

Are We in a Bubble?

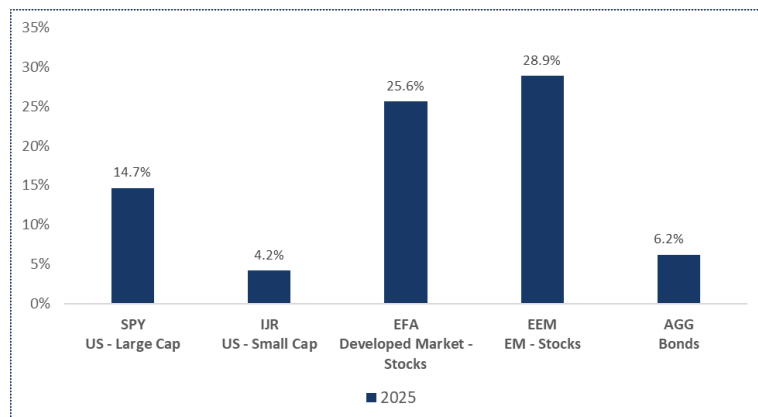
One of the biggest mistakes you can make is to think that overpriced and going down tomorrow are synonymous. Markets that are overpriced often keep going. – Howard Marks

Despite a wall of worry, stocks continued their upward climb in the 3rd quarter and the S&P 500 has returned over 14% for the year despite being down by 15% in early April. This recovery has been one of the strongest and fastest on record. As a result, many investors are now worrying if this is too much of a good thing. Despite the worries, the economy has been resilient, jobs are slowing but not plummeting, and inflation continues to cool despite tariffs. The Fed began lowering rates again in September and that backdrop is typically a tailwind for risk assets.

The 10-year treasury dropped to nearly 4% before the Fed lowered rates and that has resulted in strong performance for bonds with the indices up over 6% on the year through the end of the quarter.

Foreign markets continued their outperformance and have now

returned over 25% on the year (*MSCI EAFE*). Emerging Markets are also on a tear and are now up almost 30% through 3 quarters (*MSCI EM*). The outperformance continues to be driven by a declining dollar, which has declined by about 10% on the year when measured against a diverse basket of foreign currencies. Precious metals have also reached new highs this year with gold up 47% and silver up over 60%. Below we discuss the 3rd quarter, the possibilities of a technology bubble, and our outlook going into year-end.

