

Weekly Market Flash

Good Bubble, Bad Bubble

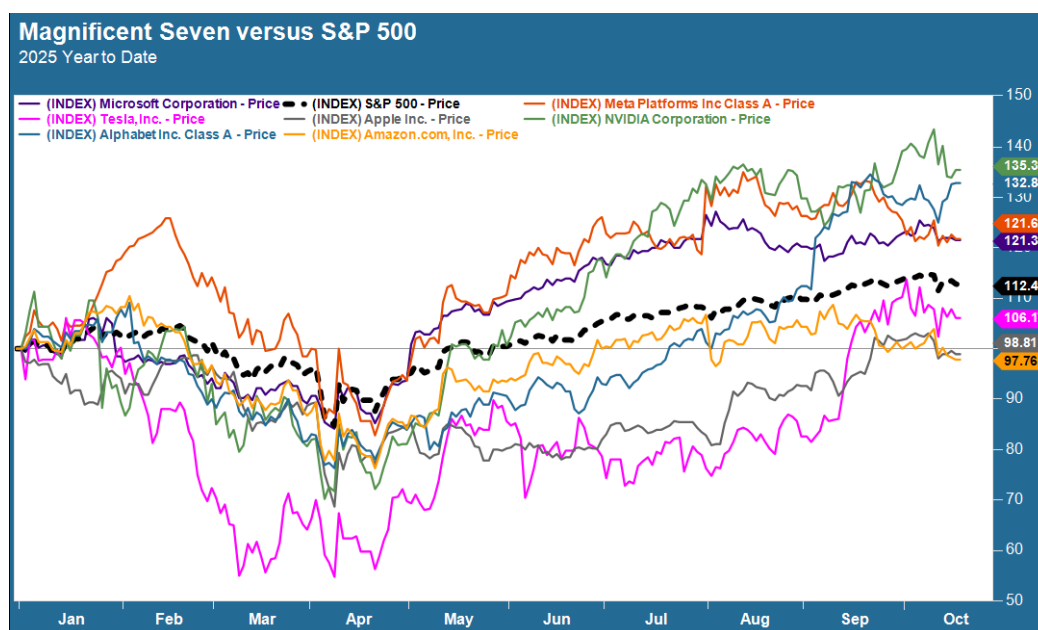
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Is it going to be one of “those” Octobers? If you tuned into pretty much any financial media this week, you would have heard “bubble” spout forth from the mouths of many a money pundit. Luminaries from JPMorgan Chase head Jamie Dimon to OpenAI maven Sam Altman have weighed in on the frothy state of the market. It’s not a hard call to make – the US stock market is undoubtedly expensive. According to Yale economist Robert Shiller’s vaunted CAPE (cyclically adjusted price to earnings) ratio, the S&P 500 is more expensive today than at any time in the history of modern markets apart from the height of the tech bubble before it blew up in 2000. And it’s only a few points off of that – 39.5 today versus the dot-com peak of 44.2 set in December 1999. For a nice historical reference to coincide with the release this week of Andrew Ross Sorkin’s book “1929” – the CAPE peak just ahead of that epic calamity was 32.6.

That’s rare air we’re breathing here. And investors have noticed, and gotten a bit jumpy. The CBOE VIX index, Wall Street’s so-called “fear gauge,” has spiked in recent days after being quiescent for most of the summer. The VIX currently trades around 25, which is above the rule-of-thumb fear threshold of 20, though still well below where it shot up to after the “Liberation Day” tariff announcement of April 2. Much of the market commentary, naturally, has focused on the AI narrative as the driving force behind the market’s gains this year. But the headline story told by those Brady Bunch panels of talking heads on the networks is not exactly seamless – and there are some important distinctions to be made when thinking about today’s market relative to the late 1990s or other bubble periods.

The Mag Seven’s Mixed Results

Let’s start with a closer look at the so-called “Magnificent Seven” – that small group of mega-cap stocks that became a byword for “AI narrative” back in 2023. This group collectively has not packed quite the same punch this year as it did back then.



Source: MVM Research, FactSet

As the chart shows, only four of the Mag Seven names are ahead of the benchmark index so far this year – Nvidia, Alphabet, Meta and Microsoft. The other three – Apple, Amazon and Tesla – are lagging the index. Now, it's true that other names have shouldered their way into the story. Palantir, a provider of data and AI services to defense and other government services, currently trades at a logic-defying forward price-earnings ratio of around 225 times. That's not exactly a screaming buy unless you assume that everything that could possibly go right in the most optimistic AI scenario actually comes to pass. But the frothiness of this bubble, in general, seems like it might be a bit more selective than the one that consumed the market 25 years ago.

Spreading the Wealth

It's also notable that while the AI hype is concentrated on US stocks, the performance of global equity assets this year has been more evenly distributed. In fact, the S&P 500 and even the tech-concentrated Nasdaq Composite are still lagging most of the rest of the world. As of Thursday's market close, the S&P 500 was up 13.9 percent for the year to date and Nasdaq was ahead by 17.4 percent; meanwhile, the MSCI EAFE index was posting a 27.4 percent gain while the MSCI Emerging Markets index, on the back of a stonking performance by China shares, was ahead 31.4 percent. So there must be other factors driving markets apart from the AI story, and the blowing up of AI-themed shares, were it to happen, would arguably not have the same deep impact everywhere at the same time. This underscores the importance of diversification, in favor now after many years in the wilderness, as a strategy for long term performance.

The AI of It All

So how worried should we be? Clearly, there are pockets of extreme frothiness in the market today. A number of the really head-scratching cases can be found in the private markets, perhaps none more so than OpenAI, the company trying to position itself as the Everything AI shop, which sports a valuation of around a half-trillion dollars even while delivering just \$4.3 billion in sales in the first half of the year while burning through \$2.5 billion in cash. OpenAI's rampage around the tech universe, making spending commitments amounting to \$1 trillion in the next five years, has also raised eyebrows among Silicon Valley observers concerned about the circular logic of infrastructure spend and valuations.

Whether one is prepared to take a few bumps along the way in pursuit of long term performance simply comes down to one's own views on what AI can eventually deliver. To paraphrase an old joke, if you put ten tech-savvy investors in a room to talk about AI's future, you're going to come away with fifteen opinions. There is just too much that we don't know today. If AI becomes the most significant paradigm shift in economic productivity since the achievements of the early Information Age, then the risk is worth taking. If, however, it never makes much headway beyond that circular universe of companies at the center of AI infrastructure and model building, then it's more likely to be an epic bust.

The good news is that, as an investors, it is not necessary to stake your entire portfolio on either side of that binary outcome. Diversification among alternative risk asset classes still works, and you can scale the AI-themed component of that up or down accordingly as part of a diversified portfolio across geographies, industrial segments and macro themes. We believe it would be wise to not ignore the longer term potential of AI. Remember that not all dot-com companies perished in the crash of 2000, and many of those that survived have delivered handsomely for those who stuck it out.

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