Novum Partners: Market Update

The AI Bill Comes Due

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Last 2 weeks performance

World Equity Indices

	% TR USD	% TR Local
MSCI World	0.6%	0.6%
S&P 500	-0.5%	-0.5%
S&P 500 Equal Weighted	2.8%	2.8%
Mag 7 Index	-3.6%	-3.6%
Russell 2000	3.7%	3.7%
Euro Stoxx 50	-1.3%	-0.7%
CSI 300 Index	-3.8%	-4.3%
Hang Seng Index	-3.6%	-3.7%
Nikkei 225	-2.5%	-3.1%
MSCI Asia	-0.6%	-0.6%
MSCI Latam	-14.1%	-14.1%
MSCI EM	-1.7%	-1.7%

S&P 500 Sectors

	% TR USD
S&P 500 Info Tech	-1.2%
S&P 500 Comm. Serv	-13.6%
S&P 500 Health Care	5.2%
S&P 500 Financials	2.1%
S&P 500 Cons Discr.	1.5%
S&P 500 Energy	2.1%
S&P 500 Real Estate	2.3%
S&P 500 Materials	1.5%
S&P 500 Industrials	0.5%
S&P 500 Cons Staples	2.2%
S&P 500 Utilities	2.9%

Key Thematic Indices

	% TR USD	% TR Local
ARK Innovation ETF	-0.3%	-0.3%
Software ETF	1.2%	1.2%
Memory ETF	4.9%	5.0%
Semiconductors ETF	-2.9%	-2.9%
Momentum ETF	-2.4%	-2.4%
GS Cyclicals	2.8%	2.8%
BBG Defensive Sectors	-1.12%	-1.12%

Fixed Income

	% TR or bps
LQD (High Grade)	0.8%
HYG (High Yield)	0.7%
US Treasuries Index	0.7%
TSY 2 year (bps)	-9
TSY 10 year (bps)	-13
Bund 10 year (bps)	-10
SOFR March 27 rate (bps)	-12

FX & Commodities

	% TR USD
US Dollar Index	0.1%
Bitcoin	-5.6%
BBG Precious Metals	-7.4%
BBG Energy	6.5%

Data as of 30 October

Executive Summary

- The mood changed in the last three days. For most of the fortnight, markets held up well and the S&P 500 closed within 1% of its record high on Wednesday. Then results from Alphabet, Amazon and Intel triggered one of the sharpest two-day sell-offs in big tech in years. The two-week figures (MSCI World +0.6%, S&P 500 -0.5%) do not yet show the full move.
- The market is no longer questioning AI demand, but its cost. Cloud growth remains strong, but capex is running well above expectations and free cash flow has turned negative. Alphabet had its worst day on record (-12.6%), and communication services lost 13.6% over two weeks.
- This is a rotation, not a flight from equities. The equal-weighted S&P 500 rose 2.8%, the Russell 2000 3.7% and health care 5.2%. Investors doubt the payoff from AI spending, not the economy: U.S. GDP grew 3.4% in Q3 and jobless claims are at their lowest level since 1969.

- Central banks paused, but with a hawkish bias. The Fed and the ECB both held rates and pointed to a hike in December. Energy keeps inflation risk alive, with Brent near USD 116 and European gas above EUR 100/MWh for the first time since 2022.
- Political risk stayed high. The French-German spread reached euro crisis levels (174bp), Lula's surprise win in Brazil sent MSCI Latam down 14.1%, and markets fear U.S. strikes on Iran after the 3 November midterms.
- Treasuries confirmed their protective role. The 10-year yield fell 13bp despite strong U.S. data, as money left big tech. This supports our positive stance on bonds.

Economy and Central Banks

The U.S. economy continues to surprise on the upside. Q3 GDP grew at an annualised rate of 3.4%, above the 3.2% expected and up from 2.2% in Q2. Weekly jobless claims fell to 194,000, and the four-week average dropped to its lowest level since October 1969. Consumer confidence also rebounded sharply in October. The weak spot is housing: housing starts fell 5.2% in September and pending home sales are down 12.6% year-on-year, a sign that higher rates are starting to bite.

Inflation remains too high for comfort. September PCE inflation rose to 3.6% year-on-year, with core PCE at 3.1%, in line with forecasts after the hot CPI data of two weeks ago.

