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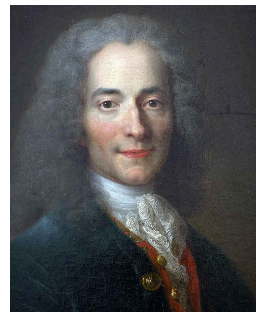
# Cultivating the Garden: Investing Beyond the AI Optimism

***"We must cultivate our garden"***

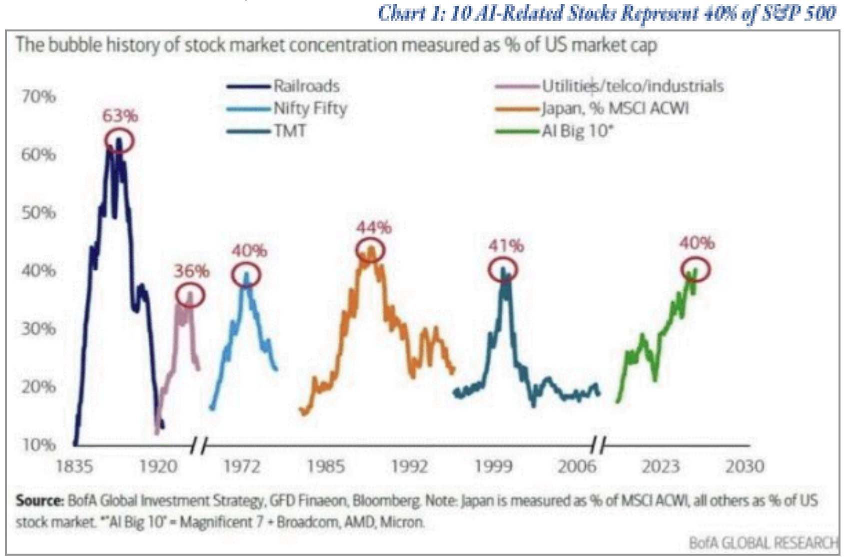
~*Candide* Francois-Marie Arouet (Voltaire) 1694-1778



In Voltaire's 18th century novella "Candide," tutor Dr. Pangloss insists that 1750s France is an "Edenic" paradise despite overwhelming evidence to the contrary. Candide, the story's protagonist, is expelled from his castle home for kissing the Baron's daughter and thrust into a world of war, a shipwreck, swindles, slavery, and disease. But while Pangloss's blind optimism never bends to reality, Candide comes to believe that optimism is dangerous once it ceases to be tested by reality.

Today's market strategists often sound similarly Panglossian about stocks, bonds, and the economy. S&P 500 earnings are booming, but that growth leans heavily on one theme: artificial intelligence. The current AI infrastructure buildout is likely the largest concentrated capital expenditure event in history, and the market reflects it—the ten largest AI stocks now make up 40% of the index (see Chart 1). Yet even the most bullish AI evangelists' revenue projections don't add up.

