Staggering Sums **Q3 2025**

It's been a relentless bull market, new high after new high. The S&P 500 rose 8% during the quarter, a strong showing, but the standout was small caps up just over 12%, briefly breaking above old highs set nearly three years ago. That may be significant, and I'll get into that in a bit. The S&P 500 is now up nearly 15% for the year, amazing given the previous two years. The tech sector led the quarter again, up 11%, followed closely by consumer discretionary. Staples and healthcare continue to lag, as both sectors struggle to grow earnings and don't have much in the way of sexy AI to brag about.

September 24th Bloomberg headline: Alibaba stock soars after hiking AI budget past $50 Billion. That's $50,000,000,000--roughly the cost of four new U.S. Navy aircraft carriers. I grew up in Norfolk, VA and when I think of something outrageously expensive, impossibly complex and truly awe-inspiring, I think of our aircraft carriers—nuclear-powered floating cities catapulting lethal fighters anywhere in the world. (BTW, we only have 11 active carriers.) The point is: that's a mind-blowing amount of spending. And Alibaba's update wasn't even close to the biggest of the AI spending announcements to rain down on the market in the last few weeks. Collectively, they're literally in the hundreds of billions and that's on top of the hundreds of billions of commitments we heard about in the spring. The markets loved it…ate it up. Normally, investors are skeptical of big increases in spending, sometimes even hostile. Capital ain't free. But those rules don't apply during big product adoption cycles. Think electricity, railroads, indoor plumbing (my favorite), the PC, the internet, and now AI. A mania can take hold when the possibilities seem limitless. I had been somewhat sanguine about AI spending to date as it had generally been coming from a select few mega caps' free cash flow production. No more. The numbers have gotten so enormous the mega caps can't/won't shoulder the full load, and now there's a mad scramble for funding including head-scratching industry partnerships, mega quasi-vendor financing deals and huge debt offerings. It seems we've arrived at a point where every player has concluded they are in a race and must spend every penny in the jar, and then some, to get there first, even though they really don't know where there is. I'll add one last observation: I recently watched an interview with the CEO of ARM Holdings, an undisputed leader in semiconductor architecture. I'm paraphrasing, but he said the endpoint of AI spending is an AI that can discover things on its own, not just cleverly regurgitate what it's been fed. He added, ominously, we're not even close. Not close? Oh boy. Some of our most consequential product adoption cycles have ended in tears for investors. The railroads were built, the internet too, but overinvestment and speculation ruined those parties. This risk is growing and may have to be proactively addressed.

But there's another narrative playing out in the shadow of the AI investment boom. The economy is healthy, bordering on hot; second quarter GDP growth was revised up to 3.8% growth, the fastest pace in nearly two years. Tariffs, legal or not (the Supreme Court will decide), aren't having much observable effect, as the cohort of consumers with money to spend aren't holding back. We may yet see tariff impacts as companies stockpiled inventory in anticipation of tariffs, and many warned in recent reporting that they will initially eat some of the added costs; these offsets probably fade. On the other hand, benefits from the One Big Beautiful Bill could counter any further drag from tariffs next year. The Fed also finally chimed in, lowering its benchmark rate by 25 basis points. Intriguingly, it seems a foregone conclusion that the President will replace Chairman Powell in May with someone more to his liking, surely threatening Federal Reserve independence. Wolves guarding the sheep? This greedy market probably doesn't care…right up to the moment it does.

Blowout AI spending, Fed easing, the Big Beautiful Bill, what's not to like? Stocks certainly do. In fact, this has been one of the strongest price momentum markets in the last 75 years, according to our friends at Empirical Research Partners. And now small caps have joined in. Equities are telling us everything is good, if not great. I wish Mr. Market was always trustworthy. Extreme momentum markets always end. One path is gradual, with the market broadening out as good economic growth reveals better expected returns beyond AI. The other is abrupt and especially destructive if too much leverage is in play. Keep in mind that most of the announced spending is just that…announced. Risk accrues as the data centers proliferate and that will take a while. The last time this happened back in 1999, there were warning signs. We're watching.

Richard H. Skeppstrom II serves Brockenbrough as Managing Director and Chief Equity Strategist. He manages two of our investment products and writes most of our investment commentary. Richard joined the firm in 2016 and has 30 years of experience in the investment management industry.