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36 South Views

By Richard "Jerry" Haworth

The Market Has Achieved Enlightenment

The market has achieved enlightenment. It no longer requires fundamentals.

The S&P 500 is trading near 7,812 and appears to have completed its final evolution into a pure sentiment vehicle. Seven stocks are doing all the heavy lifting while the rest of the index pretends this is normal. Implied volatility is 14.8, which is the options market's way of saying "nothing bad is allowed to happen until further notice." Valuations sit at levels that historically precede either a lost decade or a very interesting six months. Global oil reserves are at historically low levels after countries have been browbeaten into releasing theirs to keep the oil price low. Diesel, which used to be the poor cousin of petrol, didn't get the memo and is trading at all-time highs.

It seems like it is all part of an elaborate Potemkin village constructed to see us through the mid-term elections.

In the meantime, AI and data centre debt financing is sucking large swathes of the available capital into its potential black hole, leaving government and other corporate debt funding high and dry, gasping for breath (and higher yields).

AI still escapes as regularly as testosterone-filled teenage boarders. In my mind, it is only a matter of time before we have the equivalent of a Three Mile Island event, where there is no longer any debate about the potential dangers of AI -my best guess being it taking down a part, or the whole, of the internet.

Anything more than a day will do it. Could it do it?

The stock market will crash as AI and adjacent names get dumped. They now represent a larger share of the index than the entire internet sector did at the 2000 peak.

The bond market will crash because the AI and data centre debt will drop to cents on the dollar, and government debt will follow as investors realise that the money printing presses will need to go into overdrive to stop a real economy depression.

OK, that's the worst-case scenario, but it has gone from impossible to highly improbable.

Best-case bear scenario is that the stock market simply rolls over under its own weight and has a healthy correction.

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Key Bearish Themes

1. Valuations have entered the realm of fan fiction

Shiller CAPE in the low 40s. Market-cap-to-GDP at levels previously reserved for late-stage bubbles and certain emerging markets that later had interesting experiences. Earnings growth has been strong, which the market has interpreted as permission to ignore every other valuation metric ever invented. This is working until it isn't.

2. The AI narrative has achieved escape velocity from evidence

The index's personality now depends on a handful of companies continuing to spend tens of billions on infrastructure whose eventual returns are, for the moment, a matter of faith. Any indication that the monetisation timeline has slipped from "next year" to "eventually" will be treated as a personal betrayal. The market has not yet priced in the possibility that some of this spending produces disappointing results. It has, however, priced in the possibility that it does not.

3. Higher-for-longer is still not priced as if it is real

Elevated real yields continue to exist. Growth stocks continue to pretend this is a temporary inconvenience rather than a change in the discount rate. Bond markets and equity markets are currently having two different conversations. One of them will eventually have to concede.

4. Oil refuses to participate in the soft-landing scenario

Energy prices remain high enough to keep inflation from fully cooperating with the preferred narrative. Every time oil moves higher, someone is required to explain why this particular increase does not count.

5. Breadth has become a character in a horror movie

Most of the market is quietly struggling while the index makes new highs. This is generally not a sign that everything is fine. It is a sign that the things that are not fine have not yet been allowed to matter.

When the gap between the market's fiction and the physical economy's friction closes, we will find out exactly how much a village built on blind faith costs when the lights go out...

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