the root of all financial bubbles is a good idea carried to excess.

- *Seth Klarman, Billionaire Hedge Fund Manager*

Section I. Introduction

Artificial intelligence has become the market's defining investment theme. Semiconductor valuations have surged, Hyperscalers' capital-expenditure budgets have expanded sharply, and nearly every public company is being asked some version of the same question: What is your AI strategy?

That enthusiasm naturally invites comparisons with the late-1990s internet bubble. The comparison is useful—but incomplete. AI-related equities may be expensive in places, expectations are undeniably elevated, and speculative excess is appearing around the edges. Yet the broad AI investment cycle does not currently resemble a full-fledged bubble.

The more accurate conclusion is that AI is in an early-to-middle phase of an investment boom: one supported by rapidly growing real demand, measurable revenue, strategic necessity, and a technology platform with potentially economy-wide applications. That does not mean valuations cannot fall sharply. It means the fundamental basis for the cycle is materially stronger than the typical bubble narrative suggests.

A Bubble Requires More Than High Valuations.

High valuations alone do not make an asset class a bubble. Markets often assign high multiples to companies with exceptional growth, large addressable markets, durable competitive advantages, and strong incremental returns on capital.

A true bubble usually combines several features:

1. Prices become detached from plausible future cash flows.
2. Capital flows toward low-quality or unproven assets indiscriminately.
3. Revenue growth is largely promotional rather than economically meaningful
4. Leverage, retail speculation, and momentum dominate fundamental analysis.
5. Supply eventually overwhelms demand because investment was based on fantasy rather than utilization.

Some of these elements are visible in isolated corners of AI—especially among small-cap “AI-adjacent” stocks, certain private-market startups, and companies attaching the label to modest product features. But the core of the AI capital cycle is being funded and led by some of the largest, most profitable, and most cash-generative companies in the world. (Example: Google, Microsoft, Meta, etc.)

The companies spending the most on AI infrastructure are not fragile venture-backed enterprises relying on promotional financing. They are global platforms with massive installed customer bases, recurring revenue, dominant distribution, high-margin software businesses, and balance sheets capable of supporting multiyear investment cycles. Their spending may ultimately prove too aggressive, but it is not inherently speculative in the way that late-cycle telecom or dot-com infrastructure spending often was.

What Would Turn the Boom Into a Bubble?

The market is not necessarily in a bubble today, but several developments could push it in that direction.

Warning signs would include:

1. Hyperscaler capital expenditures continuing to accelerate while AI revenue growth and utilization decelerate.
2. Widespread debt-funded data-center construction based on optimistic assumptions about long-term demand.
3. Sharp declines in pricing for compute and inference without offsetting volume growth.
4. A broad wave of unprofitable companies raising capital under an AI label.
5. Equity valuations expanding despite deteriorating earnings estimates and weakening free cash flow.

The most reasonable stance right now is neither blind enthusiasm nor reflexive skepticism. AI is likely to be a major multiyear investment theme, but it should be analyzed through the same disciplines applied to any capital-intensive growth cycle:

revenue durability, unit economics, free-cash-flow conversion, competitive positioning, return on invested capital, and valuation.

The central point is simple: AI is not yet a broad market bubble because the core investment cycle is supported by real demand, real revenues, and financially capable buyers. But it is also not a risk-free growth story. Expectations are high, spending is enormous, and future returns will depend on whether AI evolves from a powerful technology into a sufficiently profitable economic platform.

Section II. The Federal Reserve and America's Debt Burden

For investors, the central question is not whether the United States will suddenly “run out of money.” The U.S. government borrows in its own currency, has deep capital markets, and issues the world’s benchmark risk-free securities. The more relevant concern is whether persistently large deficits and a growing debt-service burden raise the cost of capital and reduce the economy’s long-run growth potential.

The level of debt matters, but the trend and composition matter just as much. A country can sustain substantial debt if nominal economic growth, tax capacity, investor confidence, and borrowing costs remain favorable. The challenge emerges when debt grows faster than the economy or when interest expense begins to consume an increasingly large share of public resources.

The most direct investment impact of heavy federal borrowing is the potential for higher Treasury yields. If the government must issue large volumes of debt, investors may demand more compensation to absorb the supply—particularly if inflation uncertainty, fiscal risk, or reduced foreign demand enters the picture.

With total federal debt now around \$40.1 trillion and debt held by the public near \$32.4 trillion, the size of Treasury issuance and the trajectory of federal interest costs are increasingly relevant to the cost of capital across the economy. For investors, the most likely consequences are a market environment in which long-term yields may remain more volatile and structurally higher valuations may be more sensitive to discount-rate changes.

