Market Insights:

Beyond the macroscope

16 October 2026

The folly of bubble picking

- AI valuation concerns have rekindled market volatility, but it should be corrective and not mark an inflection point in the current cycle
- The underlying AI investment story still looks durable against accelerating demand, at the same time US equities have been quietly re-rating, removing some earlier froth
- It's a positive backdrop for the USD (yield and growth), even if positioning and market chop can cramp its style shorter-term and geopolitics remains a longer-term problem

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With classical risk off dynamics making a bit of a comeback this week, it is worth a dig through some of the charts that inform about these relationships, particularly at a point in the cycle where the market has refocused on the "AI bubble" theme. We are hoping to avoid becoming a proxy for the cover of the Economist with that.

We won't look at credit, which many feel is where the canary will topple. But we will muse on AI. For the moment that investment cycle looks sustainable, which took me some time to get comfortable with. Sure, it is going to be expensive, the hyperscalers are spending one Elon Musk on it this year alone (Figure 1). But making comparisons to previous bubble periods – US railroads seem to be the popular one – probably misunderstands the situation. Even in simple terms that framing looks wrong, the duration is different and a railway can only get you from A-B (and in 1836 there was often a barren patch of sand at point B). AI, in contrast, has practical uses across the economy, globally with demand at every point. And the firms doing the spending are the highest earning businesses in history, with (currently) very little leverage on their balance sheets (Figure 2). This time is different, oh dear!

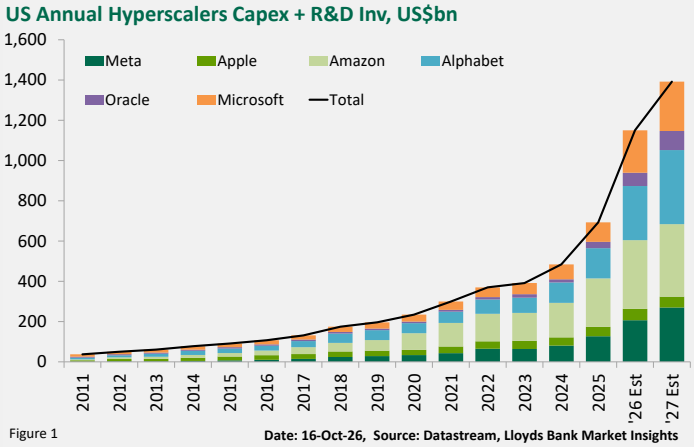


Figure 1

Date: 16-Oct-26, Source: Datastream, Lloyds Bank Market Insights

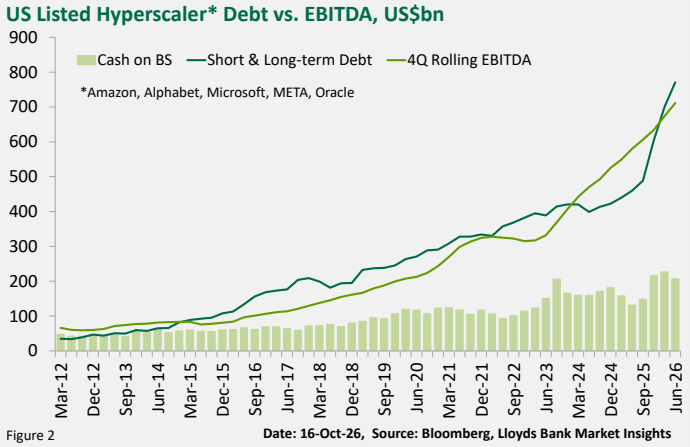


Figure 2

Date: 16-Oct-26, Source: Bloomberg, Lloyds Bank Market Insights

This breadth is why the buildout is running behind demand, despite all the hype about the cost. We look to have shifted into Jeavons Paradox territory, where the rate of improvement in the technology and the

concurrent decline in costs is driving a surge in demand, reinforcing the cycle (Figure 3). It seems more likely that the hyperscalers will struggle to deliver the desired capacity over the next few years given adoption and the logistical constraints of scaling to that. Those barriers come in the form of energy/resource availability, construction capacity and planning and local opposition (which is growing). Buying a load of snazzy chips looks the easy bit. Maybe a Brit gets more hung up about these types of things given UK construction dysfunction, but such buildouts tend to run at the pace of the slowest part.

Obviously, that still does not address the issue of whether the hyperscalers will be able to generate the return on capital they are looking for, but that is something no one can be certain of. Is this going to be a winner(s) take all race, or will the walls they are trying to construct be penetrable with a Chinese-made open-weighted trebuchet? Or will they simple be able to co-opt everyone into using their models, leveraging an edge in safety (everything is relative), robust alignment and regulation. You can see those types of themes already, as well as the political patronage that cold cash can secure.