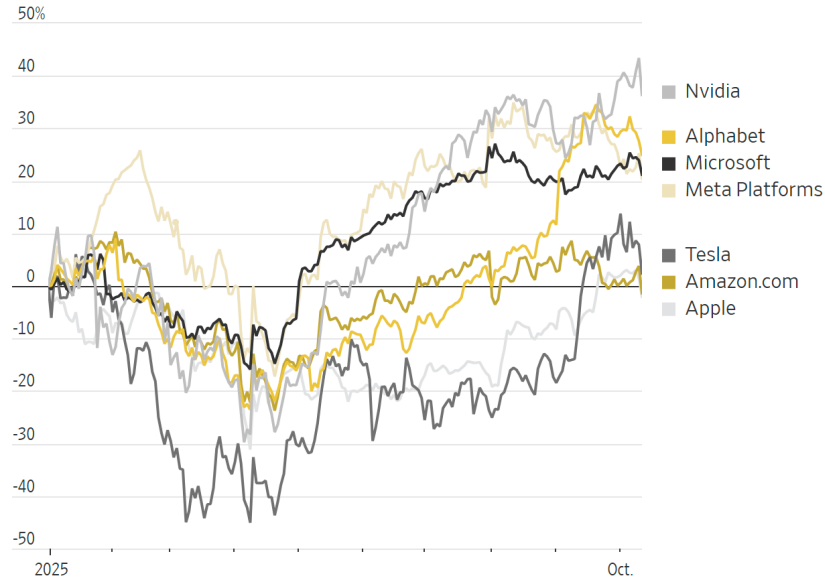


Q3

The third quarter delivered strong returns as the S&P 500 gained 8.1%, bringing year-to-date performance to 14.8%. The index reached new, all-time highs 28 times through the end of September, demonstrating continued market resilience. The quarter's advance was driven by several potent forces, most notably the ongoing artificial intelligence (AI) boom which propelled the Magnificent 7 stocks to a level that now makes up 35% of the S&P 500's market capitalization. Technology led all sectors with an 11.4% gain for the quarter, as investor enthusiasm remained squarely behind AI, semiconductor demand, and the buildout of cloud and data center infrastructure. Information Technology, Utilities, Materials, and Financials sectors led earnings growth expectations for the quarter, with eight of the eleven sectors projected to report year-over-year earnings growth.

The Federal Reserve cut interest rates for the first time since 2024 at its September meeting, bringing the target federal-funds rate to a range of 4.00%-4.25%, providing additional support to equity valuations and allowing the market to avoid the typical September swoon. Small-cap stocks showed strength during the quarter, with the Russell 2000 gaining 12.4% as these higher-beta stocks demonstrated greater sensitivity to the beneficial impact of lower rates. Looking ahead, corporate earnings fundamentals remain supportive, with Q3 expected to mark the ninth consecutive quarter of year-over-year earnings growth at 8.0%.

Share-price performance, this year



Source: FactSet

As of Oct. 10, 4 p.m. ET

Volatility has been virtually nonexistent since the April Tariff debacle. This is now the 3rd largest rally in history without at least a 6% correction, as “animal spirits” continue to push nearly all assets higher. One thing remains certain: we will have another 6%+ correction, but the question is when and how severe.

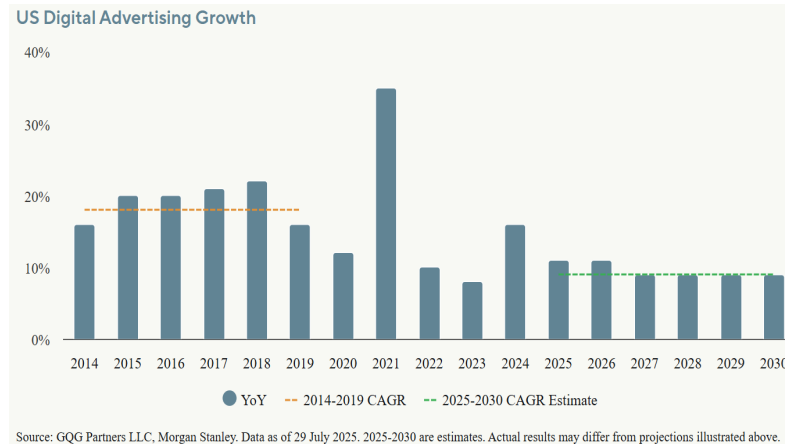
Tech Bubble 2.0?

The continued outperformance and massive valuations of AI related stocks have sparked an increasingly vocal debate about whether or not we are in the midst of another technology bubble. Understanding what made the tech bubble bust so devastating is critical to assessing today's risks. The real damage from the late 1990s boom didn't come from Pets.com going bankrupt, it came when speculation bled into the real economy. Utility companies abandoned their core businesses to build fiber networks, strategic mergers destroyed enormous value, and everyday Americans spent paper wealth before it evaporated. Interestingly, by 1999 the biggest gains were no longer even in internet companies - they were in chip makers like Qualcomm, which surged 2,600% while Amazon rose just 28%. Sound familiar?

