

FOLLOWING THE FUNDAMENTALS

Morgan Stanley

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A QUARTERLY MARKET UPDATE FROM THE VOLRATH CASTLE GROUP AT MORGAN STANLEY

AI HERE, AI THERE, AI EVERYWHERE!

BY AARON CASTLE, *Financial Advisor + Portfolio Manager*

Clearly, my children's recent requests for Dr. Seuss at bedtime influenced the title of this quarter's update! While the title may be playful, the subject is anything but as we believe Artificial Intelligence is and will continue to have a major impact on the economy and markets. It's nearly impossible to turn on a business news channel today and not immediately hear about the impact of Artificial Intelligence. We believe that is for good reasons and believe that we are starting to see the impact that AI is having on many of the data points that we track.

In this quarter's update, titled "AI Here, AI There, AI EVERYWHERE!", we attempt to cut through the noise regarding AI and present a few of the data points we believe AI is currently having a material impact on and what these developments may mean in the years ahead for the portfolios we manage.

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CYCLE INDICATOR TURNS POSITIVE

In our quarterly updates from 2022-2023, we often presented the Morgan Stanley US Cycle Indicator as a data point that raised concern due to the “downturn” reading that it indicated. However, in recent updates, we have started to point to this indicator as a source of optimism as the indicator started to turn upwards. As seen below, this data point recently exited its “downturn” reading and entered “expansion” territory.

Morgan Stanley Cycle Indicator

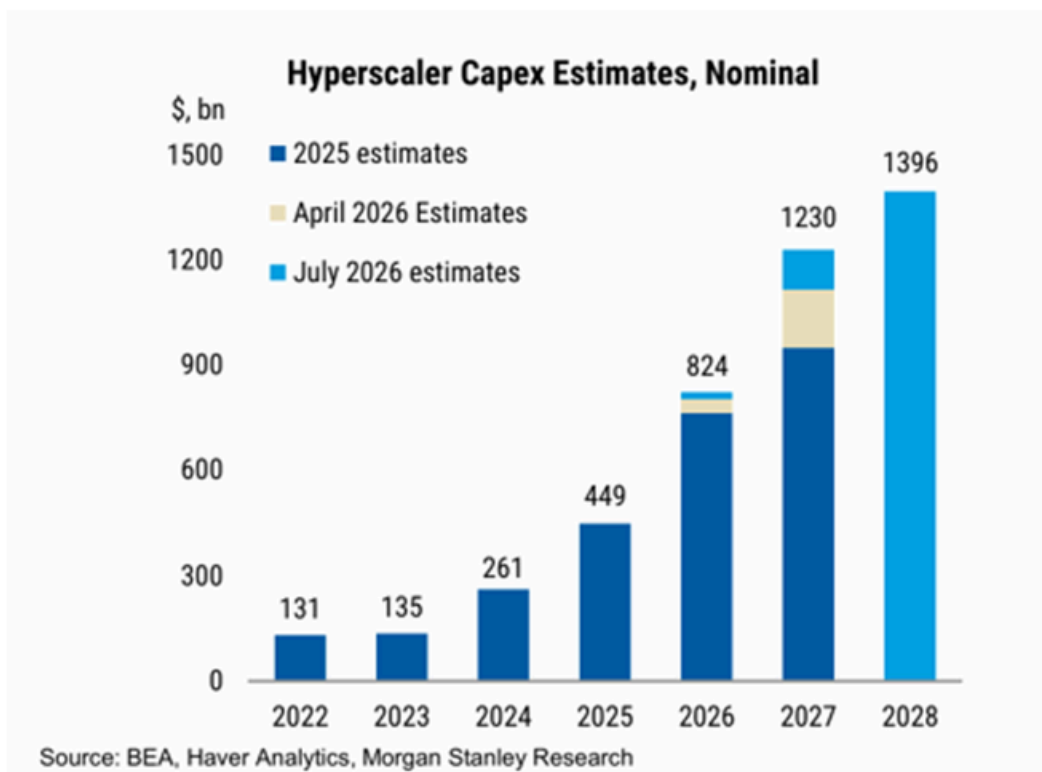
US Cycle Indicator



Source: Bloomberg, LSEG, Haver Analytics, Morgan Stanley Research; Note: For more information on the construction of the cycle indicator, please see [Cross-Asset Dispatches: Improving the Cycle Indicator – Countdown to Downturn \(31 Mar 2019\)](#).