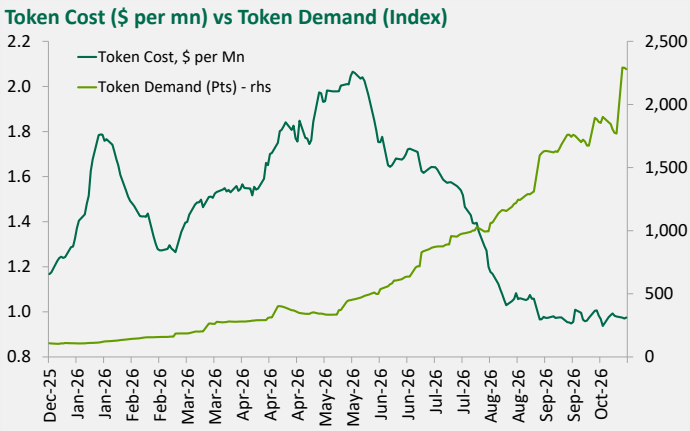


Figure 3 Date: 16-Oct-26, Source: Bloomberg, Lloyds Bank Market Insights

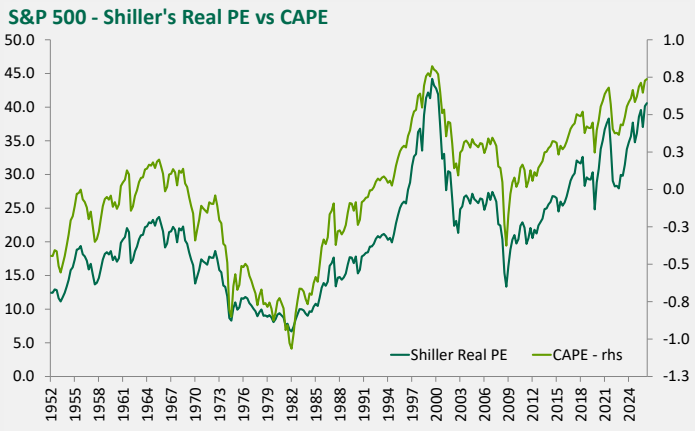


Figure 4 Date: 16-Oct-26, Source: Fed Flow of Funds, Datastream, Lloyds Bank Market Insights

What we can say is that the rest of the economy is likely to be captive to varying degrees whoever wins, as more corporate and public infrastructure embeds these technologies. It's not going to be like swapping Netflix (dross) for Apple TV (currently not dross), you will not be able to cut the cord — there will be full dependency.

That is an unprecedented level of leverage across the economy and society; it would be a miracle if they didn't reap a proportionally large fee for that. And this is even before factoring the advancement of the technology itself; we're already at a point where it is transformative. We're not starting at dial up where the internet was just promise as at the turn of the Millennium, the AI game begins at gigabit broadband, all singing and dancing.

Looking at asset prices, a lot of that hope might appear to be built in. Valuations by some of the classical bubble measures are very stretched, take the Shiller's PE and Tobin q for example (Figure 4). They imply poor equity returns over the next decade. And typically, when we see bond yields rise, we get negative feedback into equities (via the discount rate). Looking at the US equity index charts at face value, that correlation might appear weak. But there are other, positive, things

going on. The US economy has been strong, which has boosted corporate profits and margins. That is equally visible in earnings and expected earnings growth.

You can make the case that there are some unsustainable factors behind that. Tech earnings have been flattered by paper gains on their holdings of AI stocks (Anthropic, OpenAI etc.) for instance, and the Iran war has temporarily boosted profits of the energy firms (even if temporarily is turning out to be a bit longer than expected). Nonetheless, forward earnings multiples have been falling (Figure 5). In fact, they've fallen in lockstep with the rise in real yields, which is what you'd expect.

