Capital Ideas

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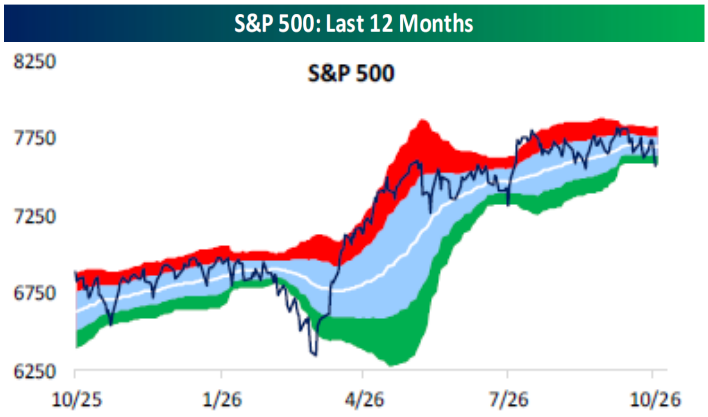
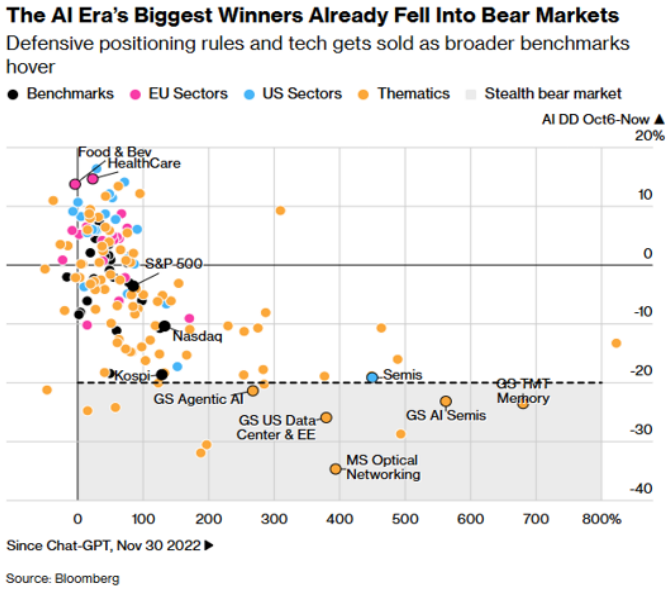
Dear Reader,

October Recap: Sloppy Sell-Off Hits the AI Trade as Losses Accelerate Into Month-End



Source: Bespoke Investment Group

Relative calm at the index level once again masked significant pain underneath—a recurring theme over the past several months. While the S&P 500 finished October down a mere 0.9%, the character of the decline felt exponentially worse in our view. Despite the index closing the month just 3% below its recent high, roughly 60% of S&P 500 constituents are now in bear-market territory (down 20% or more from their recent highs).



Much of the recent selling has been concentrated in the AI ecosystem, particularly semiconductors—the sector at the epicenter of the AI buildout. Since its early-October peak, the Dow Jones U.S. Semiconductors Index has plunged nearly 30%, placing the most vital sector powering the AI boom in a bear-market after blistering gains earlier in the year.

The market's rotation from high-growth winners into more defensive sectors was swift and violent, particularly as the month drew to a close. The key question is whether this reflects fundamental weakness in the AI trade or simply a healthy consolidation as investors take profits. Despite ongoing concerns about the sustainability of AI-related capital spending and financing needs, we believe the underlying fundamentals supporting the core of this bull market remain intact.

Volatility Moves Prices; Fundamentals Drive the Destination

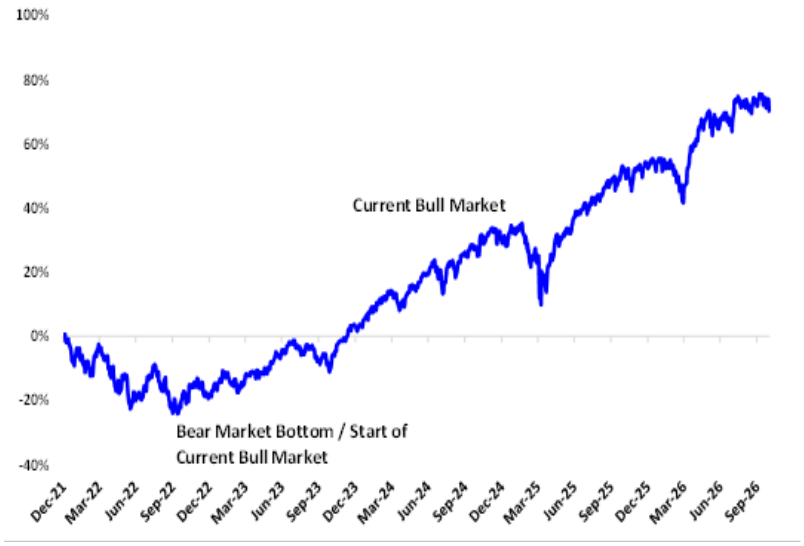
We believe there is currently a disconnect between recent price action and the underlying fundamentals for the companies that have led this bull market. This includes the technology megacaps and the sub-sectors fueling the AI buildout.

