

Bubble?

Market Update From Advanced Asset Management Advisors

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Bubbles... spoken among investors, the term conjures up rampaging prices for tulip bulbs, art, precious metals, land, or stocks. A bubble is a significant run-up in prices without a corresponding increase in the underlying asset or business value, and a subsequent collapse. Bubbles are typically not identified in advance except with speculative forecasts. It is only after a collapse that bubbles are confirmed.

Within the stock market, history provides multiple examples of bubbles bursting — railroads in the 1870's, automobile companies in the 1920's, conglomerates

in the 1960's, and of course internet companies in 2000. Currently, we are hearing speculations of a bubble in artificial intelligence. What are the prospects?

We do have a significant run up in stock prices in anything related to AI. We also have large capital investments in data centers and requisite power generation. The key question is if the underlying businesses represent a corresponding increase in value i.e. revenues and profits. It is too early to determine. Consider that:

There are 60 Gigawatts of data center capacity in the world (ex-China), and the United States plans to add 134 GW over the next 5 years at a cost of \$6.4 Trillion. The gross investment only makes sense if AI profitably changes large swaths of our economy. Companies must see profits improved to justify the cost of AI services.

AI is undoubtedly delivering efficiency gains in various business applications — customer service chat bots, data mining, code writing, and graphic design to name a few. However, the revenue realized from AI providers today is meager compared to the investment, and near-term growth opportunities seem to be softening.

Topics

AI capital expenditures and evaluating revenue opportunities with levels of investment.

Interest rates, takeaways from the Federal Reserve's economic projections, and the bond market's reaction to the September rate cut.

Stock market valuations and an overview of the earnings growth needed to justify historically high prices.

An overview of **how AAMA is positioned**, considering valuations, opportunities, and risks in the market today.

AI adoption rates for larger firms (over 250 employees) had grown from 5% to 14% over the last 2 years but has dropped to 12% over the last 3 months¹. Walmart executives say their mix of jobs will change significantly over the next three years but the head count will stay the same. The hourly rental price for Nvidia H100 chips has been falling over the last 18 months. None of these facts signal an immediate and significant economic benefit from AI implementation.

Improvements are still required for further mainstream commercialization. Remember that AI models seemingly cannot accurately answer the question “how many times does the letter “d” appear in DeepSeek” (two is the answer provided). AI has a knack for guessing, rather than admitting ignorance, a problem in applications that require data accuracy.

With less-than-proven future potential revenue streams, current investment levels have the earmark of a bubble.

In order to avoid a collapse and potential bubble, revenues from AI implementation will need to increase dramatically to justify the current pace of investments and lofty stock prices. While we wait for future revenues to be more evident, large technology companies are the safest way to gain exposure to the future of AI because, even though they are investing between 55% and 75% of their cash flow, it is largely from current cash flows. Small companies or those that borrow heavily to make AI investments are at highest risk should this potential bubble trend be confirmed with a collapse.

Interest Rates

How about that new movie, “Federal Reserve Drama”? Politicians, economists and members of the Federal Reserve Board all have widely diverging opinions of what monetary policy is appropriate. We know two things.

First, the median economic projections of the members who actually vote on interest rate policy all strengthened over the last few months — higher economic growth, lower unemployment, and higher inflation.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, September 2025