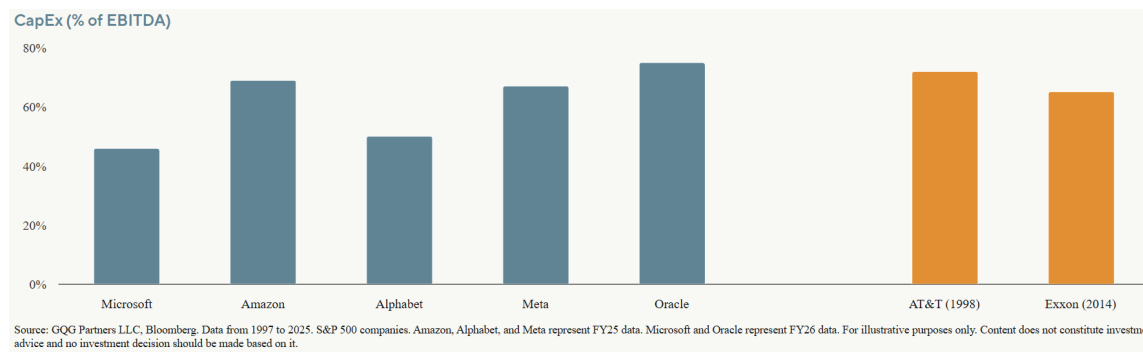
Today, according to recent analysis, nearly three-quarters of returns in the 10 biggest S&P 500 stocks are attributable to future AI success, and the industrial companies mentioning AI favorably in earnings calls have significantly outperformed those that haven't. The entire market has essentially gone “all in” on the AI ecosystem, raising questions about what happens if reality doesn't match the hype. Open AI (ChatGPT) launched nearly three years ago, but its revenues are estimated at less than \$20 billion today, which is a fraction of the \$1 trillion it plans to spend on AI buildouts by 2030. This echoes the 1990s fiber-optic buildout,

when 85% to 95% of capacity sat unused for years after massive infrastructure investments preceded actual demand.

Much of today's current AI capital expenditures are being funded by advertising revenue from the technology giants, which tends to be cyclical, yet investors are treating these revenues as a secular growth engine. As can be seen in the chart on the right, digital advertising growth has plateaued and is forecasted to grow in just the high single digits over the next 5 years.



Perhaps more concerning are the circular financing deals being made across the AI ecosystem. OpenAI has structured deals where it receives equity stakes in chip companies (AMD) in exchange for purchase commitments and also signed a \$300 billion cloud deal with Oracle. It seems all of these deals are being inked with the \$1 trillion spending goal mentioned above, but the Open AI doesn't have this kind of cash and certainly doesn't have the ability to finance it. Capital expenditures as a percentage of EBITDA now run at 50-70% for the big tech firms, which are comparable to AT&T's 72% at the peak of the 2000 telecom bubble and Exxon's 65% at the peak of the 2014 energy bubble. The top 5 tech giants are collectively spending a record \$350 billion on capital expenditures this year, predominantly for AI infrastructure (see chart below).



However, there are important distinctions that optimists are quick to point out. Unlike the dot-com era when valuations were based on expectations of growth that never materialized, today's tech leaders have genuine earnings, strong profit margins, and solid returns on equity backing their valuations, with a market P/E around 27 compared to P/E's over 50 during the dot-com peak. The S&P 500 gained over 20% annually from 1995-1999, suggesting bubbles can persist longer than bears expect, and thus some suggest we may only be in the middle innings rather than the ninth. That said, some prominent investors argue this time

could actually be worse than the dot-com bubble. Today's tech giants face decelerating revenue growth, decreasing free cash flow margins due to massive CapEx requirements, and intensifying competition. The cloud businesses, which have acted much like monopolies over the past 10 years, are losing market share as new entrants come into that space with discounted pricing. The weight of companies in the S&P 500 trading at more than 10 times trailing sales has reached 35% today versus only 25% at the dot-com peak. The key risks we are watching include power generation capacity constraints for data centers, mounting doubts about whether AI spending will generate profitable returns, and any shift by tech companies from AI infrastructure spending back to returning cash to shareholders. Any of these could mark an inflection point, and as history has shown, even the best companies can lead to poor investment outcomes when bought at inflated prices.

Year End Outlook

Currently, markets are giving a greater than 95% chance of two more rate cuts by year-end. However, as we enter 2026 the chance of rate cuts in January and March drops to 58% and 47% respectively. A declining rate cycle is a huge tailwind for the economy, so we believe that as long as rates are declining, this is a positive for most investment assets.

