

Part 2

The AI Bubble: Closer to the Checkered Flag or the Starting Line?



THE AI BUBBLE

It seems you can't look at the market, skim headlines, or frankly enjoy your holiday dinner without one topic consistently bubbling up. Leaning into that very intentional pun, the question at the center of the conversation is whether we're living through an AI bubble and, if so, how close it may be to bursting.

With every market move, new data center announcement, and capex figure that looks like a couple extra zeros slipped in, the speculation only grows louder that the AI trend is nearing its peak or, worse, has already drifted past it. That collective anxiety is shaping the narrative as we look further into 2026.

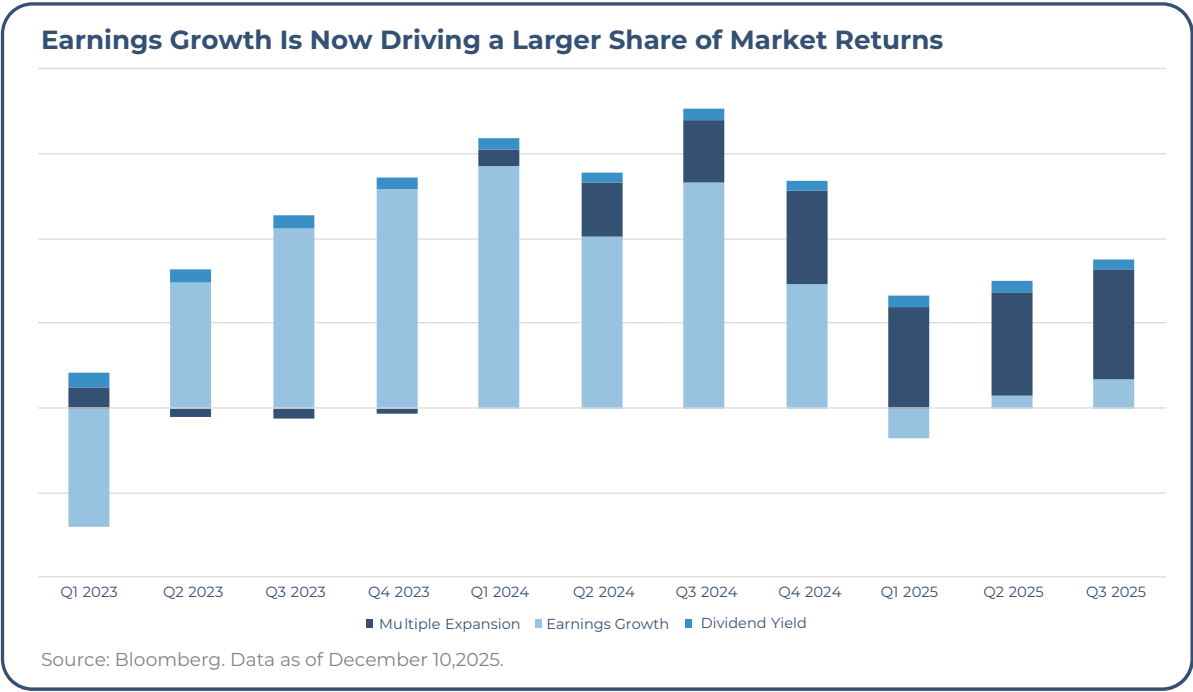
But before we declare we've reached our destination, it's worth checking the map. Leading this investment surge are some of the most profitable and innovative companies ever built, driving what could become one of the largest productivity transformations in modern economic history. There's still enormous greenfield left to explore, and by our estimation, we're nowhere near the end of the race. In fact, we're arguably early in a newly forming secular cycle. While bubble fears make for lively debate and holiday table theatrics, the more relevant question is whether we're approaching the checkered flag or still in the opening laps. And the answer, at least in 2026, is that the AI story appears to have a long road ahead.

Asset Bubble	Index	Peak Date	% Rise to Peak	% Drop from Peak
Roaring Twenties	Dow Jones Industrial Average	Sep 1929	451.20%	-66.30%
End of the Gold Standard	Daily London A.M. Fix Gold Prices	Jan 1980	1729.40%	-54.60%
Japanese Asset Price Bubble	Nikkei 225 Index	Dec 1989	407.90%	-40.60%
Dot-Com Bubble	NASDAQ Composite Index	Feb 2000	538.20%	-56.80%
Chinese Stock Market Bubble	Shanghai Composite Index	Oct 2007	315.90%	-48.20%
Housing/Commodity Bubble	West Texas Intermediate	Jul 2008	380.20%	-48.10%
AI Bubble?	BBG Magnificent 7 Index	???	275.40%	???

