

The AI Trade Isn't Over, It's Broadening

- This selloff was anticipated, driven by Middle East escalation, heavy index concentration in AI, and higher bond yields, and a pullback or correction is possible, but we don't expect a bear market.
- The AI trade isn't over, it's broadening, as leadership rotates from chips and infrastructure toward companies that put AI to work across the economy.
- We continue to buy the dips given solid economic growth, strong earnings, better valuations, and \$28 trillion in cash on the sidelines, and we encourage you to stay focused on the long term and talk with your Cetera financial professional.

Stocks have sold off, and the AI trade, which involves the buying and selling of AI stocks, is being questioned. We understand why that may be unsettling. But this is not a surprise, and it is not a reason to abandon a plan. We have been anticipating this kind of weakness in what we have called the Temperamental Era, a volatile market driven by headlines, where sentiment can swing quickly on news about geopolitics, the Fed, or interest rates, even when the underlying economy remains unchanged. In this kind of market, a pullback or even a correction is possible, but we don't expect a bear market and continue to buy the dips.

What's driving the selloff?

We have been expecting this for three reasons.

- 1) **The Middle East is adding uncertainty and escalation.** Rising tensions are pushing energy prices higher, which feeds into inflation and complicates the Fed's path. When oil moves, rate expectations move, and markets hate not knowing what comes next.
- 2) **The market is highly concentrated in AI.** The top 10 names in the S&P 500 now make up about 40% of the index, and many are tied to the AI story. That is a lot of weight on a small number of stocks. When those names wobble, the whole index feels it, even if the broader economy hasn't changed much.
- 3) **Higher bond yields are pressuring valuations.** Higher yields raise the bar for stocks, especially growth and AI companies whose value depends on earnings far into the future. When this "risk-free" rate climbs, the math gets harder for the most richly valued parts of the market.

Notice what the second and third drivers have in common: both land hardest on the AI leaders. Concentration means those names carry the index, and higher yields mean they take the biggest valuation hit. So, when markets wobble, the AI trade is the first place investors look for answers.

The AI jitters: will the returns justify the spending?

The concerns about AI are real. Let's discuss them.

The first is return on investment. AI companies are spending enormous sums on data centers, and investors are asking whether the payoff will match the price tag. Free cash flows that were once ample have turned negative at some of these companies, forcing them to borrow.

The second is newer: is there enough capital to go around? Several large AI companies are raising money at the same time, and industry leaders are warning that capital, not technology, could become the biggest constraint on growth. When financing gets more expensive, the returns needed to justify each project go up, which amplifies the original worry about whether the spending will pay off.

The market reaction showed it. AI-related stocks and the semiconductor sector were hit hard in a single session this week, and the Nasdaq had its worst day in months. But this was a rotation, not a retreat from stocks. The equal-weighted S&P 500 edged higher while the market-cap-weighted index fell, and the Dow and the Russell 2000 held steady. Investors moved away from the AI leaders, not out of equities. Treasury yields also fell, with the 10-year Treasury yield dropping back around 5%.

Our take: this tightening is healthy. When capital gets harder to come by, it gets allocated more efficiently, and the risk of over-investment goes down. That is how booms mature instead of breaking. We also expect the key players to keep their access to financing. The five major hyperscalers are projected to spend hundreds of billions of dollars this year and even more in the years ahead, and their strong cash flows, balance sheets, and market access should allow them to keep investing.

Put simply, the market is not rejecting AI. It is asking harder questions about who will earn a return on all this spending. That is a healthy shift, and it points to where the opportunity goes next.

Is the AI trade over? No, it's broadening

The answer to "who earns the return?" is a wider group than the market has been rewarding so far. That is why we don't think the AI trade is finished. We think it is broadening, and our AI Investment Continuum explains why.

The continuum is a three-stage framework for understanding how capital and market leadership move through the layers of the AI economy as a paradigm shift matures. The key idea is that the benefits of a major technology shift do not arrive everywhere at once. They show up in a sequence, starting with the companies that supply the foundational technology and spreading outward to the businesses that use it.