The 2025 (OBBBA) tax passed in July provides more tailwinds for businesses, with the biggest windfall

relating to Section 179 tax deductions and 100% bonus depreciation, two provisions that allow businesses to write off certain capital expenditures in the year of purchase versus over time. This tax incentive was made permanent and will be a massive driver of spending for both public and private companies.

The biggest risk to the Fed ending this rate cut cycle relates to tariffs. The playbook for American importers was to stockpile goods in the 1st quarter before tariffs went into effect. Many companies have since absorbed the price increase of tariffs to maintain market share, however now that markets have stabilized many companies are beginning to pass through the costs to consumers, and this is expected to show up in the inflation numbers in the coming months. The Federal Reserve is taking the stance that tariffs will be a one-time price increase. However, following Covid they made the same forecast, and we ended up with the highest inflation in decades.

The Supreme Court will begin hearing arguments from the administrations regarding tariffs on November 5th. Betting markets are giving the administration a 45% chance of winning the case. This will certainly be a

CME FEDWATCH TOOL - CONDITIONAL MEETING PROBABILITIES										
MEETING DATE	175-200	200-225	225-250	250-275	275-300	300-325	325-350	350-375	375-400	400-425
10/29/2025					0.0%	0.0%	0.0%	0.0%	98.9%	1.1%
12/10/2025	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	97.1%	2.9%	0.0%
1/28/2026	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	58.1%	40.8%	1.2%	0.0%
3/18/2026	0.0%	0.0%	0.0%	0.0%	0.0%	31.9%	48.6%	19.0%	0.5%	0.0%
4/29/2026	0.0%	0.0%	0.0%	0.0%	9.9%	37.1%	39.4%	13.3%	0.4%	0.0%
6/17/2026	0.0%	0.0%	0.0%	5.7%	25.6%	38.4%	24.3%	5.8%	0.2%	0.0%
7/29/2026	0.0%	0.0%	1.8%	12.1%	29.7%	33.9%	18.3%	4.0%	0.1%	0.0%
9/16/2026	0.0%	0.7%	5.7%	18.7%	31.3%	28.0%	13.0%	2.5%	0.1%	0.0%
10/28/2026	0.1%	1.5%	7.7%	20.7%	30.8%	25.7%	11.3%	2.1%	0.1%	0.0%
12/9/2026	0.3%	2.4%	9.7%	22.2%	30.0%	23.5%	9.9%	1.8%	0.0%	0.0%
1/27/2027	0.4%	2.8%	10.3%	22.6%	29.7%	22.9%	9.5%	1.7%	0.0%	0.0%
3/17/2027	0.4%	2.8%	10.3%	22.6%	29.7%	22.8%	9.5%	1.7%	0.0%	0.0%
4/28/2027	0.4%	2.7%	10.0%	22.1%	29.4%	23.1%	10.1%	2.1%	0.1%	0.0%
6/9/2027	0.4%	2.4%	9.1%	20.6%	28.5%	23.9%	11.7%	3.1%	0.4%	0.0%
7/28/2027	0.3%	2.0%	7.9%	18.6%	27.1%	24.7%	13.9%	4.6%	0.8%	0.1%
9/15/2027	0.3%	2.0%	7.9%	18.6%	27.1%	24.7%	13.9%	4.6%	0.8%	0.1%

market mover. Below is a chart of the tariff revenues that have been collected through August. If the tariffs are ruled unconstitutional, what happens to the billions of revenues that have been collected?