*Chart 1: 10 AI-Related Stocks Represent 40% of S&P 500*



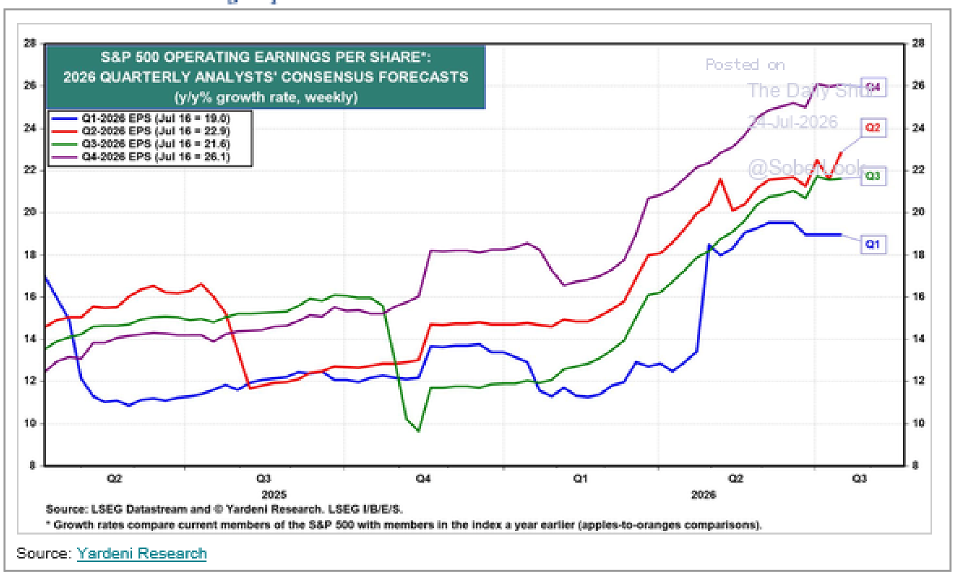

**Source:** BofA Global Investment Strategy, GFD Finaeon, Bloomberg. Note: Japan is measured as % of MSCI ACWI, all others as % of US stock market. *"AI Big 10" = Magnificent 7 + Broadcom, AMD, Micron.

Meanwhile, the new Fed Chairman touts a 2% "Holy Grail" inflation target even as debt and deficits keep climbing, and the Bloomberg Commodity Index—a key inflation bellwether—has jumped more than 30% over the past year. Just as troubling is the economy's K-shaped split: robust high-end spending, buoyed by the AI wealth effect, on one side; on the other, some of the worst consumer debt delinquency rates in decades. The question, then, is whether investors will keep clinging to their Panglossian optimism or will they finally embrace a dose of Candide's hard-won realism.

## Counting *Chips* Before They Hatch

Optimism is certainly alive and well in the equity market, thanks to impressive corporate earnings! According to Ed Yardeni Research (see Chart 2), so far this year, the S&P 500 realized an earnings increase of 27% in the first quarter, and those earnings are expected to rise over 23% again in the second quarter of this year. FactSet expects S&P 500 earnings to rise by over 24% for all of 2026 versus 2025. More than 50% of this meteoric growth is being driven by a contribution from AI-related stocks and AI capex spending, which "is becoming the foundation of the largest infrastructure buildout in history," according to Jensen Huang, CEO of Nvidia.

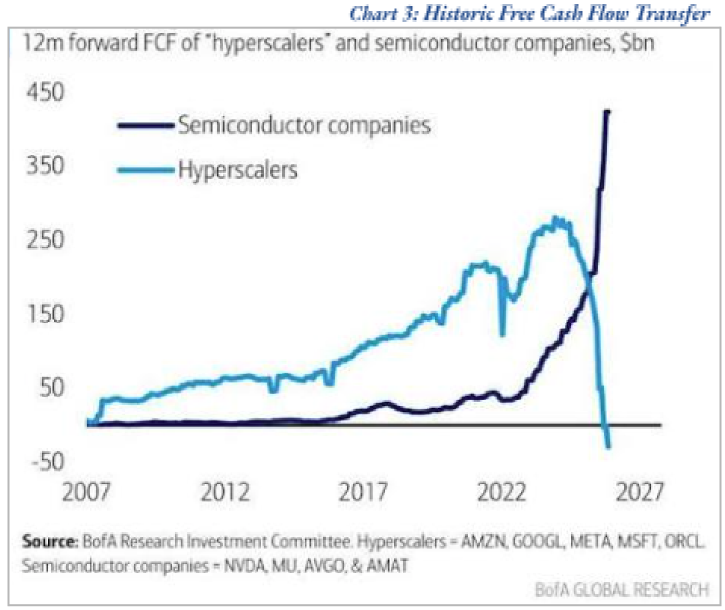
*Chart 2: S&P 500 Earnings Expected to Increase 24% in 2026*




Source: Yardeni Research

Fueling this historic infrastructure spend is a generational transfer of cash flow from AI hyperscalers (like Meta and Google) to semiconductor firms (like Nvidia) as evidenced in Chart 3. According to Anomaly Investment Partners, "between 2023 and 2026, the world's largest technology companies will have committed approximately $1.6 trillion to artificial intelligence infrastructure. By 2027, annual spending alone is projected to exceed $1 trillion."