Against this backdrop, the Fed kept rates unchanged at 3.75-4.00% on 28 October, as expected. Two members, voted for a hike. The statement upgraded the view on growth from "solid" to "strong". Chair Warsh made clear that market stress will not replace higher rates: "while overall financial conditions are tighter, I am unable and unwilling to call them tight". Markets still see an 84% chance of a hike in December, but they have trimmed expectations for 2027.

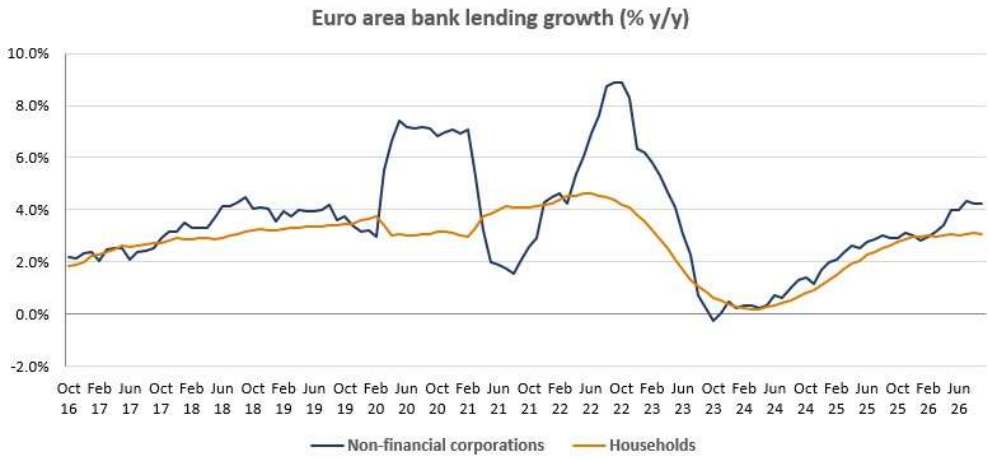


Source: Bloomberg

Europe faces a more difficult mix: rising energy costs and weakening growth. European gas prices rose above EUR 100/MWh for the first time since the 2022 energy crisis, up more than 35% in October alone. The 1-year euro inflation swap reached 3.88%, its joint-highest level since 2023, and October euro area inflation is expected at around 3.9%. Behind this average, inflation is splitting in two, as the chart below shows. In Italy and Spain it is now running at around 5% or more, while in Germany it slowed in October to below 3% and in France it remains under 4%.



At the same time, the ECB's bank lending survey showed the tightest credit conditions since 2023, and French consumer confidence fell to its lowest level since 2013. German business expectations (Ifo) were a rare bright spot.



Source: Bloomberg

The ECB left its deposit rate at 2.50% on 29 October. President Lagarde said the "direction of travel" is towards another hike in December, but the statement also noted that tighter financial conditions are likely to weigh on growth and inflation. Markets read the meeting as slightly dovish and reduced the hikes priced for 2027. Lagarde also announced that she will step down by 7 February. This means President Macron will have a say in choosing her successor, and Lagarde will be free to speak on French politics ahead of next year's election.

Geopolitics

Energy remains the main channel through which geopolitics reaches markets. The pause in direct fighting between the U.S. and Iran looks increasingly fragile. The New York Times reported that the U.S. and Israel have drawn up plans for new strikes after the 3 November midterms, possibly targeting Iran's energy infrastructure. The Wall Street Journal added that Washington has told Gulf countries to prepare for a "short, intense" campaign. President Trump said it is "getting to be decision time" between military action and a deal. Meanwhile, Houthi attacks on Saudi oil sites and on King Fahd airport continued, and the U.S. ordered non-emergency staff to leave Saudi Arabia.

Diplomacy continues in parallel. Saudi Arabia, Turkey and Pakistan met Iranian officials in Tehran, and Vice President Vance reportedly reached out to a senior Iranian security official to revive talks. Markets remain sceptical. Brent rose from about USD 110 to USD 116 per barrel over the two weeks and came close to its March peak of USD 118. Oil prices one year ahead, near USD 88, show that markets expect high prices to last well into 2027.