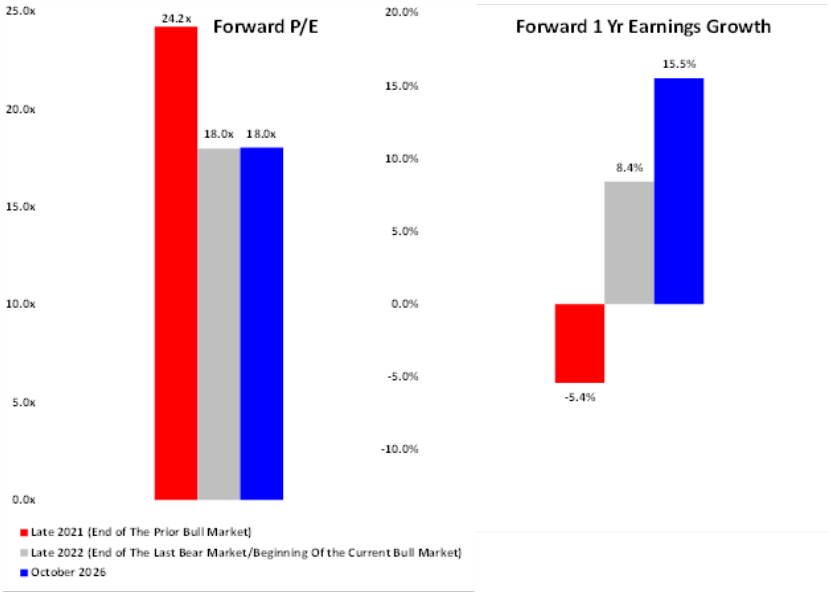
Taking a high-level view of the market's outlook, earnings estimates continue to rise despite significant downside price action across many high-growth sectors. This is typically the period when analysts trim their forward estimates into next year to set a more conservative bar for companies to clear. Instead, profit forecasts continue to increase, which we view as a distinctly bullish sign. The direction of forward earnings estimates (rising, falling, or remaining flat) is a primary indicator of where the market may be headed, as underlying profits ultimately drive stock prices over the medium to longer term.

During periods of elevated volatility, we believe it's often helpful to step back and analyze the current state of the market in a broader context. This bull market began in late 2022, when the last bear market ended. The prior bull market had run until the end of 2021, a period marked by stretched valuations and a surge in "meme" stocks that fueled speculative excess. By the end of 2021, the forward price-to-earnings multiple for the S&P 500 soared to 24x, rivaling the 1990s internet boom. What followed was a standard bear market playbook—earnings fell, valuations compressed, and the Fed aggressively raised interest rates; in 2022, the market posted its worst year since 2008.

With valuations reset and earnings estimates having bottomed, the market had the foundation in place to launch a new bull market in late 2022. What followed was a surge in AI-related capital investment, strong profit expansion, and stock prices that rose alongside earnings. Valuations, however, have not moved meaningfully higher—an unusual outcome roughly four years into a bull market. In short, the rise in stock prices has essentially mirrored the increase in corporate earnings. While multiples began to rise at various points since late 2022, both the magnitude of profit expansion and sharp corrections along the way—including the 2024 growth scare and the 2025 tariff-driven sell-off—have kept a low ceiling on valuation levels.

S&P 500 Total Return Since Year-End 2021





Source: Standard & Poors, Capital Ideas' Research. Note: October 2026 Forward 1 Year earnings reflects consensus S&P 500 earnings estimates in 2027

This lack of multiple expansion likely reflects three factors: investor skepticism regarding the AI buildout, rising interest rates, and economic concerns largely tied to the Iran conflict and higher energy costs. Each of these has created a classic "wall of worry" that has kept sentiment constrained and prevented stock prices from going parabolic. Strong company fundamentals and rising profits have allowed the market to grind higher without speculative excess taking hold. In our view, this backdrop provides a more durable foundation for a long, sustained secular bull market than a late-1990s-style blow-off top. Froth may eventually return and multiples could become overextended before the end of this cycle, but that would most likely occur at significantly higher price levels provided earnings growth persists.

