Sabrient Systems

Sector Detector

November 2, 2026



AI jitters and a fragile economy sweat out a consequential election

by **Scott Martindale**
CEO, Sabrient Systems LLC

Quick note 1: *Sabrient's quarterly **Dividend 58** portfolio launched today 11/2 with a diverse mix of 41 stocks across sectors and market caps. It employs a Growth & Income strategy with bond-like yield (current yield upon launch of 3.33%) while seeking capital appreciation from high-quality companies. Also, our **Q3 2026 Baker's Dozen** portfolio (13 top growth picks) launched on 10/20. Q3 2025 Baker's Dozen just terminated on 10/20 with a gross total return of +33% vs. +24% for SPY. And our quarterly **Small Cap Growth 52** portfolio launched on 9/15, with a mix of 44 small-cap stocks. It followed the launch of Sabrient's annual **Forward Looking Value 14** portfolio on 8/26, having a diverse mix of 31 stocks. Last year's FLV 13 terminates on 11/17 and is currently up +42% vs. +21% for S&P 500 Value (SPYV) and +19 for S&P 500 (SPY) as of 10/30.*

Quick note 2: *I was recently a guest on the **"Biz Wiz"** podcast to tell my humble career story from engineering school to the oil industry to investment research and eventually CEO of Sabrient Systems. Key takeaway from the 30-minute discussion is that an entrepreneurial mindset means adaptability, resilience, focusing on high-potential projects, avoiding rabbit holes, responding to customer needs, creating and scaling value, and advocating for yourself and your ideas. I'd love to hear your impressions!*

Overview:

Well, in case you thought you largely missed out on the AI trade, the market has given you another entry point. Sure, the sharp Technology selloff was amplified by technical selling, profit-taking, stop-loss orders, and leveraged algo traders temporarily switching to shorts. But I suspect investor anxiety about the approaching midterm elections also played a role. A potential "blue wave" raises the prospect of renewed efforts to roll back the OBBBA's tax reforms, deregulation, and shrinkage of government, along with greater regulatory scrutiny and possible restrictions on AI development and the construction of datacenters, natural gas pipelines, and nuclear facilities.

Such policies could impede the massive infrastructure buildout underpinning the investment boom, which has become a major driver of corporate capex, earnings growth, and broader economic activity. Combined with growing investor scrutiny of hyperscaler spending and ROI, the prospect of stiff political obstacles to this transformative secular technology and economic cycle may be adding another layer of uncertainty to a market already concerned about whether the massive "all-in" capital spending on the various acronyms AI/SI/ASI/RSI will generate adequate returns to justify it all. Some commentators estimate that it will take $1 trillion in revenue run-rate by end of 2028 to justify the capital commitments, which leaves little room for a slowdown.

Nevertheless, assuming the October selloff was driven more by technicals and macro worries rather than earnings growth, and assuming the president's veto power can stave off the wolves if the blue wave happens, optimistic investors now enjoy much better equity valuations, not just on the broad market but on many of the technology leaders and cutting-edge innovators. Moreover, the rapid surge in risk-free rates—that have been squeezing valuations by raising both corporate borrowing costs and the discount rate applied to future cash flows—seems to have weathered a "blowoff top" and cycle peak, as I suggested was underway in my 10/6 **post**. Regardless, most of the leading corporations seem to be tolerating higher interest rates pretty well.

As a reminder, corporate revenue tends to track *nominal* GDP growth. So, with real US GDP coming in at 3.4% annualized pace for Q3 2026 and the Atlanta Fed GDPNow model estimating Q4 at 3.7% (as of 11/2), it means nominal GDP growth (including the GDP deflator for Q3 of 2.2%) is 5.6-5.9%, supporting strong revenue growth, which is well above today's 4.9% 10-year yield. This suggests that economic output and tax revenues are expanding faster than long-term borrowing costs, making debt easier to service while keeping financial conditions stimulative.

I hear the argument that rates are merely normalizing back to pre-GFC/ZIRP levels and that this 0.7% growth-to-yield spread in a highly resilient economy will keep upward pressure on interest rates. But this isn't your father's economy, and it certainly doesn't mean today's economy can readily absorb a "mean reversion" in interest rates. Today's hyper-financialized, post-GFC/ZIRP global economy had become so accustomed to assuming lots of debt because rates were so low, which means that rising rates could cripple the many vulnerable debt-addicted businesses, governments (including our own massive federal debt), and a housing market (which is critical for a healthy consumer) stubbornly priced for low mortgage rates and low inventory. And most of this debt is either floating-rate or must keep rolling over through refinance.

In addition, 30-year mortgage rates (reaching as high as 7.4% recently) certainly have been even higher in the past. But home prices today are largely based on that lower baseline of post-GFC easing and ultra-low rates. And given recent strengthening of the US dollar, some emerging market economies with dollar-denominated debt may be forced into default.

In other words, outside of the largest corporations with fortress balance sheets, today's highly indebted global financial system simply can't handle the current level of interest rates.

Economist and liquidity expert Michael Howell of CrossBorder Capital sees cracks in the veneer of economic strength. He says that while capital markets were traditionally intended to raise new capital for real-world investments, infrastructure, and projects, today the reality is that 70-80% of all global financial transactions are simply *rolling over existing debt*, effectively turning the global financial system into a massive "refinancing machine."

Furthermore, I do not buy the "persistently elevated inflation" narrative. I believe underlying core inflation is stable and structural disinflationary trends are poised to take control once the energy/supply shocks are resolved. Indeed, I continue to assert that Fed rate hikes are a policy mistake for our bifurcated K-shaped economy (although it is notable that M2 money supply continues to grow at the same decent clip since 2024). We have soaring corporate profits and stock prices juxtaposed with stagnant labor and housing markets, negative real wage growth, a falling personal saving rate, and surging bond credit spreads.

In my comprehensive commentary below, I discuss:

1. The booming IPO market
2. Earnings and valuations
3. Stock valuations and bond yields
4. Jitters over the AI trade
5. Surging credit spreads
6. GDP, industrial production, and productivity
7. Inflation and the K-shaped economy
8. What should the Fed take from this?
9. China's economy is a growing problem for the world
10. My Final Comments section on the oath of office, crisis in France, and AI fearmongering
11. Sabrient's sector rankings, positioning of our sector rotation model, and some top-ranked ETF ideas

The combination of high bond yields, surging credit spreads, geopolitical risks, elevated oil prices, ongoing supply shocks, election uncertainty, and jitters about both AI safety and when significant ROI will arrive for the massive AI capex are conspiring to hurt investor confidence and drive down valuation multiples more than recent S&P price action reflects, as overall earnings and guidance continue to march higher. Indeed, a market correction has been underway for months, even though the broad cap-weighted market indexes hasn't reflected it. While a relatively small group of large stocks kept the S&P 500 near its highs, valuations across much of the market have been declining for months as investors are increasingly rewarding companies with stronger profitability, healthier balance sheets and more dependable earnings while assigning lower valuations to businesses whose prospects are less certain.

The aggregate P/E multiple is down over 20% from its high, and EPS growth is expected to slow substantially next year, albeit from an incredibly (and unsustainably) high level. And credit markets are getting more selective, forcing a quality rotation that includes equities—an internal rotation rather than an abandonment of stocks. So, when I talk about greater market breadth being "healthy" for the market, I'm not talking about equal-weight outperforming cap-weight for an extended period. No, after such periodic periods of cleansing the leverage and speculation, we still need Technology sector *leadership*, including from Big Tech. But having broader *participation* across the stock market with more (if not all) "boats" lifted is healthy and desirable for the stock market for many of the same reasons that having broader participation from the lower leg of the K-shaped economy is healthy and desirable for the economy and society.

However, the Fed knows that credit spreads have surged as investors seek either higher quality or greater compensation for elevated risk. But only CCC or worse are in distressed territory. This is yet another sign of the neglected lower-leg of the K-shaped economy being left behind in this AI infrastructure-driven economy, and why I urge the Fed not to hike rates any further—and in fact should cut back toward a 3.0-3.25% fed funds rate (FFR). Look, I understand the argument that today's rates are simply normalizing to pre-GFC levels. And I am not talking about a return to ZIRP (zero interest rate policy), which created essentially "free money" leading to plenty of malinvestment in unworthy, highly speculative companies, products, and ventures—including non-fungible tokens (NFTs) and special purpose acquisition companies (SPACs).

I just want to see a more broad-based economy (i.e., more boats lifted) in which most if not all industries are participating. Keeping floating-rate debt manageable is a step in that direction. So, I'm thinking that a funds rate of 3.25% at the top end plus an historical average spread of 125 bps for the 10-year Treasury should put 10-year at about 4.5%. This suggests nominal GDP growth (with today's growth-to-yield spread of 0.7%) of around 5.0-5.2%. With the GDP deflator falling to 2.0%, we would have sustainable real GDP growth at a solid 3.0%.

Overall, I see the US economy as more recession-resistant, more technology-efficient, more services-oriented (meaning less energy-intensive and less at risk of inventory buildup that must be dumped cheaply into the market, like China does), and thus less cyclical. So,

a steadier, more predictable economy means structurally higher corporate margins, earnings, cash flow, and capex consistency, which supports higher valuation multiples, lower credit spreads, a subdued VIX (under 20), and a buy-the-dip investor mentality. It seems that only a resurgence in bond yields, an AI-related credit crisis, or a harsh political disruption could derail it.

