Capital Ideas

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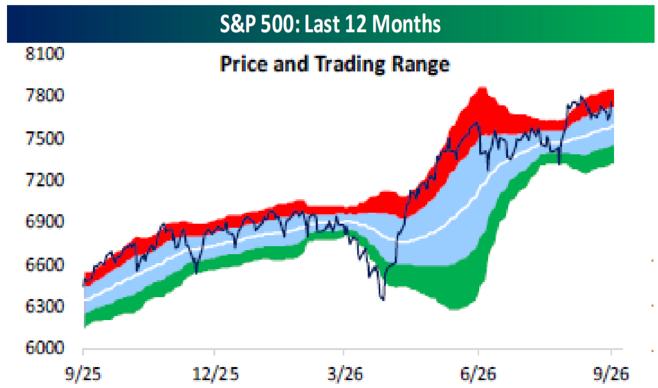
Dear Reader,

August Recap: Modest Market Gains, Meaningful AI Demand Confirmation

Stocks ground higher in August, with the S&P 500 finishing up 2.7% despite a choppy month marked by rising long-term yields and renewed talk of Fed rate hikes. The highlight came on August 26, when Nvidia delivered medium-term revenue guidance that was meaningfully more constructive than even the robust growth the market had already been assuming. With Nvidia at the center of the AI infrastructure buildout, that outlook was a fresh signal that demand across the ecosystem remains strong—with constructive implications for the many companies and sectors powering the AI revolution. With such a large percentage of the market tied to AI demand and adoption, commentary and forward guidance from the world's largest chipmaker has become a quarterly bellwether event.



Source: Bespoke Investment Group

Earnings Continue To Impress Despite Persistent Macro Concerns

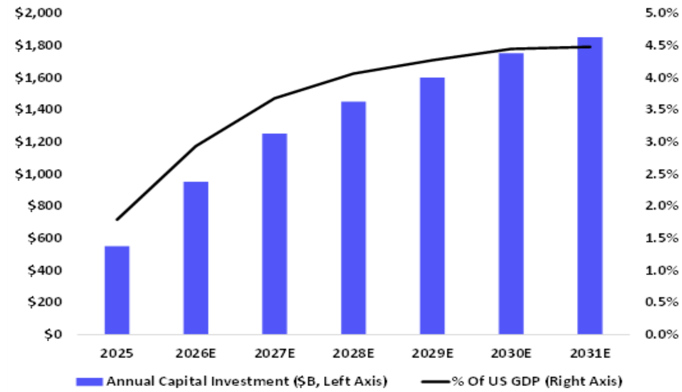
The tug of war across the market is currently twofold: strong earnings growth on one side, and slowing market price momentum due to macro concerns on the other. As we have discussed in prior letters, earnings have done the heavy lifting for this bull market since its inception nearly four years ago. That remains the case. S&P 500 profits are on pace to increase by roughly 30% this year—which, aside from 2021 (when growth was inflated by the collapse in 2020 earnings during Covid), would be the highest calendar-year earnings growth rate since 2010.

The magnitude of that profit growth is especially impressive because it is occurring in the middle of an economic expansion. Growth of this magnitude usually appears immediately after a recession, when earnings have already fallen and the subsequent rebound is measured against a weak comparable. That is not the setup today.

The catalyst for the present high-growth regime is surging capital investment tied to the AI infrastructure buildout. Based on guidance from the major technology hyperscalers, AI-related capital spending is expected to approach $1 trillion this year and to scale higher in the coming years. This capital investment boom is perhaps rivaled only by the U.S. railroad buildout during the 19th century when peak capital spending reached 5-6% of GDP.

This capital investment translates into high-margin revenue generation for the AI enablers. We estimate that every $1 trillion in AI-related capital spending translates into roughly $700-$800 billion of incremental S&P 500 profits. At that order of magnitude, the AI capex surge is both lifting economic growth and, more directly, powering corporate profit expansion. This is a secular trend we do not expect to abate for the foreseeable future, which suggests earnings growth should remain robust over the coming years as well.