Rates in most European 10-year bonds are rising because of inflation from oil in the European economy. The U.S. 10-year bond still remains relatively more attractive to international investors for its yield and AA+ credit rating, though the spread is narrowing. The U.K. 10-year yields 5.34% (AA), German 10-year yields 3.57% (AAA), France 10-year yields 4.72% (AA), Italian 10-year yields 4.51% (BBB) and Swiss 10-year yields 0.64% (AAA). These compare to our 5.17% 10-year yield.

Section III. Inflation

As discussed, the other side of the Fed's mandate is inflation. After making great progress in moving the inflation rate closer to the Fed's target rate of 2%, the past few months have seen a slight increase. Much of the increase has been the blame of oil prices.

Inflation may be a larger problem. The September FOMC meeting marked a decisive shift toward renewed inflation control. The Fed lifted the policy range to 3.75%–4.00%, its first increase since 2023. The important distinction for investors is between slowing inflation and inflation that is sufficiently low for monetary easing. The latter has not yet been achieved. The Fed expects PCE inflation to decline to 2.3% in 2027, 2.1% in 2028, and reach 2.0% only in 2029. That path makes near-term rate cuts less likely and raises the probability that real rates remain restrictive for longer than markets had previously expected

Currently the Consumer Price Index (CPI) is up 3.4% on an annual basis, and core CPI, which excludes food and energy, is up 2.4%. Both readings are for August 2026. This is still above the Federal Reserve's 2% target. As expected, the move from 3% to 2% will continue to be slow and difficult. CPI has decreased since our last report by 0.8%. Core CPI decreased by 0.5%. Most of the decrease can be attributed to the slight decrease in oil prices. While the CPI reading peaked in June of 2023 at 9.1%, the core rate actually peaked in September of 2023 at 6.6%.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in August was 3.7% and the core rate was 3.3%. Inflation in the Euro Zone was running at 3.2% on an annual basis in August. All measures are up reflecting the rise in the price of oil. Energy demand from AI is also contributing to higher inflation.

Average hourly earnings are up 3.1% year-over-year in May and overall inflation is up 3.4% as previously stated. This is a negative for the economy because it means real wages are falling.

Section IV. The Bull Market

As we stated in our December 31, 2024, report, we expected some types of correction or consolidation in the market from time to time. Corrections are part of normal volatility, and are healthy for the market. Within the first four months of 2025, the S&P 500 index had a correction of 18.9%, reaching a level of 4982.77, on a closing

basis. It has since rebounded to a high of 7800. Remember that a bear market is defined by a pullback of at least 20%. Therefore the bull market is still intact.

A recent occurrence has only happened 7 times before in history. The S&P gained 19% over a two month period ending May 29th. In the past seven times this has occurred, the S&P had an average gain of 28% over the following 12 months.

Bull markets do not die of old age. We are approaching 47 months in this bull market. Since World War II there have been 13 bull markets and the average gain was 164%, and on average they lasted 57 months. It is also true that recent bull markets have generated higher returns over longer periods of time. On average, the last five bull markets since 1980 have seen stocks advance about 240% over a period of 70 months.

Bull markets end because of Black Swan events or because of recessions in the economy. By definition, Black Swan events cannot be predicted. For reasons cited later in this report, we do not see a recession coming in the near future.

To be clear, in the short term we fully expect more corrections or consolidation in the market from time to time. Corrections of less than 10% are part of normal volatility. In addition, corrections are historically quick and sudden pullbacks while Bear Markets are slow and rolling like a dripping leaky faucet.

As of this writing, the S&P 500 is down from its intraday high of 7816.70 on August 13th, 2026, by 1.27%. The average return on the S&P 500 for the last 10 years is around 11%, and over last century the stock market is up on a yearly basis 76% of the time.

Despite recent market fluctuations and uncertainties, the momentum behind AI-driven technologies remains strong. The energy demands of AI will create other opportunities. As companies across industries continue to embrace AI to drive innovation and efficiency, investors are presented with unique opportunities to capitalize on the transformative power of artificial intelligence. The AI revolution is not just a fleeting trend but rather a fundamental shift that is poised to reshape industries and create new opportunities for growth and innovation. In our view this could be the next economic revolution.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long-term influences on the stock market. Recessions, or fear of recessions, are the

major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and tend to happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out of or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye, we have developed what we view as a recession indicator, which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of August, the unemployment rate was 4.1% and the 12 month moving average was 4.29%. By being below the moving average this indicator has remained positive.