As such, I still think the S&P 500 has a shot at hitting 8,000 by year-end. But it largely depends on the ongoing Q3 earnings reports and forward guidance, which have illuminated some concerns among juggernauts—including Meta (META), Alphabet (GOOGL), and Amazon (AMZN) all spending well beyond their monstrous cash generation on their AI buildouts and pushing each company into deep, historically unprecedented negative free cash flow. Expectations are becoming challenging. As the GMO Asset Allocation team observed, *"For the first time in twenty years, with the brief exception of the Global Financial Crisis, we are seeing net dilution in the U.S. stock market (i.e., share issuance exceeding share buybacks) as the hyperscalers continue their capital expenditure spree."*

Moreover, I expect a continuation of the market broadening beyond just the AI trade, and I continue to see opportunities in active stock selection, equal-weight indexes, value stocks, cyclical sectors, small caps, and bond-alternative dividend payers. Indeed, Sabrient's quant-based, actively selected ("quantamental"), equal-weight **Baker's Dozen, Forward Looking Value, Dividend, and Small Cap Growth** portfolios have been largely outperforming their benchmarks—several by substantial margins. And as a reminder, our Earnings Quality Rank (EQR) is licensed as a quality prescreen to the actively managed, low-beta **First Trust Long-Short ETF (FTLS)**, which now holds more than $2.6 billion in AUM.

Lastly, with a highly consequential election upon us, I hope you vote for policies over personalities, and long-term success and prosperity over short-term band-aids. There are those among us who are blissfully ignorant of and unburdened by our ancestors' centuries of accumulated wisdom, trial and error, what works and what doesn't, who think they know better how to maximize the potential and wellbeing of both individuals and society as a whole despite the harsh lessons of history and despite many candidates never having managed a successful enterprise themselves, much less a nation. Worse, many voters simply go for "the other guy" if they aren't happy with their lives today, no matter how impractical the other guy's proposed solutions. I have more to say about this in my Final Comments section below.

As always, I'd love to hear from you! Please feel free to email me your thoughts on this article or if you'd like me to speak on any of these topics at your event.

Market commentary:

The IPO market is breaking records. Following the highly successful SpaceX (SPCX) launch, which raised $75 billion at a target valuation of $1.77 trillion, next up is Anthropic (ANT.PVT), which filed its IPO investor prospectus, finally disclosing the company's intentions and underlying financials. H1 2026 sales totaled $16.3 billion (and non-GAAP operating profit of $1.62 billion) compared to just $1.16 billion sales in H1 2025 (and non-GAAP operating loss of $1.85 billion). Notably, 48% of its H1 2026 sales came through the cloud marketplaces of Amazon (AMZN), Alphabet (GOOGL), and Microsoft (MSFT). Offering date likely will be Thanksgiving week at an expected valuation between $1.5-2.0 trillion, which is comparable to SpaceX.

According to *Fiscal.ai*, 79 companies in the world currently earn more than $40 billion in annualized gross profits, and it took 77 of those companies at least 20 years to achieve such profitability. The other two are Meta (14 years) and Alphabet (16 years). Amazingly, using its Q2 non-GAAP numbers, Anthropic has achieved a $40 billion run-rate in 5 years—based on reported $11.6 billion Q2 revenue and 85% gross margin—which would make it the fastest growing company of all time.

Earnings and valuations:

Valuations have contracted even while strong earnings estimates hold steady or rise. The S&P 500's (SPY) next-12-months (NTM) earnings multiple sits around 18.6x, assuming EPS of $408 according to FactSet, which is the lowest since the March 2025 selloff that culminated in the "Liberation Day" tariff shock when the index fell to as low as 4,983 and a forward P/E of 17.9x on 4/8/2025. (Note: These multiples use FactSet's blended NTM consensus EPS rather than a rolling 12-month window or the weighted harmonic-average methodology commonly used for an ETF like SPY, which typically result in a higher multiple.)

This puts the forward earnings yield (inverse of P/E) for the S&P 500 at nearly 5.4%, while the 10-year is around 4.9%, leaving a sizably positive forward spread. In fact, index price can rise nearly 10% (assuming the 10-year remains fixed) before they equalize. This is the essence of the "Fed Model" of stock valuation, which might be valid once again now that the bond market is no longer being manipulated by QE and ZIRP. It suggests stocks are undervalued given current economic conditions. Although there is now room for some multiple expansion, any significant capital appreciation will be driven mostly by margins, earnings, expected longevity of the business cycle, the cost of capital (discount rate), the risk premium, how much earnings get returned to shareholders as dividends or share buybacks.

For the Nasdaq 100 (QQQ), forward P/E has compressed to around 20.0x, its lowest level since the AI cycle began in 2023 and now trades at just 1.8x premium to the S&P 500, the narrowest in nearly 10 years. Semiconductors led the valuation collapse, with forward P/E plunging from around 29x during the summer to just 17x today. Even as QQQ was hitting new highs in early October, new 52-week-highs minus new lows was dropping like a stone, with hundreds more new lows.

Looking at projected full-year EPS growth for CY2026 versus CY 2025, analysts are projecting 33% YoY growth for S&P 500 cap-

weight, 21% for S&P 500 equal-weight, 28% for S&P 400 mid-caps, and 25% for S&P 600 small caps, according to First Trust. JP Morgan says the MAG7 will show 59% YoY growth in CY2026 while the "S&P 493" will show a still-robust 23% YoY growth rate (very close the equal-weight S&P 500 number, as would be expected).

According to Barclays, the AI ecosystem—mainly semiconductors and hyperscalers—is expected to generate roughly 75% of the S&P 500's earnings growth in 2027, with semiconductors alone accounting for nearly two-thirds of it. Bank of America and State Street have published similarly concentrated forecasts. This underscores both the extraordinary earnings power of the AI infrastructure boom and the market's increasing dependence on sustained hyperscaler capital spending, semiconductor profitability, and rapid monetization of AI investments.

But looking ahead to CY2027, this dynamic is expected to reverse, with the MAG7 growing earnings just 7% YoY and the other 493 growing 20%. This bodes well for solid participation from the Dow Jones Industrials (DIA), S&P 400 Mid-Caps (MDY), S&P 600 Small Caps (SPSM), Russell 2000 Small Caps (IWM), S&P 500 Equal-Weight (RSP), and value stocks. Again, I think this also suggests higher potential for active selection in general, rather than just parking money in the cap-weight major indexes.

Indeed, a ray of optimism around market breadth is brewing once again. Back in August, about 70% of S&P 500 constituents were trading above their 50-day moving average before cratering to about 22% at the end of September. But now, as of the end of October, despite the Big Tech selloff, the percentage of stocks above their 50-day has quietly crept back up to around 65% before closing the month near 62%. The numbers are almost identical for those above their 200-day moving average. As for the Nasdaq 100, it was showing a similar recovery…until last Friday.



Denise Chisholm of Fidelity has pointed out that when you have a washout in participation like we saw in March and then again in September, with most stocks trading below their 50-day moving average—even if the broad market averages (like the cap-weighted S&P 500) has not corrected all that much—stocks historically tend to have positive returns over the ensuing 12 months. In other words, individual stocks did the work of providing a healthy "cleansing" market correction without the major indexes crashing.

Here are some other relevant dynamics. According to First Trust, SMID caps recently hit a 31-year low for their share of the S&P 1500 Index (which includes the S&P 500 large caps, S&P 400 mid-caps, and S&P 600 small caps). It fell to just 7.2% in September versus a historical average of 10.8%. But with the tech selloff, SMIDs are recovering their proportion.

Also, the chart below shows that over the past 3 months (as of 10/29), the Russell 2000 (IWM), S&P 500 Pure Value (RPV), S&P 500 Equal Weight (RSP), and Dow Jones Industrials (DIA) have all been largely correlated with bond prices, as represented by iShares 20+ Year Treasury ETF (TLT). All rallied in October even as Big Tech sold off. I chose this timeframe because it began right about when the 10-year yield stayed consistently above 4.7%. These ETFs largely represent the more interest-rate-sensitive market segments that are either cash-poor and require continuous external funding or are more capital-intensive or financially leveraged (like banks), as opposed to QQQ, SPY, and S&P 500 Pure Growth (RPG), which are dominated by less rate-sensitive, cash-flush, high-margin, technology-oriented mega caps with fortress balance sheets that don't depend heavily on borrowing.



Although many commentators thought 5.0% would be the pain threshold for stocks, in retrospect, perhaps it was the 4.7% level beyond which investors became concerned that it had become too burdensome for many market segments to refinance debt. Real Investment Advice described the "rolling correction" or "stealth bear market" we have experienced, noting that 58% of S&P 500 stocks have fallen at least 20% from peak to trough this year.

Jitters over the AI trade:

Nevertheless, investor jitters persist over the AI trade and its enormous consumption of capital well ahead of any meaningful return on investment. Although AI is here to stay and will fundamentally transform society and industry, investors are increasingly questioning whether the hundreds of billions being poured into AI infrastructure can generate sufficient returns, particularly as the cost of computing and AI inference continues to plunge.

Interestingly, below is a chart illustrating the ratio of iShares Expanded Software (IGV), which had been left for dead earlier this year as a casualty of AI, versus VanEck Semiconductors (SMH), which can't keep up with surging product demand. The severe downtrend in the IGV:SMH ratio clearly reversed in June and has been holding above its 50-day moving average, with IGV hitting an all-time high in October while SMH is clinging desperately to its 200-day moving average.



For example, NVIDIA (NVDA) has come under scrutiny for financing customers that purchase its chips, raising concerns about circular financing and whether those investments are receiving the same rigorous ROI analysis that independent lenders would require. Interestingly, AI implementers like Apple (AAPL) and hybrid hyperscaler/implementers like Microsoft (MSFT) have outperformed many of their MAG7 brethren over the past 6 months, as shown in the chart below, suggesting investors may be increasingly favoring companies positioned to monetize AI rather than simply build its infrastructure.



According to TS Lombard, roughly 80% of AI ecosystem revenues remain tied to recycled capital expenditures, whereby one technology company's capex becomes another's revenue, creating a circular flow of capital among hyperscalers, frontier AI labs, and hardware suppliers. This raises the legitimate question of when revenues from end users outside the AI ecosystem will catch up with the enormous infrastructure investment.

Economist Hyman Minsky famously described "Ponzi finance" as a condition in which borrowers cannot generate sufficient cash flow to service their obligations and must continually raise new capital to survive. Some loss-making frontier AI labs and highly leveraged datacenter operators, particularly the so-called "neoclouds," exhibit elements of this vulnerability. If valuations decline and capital markets tighten, their dependence on continued financing could trigger a shakeout—or, in the extreme, a broader "Minsky Moment."