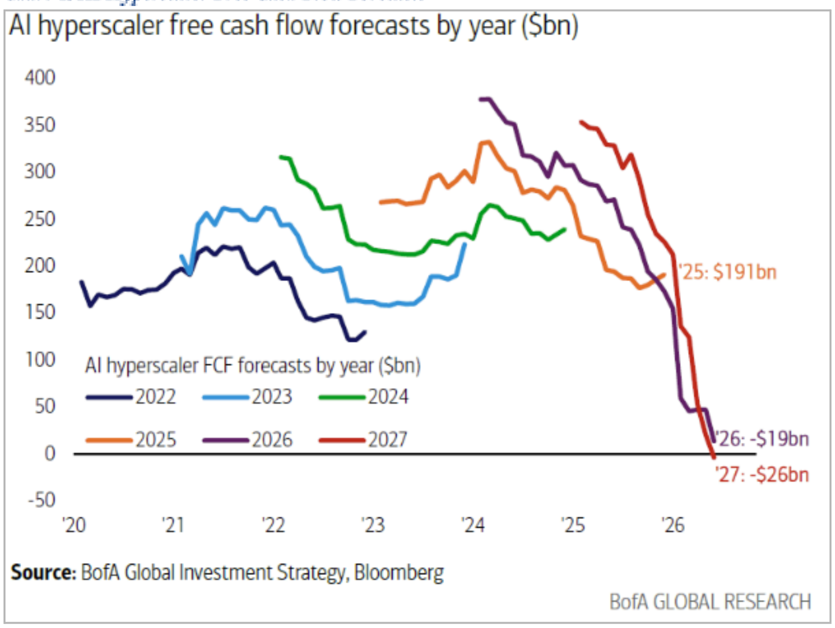
*Chart 3: Historic Free Cash Flow Transfer*




Critics of the AI revolution are quick to point out that all of this AI spend is overdone and that the market needs a dose of reality. Their points of contention include claims of artificially inflated earnings, unsustainable AI-related spending and a mathematical mismatch between the current AI infrastructure buildout spend and what these assets will actually generate in revenue.

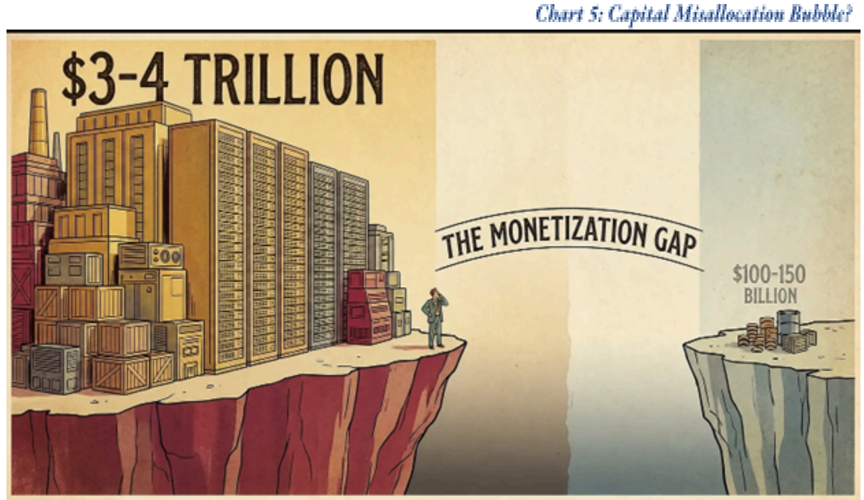
As shown in Chart 4, the large hyperscalers - primarily Amazon, Google, Oracle, Microsoft and Meta - have been spending the majority of their free cash flow to support this buildout, and the negative cash flow generated from these five hyperscalers emanating from capex spending is expected to increase in 2027.

*Chart 4: AI Hyperscaler Free Cash Flow Forecasts*




While the free cash flow of these hyperscalers is deteriorating, earnings are not. Part of the reason lies in accounting mechanics: when a hyperscaler buys a chip from a company like Nvidia, Nvidia immediately books the sale as revenue in the current year. Meanwhile, the hyperscaler books that same chip purchase as a capital expenditure, records the cost on its balance sheet as a fixed asset and allocates a portion of that cost as a depreciation expense over the useful life of the chip. But any revenue the hyperscaler realizes from using those chips is counted as current-year revenue. This is common accounting practice, and has the effect of ameliorating near-term earnings.