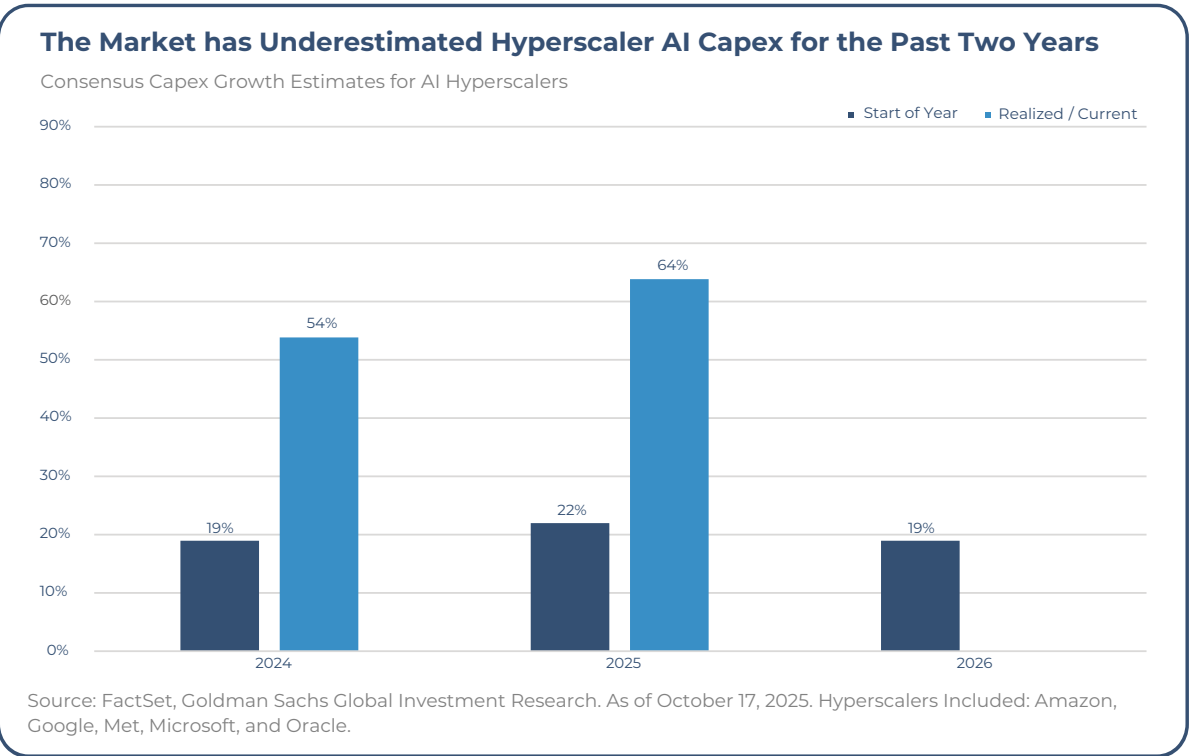
Bubbles, as history reminds us, tend to be surprisingly obvious in hindsight, yet strangely invisible while you're in them. They flicker faintly, usually detectable only to a few observers who catch the right angle and rarely become part of mainstream cultural conversation until after they've popped. What we're seeing today is the opposite. The notion that we may be in an AI bubble isn't whispered, it's shouted. It's less the hushed tension of a race nearing its finish and more the noisy energy of one that's still unfolding. To us, that signals a market doing its job, with participants actively assessing the potential risks and adjusting based on evolving information. Consideration is healthy and the heightened scrutiny around AI makes the theme more constructive, not more concerning.

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When we look back to the road that led us here, what stands out is not irrational exuberance, but instead fundamental strength. While valuations are stretched among these major player AI beneficiaries - as they are across all markets and asset classes - the primary driver recently hasn't been speculation boosted multiple expansion, but earnings growth. At the same time, the technology sector's free cash flow margin is near 20%, more than double its level during the often compared to dot-com era. Bubbles tend to dissolve into nothing, but these companies are delivering real cash flow and investing in infrastructure built for sustained growth.