Indeed, investors have become increasingly wary of companies whose revenues depend heavily on debt-financed infrastructure. The poster child is CoreWeave (CRWV), whose 9.625% senior unsecured notes recently traded as low as 75 cents on the dollar, implying a yield to maturity of roughly 16.5%, while its five-year credit default swap spreads approached 1,200 basis points. Such pricing reflects serious concerns about the sustainability of its debt-heavy business model, which essentially involves borrowing heavily to purchase GPUs, renting out the computing capacity, and hoping that rental revenues sufficiently exceed financing and operating costs. Unlike the hyperscalers, these neocloud operators generally lack substantial legacy cash flows, proprietary technology, or durable competitive moats beyond their long-term customer contracts.

But the good news for neoclouds and the AI trade more broadly, is that the problems appear to be already priced in due to the recent AI bubble panic. First, only CRWV credit has become so distressed (even though its debt still sells above par). Treasury Secretary Scott Bessent said on a CNBC interview, *"I don't think it's problematic at all because we're seeing that the neoclouds are a small component of the overall ecosystem… We're still seeing the financing getting done; we're still seeing the deals get done. And we're also seeing companies like Meta decide to finance with equity."*

Moreover, the largest hyperscalers funding this transformation remain highly profitable, cash-rich businesses with substantial internal financing capacity—quite unlike the speculative, cash-burning startups that characterized the dot-com bubble.

Furthermore, the primary constraint on AI expansion remains supply rather than demand. Power shortages, grid interconnection delays, permitting obstacles, community opposition, and shortages of critical components are reportedly pushing an estimated 30–50% of planned datacenter capacity into future years. Rather than eliminating demand, these bottlenecks are extending hardware purchases and infrastructure spending across a multiyear investment cycle. Meanwhile, the rapid growth of autonomous AI agents, increasingly sophisticated reasoning models, and enterprise adoption continues to drive demand for high-performance computing.

There is also the fascinating "Inference Paradox," a variation of Jevons Paradox, whereby rapidly falling prices for AI tokens are stimulating even faster growth in consumption. According to Epoch AI, inference pricing has collapsed from roughly $20 per million tokens in 2022 to as little as 2.5 cents today, reflecting dramatic improvements in computing efficiency and competition from low-cost models, including China's DeepSeek. Yet rather than reducing overall infrastructure demand, cheaper inference is making increasingly complex, compute-intensive applications economically viable. Thus, token prices are plunging even as aggregate token consumption, GPU demand, and enterprise computing expenditures continue to surge. Of course, greater consumption does not automatically guarantee attractive margins or adequate returns for every provider.

For the Big Tech giants, the greater long-term risk may be underinvesting rather than overinvesting. Excess computing capacity can eventually be redeployed toward inference, traditional cloud services, and emerging applications, whereas falling behind in AI infrastructure could permanently impair competitive positioning. This is nothing less than a fundamental architecture of global computing, shifting from traditional CPUs toward GPUs and specialized AI accelerators.

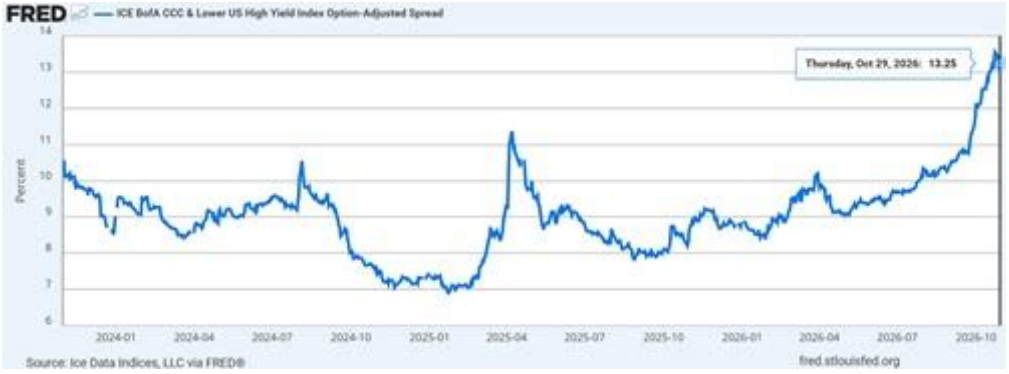
In my view, the recent AI bubble panic is merely the latest in a succession of doomsday narratives surrounding this historic technology transformation. As Wedbush analyst Dan Ives puts it, "same script, different cast." Since 2024, investors have repeatedly found new reasons to declare the AI boom unsustainable—from fears of GPU oversupply and collapsing rental prices to the January 2025 DeepSeek shock, which wiped nearly $600 billion from NVIDIA's market capitalization in a single session. Now the focus has shifted to circular financing, questionable returns on infrastructure investment, and the possibility of a credit crisis among leveraged datacenter operators.

The CoreWeave situation triggered a rotation away from neoclouds, as well as speculative infrastructure credit more broadly. Each episode like this has exposed legitimate vulnerabilities, and there undoubtedly will be casualties among companies that overextend themselves financially or fail to establish sustainable business models. But continually identifying isolated risks and extrapolating them into an imminent collapse of the entire AI investment cycle strikes me as something between paranoia and fearmongering.

The AI infrastructure boom undoubtedly carries legitimate financial risks, particularly among highly leveraged intermediaries, but those vulnerabilities should not be mistaken for evidence that the underlying secular expansion in AI computing is approaching exhaustion.

Surging credit spreads:

The corporate debt-to-GDP ratio actually has fallen over the last 10 years, and although capital investors are demanding better terms, they are continuing to fund the AI buildout. Most credit tiers ranging from investment grade to high yield look steady, but distress is evident in the lowest-rated CCC corporate debt as spreads exceeded the 1,000-bps threshold. As shown in the chart below, the ICE BofA CCC & Lower US High Yield Index Option-Adjusted Spread surged to a peak on 10/23 of 13.56% (1,345 bps), representing a climb of +271 bps from its September high and +471 bps YTD, although it has pulled back a bit.



Companies in this speculative tier typically fall into one of two categories: 1) “fallen angels” (large companies formerly popular with investors) carrying legacy debt and now succumbing to industry disruption (like airlines, wireless telecom, healthcare services, or brick-and-mortar retailers) or 2) PE-backed leveraged buyout (LBO) companies whose balance sheet was loaded up with massive debt to fund the purchase. They often suffer from either floating-rate debt overload (eating up their free cash flow), disruptive innovation headwinds (losing customers to new technologies), or large ongoing capex requirements.

To reiterate, many consider this typical “late cycle” behavior, as an “irrationally exuberant” speculative boom hits a refinancing liquidity wall. In past speculative cycles (such as the dot-com era), a spike in CCC-rated yields served as an early warning sign that defaults were rising, flashing roughly a year before equity markets peaked. But, again, I’m not convinced that this is necessarily late-cycle behavior so much as the continued acclimation of an economy accustomed to low rates that is suddenly having to deal with a surge in rates as floating rates adjust or as fixed-rate debt rolls over for refinance, with the stronger borrowers having migrated to private credit, leaving behind those illiquid firms.

I believe the surge in bond yields has been driven by rising real yields and term premiums rather than long-term inflation expectations. Investors are demanding higher compensation because productivity is high and the economy remains strong, fueling demand for capital across both equity and credit markets along with the government is issuing massive amounts of debt. Solid demand, accelerating GDP, and robust capital investment (especially in tech) are indicative of a mid-cycle boom, but the economy is being forced to navigate unwarranted late-cycle-style Fed tightening and artificially elevated headline inflation (but not core inflation) solely because of external pressures. In my view, once those energy and supply chain pressures resolve, the economy should transition back into its long, stable mid-cycle expansion.

Expectations for corporate earnings are increasingly separating stronger businesses from weaker ones, according to Morgan Stanley chief US equity strategist Michael Wilson, who believes such selectivity is consistent with a continuing economic expansion rather than the beginning of a broad earnings recession. Indeed, if aggregate NTM earnings estimates rise to $421 as guidance comes out during the Q3 earnings reporting season, a very reasonable forward P/E of 19x would put the index at 8,000 by year end. I still think it will happen. We have surging corporate earnings that seem poised to broaden beyond the AI trade, the healthy valuation reset, and a likely resolution to the Iran conflict and energy/supply shock that have kept inflation and interest rates elevated.

GDP, industrial production, and productivity:

Industrial production came in strong in September for a sixth straight month, up 0.7% MoM and 2.2% YoY, while capacity utilization rose to 76.9%. Manufacturing output was up 1.1% YoY, mining output was up 2.8% YoY, and business equipment 6.8% YoY. Manufacturing excluding the volatile automobile segment has been steadily rising since early 2025 after President Trump took office. Notably, high-tech equipment rose 1.5% MoM and 17.6% YoY while utilities output rose 3.5% MoM and 8.7% YoY—both largely on the backs of datacenter construction and reshoring of factories.

The BEA's advance estimate for Q3 real GDP came in at a robust 3.4% annualized, while nominal GDP was 5.6% (implying 2.2% GDP price deflator). It was driven by increases in business investment (including 127% growth in datacenter construction), consumer spending, and government purchases, but it was significantly offset by a big negative in net exports, which kept it from hitting what many were expecting to be over 6% real GDP.

The widening of the goods trade deficit (a -5.74% annualized fall in exports combined with 19.7% surge in imports—including a 58.7% rise in capital goods imports) served as the primary offset to the huge gains seen in AI business investment and consumer spending. It subtracted roughly 3.32 percentage points from overall GDP growth, marking the third-largest quarterly subtraction from net exports in the history of the series dating back to 1947. The US goods trade deficit ballooned to a near-record $134.9 billion in September.