Israel's election on 27 October did not produce a clear winner. Netanyahu's bloc has a slight edge, but neither side is close to the 61 seats needed for a majority, so long coalition talks or a new election are likely. The outcome matters for Iran: Netanyahu sees regime change as necessary, while opposition leader Eisenkot would limit military action to stopping a nuclear weapon.

In Europe, France was again the main source of stress. The weekend of 17-18 October saw the country's worst unrest in years, with around 550,000 protesters and 2,400 arrests. The 10-year French yield rose above 5% for the first time since 2002, and its spread over Germany reached 174bp, a level last seen at the peak of the euro crisis in 2011. The pressure eased after a calmer second weekend and Moody's surprise decision to keep France's Aa3 rating.

Markets

On the surface, the past two weeks look calm: the MSCI World gained 0.6% and the S&P 500 lost 0.5%. These figures hide a fortnight in three phases, and a sharp change in mood over the last three days.

Three phases for the AI trade

The first week extended the AI stress we described in our last comment. CoreWeave's credit default swaps widened to 1,162bp, and Meta lost 9.4% in the week after its results, as investors focused on its rising capex plans rather than its earnings beat. On 22 October, semiconductors had their worst day since June, falling 6.7%.

The second phase was a relief rally. Between 26 and 28 October, chip stocks rose for three days in a row. SK Hynix reported a tripling of its profits and the Korean market rose almost 7% intraday, while Oracle gained 10.7% after projecting a return to positive free cash flow. The S&P 500 closed within 1% of its record high. This explains why the memory chip index ended the fortnight up 4.9%, after a 23.5% loss in the previous two weeks.

The third phase began with Alphabet's results on 28 October. Search revenue disappointed, partly because AI-generated answers are taking away from traditional search, and free cash flow was negative for a second quarter. The stock fell 12.6% the next day, its worst day on record, erasing about USD 475 billion in value. Amazon followed: its cloud business grew 39%, ahead of forecasts, but quarterly capex reached USD 77 billion against USD 59 billion expected, and free cash flow over the past year swung to minus USD 42 billion. The shares fell about 7% after hours. Intel then cut its revenue guidance for the fourth quarter and was down close to 30% on Friday, pulling AMD, Broadcom and Micron lower. On Friday, the Nasdaq 100 was down around 3%, on course for its worst month relative to the equal-weighted S&P 500 since 2002. Microsoft beat expectations but could not escape the sell-off. Friday's losses are only partly captured in the two-week figures above.

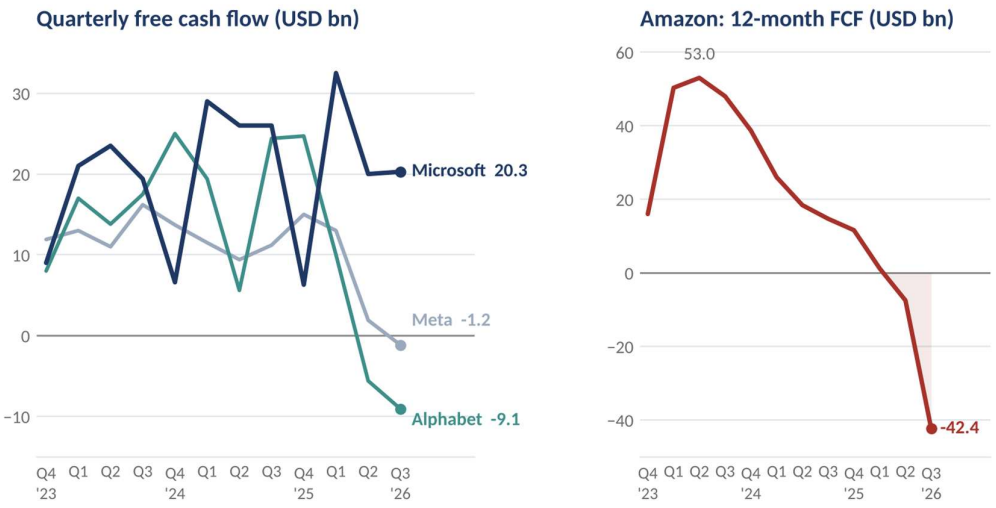
The question is now who pays for AI

The message from this earnings season is clear. Demand for AI is real: Amazon's cloud grew 39%, Microsoft's Azure beat forecasts and Google Cloud's order backlog reached USD 561 billion. What the market now questions is the cost. The large technology companies are expected to spend around USD 750 billion on AI this year,

and their free cash flow is turning negative just as their core businesses slow. They increasingly need outside funding: Microsoft issued USD 25 billion of bonds, its first large deal since 2017 and the last of the hyperscalers to tap the debt market this year, while Meta announced plans to raise up to USD 95 billion through a share sale.