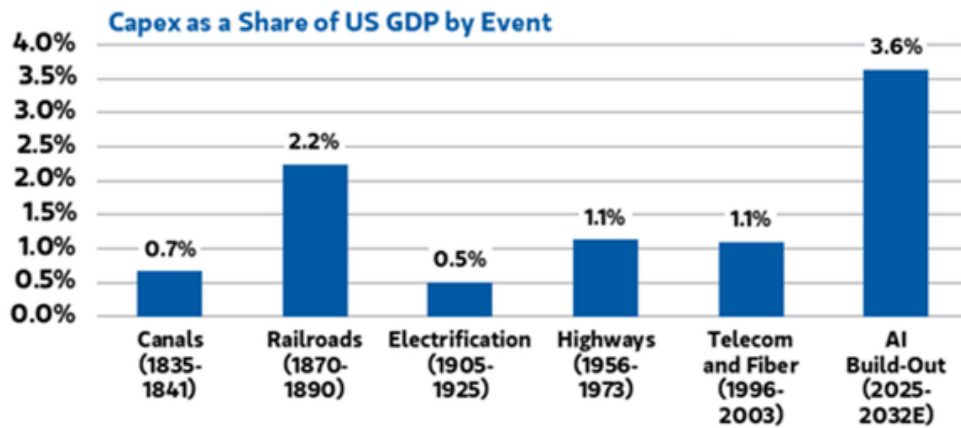
ARTIFICIAL INTELLIGENCE BUILD OUT

We believe that Artificial Intelligence has played a major role in the Morgan Stanley US Indicator entering “expansion” territory. In 2022, Hyperscaler capital expenditures registered at \$131 billion and grew approximately 3% to \$135 billion in 2023. Since 2023, capital expenditure growth has skyrocketed and recent estimates anticipate \$824 billion of hyperscaler spending in 2026 followed by over \$1 trillion in spending in both 2027 and 2028.



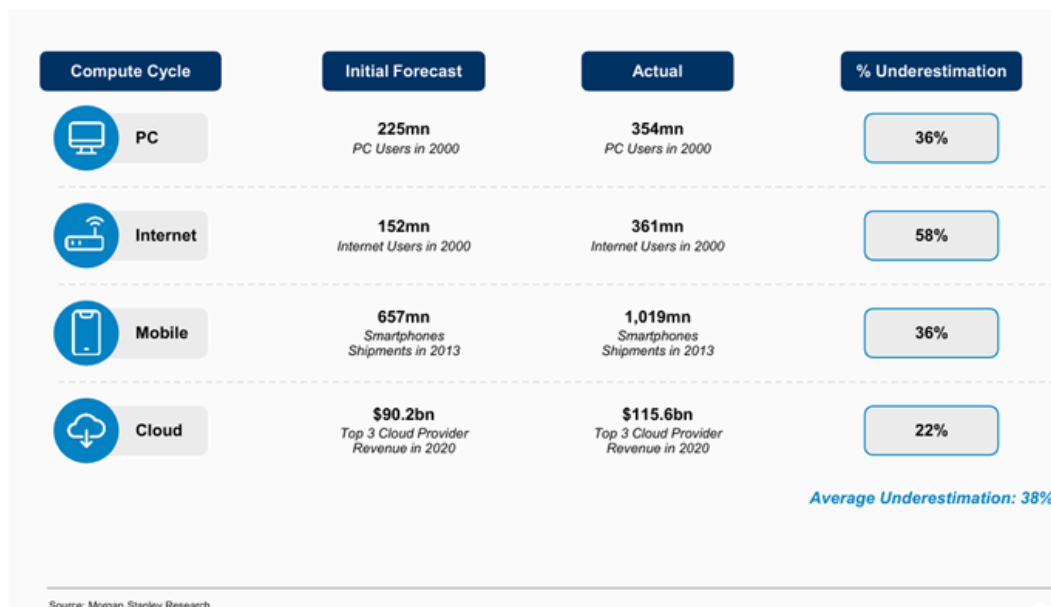
To put that level of capital expenditure into context, the chart below estimates what those levels of capital expenditures would represent as a percentage of US Gross Domestic Product between the years of 2025-2032 and compares the potential Artificial Intelligence build out to past major infrastructure build outs in the US. Based on these estimates, the Artificial Intelligence build out as a percentage of US GDP has the potential to be much larger than many of the major infrastructure projects in the US in the past 200 years.

