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EPISODE 54

Dispersion in Equity Markets Is Growing: Is It Fed Tightening or Faltering AI?

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The S&P 500 ended this week 2.5% below its record high of October 6. Corporate profits are growing more rapidly than 92% of the time since World War II. Yet, within corners of financial markets, there was panic. The collapse in CoreWeave shares and bonds echoed Bear Stearns to some.

That seems a bit hysterical. Let's start with the data center story.

While the hyperscalers are holding up well, the smaller, undiversified builders of capacity have mostly suffered double-digit drops in share prices this year (see figure 1). This is despite the fact that they aren't the largest borrowers. Their balance sheets simply aren't like Microsoft's or Alphabet's. They jumped into the data center business and borrowed like their solvency depended on it. And in some cases it does.

FIGURE 1

Are You a Hyperscaler or a Neocloud? It Matters

Share Price Performance Year-to-Date...

% change, as of 10/20 intraday

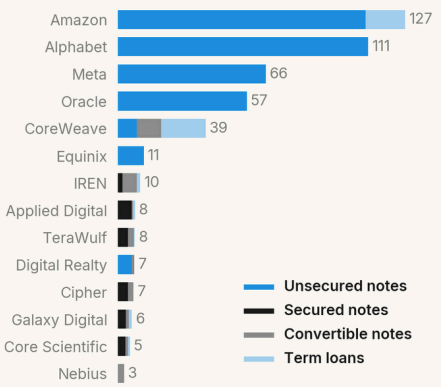
Neoclouds		Hyperscalers	
Nebius	103.4	Amazon AWS	13.7
TeraWulf	5.0	Microsoft	11.0
Core Scientific	–5.7	Google	10.8
CoreWeave	–13.8	Meta	7.1
Applied Digital	–21.5		
IREN	–26.6		
Cipher Mining	–39.4		

CoreWeave: Total Debt $52 Bln, EBITDA $5 Bln = 10.4X

Top 5 Cloud: Total Debt $770 Bln, EBITDA $651 Bln = 1.2X

...Borrowing Since 2024

Debt raised since January 2024, $ billions



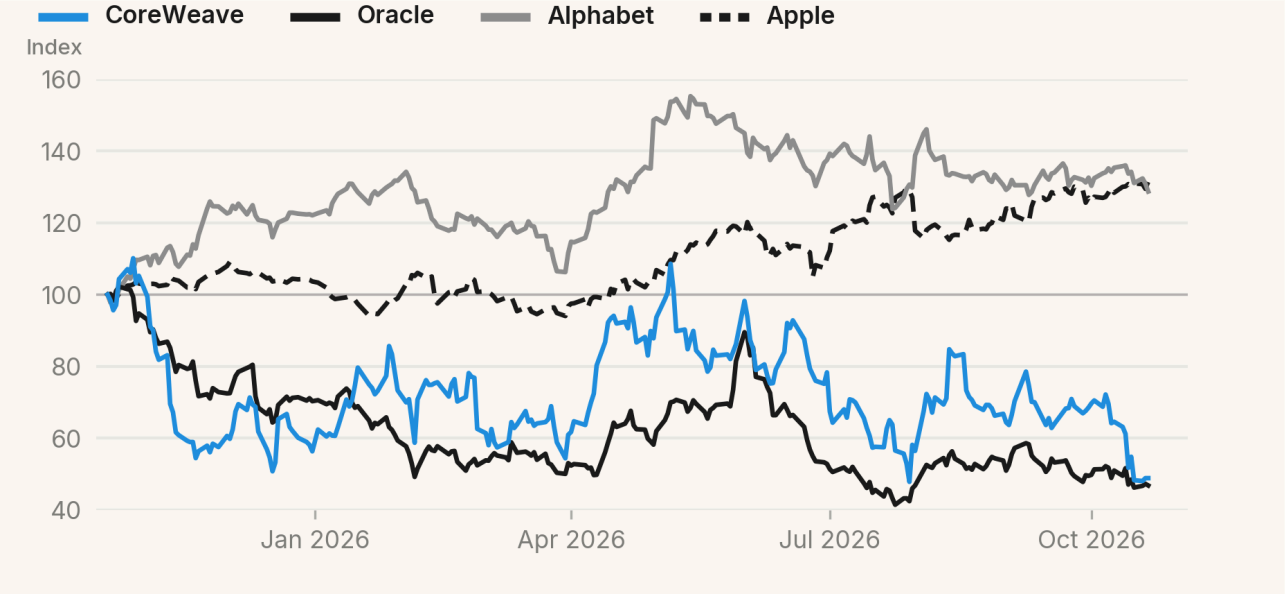
SOURCE: CIO GROUP, BLOOMBERG, SEC EDGAR

Cracks Appearing in the “AI Trade”

The Fed and rising interest rates are underrated as a catalyst for the disruption of the “AI trade”. We don’t think it is a coincidence that the blowup in neocloud shares and bonds – and the wider dispersion between this group, which now includes Oracle, and the hyperscalers – has come after a substantial jump in the expected Fed policy rate this year (see figure 2).