Political Risk Remains Elevated Post Midterms

The midterm elections, held on Tuesday, November 3, produced a blue wave as Democrats took firm control of both the House and Senate. While Democratic control of Congress was largely priced in—given the odds on platforms such as Polymarket and Kalshi ahead of the vote—the magnitude of the victory was shocking. It included upset wins in traditional Republican strongholds such as Texas, Kansas, and South Carolina. The market's reaction the following two days was clear: elevated volatility as the AI trade came under immense pressure. SOXX (the iShares Semiconductor ETF) fell 14% in two days.

The ultimate implications of these midterms will take time to play out, but political headline risk is likely to remain elevated for the foreseeable future. This includes individual state proposals for data-center bans or moratoriums and potential attempts to pass federal legislation on artificial intelligence. While any sweeping national AI legislation could still face a presidential veto, the size of the new Democratic majorities means the market will likely recalibrate its expectations for the regulatory landscape—particularly with an eye toward 2028, when the White House could also change hands. In short, while the midterms are over, political risk is unlikely to fade.

While it is difficult to handicap the ultimate effect of this blue wave, we still believe the AI buildout is likely to continue, although the trajectory may shift. It is certainly possible—and perhaps even likely—that we will see a further push for additional data-center moratoriums or outright bans in certain states and localities. That trend was already underway and will likely accelerate given the election results. There are also likely to be, at a minimum, serious discussions about the future regulatory regime and guardrails around AI.

Ultimately, however, we believe data centers will continue to be built in the remaining friendly jurisdictions and, increasingly, outside the United States. This suggests that robust demand for compute across the ecosystem—fueled by massive capital spending from the largest technology companies—is likely to continue, which remains bullish for the key beneficiaries of that spending. In short, while the political noise is likely to remain loud, the AI buildout should ultimately persist, albeit perhaps in a somewhat different fashion than previously assumed.

The other read-through from the election is tied to the Iran conflict. Following the results, oil prices quickly fell, suggesting a greater likelihood of a near-term resolution and a reduction in energy prices. Should this materialize, we would expect an economic boost from lower gasoline prices, which would ease inflation pressures and potentially support lower bond yields. These specific developments would be incrementally positive for the stock market and broader economy.

Core Fundamentals Remain Supportive Of A Sustained Healthy Bull Market

S&P 500 earnings growth forecasts remain strong, and estimates continue to rise. Consensus currently calls for more than 30% profit expansion in 2026, followed by mid-teens growth next year. Meanwhile, the index trades at a forward price-to-earnings multiple of only about 18x, roughly in line with its long-term historical average. In short, the market's valuation looks quite modest relative to the underlying profit growth being generated by the largest public companies.

Beneath the surface, earnings growth has been broadening beyond technology—another positive sign. While recent price action has been very disappointing in certain pockets of the market, we believe this strong fundamental backdrop bodes well for the market's prospects looking into next year.

Looking Ahead: Balancing Risk Awareness with Fundamental Strength

To be clear, risks remain, and they are rapidly shifting. While the Iran conflict and the related energy-price spike were primary risks throughout most of 2026, that risk may now be fading into the background. In its place, renewed regulatory risk following the midterm blue wave may cast a gray cloud over the horizon for equity investors—particularly across sectors tied to the AI infrastructure buildout. The most obvious sector caught in the crossfire is semiconductors, which remain highly sensitive to AI capital-spending plans. Despite strong underlying earnings growth, semiconductor stocks have been highly volatile of late. That volatility may persist for the foreseeable future as regulatory concerns remain elevated and financing questions linger for some of the companies funding the AI buildout.

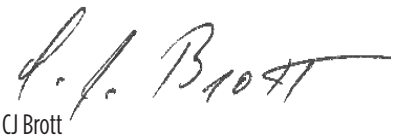
During periods of volatility, it is important to remain focused on the core factors that will drive company performance over the medium to longer term: the growth outlook, balance sheet strength, and material downside risks—both company-specific and broader sector-level implications. The good news is that there is currently ample opportunity for investors to identify companies with strong market positioning, low leverage, and a robust growth outlook trading at relatively modest valuations. Investors, however, need to remain vigilant, as pockets of risk appear to be surfacing and shifting more rapidly than usual amid the evolving political landscape and other macro factors.

In short, we believe this is an environment in which discerning investors will ultimately be rewarded for rigorous fundamental analysis of specific companies and sectors, combined with prudent risk management. It remains our view that the gap between the ultimate winners and losers will only continue to widen as this bull market evolves. In the new world of AI adoption, the landscape is evolving rapidly and the market is repricing accordingly. We believe investors would be wise to remain both grounded and nimble—filtering out the noise while staying focused on the core drivers of long-term profitability and market dominance.

While we remain constructive on the market's outlook into 2027 and beyond, we also believe the benefits of this productivity boom will not be shared equally. Identifying the key beneficiaries—both within and across sectors—will therefore be crucial for compounding strong portfolio returns over the long term.

As always, we value your trust in us and urge you to call with any questions concerning your financial matters.

Sincerely,



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