*Chart 5: Capital Misallocation Bubble?*




At some point, capex spending will slow because AI data center supply catches up with demand or other forces. The bigger concern is that there has been very little validation that scalable, profitable revenue streams will actually emerge from these capital expenditures. J.P. Morgan currently estimates that "the industry needs to generate $650 billion in new annual revenue just to achieve a 10% return on the infrastructure being built."[1] To put this into perspective, projected AI-attributable revenue currently "debt sits somewhere between $50 and $150 billion annually....a gap of between 4x to 13x."[1] This suggests the "current investment cycle has the defining characteristics of a capital misallocation bubble."[1]

## Borrowed Optimism

Much of the funding for the rapid AI infrastructure buildout has come from debt issuance in the bond market. Global AI-related companies have issued roughly $489 billion in debt in 2026 alone, up from about $322 billion issued in 2025 according to estimates tracked by Goldman Sachs. $194 billion has been borrowed by hyperscalers so far in 2026 (see chart 6). However, when prior borrowing, private credit, and off-balance-sheet commitments like data center leases are included in the equation, total financial exposure exceeds $1.65 trillion.[2]

*Chart 6: 2026 Gross AI-Related Investment Grade Bond Issuance*

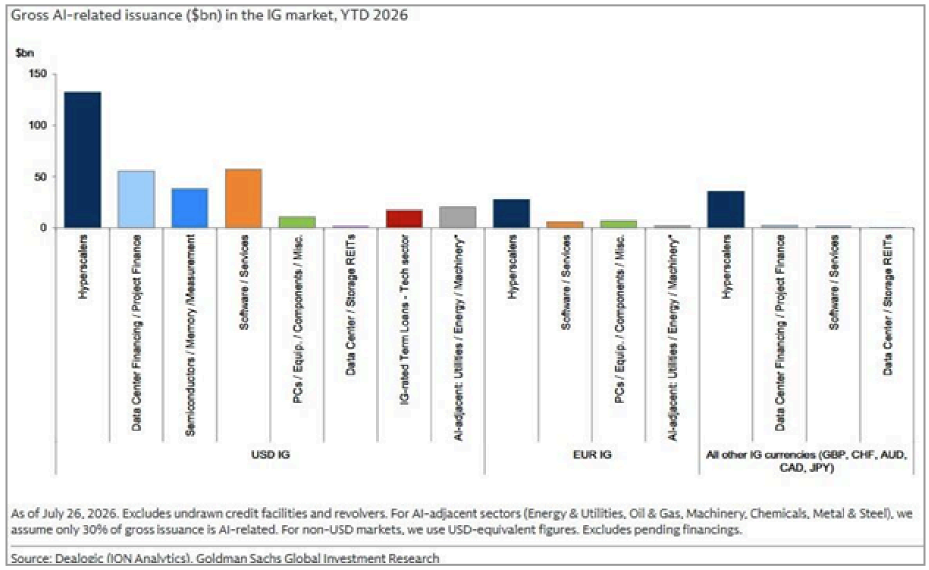
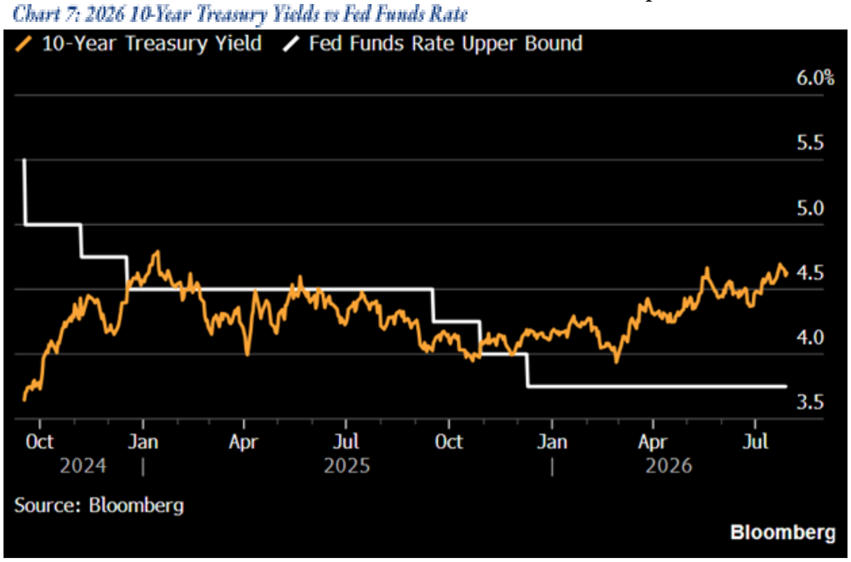



*Chart 7: 2026 10-Year Treasury Yields vs Fed Funds Rate*




There is growing evidence that the bond market will not remain as accommodative when it comes to funding AI infrastructure buildout in the future as it has been in the past. According to Bloomberg, some newly minted AI-related debt is trading off as much as 12% so far this year, reflecting a combination of credit concerns and rising interest rates.

