Letter n°156

What should we make of the stock market?

"Where the light is brightest, the shadows are deepest" Goethe.

The publication of the second-quarter results was robust, a source of much satisfaction, with a succession of positive surprises, not just in tech.

But undoubtedly, there is a certain complacency in the markets towards risks. The VIX index, at 15 compared with more than 30 at the beginning of the conflict, is evidence of this. Let us not get carried away; let us analyse in greater detail what the results are masking and examine the risk posed by interest rates.

The bright side:

Nearly 50% growth in earnings for S&P 500 companies in the United States and 15% in Europe. These are the fruits of the second quarter, unexpected and unforeseen, 30% above expectations and well above revenue growth, at 6.5% in the United States and 0.5% in Europe.

Behind these figures, let us highlight 3 positive points: margins are very high, at around 15%; according to a Bank of America study, the median increase in S&P 500 earnings has risen from 8% to 13% over 2 years; and, the 3rd point, the appreciation is no longer limited to stocks dependent on AI but is also benefiting banks, small caps, energy.

While markets are quick to reward good results – Kering +17% on results that were less bad than expected, Schneider +11%, Saint-Gobain +9% on the day of publication – the penalties for disappointments have been abrupt: Hermès -10% on the day of publication because the P/E ratio is still 35x, ST Micro -18%, Sanofi -9%... And the magnitude of the swings is even greater for tech stocks, which over the past few weeks have been seesawing, with +9%/-9% moves from one session to the next.

The shadows:

- ***Results that are sometimes less flattering than they appear and a generously valued US market***:

According to FactSet, the S&P 500 P/E ratio is at 28x, compared with 29x in May, but above the long-term average of 22x.

Many companies benefited from faster-than-expected refunds of customs duties improperly collected by the Trump administration. Washington has already refunded $128 billion and potentially, the amount could reach $165 billion. Thus, Apple received $2.2 billion, Nike $1 billion, FedEx $0.8 billion, Amazon $640 million, GM $500 million, and this helped inflate quarterly earnings. For example, for Apple, it represented 5% of total quarterly earnings.

More than 70% of Alphabet's quarterly earnings come from stakes in other companies, notably SpaceX ($900 million invested in 2015, worth $94 billion at the end of June). Gains on investments also represent 65% of Amazon's net income, mainly thanks to Anthropic (conversion of bonds in Anthropic). But these are unrealised gains that depend on the performance of the stock markets.

- ***Risks of disappointment surrounding AI***: 3 points to highlight.

On the one hand, investments are constantly being revised upwards, without a clear outlook on their future impact on productivity. $7 trillion should be spent on data centres over the next 4 years, creating a risk of disappointment if there are no productivity gains.

Alphabet could thus spend, according to FactSet, $257 billion in 2027 on AI and consequently become cash-flow negative. Apart from Nvidia, all the major tech companies are currently free-cash-flow negative and have to resort to debt.

On the other hand, there are risks related to off-balance-sheet commitments. According to the WSJ, 9 tech companies would have $3 trillion in off-balance-sheet commitments related to AI, a figure far above the $600 billion invested over the past 12 months. In the 2nd quarter, the Magnificent 7 generated $315 billion in net profit, of which $134 billion, i.e. 42%, came from gains realised on investments. Excluding these gains, the net income of these companies would have been roughly stable.

Finally, the use of financial practices that are reminiscent of the early stages of the dot-com bubble in 2000 and the subprime crisis in 2007, practices that reveal the vulnerability of the AI market. Thus, Nvidia, criticised for circular financing (taking stakes in customer companies), is developing with Blackrock, Blackstone and Apollo a securitised financing structure, potentially amounting to $500 billion, to facilitate chip purchases by smaller companies seeking to avoid excessively high borrowing costs. This is a new asset class, similar to what aircraft purchase securitisation or real estate loans (subprime) had previously represented. This reveals the fragility of the AI ecosystem.

- ***A drift higher in long-term rates and the prospect of further increases in short-term rates***:

The last years of budget surpluses in a majority of major countries date back to the early 2000s. Growing tensions on long-term rates are attributable to the drift in public debt, the multiplication of large issuances linked to AI, persistent inflation and uncontrolled budget deficits in several major countries, from the United States to France, as well as Japan and the United Kingdom.

Since the beginning of the year, bond issuances by the 6 US giants, including SpaceX and Oracle, have exceeded $245 billion according to Dealogic, compared with $108 billion for the whole of 2025 and $17 billion in 2024. This is in addition to foreign-currency issuances. This is a far cry from the financial situation of these companies two or three years ago, when they had no debt, generated free cash flow and bought back their shares.

In recent years, in the United States, the lowest inflation rate was 2.3% in April 2025, therefore never below 2% since 2021. In July, inflation slowed slightly to 3.4% and 2.5% for core inflation, but August will probably be marked by a rebound due to oil.

In England, the official rate was maintained at 3.75%, and in the Eurozone at 2.25% at the July meeting, but with inflation persisting, they will likely be increased by 0.25% in the autumn. The same could happen in Japan, as the country is facing a combination of inflation, increased public spending driven by the new Prime Minister, record public debt at 230% of GDP (2x France) and the now chronic weakness of the currency.

Reflecting these concerns over inflation, debt and the increasingly numerous weekly issuances linked to AI, 30-year bonds, at 5.33% in the United States, 5.86% in the United Kingdom, 4.9% in France, 4.15% in Japan and 3.8% in Germany, are at their highest levels since 2008. US long-term rates have reached a 19-year high and, moreover, the market is concerned about Kevin Warsh's communication. He also wants to reduce the Fed's balance sheet, which stood at $6.5 trillion at the end of 2025, down from $9 trillion in 2022, a level still more than seven times higher than in 2007. The exercise is challenging because such a reduction could well result in additional tensions on long-term rates.

Volatility has increased because hedge funds, according to the Dallas Fed, are estimated to hold $2.4 trillion of Treasuries, compared with $600 billion 10 years ago.

According to Fitch, the default rate in private credit reached a record level of 6.1% at the end of July.

Conclusion: ***"The shadow passes, but the light remains" Latin proverb.***

- ***Volatility can be a trap****:* the hedge fund Situational Awareness, after gaining 400% in tech this year with leverage of 4 to 5, lost 70% in July and had to be taken over by Citadel at a knock-down price.

- ***Seasonality cannot be ignored***: let us not forget that, since 1990, August and September have been the weakest months for stock market performance. There may therefore be a short-term consolidation. The uncertainty and concern in the markets centre on when earnings growth will begin to slow.

- ***Liquidity remains abundant***: in the 2010s, it came from central bank injections; now, from budget deficits. In the United States, there are still $3 trillion in money market funds, few alternatives outside equities, risks in fixed income as long-term rates rise, problems in private credit and setbacks in private equity.

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