The Blue Tsunami and the AI Correction

GKV CAPITAL

A Sharp Reversal

Two days after the midterm elections, the AI trade had its worst day in more than a year and a half. On Thursday, November 5th, the Nasdaq 100 Index fell 6.4%, and is now up only 5.5% for the year after peaking, up 23.4% only a month ago. The PHLX Semiconductor index posted its worst day since the depths of the pandemic. Nvidia fell 9.3% to $181.60, erasing its gain for the year. Every sector of the S&P 500 finished lower.

The selloff did not come out of nowhere. The Nasdaq had already pulled back 8% from its high in October. Third quarter results from Amazon and Alphabet disappointed, and for the first time since 2022 the "Magnificent 7" are reporting slower earnings growth than the other 493 companies in the S&P 500. The election results, along with several new governors who campaigned on restricting data centers, turned a gradual re-evaluation into a rout.

What Has Changed

Some of this week's selling is simple profit taking. AI infrastructure stocks have been the market's biggest winners for three years, and many investors are sitting on large gains. Leverage made it worse. A popular triple-leveraged semiconductor ETF lost 39% in a single day, and individual investors were on pace for their largest day of net selling since the pandemic. Sometimes markets go down because people sell, and sometimes people sell because markets are going down.

The regulatory environment for data center construction is likely to get more difficult. Texas, Ohio and Georgia are among the largest data center markets in the country, and their governor races were effectively a referendum on the buildout. In Texas, which has more planned projects than any other state, the governor-elect wants new approvals to remain on pause until the legislature meets next year. We do not expect construction to stop, but it will likely cost more: larger concessions to local communities, requirements to pay for power and

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water infrastructure, and slower permitting. Delays matter. A project expected to generate revenue in a year that instead takes three is a very different investment.

The cost of capital is higher. The 10-year Treasury yield peaked in early October at 5.31%, the highest in two decades, and the Fed raised rates for the first time since 2023. The hyperscalers can no longer fund their spending from cash flow alone and have been issuing large amounts of debt and equity. Demand for that issuance is waning. Neocloud providers, which lack the balance sheets of Microsoft, Alphabet or Amazon, are finding credit very difficult to obtain.

Capital spending growth will slow. Consensus estimates call for hyperscaler capex of roughly $800 billion this year, nearly double 2025. Spending is still expected to reach about $1.1 trillion in 2027, but that is 37% growth, and 2028 estimates call for just 10%. Capex may not have peaked, but its growth rate likely has. AI revenue has grown remarkably, to an estimated $200 billion annually, but it remains a fraction of what is being invested. With higher rates and greater scrutiny from the capital markets, that gap must narrow through faster revenue growth or more moderate spending. Probably some of both.

Our Outlook

In our opinion, the AI trade is not broken, but it is being re-evaluated. That process has been under way for months; the election accelerated it. Some of the fear is overdone. Nvidia has forecast 70% revenue growth for its next fiscal year, limited by supply rather than demand, and trades at roughly 14 times forward earnings, below the S&P 500 at about 18.5. If projects stall in one state, chips will find buyers elsewhere.

That said, growth assumptions into 2027 may need to come down. Analysts expect S&P 500 earnings to grow 16% next year, with semiconductors the largest contributor. Last quarter we wrote that an election matters to the stock market only if it changes the trajectory of corporate earnings. This one may, at least for the AI infrastructure trade.

There is a broader economic consequence. Business investment, much of it AI-related, contributed 1.3 percentage points of the 2.2% GDP growth in the second quarter, more than double its long-term average. Slower AI spending would likely mean slower economic growth.

Meanwhile, AI capabilities keep improving. The most advanced AI agents can now work through tasks that take a person hours, and nearly a quarter of U.S. businesses use AI. That progress will continue to drive demand for computing capacity despite political headwinds.

We believe there is an investment middle ground. Overinvestment is common with any revolutionary technology. Railroads and fiber optic networks produced both bankruptcies and enormous long-term value. Amazon lost 90% of its value in the dot-com crash, then compounded at 27% a year for 25 years. Over-building is not a reason to shun the opportunity; it is a reason to be selective.

We will continue to focus on fundamentals: revenue, earnings, margins and the price we pay. Many valuations remain attractive, but sentiment has shifted, and lofty multiples and growth rates are rightly being questioned. We favor leading companies with strong balance sheets and durable demand, and we will have to be more cautious on those that depend on cheap capital and uninterrupted construction.

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