Indicator number two is represented in Chart #1. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. Currently the reading is 2.58% for August, so this indicator remains positive since our last report.

Indicator number three is represented in Chart #2. This shows the year over year change in Industrial Production. This indicator has remained positive. It currently sits at 1.42% for August 2026.

For indicator number four (Chart #3), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year-over-year percentage change basis. This indicator stands at 0.94% showing a slight strength in employment. Therefore, this indicator is positive.

Indicator number five (Chart #4) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year-over-year percentage basis. Currently the reading is 1.71%, so this indicator remains positive.

Currently all five indicators are positive and the S&P 500 Index is 6.25% above its 40-week moving average as of August 18th. The S&P 500 is above its 40-week

moving average; therefore this model is not giving a recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation, we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile, so we track three-month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index, which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is at -0.15 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average stands at 0.01.

In summary, the two “early warning signs” are not predicting recession at this time.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently, 8 out of 12 of our price/volume indicators are positive. The S&P has returned to 7800. But that doesn't necessarily mean the end of the rally. The market needs corrections from time to time in the short term to stay healthy and growing over the long term.

Our advance/decline line has been positive for the last nine out of the past eleven weeks, but negative for the last two weeks and sits at 47.7%, and is reflecting there may still be some room to the upside by not being overextended.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is providing

negative signs and may be signaling an intermediate term correction is in the near future.

Section VII. The Economy

The U.S. economy entered the third quarter of 2026 in a resilient but inflation-constrained expansion. Growth and labor-market conditions have held up better than expected, but inflation remains materially above the Federal Reserve's 2% objective—prompting the Fed to resume tightening in September and signal a higher-for-longer policy stance.

The economy appears to be expanding at a moderate, above-trend pace as real GDP growth grew at 1.5% annualized rate in Q2 2026. The Federal Reserve lifted its full-year 2026 real GDP-growth projection to 2.3%, from 2.2% in June suggesting officials see continued support from household consumption, business spending, and resilient employment.

The labor market remains the principal source of macroeconomic resilience. At 4.1%, unemployment is low by historical standards and is projected by the Fed to stay at that level through 2029. That forecast implies policymakers do not currently expect a recessionary labor-market adjustment as the necessary mechanism for restoring price stability.

Indexes that measure manufacturing data are positive. The Philly Fed Manufacturing Index has stayed positive, moving up to 37.8 in September of 2026. The Empire State Manufacturing Index fell to -20.0 in March of 2025, but after reaching positive territory in October and November, its September 2026 reading was 7.60. The national ISM manufacturing index was 54.6% in August and the ISM services index improved to 55.4% (above 50 is considered growth, above 55 is considered exceptional growth).

Section VIII. Conclusion

The market started the year on the weak side, but since then it has been strong. This can primarily be attributed to the expectations of the Federal Reserve being more restrictive with their monetary policy, offset by the surge in AI. Also concerning to markets is the war in Iran. While the market-weighted S&P 500 index is up 7.31% year to date, Yahoo Finance calculates that an equal-weighted return for the index is about 9.84%.

We continue to be optimistic moving forward. As previously stated, we expect a positive, but more muted, return for 2026. As stated earlier, after moves like we have just experienced over the past few years, short-term corrections would not be surprising and are usually healthy for the market. However, we feel that the indicators show that keeping a longer view of the market will be rewarding.

