The AI Bubble Is Deflating



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Weekly Market Summary

In a wild rotation week, stocks were mostly lower (S&P 500 -0.56%). Mag 7 and AI stocks struggled for the week. Breadth was positive with the equal-weight S&P 500 +0.8%. Best sectors were health care (+3.15%), utilities (+2.04%), and materials (+2.02%); the biggest decliners were communication services (-8.49%) and technology (-1.76%).

Market Analysis

Will the Deflating AI Condition Bleed Into the Economy?

The impact of the deflating AI bubble has started to spread to more asset markets. Importantly, credit spreads have widened. Rising credit spreads have historically been bearish for equities, and indeed most stock markets have recently stalled/corrected. Ongoing solid economic growth implies six to 12 months of further upward pressure on inflation. However, the contagion from the deflating AI bubble on equity and credit market raises the risk of a growth scare, via the prospects for sizable wealth losses as well as the potential for a marked slowdown in the AI capex boom.

It appears that our expectation in recent months that yields would rise until "something broke" may now be panning out. To this end, recent bouts of risk-off have helped to cap the rise in government bond yields, as most economic and inflation data have not been weak. At the margin, this is bond positive and equity negative.

The risks related to the AI investment and capex stampede have been growing and investors are finally starting to balk. In economic terms, AI developments have a long way to run, but investment expectations had become unsustainable.

Meanwhile, one risk factor that investors believed had been receding has proved far more resilient, namely the ongoing energy shock. Hopes for a deal to allow normal energy supplies from the Middle East and for geopolitical tensions there to recede have been persistently too optimistic. Neither side in the conflict is willing to give in, underscoring the danger that the shock persists for some time yet. Worrisomely, energy product prices remain elevated and represent a non-trivial economic headwind.

A positive corporate profit backdrop is a necessary, but not sufficient, condition for further gains in risk-asset prices. Markets seem to be suggesting that either bond yields resume rising if AI plays stop deflating, or else risk assets will continue to deflate and generate a growth scare.

In sum, although the economic and policy backdrops remain supportive, the risks for equities and credit have deteriorated and could shift to outright negative. Much depends on how the AI bubble progresses and whether sky-high AI capex plans crest on the one hand, and whether bond yields undergo another upleg on the other.

Key Takeaways

The AI bubble is deflating and the risks of a bust have increased as investors are starting to realize that expectations are too elevated and likely unachievable. Mounting AI woes and wider credit spreads warrant a more constructive view of bonds and a more cautious view on equities.

Market & Economic Highlights

1.	**The recent Fed meeting looked like a "skip" versus a sustained "hold."** We continue to expect a rate hike at the December FOMC meeting. The Fed will likely hike rates at a pace of 25 basis points (bps) per quarter until either falling inflation or tighter financial conditions cause it to stop.
2.	**The Conference Board's consumer confidence index rose in October** (from 84.2 to 91.7) in response to lower energy prices.
3.	**October Flash PMIs signal that the U.S. economy continues to show solid momentum**, while the euro area growth outlook is softening.
4.	While higher-for-longer rates have broad implications for the economy, **we do not think the current rate backdrop should derail equities given the strong earnings anchor**.
5.	According to Yardeni Research, **so far this quarter, revenues are ahead of the consensus forecast by 1.7%**. (That's down from 3.8% in 2Q26, which was the biggest beat since 2Q21.) **Earnings have exceeded estimates by 6.5%** so far (down from 8.4% in 2Q26 and 8.7% in 1Q26). (Nearly 45% of the S&P 500's earnings beat is attributable to just three of the 155 companies reporting: Goldman, Meta, and Micron.)
6.	So far in earnings season, **the consensus EPS estimate for 3Q was revised higher by $0.18**, with upward revisions also recorded for each of the following three quarters.
7.	**The "bubble" in technology stocks appears to be increasingly vulnerable**, making diversification paramount for equity investors even as AI provides a compelling longer-term theme.
8.	Despite the significant tech sell off through last Thursday, **month-to-date nine of 11 sectors are up and eight are up 5% or more**. (Courtesy of BTIG)
*9.	**AI demand remains capacity constrained. We believe the AI investment problem is the challenge of effectively converting capex into free cash flow. The jury is out. Those that do will likely remain good investments**.
*10.	**We became more constructive on bonds in our Sept. 28 commentary as the 10-year yield hit 5.3%. Believing the equity sell off has further to go (despite the average stock still in an uptrend), we reiterate that sentiment**.

Weekly Index Performance

U.S. Equity Market Performance

Equity markets (Index total return %)	Last Week	Year-to-Date
Dow Jones	-0.83	9.08
S&P 500	-0.56	11.77
NASDAQ	-1.99	9.95
Russell 1000	1.28	13.56
Russell 1000 Growth	-1.70	-0.18
Russell 1000 Value	0.48	24.50
Russell 2000	3.00	16.29

S&P 500 Sector Performance

S&P equity sectors (Index total return %)	Last Week	Year-to-Date
Communication Services	-8.49	-11.31
Consumer Discretionary	0.99	-2.11
Consumer Staples	1.63	18.30
Energy	1.01	59.92
Financials	1.09	4.53
Healthcare	3.15	21.02
Industrials	1.71	8.87
Information Technology	-1.76	19.65
Materials	2.02	15.97
Real Estate	1.37	10.66
Utilities	2.04	3.94

International Equity Market Performance

International equity markets (Index total return %)	Last Week	Year-to-Date
MSCI ACWI	1.23	12.88
MSCI ACWI ex U.S.	1.18	12.00
MSCI EAFE	1.28	9.96
MSCI EM	0.92	15.33

Fixed Income Market Performance

Fixed Income markets (Index total return %)	Last Week	Year-to-Date
Bloomberg U.S. Agg Bond TR	0.27	-0.83
Bloomberg U.S. Corp High Yield TR	0.69	0.60
Bloomberg U.S. Govt/Credit TR	0.23	-0.91
Bloomberg U.S. T Bill 1-3 M TR	0.05	3.09

Alternative Investment Performance

Alternatives (Index total return %)	Last Week	Year-to-Date
Real Estate (FTSE NAREIT)	1.15	11.80
Commodities (DJ)	-1.65	32.75
Global Listed Private Equity (Red Rocks)	2.57	-9.80
Currencies (DB G10 Currency Future)	0.23	13.11

Source: Bloomberg as of Oct. 30, 2026

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