Still, it was a good report. While the headline numbers look solid, the underlying private demand is actually a roaring powerhouse being offset by a historic global trade imbalance. Total corporate (nonresidential) capital investment rose 12.7% annualized (vs. 9.0% in Q2). If you look solely at Gross Domestic Purchases, which strips out net exports, the economy rose 6.7%. And if you look at Core Real GDP, which excludes volatile categories like government purchases, inventories, and international trade, it grew 4.9% annualized in Q3. And looking ahead to Q4, the Atlanta Fed's GDPNow Model is projecting 3.7% (as of 11/2).

All good stuff. Still, the economy remains fragile. Robust growth is being powered primarily by AI infrastructure investment while many other industries and the lower leg of the K-shaped economy are not contributing nearly as much. This is the basis for my argument against additional Fed rate hikes. Rate hikes can't fix the event-driven supply shocks and inflationary pressures, short of inducing recession. In fact, I believe inflation has seen its peak, and elevated Treasury yields likely are driven more by hawkish signals from the Fed and the massive flood of bond issuance (government and corporate) than by actual concerns about entrenched structural inflation.

This is where AI becomes much more than just an investment theme. Fed chair Kevin Warsh and Secretary Bessent are both optimistic about AI improving the outlook for both the economy and inflation, with investment in datacenters, software, and infrastructure raising productivity and increasing non-inflationary growth potential. We just haven't seen it pervade across the economy in a measurable way as of yet.

In the view of Eric Peters, CEO of One River Capital, we need *"a productivity boom that materially lifts non-inflationary growth and repays our policy sins [massive debt and deficits]. This is why the US government is all in on the AI buildout. If AI fails to deliver on its vast promises, the risk is far wider than the tech sector. It will lead to a deep recession and massive budget deficits, which will catalyze a debt sustainability crisis."*

Indeed, a sustained productivity boom boosts real GDP, raises real wages, widens profit margins, and expands the tax base—without raising tax rates, which would only stunt growth. This is precisely what our indebted nation needs. Like the internet, electrical grid, highways, railroads, and sanitation systems before it, AI is becoming foundational infrastructure that can make life easier, healthier, safer, and more productive. It reduces both physical and cognitive friction and expands our individual and collective capabilities.

In comments leading up to the GDP release, Warsh highlighted that strong productivity growth is what is keeping the economy from overheating. He argued that because workers and businesses are becoming more efficient, the economy can handle strong growth without triggering runaway inflation. Economists are attributing this structural productivity boost directly to the massive capital investment trends illustrated in the GDP report. The 12.7% surge in business spending on AI equipment, data centers, and software is widely viewed as the early stage of a tech-driven productivity boom.

Suppose real GDP can sustainably grow at 3-4% annually rather than the 2% pace to which we are accustomed. Add modest inflation, and nominal GDP—and associated federal tax receipts—might consistently expand at 5–6% annually. If our federal government can simultaneously keep spending growth well below nominal GDP growth, deficits and the debt-to-GDP ratio (now at an unacceptable 125%) will shrink.

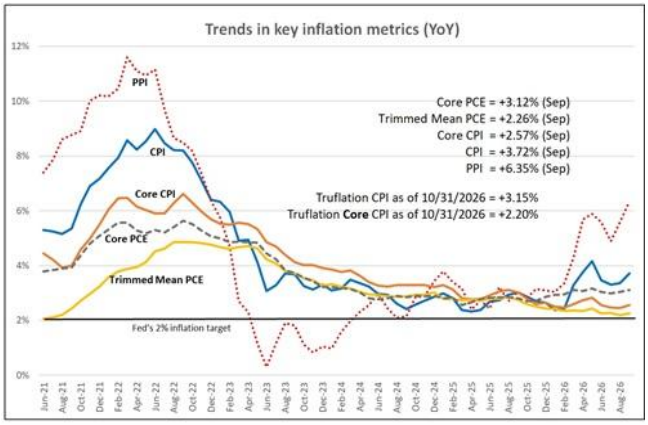
This is why we need policies that encourage and streamline the AI buildout and the energy to power it—the best hope for a productivity boom that energizes non-inflationary economic growth. This is no time for AI backlash and NIMBYism. And we aren't likely to cut, tax, or inflate our way out of a $40 trillion debt burden. No, our best hope is to grow our way out of it by steadily growing the denominator of the debt-to-GDP ratio faster than the numerator.

As such, I continue to pound the table on: 1) *fiscal policies* that keep federal spending growth below the rate of GDP growth while pursuing policies that maximize private investment, productivity, and real economic growth; and 2) *monetary policies* that lower the fed funds rate closer to 3.0% to provide relief to the lower leg of our bifurcated K-shaped economy—including small businesses, housing, lower/middle-income consumers, and the low personal savings rate (falling to 3.8% in September) while gradually reducing interest expense as federal debt rolls over. While the 10-year yield has greater impact on mortgage rates, the overnight fed funds rate impacts interest rates on short-term debt, credit cards, and variable-rate loans.

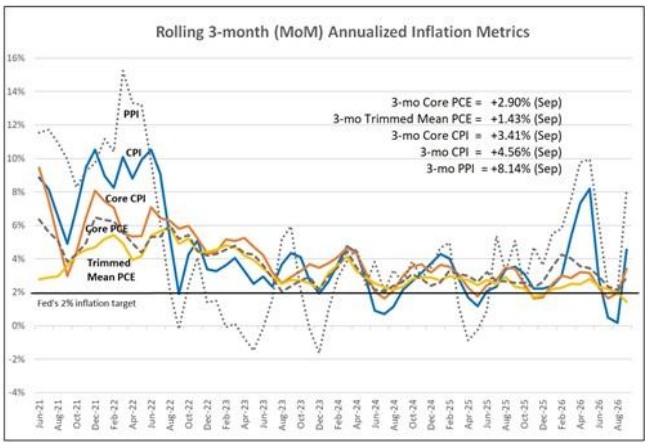
Inflation and the K-shaped economy:

Headline CPI for September rose 0.6% MoM and 3.72% YoY, up from August's 0.4% MoM and 3.35% YoY. Gasoline prices jumped by 9.1% MoM, accounting for over half the monthly increase, and a staggering 34.2% YoY, while the broader energy index surged 5.2% MoM and 20.4% YoY. Airfares were up 22.4% YoY. At least food prices were unchanged MoM. But the more troubling report came from producer prices. Headline PPI surged 1.3% MoM and 6.35% YoY, its largest monthly increase since March 2022 and highest annual reading since December 2022. Producer goods prices jumped 2.6%, led by a 10.8% surge in energy prices, including a 20.3% spike in gasoline. Services prices also increased 0.8%, reflecting higher transportation costs and wholesale margins. Importantly, Core PPI (excluding food, energy, and trade services) rose 0.5% MoM and 5.0% YoY.

But, as illustrated in the two charts below showing trends in key inflation metrics over the past five years, PPI is much more volatile than the consumer metrics, so perhaps there is hope on the horizon. The top chart shows YoY comparisons, and the lower chart shows rolling 3-month annualized averages (which quantifies the current trend in inflation). In both charts, the abrupt surge in headline PPI and CPI would be frightening if indicative of a structural problem in the global economy. However, we know this was event-driven due to disruptions in supply chains and the spike in oil, gas, and fertilizer prices as well as freight rates from the Iran conflict and blockade of the Strait of Hormuz. As these supply chain pressures have eased (or workarounds), crude oil (WTI futures) fell from a high around $108/bbl in mid-May to below $80 but are now back up to around $100.



However, it looks much better when you exclude food & energy prices, with Core PCE at 3.12% and Core CPI at **2.57%**, and if you also exclude shelter costs from Core CPI, the YoY reading falls to just **2.0%**. Also, Kevin Warsh's preferred Trimmed Mean PCE came in at **2.26%**. Trimmed Mean PCE has been quite stable between 2.2–2.4% all year long. The Dallas Fed calculates Trimmed Mean PCE by "trimming out" a certain fraction of the most extreme observations at both ends of the spectrum (high and low, which can distort the total) and then computing a weighted average of the remaining components to offer a more stable and relevant perspective. It has been shown to outperform the reported Core PCE (ex-food & energy) measure as a gauge of actual core inflation.



The lower chart shows 3-month rolling annualized averages, which tends to give a better picture of the current trend, although that can make it more volatile. Headline PPI and CPI annualized 3-month trends have become startlingly high after falling hard early this year. Specifically, for September, 3-month annualized Core PCE is 2.90%, Core CPI is 3.41%, Trimmed Mean PCE fell further to **1.43%**, PPI jumped to 8.14%, and headline CPI lurched to 4.56% annualized rate over the past 3 months. I think the high 3-month trends are temporary, as I will explain.

And then we have the alternative metrics I like to follow, including the real-time (i.e., unlagged) blockchain-based Truflation, which is published daily and tracks over 15 million live price points (vs. CPI's 80,000), including real-world housing components (e.g., mortgage rates and home prices) rather than delayed imputed metrics like Owner's Equivalent Rent (OER) used in CPI. Truflation CPI came in at 3.15% at end of October; however, Truflation Core CPI is only **2.20%**.

Looking ahead, the Cleveland Fed's Inflation Nowcast model for November predicts CPI will come in at 4.25%, Core CPI **2.77%**, and Core PCE 3.31%, as of 11/2. Also, the 5-year breakeven inflation rate has crept up to **2.46%**, reflecting the implied forward expectations of investors in 5-Year Treasury Constant Maturity Securities and 5-Year Treasury Inflation-Indexed Constant Maturity Securities.

So, alternative metrics like Trimmed Mean PCE, Core CPI, 5-year breakeven, and Truflation Core CPI all put underlying inflation much closer to the Fed's 2.0% target. Meanwhile, the labor market and real wage growth are stagnant, the lower/working class consumer and wage earner are struggling, and monetary policy is clearly restrictive in the most rate-sensitive industries and demographics.