Projected AI-Driven Capital Investment: 2025-2031



Source: : xAI's AI Buildout Funding and Plans - Grok, Company Reports & Guidance From MSFT, META, AMZN, GOOG, & ORCL

Note: Reflects the latest company guidance from the major hyperscalers, percentage of nominal GDP – assumes nominal GDP grows 5% from 2027-2031 and uses annualized nominal GDP based on 2026 actuals

Negative Headlines & Macro Risks Continue To Weigh On Sentiment

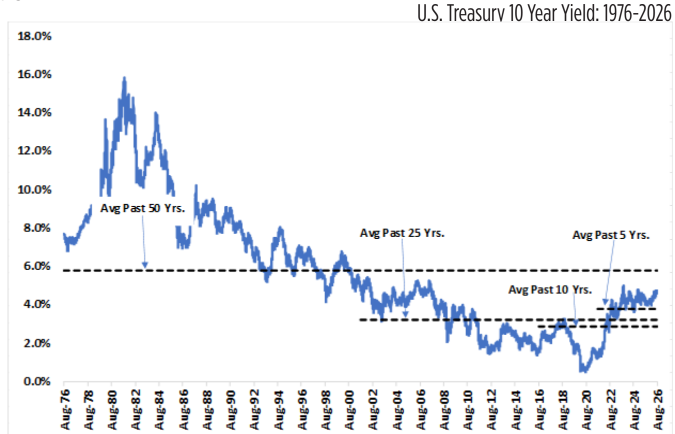
While company fundamentals remain strong, sentiment is currently being depressed due to three factors: the war with Iran and elevated energy prices, concern over interest rates, and growing public pushback against data-center development.

Energy costs are high, but not high enough, in our view, to trigger a meaningful downturn. Crude oil is around $90 a barrel, well below levels that have historically derailed expansions. Developments in the Strait of Hormuz are worth monitoring, but the U.S. economy is far less energy-intensive compared to past periods, and producers have more ability to raise output than they did during prior Middle East shocks. At current prices, energy is a drag on sentiment, not a sufficient condition for recessionary concerns.

The outsized attention on interest rates is hard to justify in our view. The 10-year U.S. Treasury bond has essentially traded in a 4–5% yield range for roughly two years and currently sits near 4.8%. Mid single-digit yields and an upward-sloping curve are normal in an expansion, not a warning sign. Rate volatility has been relatively muted by historical standards; the bond market is behaving as one would expect at this stage of the cycle.

Turning on the financial news, one might be tempted to think yields are spiking or approaching concerning levels. We believe this is simply untrue. While the Fed may raise short-term rates in a measured way if inflation stays above target, we believe the present anxiety about rising yields is significantly overblown.

U.S. Treasury 10 Year Yield: 1976-2026



Source: U.S. Federal Reserve

Hyperscalers refer to massive cloud service providers that operates at an enormous, globally distributed scale to deliver the computing power, storage, networking, and specialized hardware required for modern artificial intelligence workloads. The term "hyperscaler" comes from hyperscale computing — architectures designed to scale dynamically and seamlessly to handle exponential growth in demand (millions or billions of users, or massive AI training/inference jobs). These companies run thousands of hyperscale data centers packed with servers, often containing tens of thousands of units each, optimized for high-performance, low-latency operations..

In AI specifically, hyperscalers are the foundational infrastructure providers that make large-scale AI possible. These companies include Microsoft, Amazon, Google, Meta, and Oracle.

