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Wealth Advisory Market Update

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Market Update

Market Commentary

Equities

After two consecutive months of negative returns, equities rebounded, with the S&P 500 rising more than 2.5%. The advance was led primarily by large-cap technology, with several members of the Magnificent Seven driving the gains. The rally occurred against a backdrop of increasing circular and off-balance-sheet financing arrangements, rising yields driven by elevated corporate debt issuance, continued geopolitical tensions in the Middle East, and growing expectations that the Federal Reserve's next move could ultimately be a rate hike.

While market breadth appeared to be improving a month ago, that trend has since reversed. Only 45% of S&P 500 constituents are currently trading above their 50-day moving averages, the lowest level since mid-May. The increasingly choppy market has also been evident across both momentum and value factors. Notably, the 45-day correlation between high-beta and low-volatility stocks has fallen to its most negative level on record. Historically, extreme negative readings in this relationship have occurred during periods of elevated market stress.

We remain particularly concerned about the growing number of off-balance-sheet and circular financing arrangements being announced. Morgan Stanley estimates that the hyperscalers collectively have approximately $3 trillion of off-balance-sheet liabilities. In our view, this creates a growing risk of a credit event rather than a traditional equity-market event.

The compute agreements between hyperscalers and large language model (LLM) companies bear some similarities to the dynamics seen during the subprime mortgage crisis. Many of these LLM companies remain unprofitable and are relying on expectations of exponential revenue growth to meet increasingly large contractual obligations. Between 2027 and 2028, OpenAI and Anthropic reportedly have approximately $712 billion of notional contractual commitments commencing, requiring substantial payments over the life of these agreements. OpenAI's latest reported financial data showed approximately $40 billion in revenue. For a company that is not yet profitable, meeting these obligations would require extraordinary revenue growth and potentially significant additional capital raises.

At the same time, the economics of the LLM industry are becoming increasingly challenging. Tokenization costs—the cost of using LLMs—have fallen sharply in recent months, while new and lower-cost models continue to enter the market. This dynamic could erode pricing power and make it increasingly difficult for LLM companies to meet their contractual commitments, which are in the trillions.

Another area we are closely monitoring is the balance sheets of the hyperscalers. Historically, many of these companies maintained what we would characterize as fortress balance sheets. However, we have cautioned that the extraordinary level of capital expenditures required to support the AI buildout will eventually dry up free cash flow if there continued to be no return on investment. As that occurs, companies must increasingly rely on their balance sheets and access either debt or equity markets to fund additional investment.

Debt remains the more attractive source of capital from a cost perspective, but rising yields are making that financing increasingly expensive. If these investments fail to generate sufficient returns—and particularly if the underlying demand comes from companies we view as having subprime-like financial characteristics—hyperscalers could ultimately slow their capital expenditures.

That would present a significant risk to the broader market, given the degree to which the current market environment depends on continued AI investment. There is also an extraordinary concentration of revenue among the largest LLM providers. Ramp estimates that approximately 80% of the enterprise revenue of the two largest LLM companies is derived from just 1% of their customers—the hyperscalers. Any meaningful slowdown in the AI buildout could therefore have an outsized impact on their revenues and, consequently, their ability to meet compute-related contractual obligations.

Geopolitics and the Fed

There have been few signs of progress toward a resolution with Iran. Both sides appear to remain far apart, with limited meaningful dialogue over the past several weeks. While strikes from both sides have represented an escalation, the primary focus remains on the Strait of Hormuz and whether an agreement can ultimately be reached that would alleviate pressure on energy prices.

With markets closely focused on Jackson Hole, Chairman Warsh's comments were interpreted as hawkish. His statement that "the numbers are more concerning" with respect to the inflation mandate, combined with his characterization of short-term interest rates as the Fed's strongest policy tool, has led some market participants to begin forecasting potential rate hikes.

At the same time, Warsh's warning against creating a "hall of mirrors" effect—where markets become overly dependent on the Federal Reserve, or the Fed becomes overly responsive to markets—complicates the case for assuming an imminent rate hike.

We continue to view the current rate environment as restrictive for Main Street, but less restrictive for Wall Street. Mortgage rates, consumer lending rates, and financing costs remain elevated, while financial markets have remained comparatively loose. If the Fed's objective is to tighten financial conditions more directly within financial markets, reducing the size of its balance sheet would be the mechanism. A smaller balance sheet would reduce liquidity and increase funding costs across the financial system.

The composition of inflation is also worth monitoring. In the most recent Personal Consumption Expenditures (PCE) data, portfolio management costs accounted for more than half of the increase in core services. Meanwhile, goods prices continue to moderate and shelter costs have been moving lower. If those trends persist, further tightening of financial conditions through balance-sheet reduction could potentially address some of the financial-market-driven inflation pressures without relying solely on higher short-term interest rates.

Strategy

While we remain vigilant regarding the risks we see developing across the markets, we continue to identify attractive opportunities in select areas.

Healthcare remains an area of particular interest. Certain subsectors have produced attractive entry points, with companies trading materially below our estimates of intrinsic value. Historically, healthcare has also demonstrated relative resilience and has often outperformed other sectors during periods of market weakness.

Within our portfolios, we continue to prioritize companies with strong pricing power, robust balance sheets, and consistent free cash flow generation. We also actively monitor portfolio exposures to ensure that individual companies or sectors do not become disproportionately large relative to the overall portfolio or trade materially above our estimates of intrinsic value. Where appropriate, we will adjust positions to mitigate these risks.

Fixed income yields also moved meaningfully higher toward the end of the month. As discussed above, several hyperscalers have moved into negative free cash flow territory and increasingly need to access external sources of financing. This has contributed to a notable increase in corporate debt issuance.

Investors have shown a preference for highly rated corporate paper relative to Treasuries, contributing to Treasury weakness amid the increase in corporate supply, ongoing energy concerns, and elevated fiscal spending. This environment has allowed us to incrementally increase duration as bonds mature and are reinvested.

We believe current yields provide an attractive opportunity to lock in income, particularly given our view that rates could ultimately move lower if concerns surrounding the sustainability of the AI buildout materialize. We are not extending duration beyond the middle of the curve, as longer maturities introduce greater exposure to inflation and growth risks.

Mortgage-backed securities continue to offer attractive spreads, while tax-exempt municipal bonds remain compelling for taxable accounts. From a credit perspective, we continue to favor higher-quality issuers over lower-quality credits, given both the relative value of current spreads and our concerns regarding the direction of economic growth.

Outlook

We remain committed to active, risk-aware portfolio management as the macroeconomic environment continues to evolve. While uncertainty remains elevated, periods of market dislocation can create opportunities for disciplined, long-term investors.

Our focus remains on valuation, balance-sheet strength, pricing power, and sustainable free cash flow generation. By maintaining these principles while actively managing portfolio risk, we believe our portfolios remain well positioned to navigate changing market conditions and take advantage of opportunities as they arise.

Thank you for your continued trust and partnership.

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