

# MARKET COMMENTARY

## EQUITY ANALYSIS



### THE AI INVESTMENT BOOM AND THE PROFIT CYCLE

It is now all about earnings. Surging capital spending has been the main driver of profit expectations and the stock market. Despite all the worry about oil, Iran, stagflation, and AI disruption, the forward view of earnings is still strong and the S&P 500 trades at a higher than average multiple of expected earnings.

Since earnings growth has driven about two-thirds of the gain in the S&P 500 post 2019 and much of the gain since the end of 2024, what happens over the upcoming earnings season should be of utmost importance (Chart A, page 3). Expectations are high as analysts are looking to extend the profit growth winning streak to six straight double-digit EPS gains in a row.

### INVESTMENT IN CAPITAL EXPENDITURES AS DRIVER

It is abundantly clear that spending on artificial intelligence and related infrastructure is reshaping the landscape. Since the launch of ChatGPT in 2022, capital expenditures on datacenters, energy infrastructure, and semiconductors have exploded (Chart B, page 3). Global technology spending growth was over 12% last year, one of the strongest growth levels in the past 25-30 years, according to S&P Global. As businesses spend to expand, these capex dollars are recycled into profits because investment by one company becomes revenue for another, turning spending on data centers, semiconductors, and power infrastructure into profits across corporate America. Capital spending feeds the profit cycle, reinforcing expectations for growth, and fosters the risk appetite necessary to fund investments. Surging investment in artificial intelligence is driving the cycle today much like railroads did in the late 1800s, electrification did in the 1920s, and the internet did in the 1990s. Each era produced a wave of infrastructure spending that lifted profits across the economy. While AI technology is new, the phenomenon of investment-led profit and credit growth is not.

### THE AI SUPERCYCLE AND CREDIT CONNECTION

Increasingly, investments in artificial intelligence require financing beyond operating cash flow. Hyperscalers are increasingly turning to debt and leases to finance AI capacity. Ratings agency S&P Global forecasts the five largest companies in this arena (Amazon, Microsoft, Alphabet, Meta, Oracle) will spend over \$700 billion this year, and the present value of hyperscaler lease obligations is also estimated to be near \$700 billion. Fortunately, these same companies, in total, produced more gross cash flow

than capital expenditures, but the speed of capital deployment, coupled with wide ranging uncertainty about the ultimate profitability of the investments, raise both risk and opportunity.

The risk cuts both ways. If a hyperscaler fails to invest enough, it risks falling behind competitors. But if it invests too aggressively, it risks creating excess capacity and writing down investments later. In our view, underinvestment is the bigger risk, which means that risks are likely skewed to producing overcapacity, falling prices, and write-downs once the AI capex Supercycle crests. These developments do not appear priced into credit markets as credit spreads among the highest risk borrowers remain in the lowest decile relative to historic spreads (Chart C, page 4).