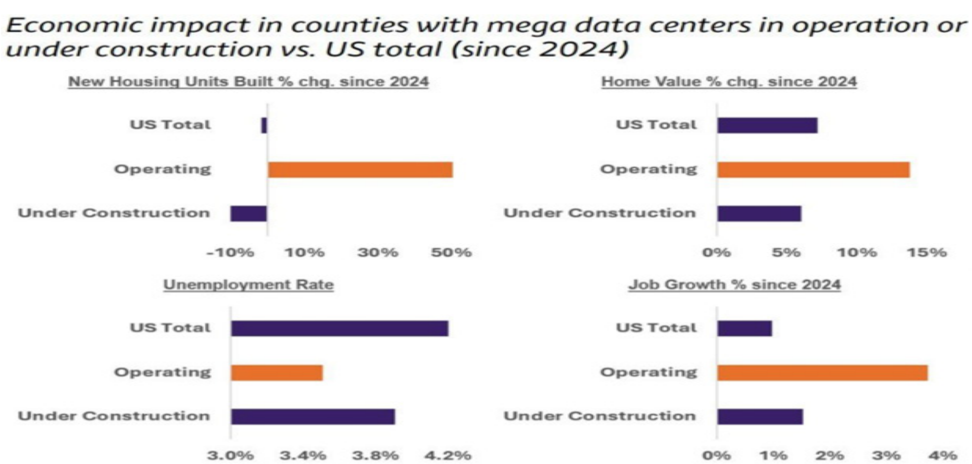
Data centers have recently received significant public pushback and become a hot button issue heading into the mid-term elections. A growing number of municipalities are considering (or have already passed measures) slowing or blocking new construction, raising questions about the speed and scale of an expansion that sits at the center of the AI infrastructure buildout.

We expect the politics to stay loud. We do not expect them to stop the build. The underlying economics still favor development, and there remain sufficient communities across the country that want the jobs, tax base, and investment that come with it. Wells Fargo recently highlighted meaningfully stronger job growth, lower unemployment, and greater home construction in U.S. counties that host major data centers.

Activists and some politicians will keep filling the headlines with opposition. In our view, the data centers that this cycle requires will still get permitted and built at scale. Keeping the AI buildout on track is mission-critical for the U.S. economy, national security, and American competitiveness—and we believe the local economics are compelling enough that many communities will continue to say yes.

Tune Out The Noise While Being Mindful Of Evolving Risks; Stay Focused On Fundamentals

Negative headlines are a constant. Over the medium and longer term, we expect fundamentals—not the daily tape—to drive the market. Earnings are still growing at a pace seldom seen in the middle of an expansion, underwritten by robust, durable capital spending. From an investment perspective, this suggests favoring companies well positioned in key sub-sectors that are beneficiaries of this capital investment with a clear roadmap for recurring revenue growth and defensible margins. At this stage of the cycle, it's also prudent to be mindful of leverage, favoring companies that are predominately funding future growth with operating cash flow versus stretching their balance sheets.



Source: Wells Fargo Securities, LLC, FracTracker, US Census

As AI achieves greater adoption, we believe productivity gains will increase and broaden. If this occurs, we'd expect a handful of non-technology sectors to enjoy the benefits of revenue growth and margin expansion as well. We believe investors should be screening for companies across sectors such as energy and industrials with dominant market positioning and the potential for revenue and margin expansion as they reap the benefits of this productivity boom.

While we remain bullish, there are always evolving risks that warrant monitoring. Currently, we are watching debt levels for corporate issuers as well as margin debt. While neither of these are at levels that merit great concern at present, both have steadily been climbing as companies tap the bond market to fund growth initiatives and investors increase margin debt to fund new stock purchases. Furthermore, over the very near term we are entering a traditionally weak seasonal period in September, which has historically brought elevated market volatility.

Ultimately, we believe the market's future looks bright, firmly supported by sustained capital spending growth and a durable expansionary cycle. While there have been moving pockets of volatility underneath the surface, the core fundamentals supporting this secular bull market remain strong and well intact. As earnings have continued to grow at a meaningfully greater pace compared to stock prices, valuation levels have become more modest despite the market's continued ascent, providing a potentially attractive entry point for long-term investors.

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

Sincerely,

CJ Brott

Karen Burns

Andrew Kerai