ARTIFICIAL INTELLIGENCE BUILD OUT



Source: Bloomberg as of Aug. 10, 2026

Based on the previous charts estimates, we believe analysts are optimistic about the potential growth the US Economy might experience in the coming years from the Artificial Intelligence build out. Interestingly, as seen below, history shows that analysts were too conservative when estimating levels of adoption and growth regarding 4 of the major tech build outs the past 2-3 decades. On average, analysts underestimated the number of users, shipments, and revenue of the PC (users), Internet (users), Mobile (shipments), and Cloud (revenue) revolutions by 38% compared to actual results.



EARNINGS GROWTH

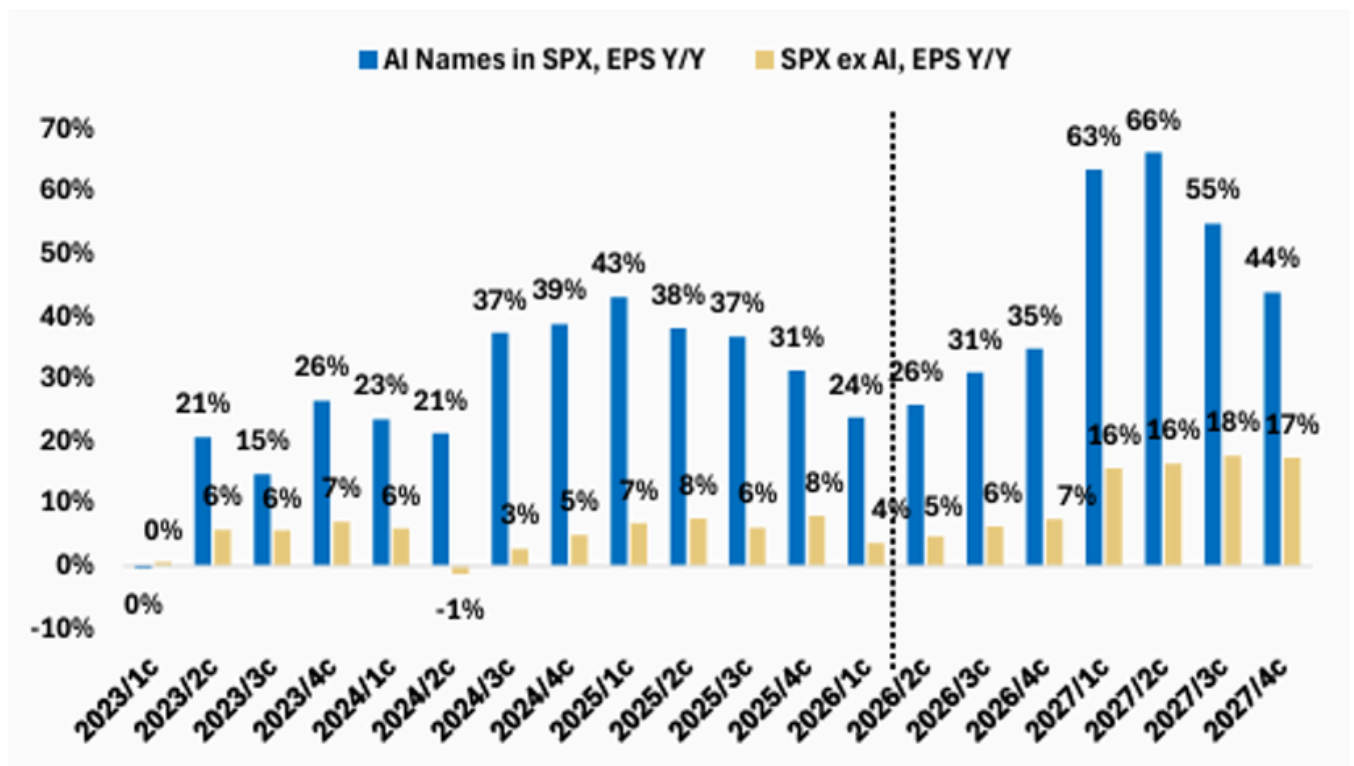
We believe the large growth in capital expenditures and efficiency gains that have resulted from the build out and utilization of Artificial Intelligence is having a significant impact on earnings of S&P 500 companies. As seen below, as recently as 2022, the year over year growth rate of earnings from S&P 500 companies was negative. However, as of 9/2/26, the year over year earnings growth rate of S&P 500 companies had grown to 35%.