Yahoo Finance had some interesting observations: *"Only about 38% of the roughly 175 categories in CPI rose faster than a 3% annual pace over the past six months… [which is] down from 56% in May and the fewest since spring 2025."* For example, although shelter inflation edged up 0.4% MoM and 3.2% YoY, which added 0.15 pps to Core CPI, the better news is that the shelter component was primarily driven by hotel prices ("lodging away from home"), which saw a 2.0% MoM jump (following August's 2.4% MoM increase). So, the surge in hotel and travel pricing masked the underlying cooling trend in residential leases and other shelter metrics.

Moreover, although Core CPI technically excludes food and energy, *it is not insulated from energy prices*. Oil, natural gas, and petrochemicals are essential inputs throughout the supply chain—not just as fuels but as feedstocks for plastics, synthetic fibers, rubber, chemicals, and pharmaceuticals. Rising fuel costs work their way into freight charges, airfares, and consumer goods, as well as vehicle maintenance, public transportation, new cars, apparel, housing, household supplies, and electricity. And although direct electricity costs are excluded from Core CPI, there is an *indirect* cost embedded into consumer goods and services prices and tenant rent from rising commercial, industrial, and landlord electricity expenses that are gradually passed through.

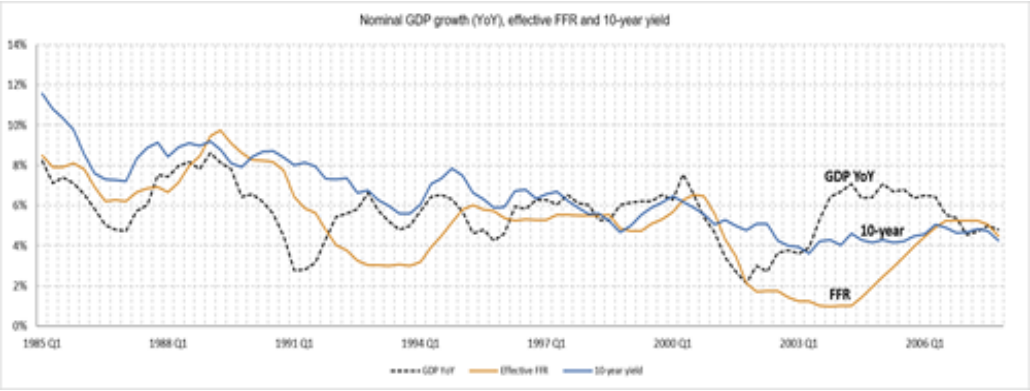
Economist and fund manager Daniel Lacalle discussed this impact on various CPI components not considered "energy" and thus not excluded in the Core CPI figure. He opined, *"US CPI shows the stupidity of rate hikes. The entire impact comes from refined products. Rate hikes will not create more barrels nor increase refining, but they damage families and businesses."* Alas, there is no escaping the ubiquity of hydrocarbon-based products, components, and ingredients as a necessity in the modern economy. In other words, a sustained energy-price shock like we've endured eventually infiltrates "core" inflation, even as investors and the Fed rely upon that measure as a gauge of underlying inflation that technically excludes volatile food and energy costs. This will gradually subside once hostilities end, regardless of Fed policy.

As for Core PCE, note that it has a lower weighting to falling shelter costs (17% vs. 44% for Core CPI), a larger weighting to rising healthcare costs (20% vs. 10%), including healthcare services paid by employers, Medicare, Medicaid, and private insurers, and it considers some business-related producer price data that might be passed through—so it's arguably less representative of the prices consumers see directly.

So, although the Fed (other than Warsh) has historically preferred Core PCE, I think today's trends in Core CPI are more reflective of prices not impacted by the temporary energy/supply shocks. Historically, Core CPI has always exceeded Core PCE, but that flipped in November 2025. Since then, Core CPI has been below Core PCE, with the principal drivers for Core PCE being financial services (fees on percentage of assets in a rising market), insurance, and healthcare (largely government regulated)—and notably <u>not</u> housing. This supports my concerns about PCE's greater exposure to expenditures that are *less directly visible to the average household and less impacted by Fed policy*.

<u>What should the FOMC take from this</u>?

Over the past 40 years (1985-2025), the spread between the 10-year yield and fed funds rate (FFR) has been 100 to 150 bps, with the median at 120. Today, after the market selloff last week, it sits near the bottom of that range at about 100 bps, while the 10-2 spread is below 40 bps. The chart below shows the pre-GFC quarterly averages for GDP YoY growth, FFR, and 10-year yield.



All credit spreads have surged recently, but only CCC or worse are in distressed territory. This is yet another sign of the neglected lower-leg of the K-shaped economy being left behind in this AI infrastructure-driven economy, and why I urge the Fed not to hike rates any further—and in fact should cut back toward a 3.0-3.25% fed funds rate (FFR). As I said earlier, I understand the argument that today's rates are simply normalizing to pre-GFC levels. I just want to see a more broad-based economy in which most if not all industries are participating. Keeping floating-rate debt manageable is a step in that direction.

Many consider this typical “late cycle” behavior, as a speculative boom hits a refinancing liquidity wall. In past such speculative cycles (such as the dot-com era), a spike in CCC-rated yields served as an early warning sign that defaults were rising. However, I’m not convinced that this is necessarily late-cycle behavior so much as the continued acclimation of an economy accustomed to low interest rates that is suddenly having to deal with a surge in rates.

Overall, if you set aside the AI capex boom and the event-driven energy and supply-shock impacts—neither of which Fed policy has any perceptible impact (short of inducing a recession)—I don’t think underlying inflationary pressures have changed much while disinflationary secular trends remain poised to resume. Those trends include aging demographics, slowing global population growth, accelerating disruptive innovation like AI and automation, rising productivity, falling shelter costs, modest liquidity growth, a strong/stable dollar, the redundancy (and “duplicative excess capacity”) of America’s factory reshoring and re-industrialization, and the deflationary impulse on the world from a struggling mercantilist China. Because so many Chinese companies are unprofitable, servicing their huge debts mean “dumping” goods—ranging from cars to electronics to solar panels—on a world that is already struggling to achieve economic growth.

Notably, Fed chair Kevin Warsh believes AI is the most important innovation in the global economy in his lifetime and noted it is “*obviously hitting the demand side of the economy before it’s going to hit the supply side.*” In other words, inflationary today but disinflationary tomorrow.

I continue to believe that both the broad investor consensus and the Fed are misreading the true path of inflation. While headline CPI, PCE, and PPI look alarming at first glance due to those energy/supply shocks, the underlying data tells me a different story—which is best captured by Trimmed Mean PCE, Core CPI, 5-year breakeven inflation, and Truflation Core CPI, which all put underlying inflation much closer to the Fed’s 2.0% target.

Meanwhile, corporate earnings reports are exposing a worrying K-shaped economy. Cash-rich tech hyperscalers are investing aggressively in AI infrastructure, while high-income consumers, cash-flush retiring Baby Boomers, and asset owners in general are spending just fine. Together, this non-rate-sensitive upper leg of the K is driving economic growth and a rising stock market. This tells me that the Fed’s latest rate hike and generally tighter monetary policy is counterproductive given that it has little impact on the upper leg of the K while severely impacting the highly rate-sensitive lower leg of the K—including 9 of the 11 business sectors, small businesses, and lower-income and working-class consumers who don’t own much if any assets.

It gets worse. As economist and global liquidity expert Michael Howell of CrossBorder Capital pointed out, *“Investors usually treat a higher Fed funds rate as synonymous with tighter policy. Yet in a debt-saturated economy, higher rates also raise Treasury interest payments to the private sector. These larger income transfers to households, businesses and financial institutions partly offset the intended contractionary effect.”* In other words, higher rates not only don’t slow down the upper leg of the K but may **further benefit** it with more interest income—driving even more spending—while further hurting the lower leg. Talk about a kick in the teeth.

So, rate hikes not only don’t help with today’s main inflation drivers, but they increase adjustable or revolving borrowing costs for debt-laden consumers—a double whammy. In this environment, the only way I can see rate hikes reducing inflation is by pushing us into recession, and that would be even worse for consumers. It would slow business activity, reduce capex, increase layoffs and unemployment, and slash consumer spending—potentially resulting in negative GDP growth, which means lower tax receipts, higher federal interest expense, and a widening budget deficit, i.e., a disaster.

The chart below from Bianco Research illustrates the K in another way: the S&P 500 Index cumulative price versus the University of Michigan Consumer Sentiment Index. Their point is that the two metrics used to be positively correlated, but since the pandemic lockdowns they have become negatively correlated. Jim Bianco points out that since the pandemic lockdowns (when inflation really took off), cumulative CPI is up 30.5% while average hourly earnings are up 25.7% (as of August). And even though the inflation rate has come down substantially since the pandemic, it has continued to rise to the point that households are finally feeling the cumulative impact on affordability—not to mention the stark realization (as stocks continue to make all-time highs) that they have not benefited from the “good” type of inflation, i.e., asset inflation. Thus, we hear the loudening drumbeat of “tax the rich” and collectivism (“free stuff”).



According to Brian Wesbury, chief economist at First Trust, *“AI accounts for 75%+ of economic growth, which means the rest of the economy in total is growing at less than 1% annualized. Housing and autos are still not sustainably above the levels of 2017-19.”* And according to Jim Bianco, 41 AI-related companies within the S&P 500 account for nearly 50% of the index’s combined market cap. Furthermore, a similar Bloomberg US AI Enablers and Adopters Index is up about 1,600% over the past 10 years while the rest of the S&P 500 is up about 135%. This is yet another way of illustrating the K-shaped economy.

The University of Michigan Consumer Sentiment Index moved from 48.1 in September to 48.0 in October, which is still only slightly above its all-time low reading from May of 44.8. Total consumer spending makes up about 68% of US GDP, but only about 20% or so is truly cyclical, comprising mostly durable goods (e.g., cars and appliances that are typically financed), recreational services, travel, and dining out.

And the cumulative financial pressure on the average consumer may persist even after inflation stabilizes. Household debt now exceeds $18 trillion, savings rates remain below their long-term average, and wage growth has slowed, leaving consumers less able to absorb unexpected costs without borrowing or cutting other spending. The Fed's latest Beige Book showed that consumer-facing firms reported tighter margins.