Stage 1: Semiconductors. The first investment dollars go to the companies that design and manufacture the chips and equipment that make AI possible. Demand shows up here first, so this is where earnings and enthusiasm tend to appear earliest.

Stage 2: Infrastructure. Once the chips exist, they need somewhere to run. This stage covers data centers, power and cooling, and networking, which form the physical backbone required to put the computing power to work.

Stage 3: Technology implementation. Finally, companies across other sectors, such as healthcare, financials, industrials, and consumer, adopt AI to raise productivity, cut costs, or create new products. This stage is the broadest and typically plays out over the longest period.

We think we are entering Stage 3. The first two stages have done the heavy lifting. The chips have been built, and the data centers, power, and networking are being put in place. The next leg is about who uses all that capability. That is why we expect to see more types of companies benefit as they put AI to work to lift productivity and cut costs. Tighter capital also fits this picture. As the cost of building rises, investors will reward the companies that can show real returns from using AI, and that favors the broader group of adopters. This week's rotation was an early sign of that. Because Stage 3 is the broadest and typically the longest, there is a lot of runway left. The AI story isn't ending. It is spreading out.

That's also why diversification matters. A portfolio leaning only on the Stage 1 and Stage 2 names is missing much of what comes next. Being diversified helps you capture exposure across the whole continuum, not just the part that has already run.

Why we still buy the dips

Our playbook has not changed. We continue to buy the dips for five reasons.

- 1) **Pullbacks are not bear markets.** Historically, you need a recession to have a bear market. The economy is slowing, but it is still solid. Slowing is not breaking.
- 2) **Corporate earnings look very strong.** Stocks follow earnings over time, and profits are holding up well. That is the foundation under this market.
- 3) **Valuations are more attractive.** The forward P/E ratio of the S&P 500 has come down and is now below its 10-year average. That is a better entry point for long-term investors.
- 4) **There is \$28 trillion in cash on the sidelines.** That is a lot of buying power waiting for better prices. When valuations improve, that cash tends to come off the bench, which can help cushion the downside.
- 5) **The Fed likely will do less than expected.** Market volatility and high bond yields are doing some of the Fed's work for it. Higher yields tighten financial conditions on their own, so the Fed has less need to raise rates aggressively. We think the Fed will raise rates less than the market currently expects. Housing is the case in point. High mortgage rates have already produced noticeable weakness in the housing market, which shows tighter conditions are working their way through the economy without the Fed having to push harder.

Volatility is the price of admission

A selloff may feel abnormal in the moment, but it is a normal part of investing. Over the last 46 years, the S&P 500's average maximum drawdown within a given year has been 14.2%. Yet the index finished the year positive in 38 of those 46 years.

Again, even in years with a double-digit scare, stocks usually ended higher. The investors who did best were generally the ones who stayed invested through the discomfort, not the ones who tried to dodge it.

What you should do

- **Don't react to the noise.** Headlines move fast, and portfolios shouldn't. Selling after a decline often means locking in losses and missing the rebound.
- **Focus on the long term.** Your plan was built for your goals and time horizon, not for this week's market.
- **Stay diversified.** With this much concentration in the market, balance matters. Look beyond the mega-cap AI names so you are positioned for Stage 3 of the AI trade.
- **Use weakness as an opportunity.** For investors with cash and a long horizon, pullbacks can be a chance to add quality at better prices.
- **Talk to your Cetera financial professional.** Every investor's situation is different. Your financial professional can help you decide whether any adjustments make sense for your goals, risk tolerance, and timeline.

Final thought

Pullbacks and corrections are the toll we pay for long-term returns. We expect more bumps because the Middle East, the Fed, bond yields, and AI expectations will keep generating headlines. But the economy is solid, earnings are strong, valuations are better, the Fed has help from the bond market, and there is a mountain of cash waiting to get in. The AI trade isn't over. It's broadening. Stay calm, stay invested, and stay in touch with your financial professional.

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Glossary

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The **Nasdaq Composite Index** includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad-based capitalization-weighted index.