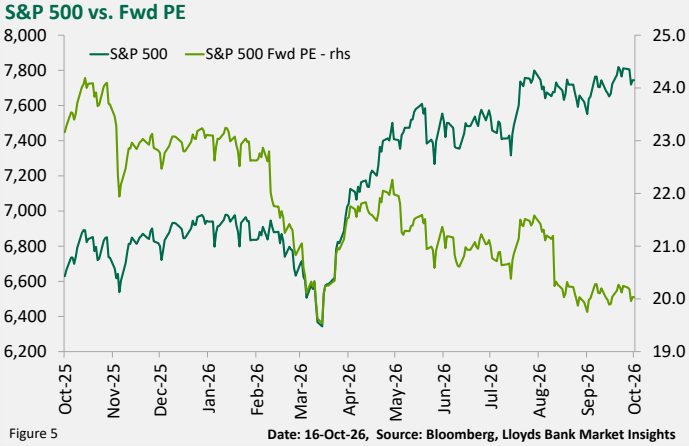


Figure 5

Date: 16-Oct-26, Source: Bloomberg, Lloyds Bank Market Insights

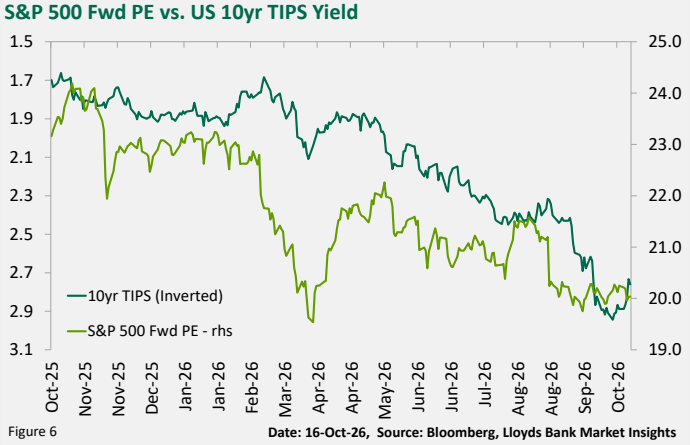


Figure 6

Date: 16-Oct-26, Source: Bloomberg, Lloyds Bank Market Insights

So higher yields have impacted equity performance, and valuations are now less stretched (Figure 6). There has been a larger rerating of growth stocks versus value, both are now less richly priced. That leaves the S&P 500's estimated forward PE at a bit over 20 from a recent peak of 24, still expensive versus the long-run average of 17.6, but not markedly so.

While it's possible to be optimistic about the AI theme (despite the cost) and more comfortable with equity risks to the macro economy, that does not absolve all of the risks. The economy has faced numerous challenges in recent years. Its ability to weather those shocks has been encouraging. Central bankers even seem to think this is the new normal. But stresses that continually accumulate will eventually generate a fracture. You'll know it when you see it (being in a recession), but not before, is usually hot it goes.

One other aspect of the AI buildout has been the change in equity flow dynamics. The shift towards negative hyperscaler cashflows has meant an end of the share buybacks that the tech giants have delivered in recent years (Figure 7). That is good, long have people complained that large scale buybacks reflected a situation of firms lacking viable investment opportunities. Now hyperscaler stocks are a pure play on investment bets. Equity markets have proved resilient to that drop. Filling the gap has been overseas buyers (Figure 8), lured by the AI story and yield. US exceptionalism is back; Trump be damned.

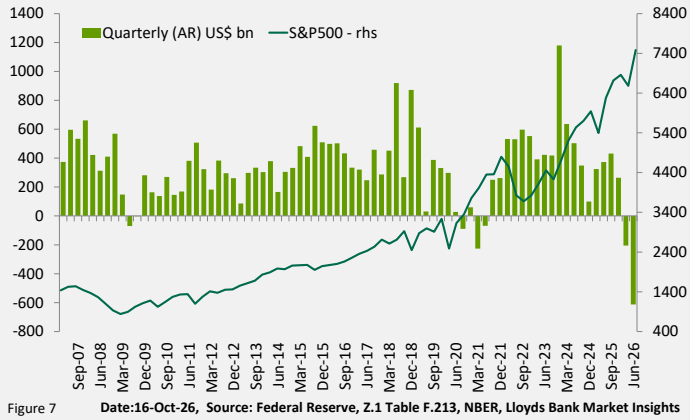


Figure 7 Date:16-Oct-26, Source: Federal Reserve, Z.1 Table F.213, NBER, Lloyds Bank Market Insights

