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Wealth Advisory Market Update

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Market Update

Market Commentary

Equities

July was a relatively subdued month for equities, with the S&P 500 finishing modestly lower. Technology underperformed as semiconductors came under pressure. Earnings season has been the primary focus. So far, earnings and revenue data has been good. The Federal Open Market Committee (FOMC) also met during July and held rates steady. This was expected after an inflation print that came in much cooler than expected. Geopolitical tensions involving Iran persisted without a meaningful resolution.

As of August 7, approximately 90% of S&P 500 companies have reported second-quarter earnings. Results have been robust, with 88% of companies exceeding earnings expectations and aggregate earnings surprising to the upside by roughly 11%. Revenue growth is tracking at its strongest pace in 25 years, while profit margins have reached record levels. Consensus estimates for forward earnings have continued to move higher.

A significant driver of these results has been the ongoing AI infrastructure buildout. Demand for memory chips, in particular, has led to substantial price increases driven by supply shortages, with pricing in some cases more than 400% above year-ago levels. These pricing dynamics have flowed through the broader AI ecosystem, providing a meaningful boost to earnings and margins.

We question the sustainability of these elevated margins. Any normalization in supply chains or a reduced willingness among customers to absorb current pricing levels could quickly pressure profitability. In our view, current earnings and margin expectations for portions of the AI ecosystem remain difficult to sustain over the longer term. We also circle back to the missing ROI component of AI. The end product does not generate enough revenue to justify the capex being utilized.

Market valuations remain elevated. The Cyclically Adjusted Price-to-Earnings (CAPE) ratio ended the month at 41.4x, a level exceeded only once in more than 140 years of history which was during the peak of the technology bubble in December 1999. This compares with a long-term median of approximately 16x.

We remain particularly cautious given the scale of capital required for the AI infrastructure buildout. Recent earnings suggest many hyperscale cloud providers are generating little free cash flow after accounting for capital expenditures, with some already producing negative free cash flow. As analysts continue to project trillions of dollars of incremental AI investment, financing those expenditures will become increasingly challenging.

Without sufficient internally generated cash flow, hyperscalers will likely need to rely more heavily on debt or equity financing, both of which carry increasing costs. Several have already entered the debt markets, contributing to pressure across fixed income markets. Given that hyperscalers are estimated to fund roughly 80% of AI infrastructure spending, any moderation in their capital expenditure plans could have meaningful implications across the broader AI investment cycle.

To date, measurable returns on these investments remain limited. At the same time, financing costs continue to rise, making future investments more expensive. The circular financing dynamic we have discussed previously has helped support demand but is unlikely to represent a durable source of long-term revenue growth. The emergence of increasingly capable and lower-cost AI models from China also raises questions regarding the long-term efficiency of current investment levels. These considerations may increasingly influence capital allocation decisions among hyperscalers and could materially affect the broader AI trade.

Geopolitics and the Federal Reserve

The geopolitical situation involving Iran remains unresolved. Recent proposals from Iran would reportedly restrict U.S. and Israeli shipping through the Strait of Hormuz while imposing tolls on vessels from other nations. Such proposals appear well outside what the United States would likely accept, leaving both sides far from a negotiated agreement.

Although oil prices have remained volatile, equity markets have largely looked through these developments. That said, any significant escalation could quickly alter investor sentiment and introduce greater market volatility.

The FOMC concluded its July meeting by leaving interest rates unchanged, in line with market expectations. Inflation data released ahead of the meeting was encouraging, with both the Consumer Price Index (CPI) and Producer Price Index (PPI) coming in below expectations. Nevertheless, Chairman Warsh emphasized that several additional months of data will be needed before drawing firm conclusions regarding the inflation outlook.

While many commentators continue to argue for higher interest rates to combat inflation, we believe monetary policy is already restrictive, particularly as reflected in current lending rates. In our view, reducing the size of the Federal Reserve's balance sheet would be a more effective mechanism.

The wealth effect created by abundant liquidity has continued to support consumer spending despite elevated interest rates. Balance sheet reduction would likely diminish this support, encouraging greater saving by both consumers and businesses, reducing inflationary pressures. In our view, monetary conditions remain restrictive for Main Street, while Wall Street continues to benefit from excess liquidity. We also point to the current AI buildout which has caused a meaningful portion of current inflationary pressures.

Strategy

Given the current geopolitical backdrop, historically elevated equity valuations, and concerns regarding the long-term sustainability of AI-related capital spending, we continue to maintain a cautious investment stance.

Our investment discipline remains unchanged. We continue to seek businesses with durable competitive advantages, strong pricing power, resilient balance sheets, and the ability to generate sustainable free cash flow across economic cycles.

Despite elevated index valuations, we continue to find attractive opportunities in select areas of the market. Healthcare remains one sector where there are companies trading at compelling valuations while offering defensive characteristics. Historically, these businesses have performed relatively well during periods of economic slowdown.

Although many market participants have shifted toward higher-momentum trades, we do not believe the current valuations of these high beta names provide an attractive long-term risk-reward profile.

Within fixed income, Treasury yields have moved meaningfully higher amid increased debt issuance and geopolitical uncertainty. The 10-year Treasury yield approached 4.7%, while the 20- and 30-year Treasury yields moved above 5.2%.

We have taken advantage of this move by extending duration within mortgage-backed securities (MBS) and municipal bonds, with a particular focus on the intermediate portion of the yield curve. Credit spreads continue to support an emphasis on higher-quality issuers rather than lower-rated, high-yield securities, where compensation for incremental risk remains less compelling.

Outlook

We remain committed to active, risk-aware portfolio management as the macroeconomic environment continues to evolve. While uncertainty persists, periods such as these often create opportunities for disciplined, long-term investors. By maintaining our focus on valuation, balance sheet strength, and sustainable cash flow generation, we believe portfolios will remain well positioned to navigate changing market conditions.

Thank you for your continued trust and partnership.

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