FIGURE 2

Dispersion of Returns For Stronger vs Weaker Balance Sheet Tech (Share Prices Indexed to 100 on Oct 20, 2025)



SOURCE: CIO GROUP, FINANCIAL MODELING PREP

When credit is easy, new players can use it to get into a business and take a share of industry profits. This is what the “neocloud” companies are doing to a large extent. But access to credit is not infinite. As interest rates rise, the hurdle for taking credit risk increases for lenders. CoreWeave’s troubles are not indicative of a broader credit collapse. But the environment of easy credit for everyone has ended.

What Changed Investors' Minds About Neoclouds?

Sometimes, "mortgaging the farm" to enter the right new business pays off. While AI demand and supply fundamentals are changing fast, the latest indicators show users are paying more now for access to aging chips than when the processors were first installed. This suggests AI demand is still exceeding computing supply, at least in an immediate sense.

But the demand for compute is not infinite nor will it remain in short supply. Suppliers to the data centers are also suffering greatly. Shares of Vertiv, a leading maker of data center power and cooling equipment, have fallen about 40% over the past six months, and Super Micro Computer has dropped about 21% in the past month alone. Political and environmental concerns about the power, water and land that data centers demand are rising, amplified by the elections.

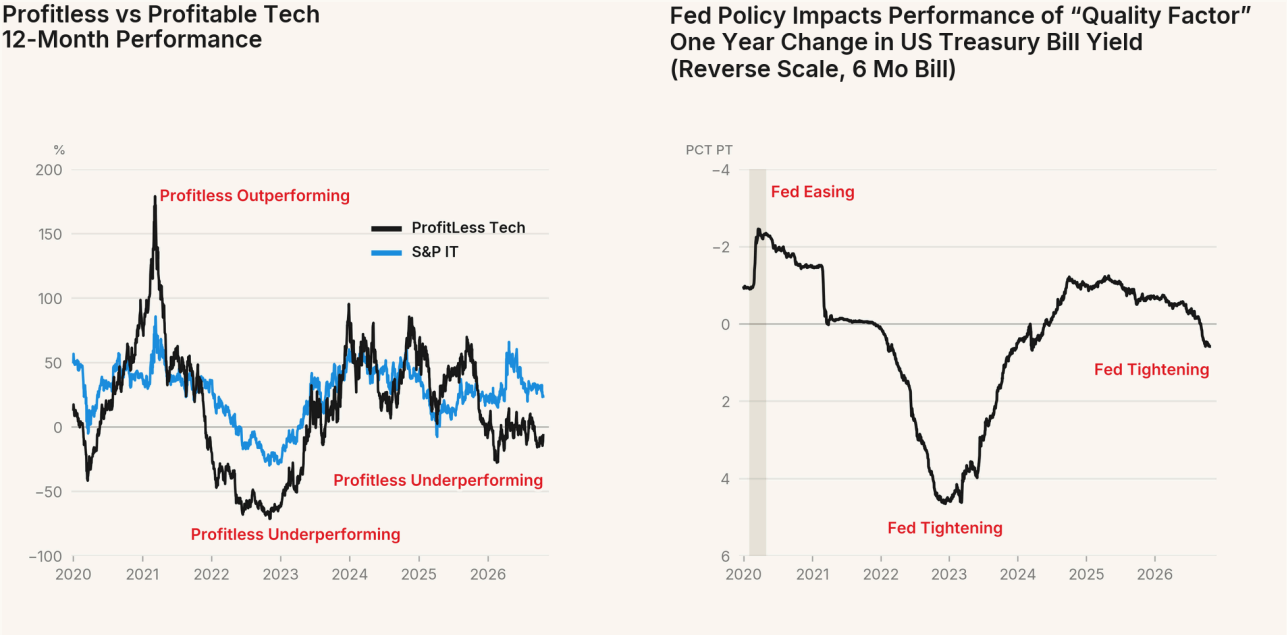
The Fed Is Raising Rates to Fight Inflation – An Echo of 2022

The Fed is raising rates to fight inflation. What makes it scarier is Fed Chair Warsh's notion that it is the Fed's job to beat down inflation regardless of what drives it.

What may be missed in market analysis is the "echo" of the 2022 trade and many other periods when Fed policy meant a falloff of weaker assets, leaving only higher-quality assets to perform well (see figure 3). This effectively "narrows" market leadership.

FIGURE 3

Performance of Profitable or Profitless Tech Shares (Y/Y%) and Changes in the US Treasury 6-Month Bill Yield (Realized and Expected Fed Policy Rate)



SOURCE: CIO GROUP, BLOOMBERG, UBS, HAVER ANALYTICS

As we discussed last week, monetary policy is often just the "prick" that bursts a bubble. In the late 1990s, one couldn't blame the Fed for the outrageous risks some investors took on profitless companies. And in 2008, it was more the Fed's regulatory oversight than monetary policy that contributed to the financial system's weakness and eventual collapse. Yet a series of rate hikes happened close to the peak of the dot-com spending bubble and the sub-prime lending spree.