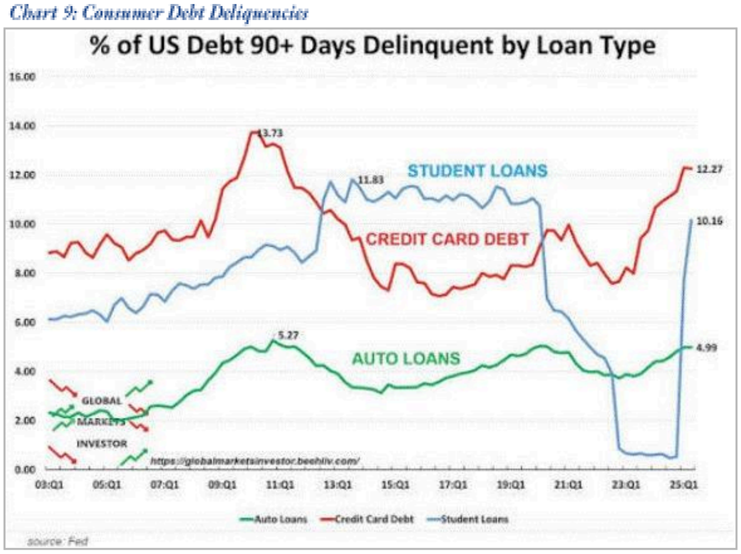
*Chart 8: Commodity Prices Up Over 30% Past 12 Months (Source: Bloomberg)*


Beginning in September of 2024, the Federal Reserve lowered the Fed Funds Rate from a range of 5.25% - 5.5% to the current range of 3.5% -3.75%, even though the economy has been expanding at a historically healthy pace and inflation has remained stubbornly high. Since the

Fed began cutting rates 22 months ago, the Bloomberg Commodity Index has risen by about 40%. Over the past 12 months alone, the Index has risen by over 30%, and it is up more than 20% so far in 2026 (See Chart 8). But while the Fed cut short term rates by 1.75% or 175 basis points during this timeframe, the yield on the 10-year Treasury has actually risen from 3.65% to roughly 4.7% - an increase of 1.05% or 105 basis points - and is now trading at its highest level since September of 2007.

While the stock market wealth effect has helped fuel positive consumer spending, there are significant signs that much of the economy is not benefitting from the AI infrastructure spending boom. The Federal Reserve Bank of New York recently published a chart illustrating how the lower half of the K-shaped economy is actually faring. As evidenced by Chart 9, student loans, credit card debt and automobile loans are experiencing some of the highest 90-day delinquency numbers on record.

*Chart 9: Consumer Debt Deliquencies*




## Keeping the Garden in Perspective

Like Candide, today's market could use a dose of reality to temper its Pangloss-level optimism. Earnings are strong and the AI buildout is genuinely historic, but the capital deployed still may lack returns to justify them. That mismatch between investment and actual AI revenue demands caution, given: 1) an accounting convention that defers the gap rather than closes it, 2) a Fed cutting short-term rates (albeit currently they are on hold) even as long-term yields and commodity prices rise, and 3) a bottom-half economy where delinquency rates tell a very different story than the top's wealth effect.

None of this means the buildout is a mirage or the economy is headed for collapse. So in the moment, enjoy the earnings while they last, but resist assuming today's capex automatically becomes tomorrow's revenue, that 2% inflation is a foregone conclusion or that a wealth effect concentrated in ten stocks and one income cohort adds up to a healthy economy. The task now, like Candide found, is simply to cultivate the garden in front of us — carefully, skeptically, and with eyes open.

Sincerely,

Chris L. Doucet

[1] “This Obviously is an AI Bubble: The Math Says So,” Anomaly Investment Partners, June 7, 2026

[2] “Tech’s AI Boom,” Yahoo Finance, Brian Sozzi, July 23,2026

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