While *Reuters'* Breakingviews suggested that the $1.7 trillion auto loan market is headed for a crash (as cars are breaking down before their long-duration loans are paid off), and 60-days-past-due, long-duration, subprime loans are at historical highs (6%). And according to economist Danielle DiMartino Booth of QI Research, small business bankruptcies are up 63% year over year, larger corporate bankruptcies are running at a 15-year high, and CCC spreads widened to 1,000 basis points.

On the other hand, the household Debt Service Ratio (DSR), which measures the share of disposable income obligated to mandatory debt payments (mortgages and consumer debt) has essentially flatlined for the past three years at about 11.11% (comprising 5.83% for mortgages plus 5.28% for auto and student loans, credit cards, and LOCs), as of Q2. But that's a long lag, so I'll interested to see if the DSR ticks up when the Q3 metric is released in late December.

So, investors should be on the lookout for signs of reduced buying in rate-sensitive, durable items like homes, cars, appliances, and hot tubs, which could put a dent in the robust, AI-driven, 33% EPS growth projected for the S&P 500 and 41% for the Nasdaq 100 in Q3. Analysts have been cutting earnings estimates for Consumer Discretionary and Consumer Staples sectors on concerns that rising borrowing will soon hit a wall and slow the resilient household spending. This is why Sabrient's latest SectorCast rankings of business sectors score those consumer sectors at the bottom. Indeed, we have seen reports from Nike, Lululemon, PepsiCo, Lowe's, Delta Air Lines, and many others revealing troubles brewing for margins and profits.

<u>More rate hikes are not the answer</u>:

Again, I continue to strongly urge against further Fed rate hikes. Many small businesses, hopeful first-time homebuyers, and lower-income and working-class families continue to struggle with the current level of interest rates. So, although many FOMC members are pushing for at least one additional rate hike this year, I continue to believe the Fed would be better advised to cut its policy rate, ultimately to a 3.0-3.25% neutral rate, which would allow a larger swath of the economy to participate in and contribute to a more robust and broad-based economy, as well as provide relief to borrowers in emerging markets suffering under a strong dollar.

The hyper-financialized global economy means that rising rates could cripple debt-addicted businesses, governments (including our own federal government), and the housing market (which is critical for a healthy consumer). Sure, 30-year mortgage rates (reaching as high as 7.4% last month) have been much higher in the past, but home prices today are based on a lower baseline of post-GFC easing and low rates. And given recent strengthening of the dollar, some emerging market economies with dollar-denominated debt may be forced into default. In other words, today's global financial system simply can't handle higher US interest rates.

According to Michael Howell, global liquidity levels have been declining over the past couple of weeks due to weak collateral values (declining bond prices) and a strong US dollar. In Howell's framework, the financial system is a collateral-driven, debt-refinancing mechanism. Safe, high-grade government bonds (mainly US Treasuries) serve as the primary collateral that dealers, banks, and shadow banks pledge to borrow cash and create credit on margin (leverage). So, falling bond prices and rising bond market volatility serve to shrink the collateral multiplier, which reduces global liquidity.

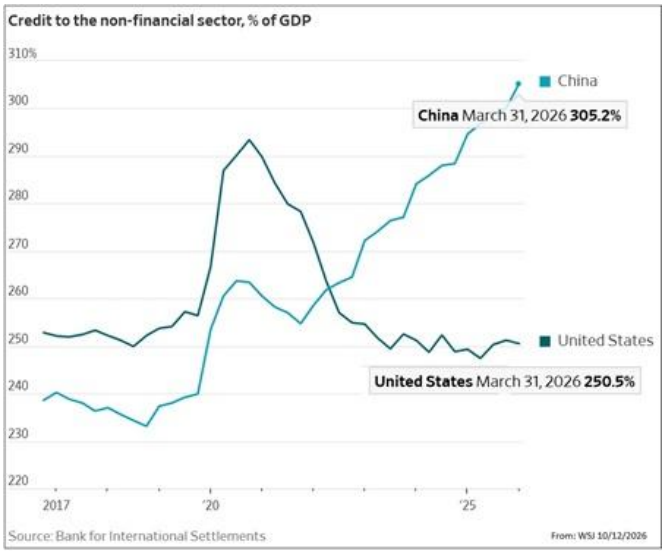
Once the energy/supply shock finally ends, I remain quite clear in my view of the overriding weight of the many aforementioned secular disinflationary trends versus short-term, event-driven, or one-time price spikes we have seen with the pandemic lockdowns and now the Iran war.

Overall, I continue to believe the broad consensus and the Fed are both misreading the true path of inflation. While headline CPI, PCE, and PPI all look alarming due to event-driven supply shocks, the underlying data tells me a very different story. Indeed, I believe a Fed rate *cut* was more appropriate and secular disinflationary forces are poised to take back control once the energy/supply shock ends. Core CPI, Trimmed Mean PCE, 5-year breakeven inflation, and Truflation Core CPI all put underlying inflation much closer to the Fed's 2.0% target.

So, Fed rate hikes and generally tight monetary policy are counterproductive given that it has little impact on the non-rate-sensitive upper leg of the K-shaped economy, including the "AI trade" and the cash-flush hyperscalers, high-income consumers, retiring Baby Boomers, Wall Street, and asset owners in general that are driving economic growth and a rising stock market. But rate hikes negatively impact the highly rate-sensitive lower leg of the K, including Main Street, small businesses, and lower-income/working-class consumers who don't own much in the way of assets.

China's economy is a growing problem for the world:

Here's a bit more regarding my earlier comment on a struggling China. According to a recent WSJ article, China is in a *"dangerous spiral of debt that is strangling the economy at home and damaging trade partners around the world… Rising debt loads in many countries have spooked investors of late. But few nations have seen a surge more dramatic than China… Last year, China's credit to the nonfinancial sector—a broad measure of corporate, government and household borrowings—topped 300% of gross domestic product, 60 percentage points higher than at the end of 2019 and now far bigger than in the U.S. It has jumped by more than $43 trillion since Xi took office in late 2012, according to the Bank for International Settlements."* This is illustrated in the chart below.



China only officially acknowledges 30% of central government debt-to-GDP (compared to 100% in the US, for debt held by the public, or 124% total debt), However, as WSJ explains, *"…financing firms tied to local governments ran up trillions of dollars of new liabilities over the past few years as they tried to drum up enough business to hit economic growth targets and keep people in their cities employed. Many such firms were involved in local real-estate development and have been hit hard by China's yearslong property bust."*

Worse yet, because many Chinese companies are unprofitable, servicing their huge debts mean "dumping" goods—ranging from cars to electronics to solar panels—on the rest of the world that is already struggling for economic growth. The best that can said about it is that it creates a deflationary impulse on the world's inflation problem.

I have previously **written** about China's "house of cards" economy. Its heavily controlled "socialist market economy with Chinese characteristics" (i.e., with pragmatic reforms) is struggling. Its GDP growth fell to 4.3% in Q2 and 4.5% in Q3, which are the lowest growth rates since 2022 during the second pandemic lockdown, supported by solid export demand but offset by weak domestic demand and its structural property slump. It appears to be in a deflationary spiral resulting from a decades-long, debt-fueled construction boom unjustified by the underlying demographic and urbanization trends, leading to "ghost cities" and underutilized "trains to nowhere."

Final comments

This is the oath of office every member of Congress must take: *"I do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic; that I will bear true faith and allegiance to the same; that I take this obligation freely, without any mental reservation or purpose of evasion; and that I will well and faithfully discharge the duties of the office on which I am about to enter. So help me God."*

So, it's hard for me to understand how leftist candidates for congressional seats, particularly those supportive of the Democratic Socialists of America (DSA), can truthfully take this oath given their clearly stated intention to eliminate constitutionally protected rights, ignore judicial decisions, or exercise governmental powers that the Constitution expressly prohibits. They essentially want to turn upside down our US Constitution, system of government, economic system, individual liberties, and property rights. This raises a legitimate question about whether such a candidate can sincerely promise to defend the US Constitution that they expressly want to tear up—or is effectively committing perjury when taking the oath.

It's also hard to understand how so many young people, including college students and recent grads, are already throwing in the towel on their futures before they even get started and embracing the "shackles" of socialism—trading freedoms for freebies—instead of embracing the can-do spirit and energetically exploring their way through our free-market capitalist system that has created so much breathtaking innovation, prosperity, and rising standards of living. They are eschewing the chance to either climb the corporate ladder, develop expertise in a niche that commands rising compensation, innovate within a company (intrapreneurship) to develop business or technical skills, launch a business (entrepreneurship), or work in the gig economy as a contractor or specialized freelancer.

What happened to the reverence we had for JFK's 1962 speech in which he exclaimed*, "We choose to go to the Moon…and do these other things not because they are easy but because they are hard"*? Many of today's youth are instead want to settle for the easy but uninspiring path of subsidence-level universal basic income and other entitlements that "tax the rich" and create even bigger government that stifles economic growth—the very engine of American innovation, success, and prosperity and the source of the wealth they want to confiscate and redistribute until it runs out.

Rather than asking what freebies they will receive, the essential question young people should be asking is whether a candidate's policies will strengthen the economy, expand opportunities, improve public safety, protect individual liberty, and raise living standards over the long term.