That surge of capital deployed to build out an economy capable of supporting AI's enormous demands isn't showing signs of easing off the accelerator. If anything, it's the pace of a field still gaining speed rather than one pulling into the final laps. The Magnificent 7 companies' willingness to spend continues to exceed even Wall Street's expectations. These historical levels of capital expenditure are often cited as one of the key reasons why this market is ready to pop, and the nominal figures certainly come with their fair share of sticker shock.



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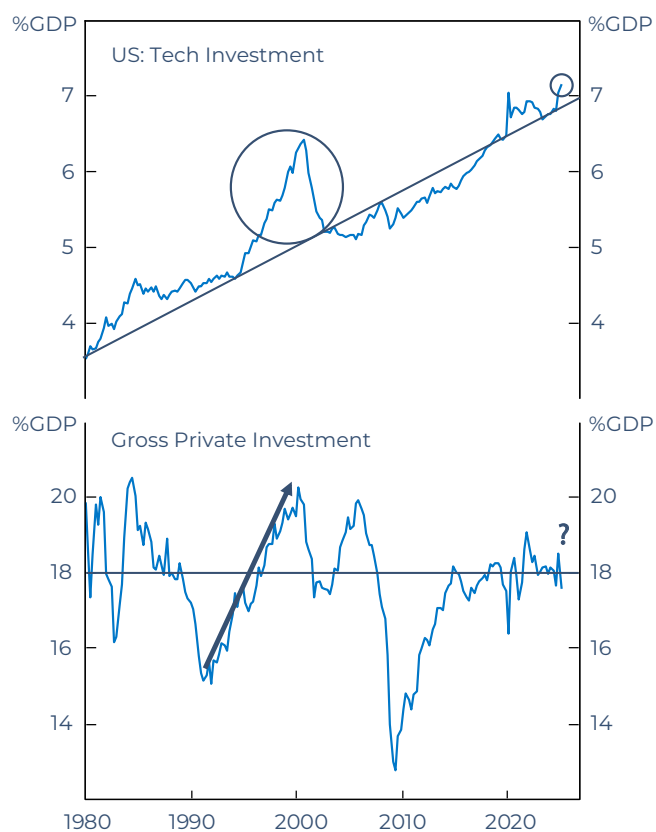
But zoom out and the numbers that appear dizzying out of context begin to align with long-term trends in private investment. Since technology began burgeoning in the 1980's, tech sector spending has steadily increased as a share of the economy. Today we sit just above that long run trajectory, and when we widen the aperture further, gross private investment across the entire economy is still slightly below its 45-year average. Both of those metrics were badly dislocated during the dotcom era. In contrast, the current capex surge looks more like the necessary capital formation required for a genuine secular shift than the excesses of a speculative top.

Of course, even a constructive cycle comes with tradeoffs. The very companies leading this buildout were once rewarded for being asset light. Now, meeting AI's substantial infrastructure demands requires adding leverage and carrying heavier balance sheets, a shift already showing up in widening CDS spreads across major tech names. It doesn't negate the long-term thesis, but it does highlight an important truth: AI's ascent isn't free. This race requires fuel, and that means real capital, real risk, and meaningful balance sheet transformation as a result.

Which brings us to the heart of the matter. The spending is massive, and some portion of it will, without question, prove excessive. But the real question isn't how large the numbers are, it's why they are this large. What are a handful of the world's most sophisticated companies trying to achieve with this wave of capex? Firms invest at this scale when they believe the opportunity ahead is not just meaningful, but transformational.

These titans are racing to build the equivalent of an operating system for the entire economy, where every application, every action, every click eventually runs through their ecosystem. Their business models, and in many ways their futures, depend on securing this position. Whether they are constructing the computational backbone for AI or by deploying it to develop the next generation of AI-enabled products, scale becomes both a competitive weapon and a prerequisite. In this battleground, the victor takes the spoils, and with victory comes the potential for earnings already reshaping their industries.