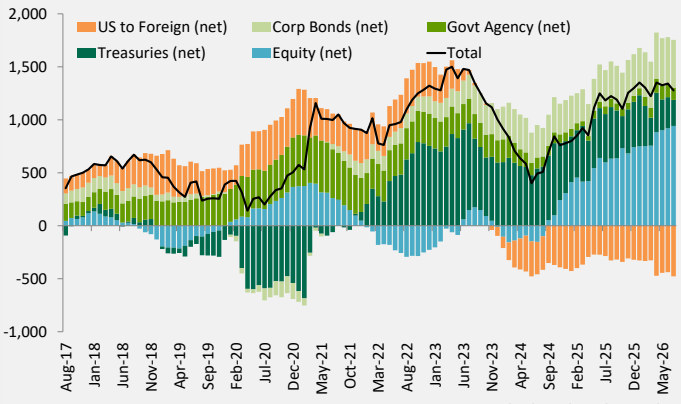


Figure 8 Date: 16-Oct-26, Source: US Treasury, Lloyds Bank Market Insights

If that marks a shift towards flightier money, it will sit on the risks side of the ledger. But perhaps that flow is just a stop gap, not an enduring vulnerability. We haven't seen any deterioration in the current account, which would indicate an increase in demand for overseas savings. Now the chip firms look to be stepping into the buyback void as their cashflows go parabolic (Figure 9). Maybe in a world that operates on excessive margins, buildout costs are less relevant. It serves those doing it quite well in reality – no one else can get in on the game. 75% gross margins, like Nvidia, never last forever, but they might last long enough to dig the moat (if it's not already dug).

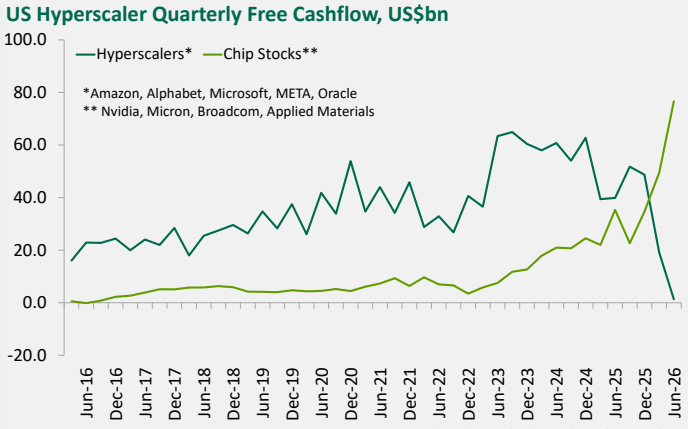


Figure 9 Date: 16-Oct-26, Source: Bloomberg, Lloyds Bank Market Insights

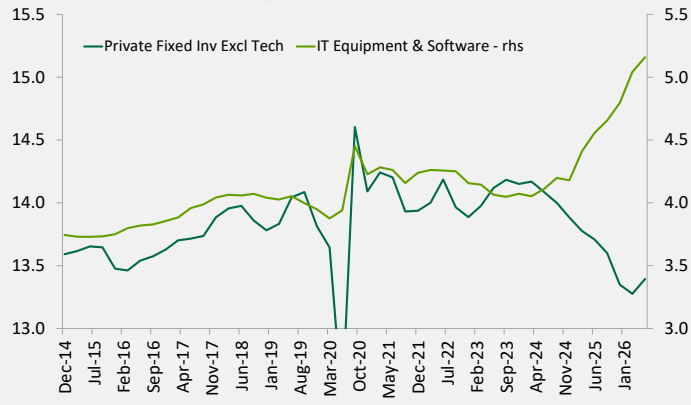


Figure 10 Date: 16-Oct-26, Source: BEA, Lloyds Bank Market Insights

Looking at the level of investment itself, it does not look unsustainable either. The change in technology capex and R&D has been large, getting on towards a couple of %pts of GDP so far, but total private investment hasn't grown by anything like as much. That might be partly a crowding out effect (Figure 10), but if you believe in efficient markets you have to think these is also a reallocation of resources going on too. The full commercialisation of AI requires infrastructure which still does not exist. Most cycles end at an extreme. It looks rather early to think we're close to the cliff.

How ought this to feed through into markets? It would support the thesis that the rise seen in real rates is going to be durable. That ought not to strangle investment as those decisions are made on the available returns, not the simple yield level. Government on the other hand might have a bigger problem.

As AI washes through, opportunities to innovate and increase productivity ought to multiply beyond the hyperscaler/chip ecosystem. Whether that is good for labour is another matter — we're sceptical that human cognition is uniquely superior for many tasks (creativity is by definition rare, lots of work is mundane). Broader steps in automation/robotics are going to add further competition. The optimists are left with historical precedents for 'the new types of jobs that are always created'; failing that we'll just have to be thankful the public sector lost interest in generating its own productivity a long time ago. There look good odds that the owners of capital will reap the bulk of the gains.