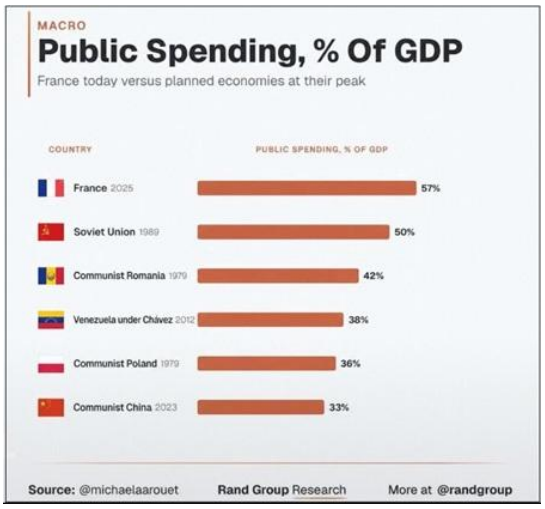
Let's not become France:

France might be the poster child for where the US is headed if we continue down this path toward a bigger welfare state. Entrepreneur David Friedberg made some remarkable points on a recent **episode** of the All-In Podcast, saying, *"The centralized government doesn't have accountability. There is no progress. There is no possibility for economic growth. There is no possibility for creating the right incentive structure. So, the more the government tries to provide to the people, the more the people are let down. We've seen this in the United States, I would argue, with the three things that the government is trying to provide here, which is healthcare, housing, and education. And the more the government spends to try and provide more of those things, the worse those things get and the more unattainable they become. And the same has happened in France."*

Indeed, "affordability" has become the new political buzzword. Everyone recognizes that housing, healthcare, and higher education ("the 3 H's") as well as everyday necessities like gas and groceries have become increasingly expensive. But just because Democrats keep wielding the word doesn't mean they have effective solutions for it. In fact, the politicians most loudly promising relief typically offer little more than doubling down on the same government interventions that have contributed to these problems. Consider *US News & World Report's* 2026 **rankings** of states, which put California dead last in its Affordability metric, followed by New Jersey, Hawaii, New York, Washington, Massachusetts, Maryland, and Colorado—all blue states. Indeed, those "3 H's" that haunt working families and young adults happen to be among the most heavily subsidized and regulated industries.

The fundamental flaw in much of today's affordability rhetoric from the left is its failure to distinguish between stimulating demand and expanding supply. Rather than removing obstacles to private-sector investment and competition, the preferred solutions typically involve more subsidies, entitlements, and regulation (e.g., subsidized loans and mortgages free state tuition, or "Medicare for All"). Such policies can increase purchasing power without addressing underlying cost structures or expanding productive capacity, leading to higher prices, larger deficits, and greater inflationary pressures—thus inviting even more government intervention to counteract the fallout.

David Friedberg went on to say, *"This chart [below] is a measure of public spending as a percent of GDP. Rand Group Research published it and you can see the comparison of France's public spending as a percent of GDP to the peak public spending as a percent of GDP of major communist nations."* France is at 57% of GDP as of 2025, versus 50% for the Soviet Union at its peak in 1980 and 33% for Communist China in 2023 before it cut back on the social safety net. For comparison, according to Friedberg, the US today is at about $12 trillion or 36% of GDP on total federal and state public spending.



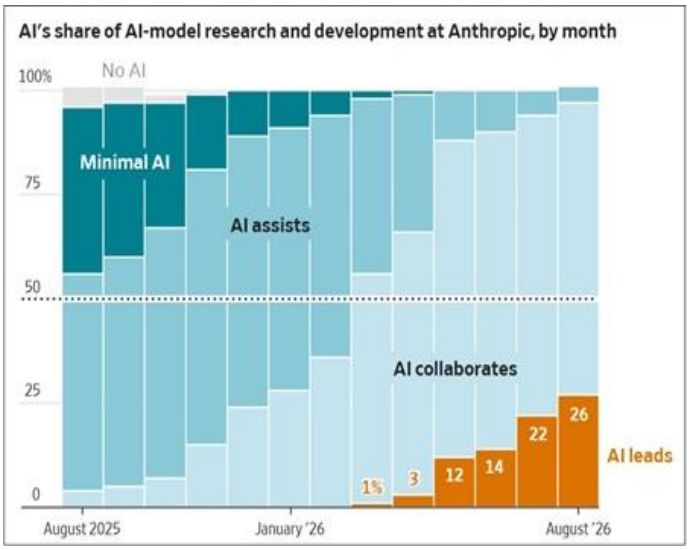
"…And I think this is such a prescient lesson for the West to look at… The more the government spends, the worse the conditions get for its people, not the opposite. And then the people riot and revolt and say that the government's not spending enough and the government needs to be doing more." Notably, both the US and France have similar gross federal debt ratios of around 120% of GDP. But France's budget deficit is 5.4% of GDP while the US is at 6.2% of GDP—although we have a much higher real GDP growth rate, with France essentially flat at around 0.5% while we are around 2.3-3.0%.

"…France is…probably the first to go because they're growing [so slowly]... But I would argue that we are facing the same sort of fiscal cliff which leads to this same extraordinary social unrest as France… I think that France is a bellwether for the West. You can load in all the immigration stuff with it because I do think that that's a big part of it, where you open the border to let people in to try and grow the economy. You promise them things."

"…Fundamentally, socialism destroys progress. It limits everyone's upside by giving everyone a floor. And the limiting of the upside is what leads to these sorts of problems where no one feels like they can progress. And as soon as the quality collapses because you've taken out all the incentives in the system, everyone starts to feel incredible discontent. France, I think, is one of the first to go. But if we don't write the ship in all these other countries in the west, I think we might find ourselves falling down the same hole."

Stop the AI fearmongering:

Lastly, I must say that all the fearmongering intended to slow or halt America's advances in artificial AI/SI/ASI—and especially RSI (recursive self-improvement)—must stop. The *WSJ* just published an **article** on this, explaining, *"Anthropic refers to [RSI] as 'closing the loop,' a cycle in which each improvement makes the machines better and faster at improving themselves… AI companies say they are now seeing the early signs of [RSI], which is speeding up their research—and freaking everyone out. As this technology accelerates its own evolution, the risk is that we struggle to keep pace and keep it under control."* The article included the chart below created by Anthropic itself illustrating the rapid growth in how much of the R&D is actually being done by the AI itself.



But scary or not, there is such enormous promise in this transformative technology that it is necessary for our country to maintain leadership in its development. Indeed, one of America's greatest strategic advantages is its central role in all the interconnected global systems that facilitate trade, energy, food production and distribution, finance, communications, and technology. These systems benefit from powerful network effects: the more countries and businesses that participate, the more efficient, productive, and valuable they become, further reinforcing our country's economic and geopolitical influence.

This interconnected architecture has been the foundation of globalization, generating extraordinary prosperity but also exposing vulnerabilities in national security, critical supply chains, and economic sovereignty. It has also given America considerable leverage through sanctions, export restrictions, and access to essential technologies and financial networks. Although such measures can be necessary to counter aggression, their excessive or arbitrary use risks encouraging other nations to develop competing systems that undermine American influence.

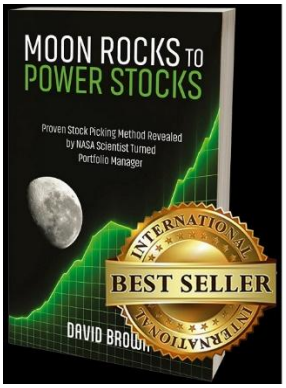
Of course, economic incentives cannot overcome every ideological, territorial, or authoritarian ambition. Nor is American leadership assured, particularly as China pursues its own (mostly open source) AI capabilities and alternative technological and financial networks (note: Alibaba's Qwen models, DeepSeek, and Moonshot's Kimi publish their model source code and weights to drive global uptake and feedback loops). But rather than becoming another source of international division and instability, AI/SI/RSI ultimately seems destined to strengthen an American-led global architecture that promotes greater economic integration, shared prosperity, and geopolitical stability. And assuming the US and its allies can maintain technological leadership while remaining fair and reliable stewards of an open international economic order, even geopolitical rivals will face increasingly strong incentives to cooperate rather than confront.

Indeed, perhaps the greatest strategic danger is not that this transformative technology becomes too powerful, but that America, through excessive fear, regulatory paralysis, or political fragmentation, voluntarily relinquishes its leadership to authoritarian regimes with fundamentally different priorities. The ultimate prize is not simply technological supremacy, but an international order in which American leadership makes cooperation increasingly profitable, confrontation increasingly costly, and prosperity more broadly attainable.

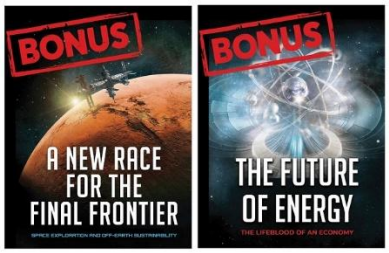
As you vote in this election and the next one in two years, I hope you can maintain a sober mindset and vote for policies that are in your and your country's best long-term interests.

Gain access to Sabrient's proven models:

Again, Sabrient employs a variety of fundamental financial factors in our quantitative models and portfolio selection process. The **Sabrient Scorecards** for Stocks and ETFs are investor tools that provide access to several of our proprietary models for idea generation and portfolio monitoring. To learn more, I invite you to visit **https://www.moonrockstopowerstocks.com** where you can download founder David Brown's latest book (an Amazon international bestseller) and 2 bonus reports (on investing in the Future of Energy and Space Exploration)—all in PDF format—and start subscribing to the Scorecards, which make David's process easy for idea generation and portfolio monitoring. They include our Top 30 stocks each week for 4 distinct investing strategies—Growth, Value, Dividend, and Small Cap.

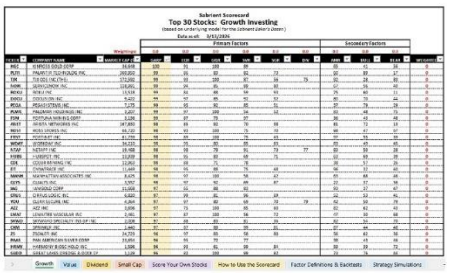


+



Bonus Reports

+



Sabrient Scorecards

Latest Sector Rankings

Relative sector rankings are based on Sabrient's proprietary SectorCast model, which builds composite profiles for each of over 1,800 equity ETFs based on bottom-up aggregate scoring of the constituent stocks. The *Outlook Score* is a Growth at a Reasonable Price (GARP) model that employs a forward-looking, fundamentals-based multifactor algorithm considering forward valuation, historical and projected earnings growth, the dynamics of Wall Street consensus earnings estimates and recent revisions (up or down), quality and sustainability of reported earnings, and various return ratios. It helps us predict relative performance over the next 3-6 months.