Technology Capital Expenditures Reflects Structural Change in Overall Investment



*Private fixed investment in information processing equipment, software and R&D

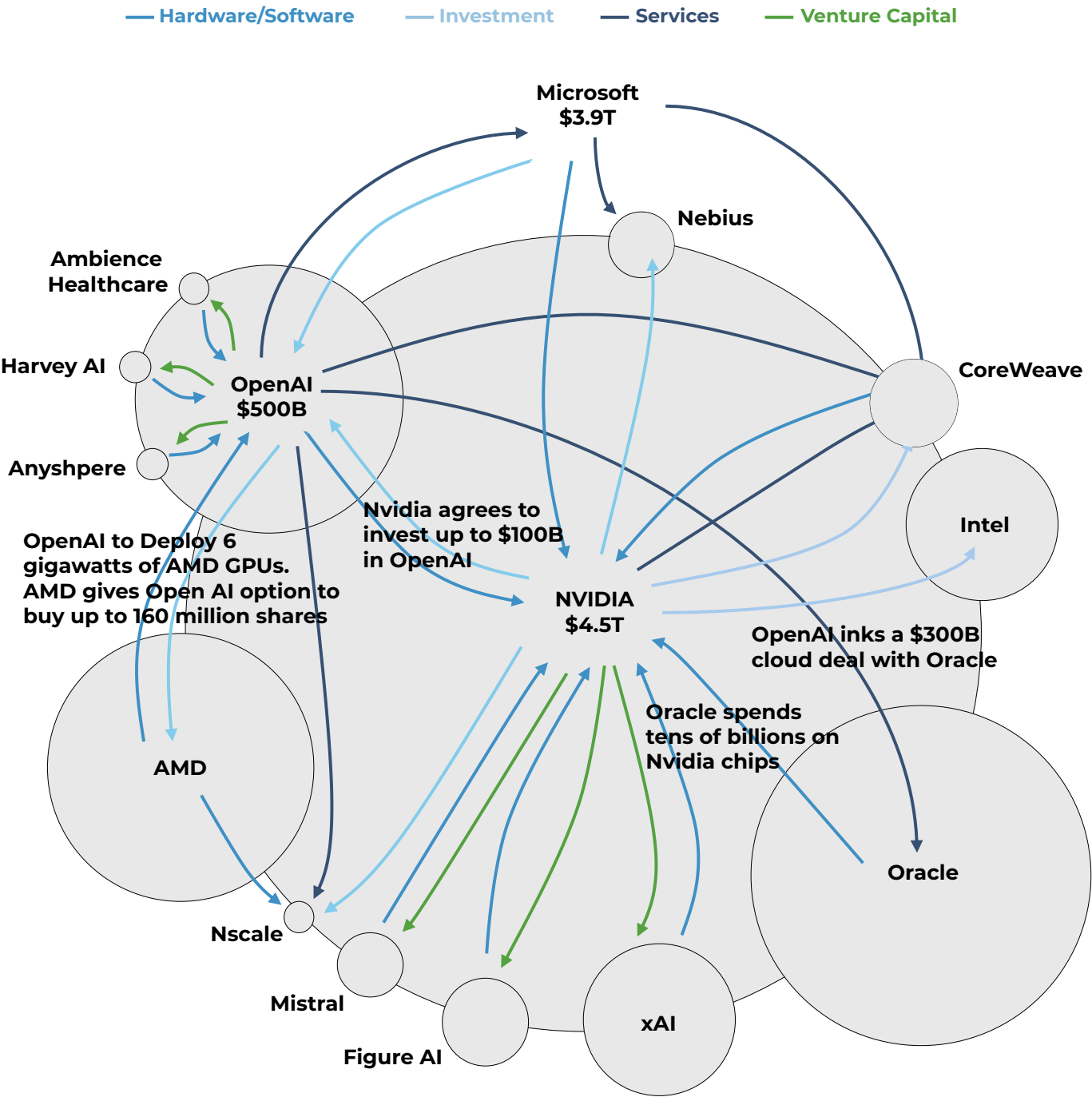
Source: Alpine Macro, Waterloo Capital

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In pursuing this advantage, they've created their own microeconomy by investing in and spending amongst each other. The much discussed circular financing ecosystem is less a smoke-and-mirrors scheme and more the modern form of vendor financing and vertical integration at unprecedented scale. The simplest explanation is the most convincing when it comes to distilling why this sharing of capital is a feature and not a bug: the companies committing their futures to this transformation are likely the best equipped to judge which partners merit investment and which suppliers deserve their spending. That said, this developing interdependence binds their fortunes together, amplifying the contagion effect already evident. In a drafting formation like this, a wobble from one competitor quickly ripples through the pack.