Within the tech sector, there are also major questions. What really is the "AI trade"? Does it mean an endless surge in memory chip prices or vast increases in demand for data center capacity at any price? Or is it Anthropic's next breakthrough model and the cyber defenses we need against rogue-state developers?

Dispersion Is the New Story

Against all this, smaller shares and the AI trade are coming under pressure, reflecting the widening *dispersion* of returns within AI and broader financial markets. For example, unlike large caps, US small caps have fallen 9% from their peak. Large-cap technology (the S&P IT sector) is up 21% year-to-date, second only to energy among the 11 sectors. Yet loss-making tech shares are +4.1%, trailing far behind.

Strong AI demand does not mean the economy is "boundless." The risk-free hurdle rate and the supply of credit will ration even the growing potential of the economy. How high the rate needs to go is the question. When demand exceeds supply, markets and the Fed together raise the hurdle rate, which at some point binds (see figure 4).

FIGURE 4

Growth of Real Private Fixed Investment vs Change in US Treasury 2-Year Note Yield



SOURCE: CIO GROUP, HAVER ANALYTICS

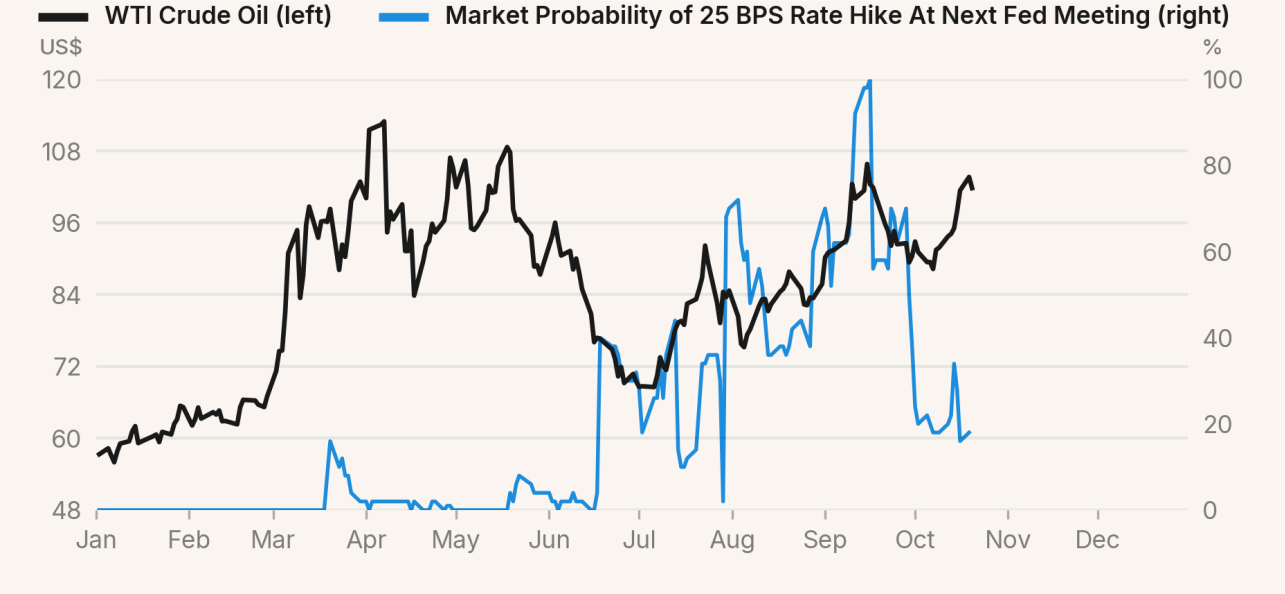
Rates, Inflation and the Technology Trade

A total of four 25-basis-point rate hikes, including September's, is expected at the moment. (The Fed meets Wednesday this coming week. We believe the chance of a tightening step is somewhat higher than markets expect.)

The Iran war and its aftermath are driving energy prices higher, and with them broader inflation. As figure 5 shows, the war-induced jump in crude oil largely predicted the Fed's initial tightening action.

FIGURE 5

Conflict-Led Crude Oil Spike Predicted Fed Tightening



SOURCE: CIO GROUP, HAVER ANALYTICS

Against that backdrop, we see investors wondering if the "AI trade" will resume. The present boom has already given us meaningful setbacks in asset prices without stopping what is likely history's most rapidly accelerating technology.

As we noted last week, constraining some of the excesses of the present boom might help it endure in a healthier way. For now, CIO Group balances portfolio quality and defense while remaining optimistic on AI profits and market opportunity in our asset allocation.

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