There is also an inflation effect, rising investment demand is running ahead of the capacity to deliver. That creates a cost headache for that sector directly, but it also bleeds across the economy via the many shared inputs (not just iPhone memory, many other components, energy, construction etc). That suggests a higher equilibrium rate and/or a need for tighter financial conditions, certainly if 2% inflation is going to be durably achieved, as Chair Warsh has pledged. Markets have not worried too much about inflation thus far, despite energy price rises (evident in steady breakeven rates), but that looks to underestimate the cyclical risks present and broader pricing power that a strong US economy facilitates. It's not a good backdrop for fixed income, even before considering fiscal profiles.

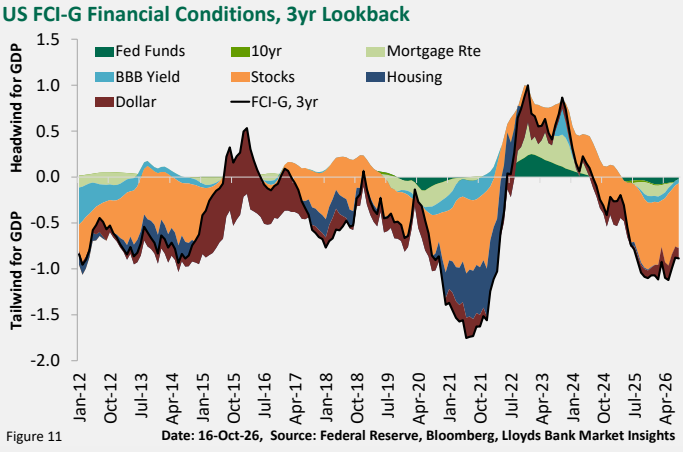


Figure 11 Date: 16-Oct-26, Source: Federal Reserve, Bloomberg, Lloyds Bank Market Insights

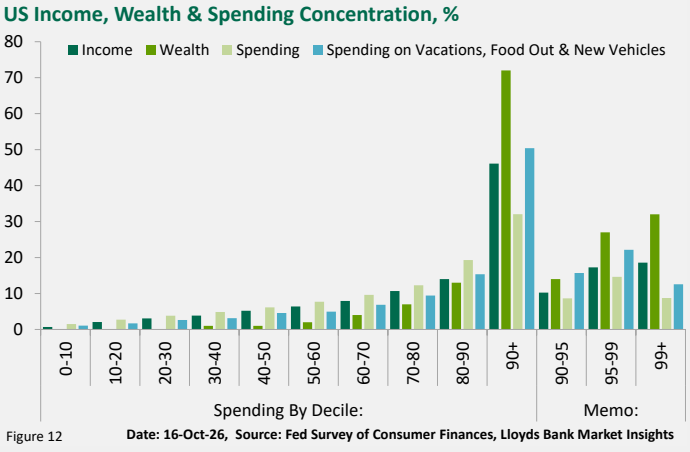


Figure 12 Date: 16-Oct-26, Source: Fed Survey of Consumer Finances, Lloyds Bank Market Insights

Equally, if monetary transmission is compromised, as households are largely fixed and corporates insensitive, delivering tighter financial conditions is harder. It would require durably lower equity prices. That would stomp on the (concentrated) wealth effects that have been supporting demand (Figure 11, 12). If the dot.com bust is anything to go by, that would pass most of Main Street by. The Fed funds rate is not the tool to deliver that though. We remain concerned second round risks are underestimated, by the Fed and the market. Both seem more focused on expected favourable energy base effects.

This week's equity wobble initially took a bite at the dollar, which probably reflected an unwind of the faster money flows into yield and the AI trade. But with the lure of AI investment spending, asset price returns and higher bond yields (real and nominal), it's hard to take a negative view at this point. Doing so is really picking a turn in the US

economy and asset prices. There is always a worry list on that front, when you can't find things like that, then worry.

Many investors still crave divestment or at least some diversification from the Greenback. Trump's impact will have a longer-term effect on investment flows, even if you can't see it now — the foundations have changed. That does not make it easy to do though, particularly in a world where technological innovation and the growth that creates remain US-dominated.

That might leave the dollar looking a concentrated bet, but alternatives are scarce, only the higher yielders with a resource base (NOK and AUD) look appealing, although they've not decorrelated from the broader G10 basket. A US yield premium risks dampening growth in a Europe already struggling with manufacturing malaise and another energy shock. And one could argue EU politics are not much better than polarised America. Across the bloc the centrist parties are continuing to slide while the populists get closer to breaking out (the French presidency topping that list). Weak growth reinforces the social problems that drive voters to the fringes — it is the classic prisoner's dilemma. It's hard to argue for the EURs other positives for the moment, being long USD leaves you in the better penitentiary.

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