Source: Bloomberg as of Sept. 2, 2026

EARNINGS GROWTH

When digging deeper into the earnings growth of the S&P 500, it becomes clear to us that the build-out and adoption of AI is having a materially larger impact on the earnings of the companies that are focusing on AI. As seen below, companies in the S&P 500 that have a stated focus on AI have seen materially larger growth rates than the average growth of companies in the S&P 500 not focusing on AI.



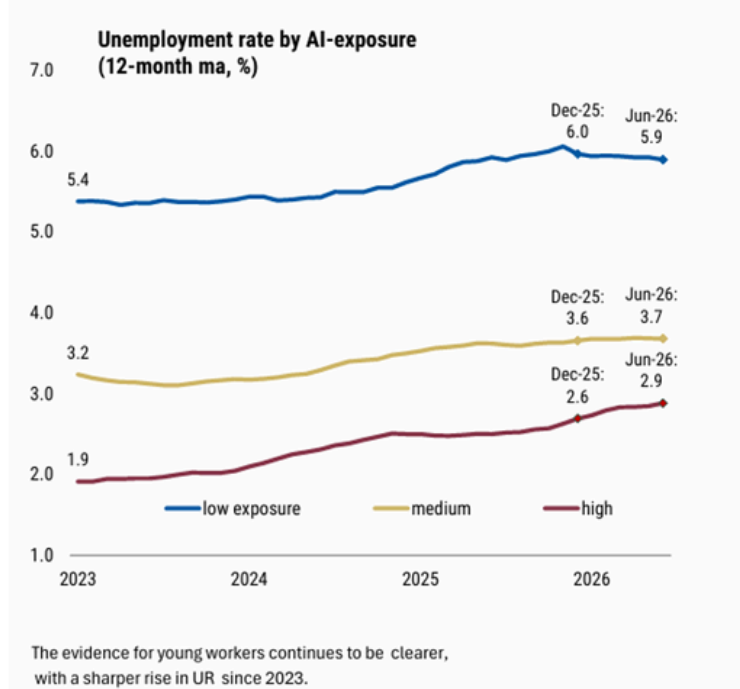
Source: FactSet, Morgan Stanley Research

CONCLUSION

In recent quarterly updates, we have become much more constructive on the US economy and US stock market compared to previous years when we expressed concern that the economic expansion the US was experiencing was largely due to the historically high levels of deficit spending by the government. We believe the US economy is in the initial stages of economic expansion led by the build out and adoption of Artificial Intelligence and is growing organically without elevated levels of government spending.

With a growing level of AI infrastructure spending and adoption from companies, we anticipate that S&P 500 companies can continue to show earnings growth in future quarters, which we believe creates a sound fundamental base that could lead to appreciation in the price of the S&P 500 Index.

However, the adoption of AI from companies also comes with potential negatives that we must keep an eye on as well. As companies continue to improve their productivity using AI, the data is starting to show that productivity is coming at the cost of jobs for a portion of the US job market. Since 2023, the unemployment rate for jobs with high AI-exposure has jumped from 1.9% to 2.9%. We believe the balance between corporate earnings and productivity needs to be monitored closely as job loss and reduction of hiring can also have major impacts on the economy and markets.



JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on Tuesday, October 20th. Keep an eye out for additional details hitting your inbox in the coming weeks. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

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