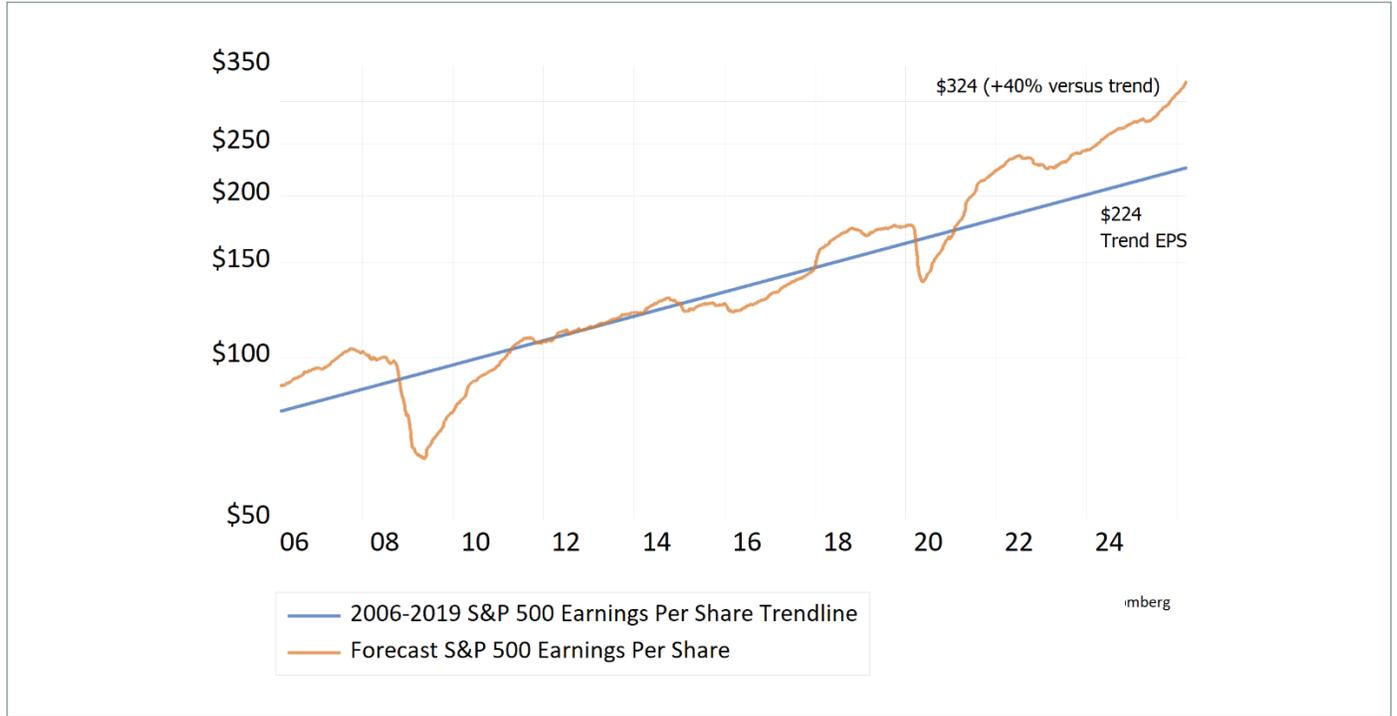
### MARKETS DIGESTING NEW RISKS

Markets can struggle when investment booms collide with tightening credit conditions. Following a period where confidence has been running exceptionally high, energy and credit are introducing a new risk case. \$100+ oil and widening spreads in high yield could throw a monkey wrench into the outlook. This is why the S&P 500 is finding it hard to move to higher ground despite an otherwise good economy. Even before the beginning of the Middle East conflict, which is currently shutting in large amounts of global crude production and shipments, there were signs of pressure in credit markets. As Chart D on page 4 shows, the spread for high-yield corporate issuers began to rise from record lows in January.

While hard to see in the chart, the spread reached a near record low on January 21 at 2.5%. Today, that spread stands near 3%, a 50 basis-point increase off the lows. While far from a blow-out, the broader credit environment is also showing some sign of pressure. Financial stocks are down 10% since the start of the year, and troubles at fast growing private credit managers are grabbing headlines. Higher quality companies, represented by the WCA High Quality Index, are outperforming lower quality companies, represented by the WCA Low Quality Index, by about 5% year-to-date. It seems investors may be starting to demand higher return for risk.