Circular Financing Has Created an AI Microeconomy

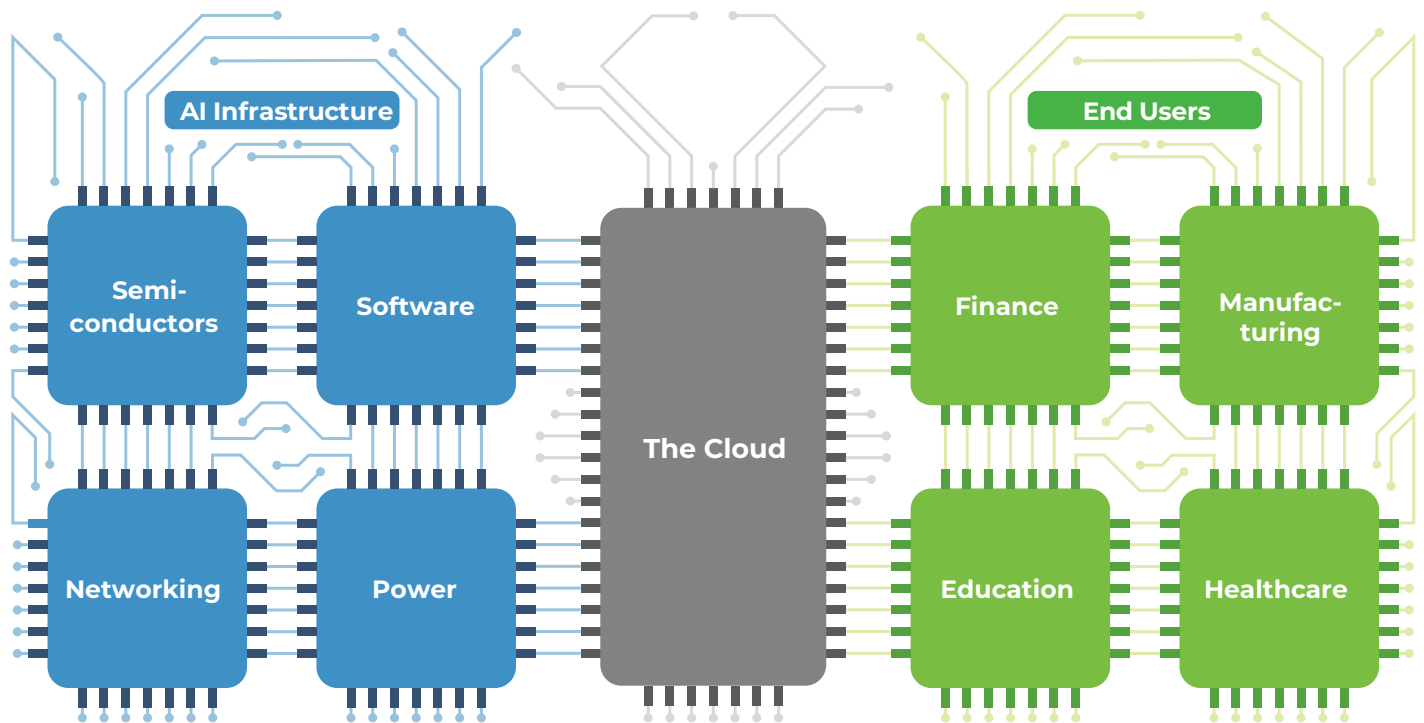


Source: Bloomberg News, Waterloo Capital

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This entanglement complicates the process of predicting which individual companies will emerge as the dominant winners. But the good news is that the benefits of their spending extend well beyond the titans themselves. As the AI ecosystem matures, we are likely seeing a transition along the spectrum, from the enablers of the AI revolution to the innovators developing new products and services, and ultimately to the adopters that will use these tools to reshape their business models. Those adopters may prove to be the clearest beneficiaries as they leverage these new capabilities to operate faster, cheaper, and with far fewer constraints than before. They're building systems where processes that once took hours happen in seconds, where tasks that demanded entire teams can be executed by a few, and where outputs that once required massive budgets can be generated instantly.

Beyond Tech - AI's Transformative Potential Across Sectors



Source: T. Rowe Price, Waterloo Capital

As these gains compound, the positive effects will ripple outward, gradually lifting the broader market and economy. That's the element most bubble narratives overlook: this capital isn't merely inflating valuations; it's laying the groundwork for the next phase of economic growth. What's unfolding goes beyond companies spending simply to secure their own positions. It's an incentivized effort to reshape the baseline capabilities of the economy itself, a shift that appears poised to accelerate the trends already taking hold as progress into 2026.

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2801 Via Fortuna #250, Austin, TX 78746 • (512) 777-5900 • www.WaterlooCap.com