In addition, SectorCast computes a *Bull Score* and *Bear Score* for each ETF based on recent price behavior of the constituent stocks on particularly strong and weak market days. A high Bull score indicates that stocks held by the ETF recently have tended toward relative outperformance when the market is strong, while a high Bear score indicates that stocks within the ETF have tended to hold up relatively well (i.e., safe havens) when the market is weak. Outlook score is forward-looking while Bull and Bear are backward-looking.

As a group, these three scores can be helpful for positioning a portfolio for a given set of anticipated market conditions. Of course, each ETF holds a unique portfolio of stocks and position weights, so the sectors represented will score differently depending upon which set of ETFs is used. We use the iShares that represent the ten major US business sectors: Financials (IYF), Technology (IYW), Industrials (IYJ), Healthcare (IYH), Consumer Staples (IYK), Consumer Discretionary (IYC), Energy (IYE), Basic Materials (IYM), Telecommunications (IYZ), and Utilities (IDU). Whereas the Select Sector SPDRs only contain stocks from the S&P 500 large cap index, I prefer the iShares for their larger universe and broader diversity.

The table below shows the latest fundamentals-based Outlook rankings and our full sector rotation model:

Sabrient SectorCast Sector Rotation Strategy - As of 10/31/2026
Suggested Top 3 Sector ETFs for Bullish, Neutral, or Defensive Outlooks
Bullish/Neutral/Defensive bias based on SPY vs. 50/200 day moving averages; 30-90-day forward look

Sector	ETF	Outlook Score	Bull Score	Bear Score	Net Score: Neutral Bias	Net Score: Bullish Bias	Net Score: Defensive Bias
TECHNOLOGY	IYW	84	64	49	84	90.0	42.6
ENERGY	IYE	82	45	73	82	42.7	90.0
TELECOMMUNICATIONS	IYZ	59	65	53	59	83.7	42.0
FINANCIALS	IYF	50	53	56	50	51.1	44.9
INDUSTRIALS	IYJ	49	57	54	49	60.6	40.6
BASIC MATERIALS	IYM	47	58	55	47	62.3	41.9
CONSUMER DISCRETIONARY	IYC	21	55	52	21	45.9	27.0
HEALTHCARE	IYH	20	54	60	20	43.1	42.7
UTILITIES	IDU	13	53	65	13	38.2	50.3
CONSUMER STAPLES	IYK	11	48	69	11	25.2	57.6

Sabrient's ***Outlook Score*** employs a forward-looking fundamentals-based scoring algorithm to create a composite profile of the constituent stocks. ***Bull Score*** and ***Bear Score*** are based on price behavior of the underlying stocks on particularly strong and weak days over the prior 40 market days. High Bull indicates a tendency for relative strength in a strong market, and high Bear indicates a tendency for relative strength in a weak market (i.e., safe havens). High for all scores is 100, and higher is better.

The latest rankings display a **bullish** bias, in my view, given that cyclicals and secular growth sectors dominate the top of rankings, and defensive sectors are at the bottom. Next 12 months (NTM) analyst earnings forecasts still look quite strong across the board, and investors seem optimistic that impacts from the Iran conflict and shipping blockade are either shrinking or worked around. However, a few sectors (Consumer Staples, Consumer Discretionary, and Utilities) have seen negative revisions to forward estimates, although Technology and Energy are seeing substantial increases.

Technology (dominated by the mega-cap Big Tech titans and AI-driven highflyers) remains at the top with an Outlook score of 84, although it is finding rare competition from Energy at 82. Its continued strength reflects the high quality of those juggernaut cash machines. Notably, the recent "Tech Wreck" has brought down its forward P/E to an attractive 23.6x, which is about 25% below the 31x it reached last fall. The consensus NTM EPS growth estimate has risen faster than price such that the forward PEG (ratio of P/E to EPS growth) for Tech has fallen to a modest 0.80. Only Energy at 0.79 is lower.

Tech displays strongly positive sell-side analyst earnings revisions and the highest profit margins, return ratios, and insider buying (albeit more subdued). Because many Tech stocks are riding secular growth trends (i.e., little cyclicality), no other sector comes close to the consistent sales growth, margins, operating leverage, and ROI. And Tech not only benefits from its own product development and productivity gains, but those products help companies in other sectors with their product development, product delivery, and productivity. So, Tech benefits by helping all sectors grow and prosper.

Across all sectors of the economy, spending on technology is dominating capex. According to Andreessen Horowitz's 2026 *State of Markets*, high-tech equipment, software, and R&D account for roughly 55% of US capital spending. The main concern is whether spending of over 100% of hyperscalers' massive cash flow on capex will generate sufficient ROI in the near term to placate investors.

After Tech, the next 5 sectors by Outlook score are Energy, Telecom, Financials, Industrials, and Basic Materials, which is bullish. Then the scores drop off quite a bit. At the bottom of the rankings are noncyclical and/or defensive sectors Consumer Staples, Utilities, and Healthcare. Utilities and Staples continue to display by far the lowest forward EPS growth rates (the only ones in single digits), among the lowest consensus analyst revisions to EPS estimates, and little insider buying.

Keep in mind, the Outlook Rank does not include timing, momentum, or relative strength factors, but rather reflects the consensus fundamental expectations at a given point in time for individual stocks, aggregated by sector.

***To learn more about how you can access our weekly Stock and ETF Scorecards**, please visit:*
https://www.moonrockstopowerstocks.com

Sector Rotation Model and ETF Ideas

Our rules-based Sector Rotation model, which appropriately weights Outlook, Bull, and Bear scores in accordance with the overall market's prevailing trend (bullish, neutral, or defensive), moved to a **neutral** bias when the S&P 500 fell below its 50-day moving average. *(Note: In this model, we consider the bias to be bullish from a rules-based trend-following standpoint when SPY is above both its 50-day and 200-day simple moving averages, but neutral if it is between those SMAs while searching for direction, and defensive if below both SMAs.)*

As highlighted in the table above, the Sector Rotation model suggests holding **Technology (IYW), Energy (IYE), and Telecom (IYZ),** in that order. Or, if you prefer to take a bullish stance for a post-election rally, it suggests holding Technology, Telecom, and Basic Materials (IYM). However, if you prefer a defensive stance, it suggests holding Energy, Consumer Staples (IYK), and Utilities (IDU).

Here is an assortment of other interesting ETFs that are scoring well in our latest rankings: SonicShares Global Shipping (BOAT), VistaShares Artificial Intelligence Supercycle (AIS), Tuttle Capital Concentrated Memory Stack (HBMX), First Trust Natural Gas (FCG), Global X AI Semiconductor & Quantum (CHPX), NestYield Visionary (EGGQ), NestYield Dynamic Income (EGGY), VanEck Semiconductor (SMH), SMART Mid Cap (SMCP), iShares AI Innovation and Tech Active (BAI), Xtrackers Semiconductor Select Equity (CHPS), US Global Technology and Aerospace & Defense (WAR), Abacus FCF Small Cap Leaders (ABLS), Golden Eagle Dynamic Hypergrowth (HYP), iShares Future AI & Tech (ARTY), Pacer Data and Digital Revolution (TRFK), AXS Esoterica NextG Economy (WUGI), Shipping & Global Logistics (HULL), Invesco Next Gen Connectivity (KNCT), Global X MSCI Argentina (ARGT), First Trust Nasdaq Semiconductor (FTXL), iShares US Oil & Gas Exploration & Production (IEO), SMART Small Cap (SSCP), and VanEck Data Center Supply Chain (RACK). All score in the top 6% (94-100) of Sabrient's Outlook scores.

As always, I welcome your thoughts on this article! Please email me anytime. Any and all feedback is appreciated.

Also, please let me know of your interest in any of Sabrient's **new indexes for ETF investing**, such as *High-Quality Energy, High-Quality Healthcare, Defensive Equity, High-Quality SMID Growth, High-Quality Growth & Income, and High-Quality Value,* as well as the actively managed *Space Exploration & Off-Earth Sustainability, Future Energy, and Sabrient Select High-Conviction Portfolio (similar to our Baker's Dozen portfolio, but larger). Visit Sabrient.com for more information on the six passive indexes.*

IMPORTANT NOTE: I post this information periodically as a free look inside some of our institutional research and as a source of some trading ideas for your own further investigation. It is not intended to be traded directly as a rules-based strategy in a real money portfolio. I am simply showing what a sector rotation model might suggest if a given portfolio was due for a rebalance, and I do not update the information on a regular schedule or on technical triggers. There are many ways for a client to trade such a strategy, including monthly or quarterly rebalancing, perhaps with interim adjustments to the bullish/neutral/defensive bias when warranted, but not necessarily on the days that I happen to post this article. The enhanced strategy seeks higher returns by employing individual stocks (or stock options) that are also highly ranked, but this introduces greater risks and volatility. I do not track performance of the ideas mentioned here as a managed portfolio.

Disclosure: *At the time of this writing, of the securities mentioned, the author held positions in QQQ, IWM, FTLS, IGV, MAGS.*

Disclaimer: *Opinions expressed are the author's alone and do not necessarily reflect the views of Sabrient. This newsletter is published solely for informational purposes only. It is neither a solicitation to buy nor an offer to sell securities. It is not intended as investment advice and should not be used as the basis for any investment decision. Individuals should consider their personal financial circumstances in acting on any opinions, commentary, rankings, or stock selections provided by Sabrient Systems. Sabrient makes no representation that the techniques used in its rankings or analyses will result in profits. Trading involves risk, including possible loss of principal and other losses, and past performance is no guarantee of future results. Investment returns will fluctuate, and principal value may either rise or fall. Sabrient disclaims liability for damages of any sort (including lost profits) arising from the use of or inability to use its rankings or analyses. Information contained herein reflects our judgment or interpretation at the time of publication and is subject to change without notice.*

Copyright © 2026 Sabrient Systems, LLC. All rights reserved.