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Chart 1

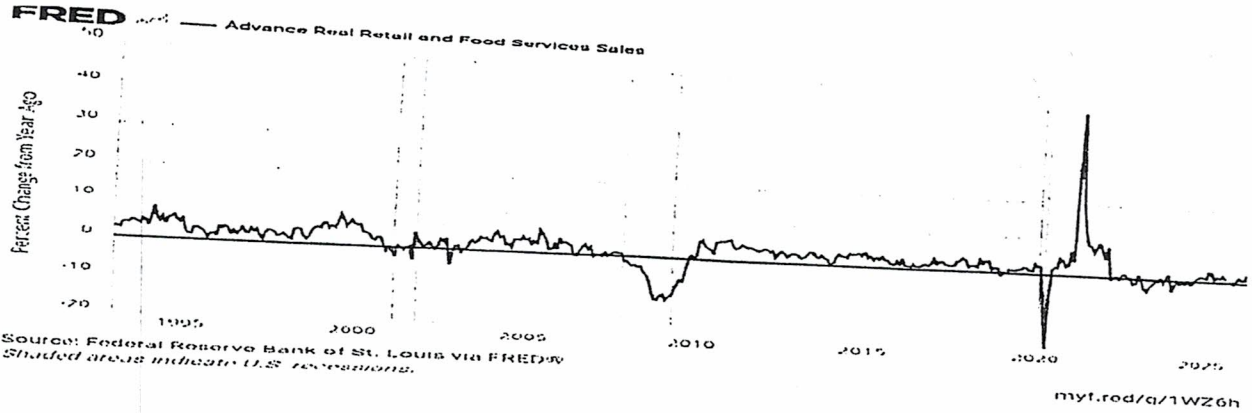


Chart 2

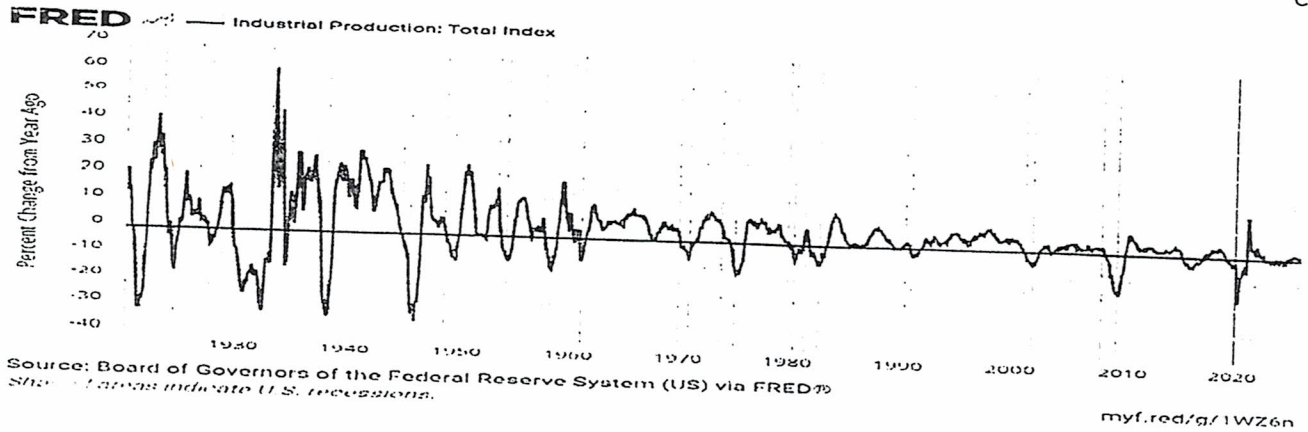


Chart 3

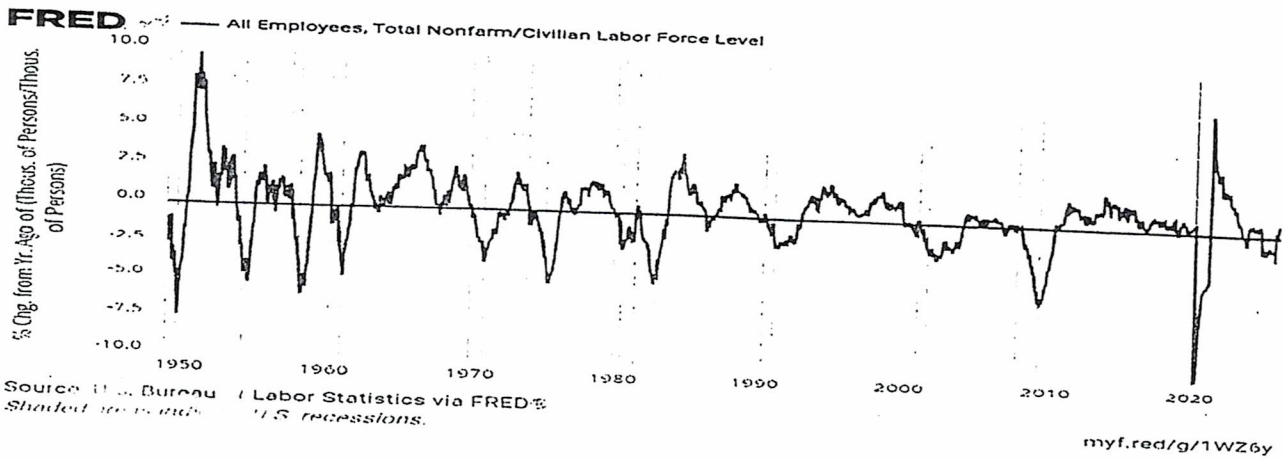


Chart 4