Percent

Variable	Median ¹					Central Tendency ²					Range ³				
	2025	2026	2027	2028	Longer run	2025	2026	2027	2028	Longer run	2025	2026	2027	2028	Longer run
Change in real GDP	1.6	1.8	1.9	1.8	1.8	1.4-1.7	1.7-2.1	1.8-2.0	1.7-2.0	1.7-2.0	1.3-2.0	1.5-2.6	1.7-2.7	1.6-2.6	1.7-2.5
June projection	1.4	1.6	1.8		1.8	1.2-1.5	1.5-1.8	1.7-2.0		1.7-2.0	1.1-2.1	0.6-2.5	0.6-2.5		1.5-2.5
Unemployment rate	4.5	4.4	4.3	4.2	4.2	4.4-4.5	4.4-4.5	4.2-4.4	4.0-4.3	4.0-4.3	4.2-4.6	4.0-4.6	4.0-4.5	4.0-4.5	3.8-4.5
June projection	4.5	4.5	4.4		4.2	4.4-4.5	4.3-4.6	4.2-4.6		4.0-4.3	4.3-4.6	4.3-4.7	4.0-4.7		3.5-4.5
PCE inflation	3.0	2.6	2.1	2.0	2.0	2.9-3.0	2.4-2.7	2.0-2.2	2.0	2.0	2.5-3.2	2.2-2.8	2.0-2.4	2.0	2.0
June projection	3.0	2.4	2.1		2.0	2.8-3.2	2.3-2.6	2.0-2.2		2.0	2.5-3.3	2.1-3.1	2.0-2.8		2.0
Core PCE inflation ⁴	3.1	2.6	2.1	2.0		3.0-3.2	2.5-2.7	2.0-2.2	2.0		2.7-3.4	2.2-2.9	2.0-2.4	2.0-2.2	
June projection	3.1	2.4	2.1			2.9-3.4	2.3-2.7	2.0-2.2			2.5-3.5	2.1-3.2	2.0-2.9		
Memo: Projected appropriate policy path															
Federal funds rate	3.6	3.4	3.1	3.1	3.0	3.6-4.1	2.9-3.6	2.9-3.6	2.8-3.6	2.8-3.5	2.9-4.4	2.6-3.9	2.4-3.9	2.6-3.9	2.6-3.9
June projection	3.9	3.6	3.4		3.0	3.9-4.4	3.1-3.9	2.9-3.6		2.6-3.6	3.6-4.4	2.6-4.1	2.6-3.9		2.5-3.9

Source: Federal Reserve Summary of Economic Projections, September 2025

Second, inflation has been increasing over the last several months and the 3-month average rate is 3.5% (based on the Fed's 'favorite' gauge)². But the Fed dropped rates anyway.

Now déjà vu versus last year. Longer term rates and mortgage rates are higher by 0.20% since the decision. After the Fed's rate cuts a year ago, ten-year rates increased by 1 full percent. The yield curve is steepening as investors continue to build higher inflation expectations into their outlook as the Fed loosens monetary policy in the face of a strong economy and firm labor market. Absent an economic or financial shock, this trend does not appear to be ready to reverse. Our fixed income portfolios remain focused on short-term, high-quality issues.

Stock Prices

The S&P 500 has gained 14.8% year to date³, leaving its price to trailing earnings ratio higher than 93% of observations over the last 38 years. Not unlike AI investments, corporate earnings will need to grow to justify this level of valuation. The strength of the capitalization-weighted S&P 500 continues to be heavily influenced by large tech companies. The average stock in the S&P 500 has gained only 9.9% for the year³.

S&P 500 Trailing Price To Earnings Ratio



Source: Standard & Poor's

Broad measures that compare the total value of the U.S. stock market to the size of the economy are at extreme high levels, eclipsing levels as far back as the 1920s. This ratio is Warren Buffet's favorite thermometer for measuring stock market risk. Lofty valuations do not presage a stock market selloff. They do however, indicate more price risk if there were to be an economic or financial shock or disappointing earnings.

Earnings for the full year 2025 are currently expected to grow by 10.5% (the expectation was 16.5% at the start of the year)³. Estimates tend to start out optimistic then ratchet lower as the year progresses. Expectations for 2026 seem to fit this pattern with forecasts again topping 17%. Earnings growth needs to be robust if we are going to grow into the current market valuations.

Given elevated valuations, we continue to maintain higher exposure to market sectors that historically have lower volatility in both earnings and stock prices (i.e. Health Care, Consumer Staples, and Utilities).

¹US Census Bureau

²Federal Reserve Bank of St. Louis

³Morningstar

Disclosures

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