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Investment Insights

Innovation Doesn't Just Stop, It Adjusts

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The large-scale change in power in the House of Representatives, the Senate and many State Governor elections across the U.S. has significantly changed investors' views regarding the strength and magnitude of the Artificial Intelligence (AI) buildout story. This has not only created concerns about the level of economic growth but also the timing of peak profitability for many of the key companies at the center of the buildout. Mix this new development with worries over potentially higher deficits and you get a risk-off episode that is very sharp. Lower capital investment may lead to better free cash flow and less "crowding out" effect from hyperscaler bond issuances but this is being outweighed by the concerns of much slower growth than expected for the economy and S&P 500 Index earnings overall.

Violent equity market reversals have often been characterized by both a change in fundamental views and a sharp, sometimes, forced liquidation in positions, particularly of the largest mega capitalization Technology shares. We have experienced sharp reversals like this in the last few years in terms of the tariff jolt, the Deepseek moment and the flush from the hedge fund Situational Awareness. These episodes have tended to create a domino effect in which index managers and trend followers also recalculate their positions lower causing even more pressure to the downside. This takes time to settle down and for more rational market environments to develop. The domino effect generally doesn't end until a realization takes hold that the "liquidation" went too far relative to the rational fundamental backdrop that is still powering ahead. Agentic, physical AI, and quantum computing are still around the corner—new power generation sources are still going to be developed, electrification is still going to be a major growth force, the biotechnology renaissance is just beginning, and productivity through AI adoption is still in its infancy. Delays in data center buildouts or a change to the rules of what is needed to build them in certain communities is not considered an end to the massive capital investment trend needed to advance the modern digital economy. Innovation doesn't just stop in its tracks, it simply adjusts.

Furthermore, while equity volatility remains elevated in the short-term, investors will be assessing how much the growth story has changed and will be much more selective in their individual positions, in our view. They will be analyzing which areas have become overly attractive on price-to-earnings growth basis and what segments of the market offer solid free cash flow stories with lower volatility and, perhaps, with healthy dividends. Again, this will take some time.

The magnitude of the AI buildout growth story has been called into question. However, we believe this supply led expansion still has years to go and will remain the primary engine for both the U.S. and global economies. The race for compute and hyper-competition with China continues to underpin the need for AI infrastructure. Capital investment, the number of total datacenters built in the U.S. and the supply shortages of key components, including financing, are all being reforecasted lower. This new, slower expected growth could lead to lower inflation (as compute prices exhale some), potentially lower bond yields, and just might lead to less rate hikes through the cycle.

We are in the reassessment period where many different scenarios are built and volatility stays elevated. This is a time to recalibrate portfolios, examine tax efficiency methods, have "buy in weakness plans" ready, and add to thematic investment areas that are still the leaders of this cycle, which are now much more attractively priced.

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