2025	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	YTD total
Tariff revenue (billions)	\$7	\$7	\$8	\$16	\$22	\$27	\$28	\$30	\$144
Imports (billions)	\$317	\$288	\$343	\$276	\$276	\$266	\$292	\$262	\$2,320
Effective tariff rate	2.3%	2.5%	2.4%	5.7%	8.0%	10.0%	9.5%	11.3%	6.2%

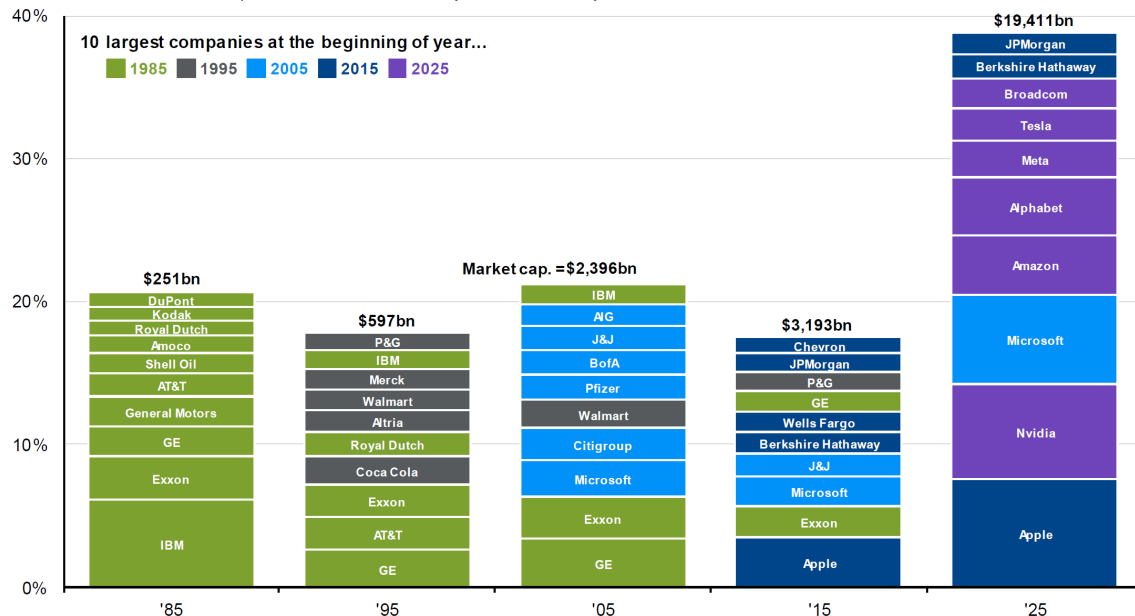
Source - US Treasury Department

As we enter earnings season, future guidance will be at the top of mind to investors. Expectations are for earnings to grow by 10% this year and 13% in both 2026 and 2027. Much of this earnings growth is expected to come from expanding profit margins, which analysts believe will grow to all-time highs. This is very important as we tie all of this together: the overall market is more profitable than it has ever been, and this is because the overall makeup of the market has changed dramatically over time.

Below, we see the top 10 companies by size over the past 5 decades. Twenty years ago, financial and energy stocks made up 1/3 of the overall market and technology made up 18%. Today, these percentages have changed dramatically, technology related companies make up 49% of the market and financial and energy stocks are only 16%.

Top 10 S&P 500 companies by market capitalization

Percent of S&P 500 market capitalization as of the first day of the indicated year



Source - Bloomberg, Standard & Poor's, JP Morgan Asset Management

The old market that was dominated by slow growth and low profit margin companies has been replaced by fast growing and very profitable technology companies. Therefore, when we discuss today's valuations versus yesterday's, we are talking apples and oranges. If we use today's sector-weighted average, the historical P/E ratio increases to 21.6x, which is very different than the 17-18x historical numbers that we

hear in the news. Today the market is trading at 22x forecasted earnings, so maybe stocks aren't all that expensive and there is a long way to run before markets are truly in bubble territory.

In summary, we believe the most likely outcome is that markets continue to grind higher into year end, supported by falling interest rates, strong corporate earnings growth, and pro-business tax incentives that should stimulate capital investment. While inflation risks tied to tariffs could create short-term volatility or delay additional Fed cuts, the broader backdrop remains constructive. In our view, the biggest risks stem from policy missteps or a tariff-driven inflation surprise that forces the Fed to pause or reverse its rate-cut cycle.

Resources

What We Are Reading:

1. GQG Insights: [Dotcom on Steroids](#)
2. Robin Hood Conference - [AI Debate](#)

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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