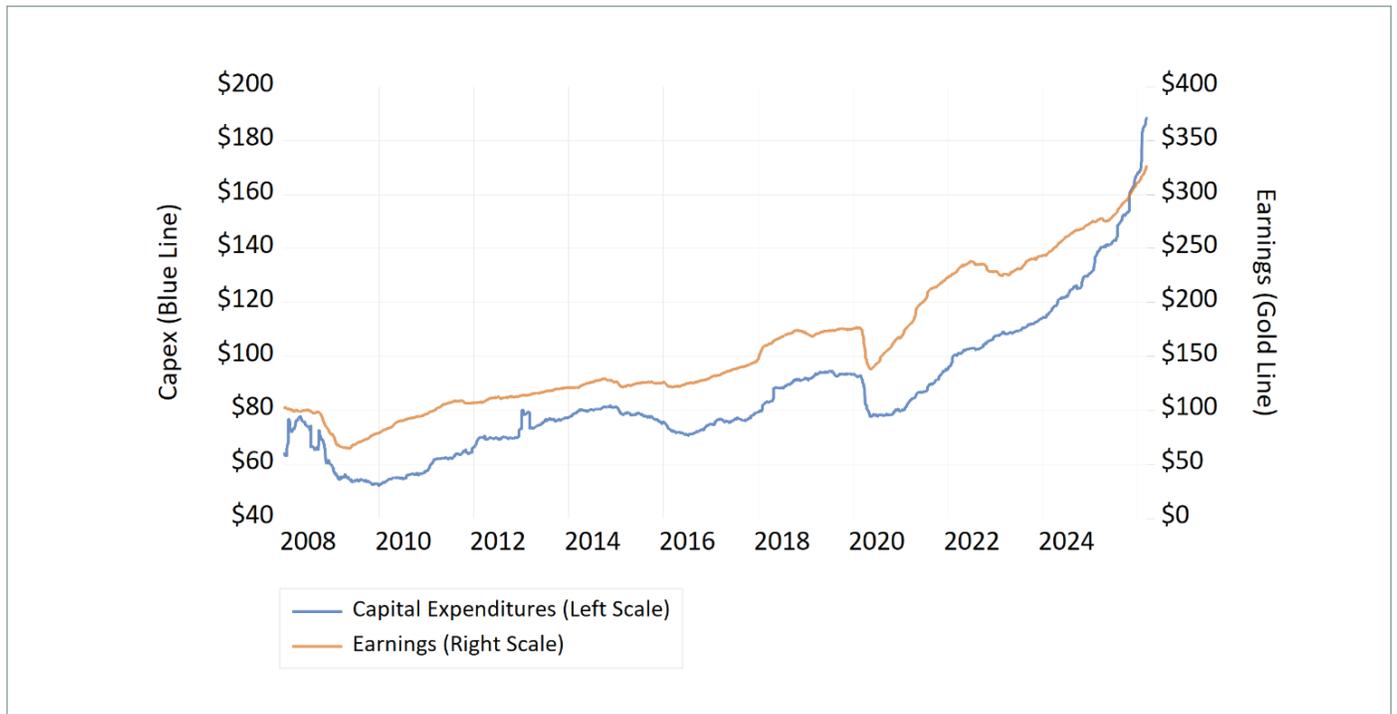
**CHART A | S&P 500 EARNINGS FORECASTS VERSUS TREND**

Source: WCA, Bloomberg



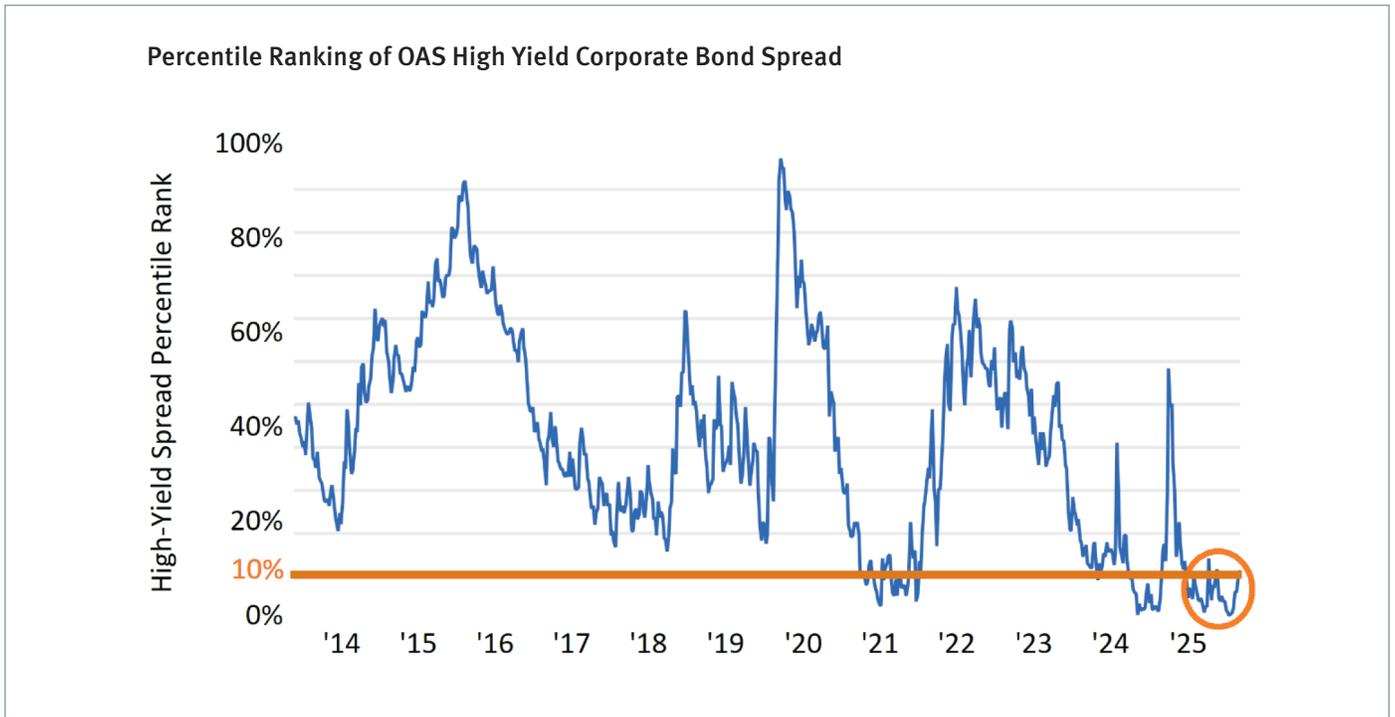
**CHART B | S&P 500 CAPITAL EXPENDITURE GROWTH LEADING EARNINGS (PROFITS)**

Source: WCA, Bloomberg



**CHART C | HIGH YIELD CORPORATE SPREADS IN LOWEST DECILE**

Source: WCA, Bloomberg



**CHART D | HIGH-YIELD CORPORATE SPREADS TIGHT, BUT OFF LOWS**

Source: WCA, Bloomberg



## CONCLUSION



**M**arkets have been driven higher by surging profits, bolstered by surging investment in AI. Even before the troubles in the Middle East became front page news, there were signs that the credit cycle was set to turn. As more companies rely on credit to finance the AI capital spending Supercycle, the AI-Credit nexus has become central to where markets go from here. The next few months will allow companies to show investors how they intend to manage the cycle.

As we have said before, the quality cycle has grown long in the tooth as the past three years' market returns have been dominated by companies with above average risk and lower quality. We believe the right play now is for investors to look to high quality businesses that are flexible, durable, and predictable. Low debt, profitable assets, and consistency should help in the months ahead. A steady and well covered dividend is also helpful to build a solid portfolio with good defense and offense.

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## IMPORTANT DISCLOSURES

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

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The Washington Crossing Advisors' High Quality Index and Low Quality Index are objective, quantitative measures designed to identify quality in the top 1,000 U.S. companies. Ranked by fundamental factors, WCA grades companies from "A" (top quintile) to "F" (bottom quintile). Factors include debt relative to equity, asset profitability, and consistency in performance. Companies with lower debt, higher profitability, and greater consistency earn higher grades. These indices are reconstituted annually and rebalanced daily. For informational purposes only, and WCA Quality Grade indices do not reflect the performance of any WCA investment strategy.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager. Changes in market conditions or a company's financial condition may impact the company's ability to continue to pay dividends. Companies may also choose to discontinue dividend payments.

The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

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