The chart below shows how quickly this has happened. Amazon's free cash flow over the past twelve months has fallen from more than USD 50 billion in mid-2024 to minus USD 42 billion. Alphabet's has been negative for two quarters in a row, and Meta's turned negative in the third quarter. Microsoft is the exception, still generating around USD 20 billion per quarter, which helps explain why its shares held up better than its peers.

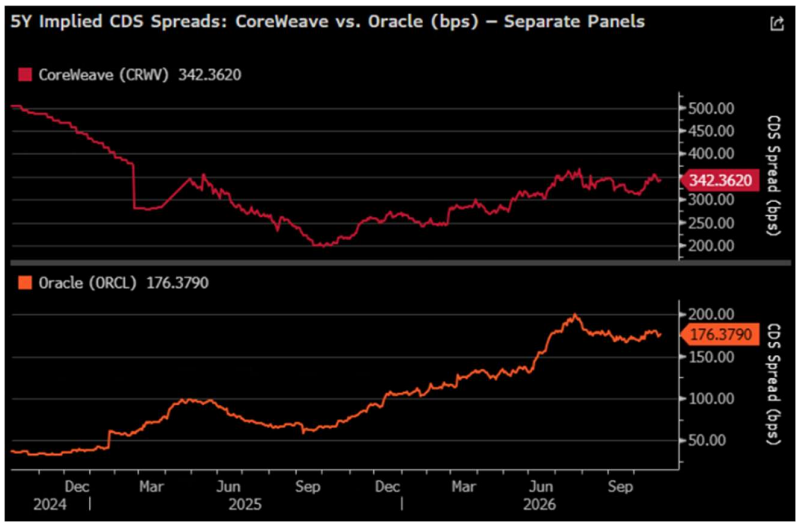
Free cash flow is turning negative



Source: Bloomberg. Amazon on a trailing 12-month basis; Microsoft, Alphabet and Meta per quarter.

Credit investors started asking this question before equity investors did. The cost of insuring Oracle's debt for five years has risen roughly five-fold since late 2024, peaking near 200bp in July. For CoreWeave, whose revenues depend almost entirely on AI data centres, it has climbed back well above its 2025 lows. Spreads have stabilised in recent weeks, but the message is clear: lenders now want a higher premium to finance the AI build-out, and the companies most dependent on borrowing are the most exposed if returns disappoint.

Credit markets are pricing the risk



Source: Bloomberg. Model-implied 5-year CDS spreads, in basis points.

The two-week numbers reflect this shift. Communication services lost 13.6%, driven by Alphabet and Meta. The Mag 7 index fell 3.6%, semiconductors 2.9% and momentum stocks 2.4%. The technology sector lost only 1.2%, helped by the rebound in memory chips and a 1.2% gain in software, but this does not yet include Intel's collapse.

A broad rotation, not a sell-off

Outside big tech, equities did well. The equal-weighted S&P 500 rose 2.8% and reached its highest level since August, small caps gained 3.7% and cyclical stocks 2.8%. On Thursday, 406 S&P 500 stocks rose even as the index fell. Health care led (+5.2%), with every company in the sector beating forecasts so far; Eli Lilly gained almost 12% in the week. Utilities (+2.9%), real estate (+2.3%), staples (+2.2%), financials (+2.1%) and energy (+2.1%) also gained. Investors are questioning the return on AI spending, not the health of the economy.

Overall, Q3 earnings are strong. With about half of the S&P 500 market cap reported, earnings are growing close to 29% year-on-year and around three quarters of companies have beaten forecasts. European earnings are closing the gap, with Q3 profit growth expected at around 23%.

What stands out, however, is how little the market is rewarding these strong numbers. Share prices are reacting less to earnings beats than they have in the past. Expectations are clearly high, and good results alone are no longer enough to push stocks higher. Misses, on the other hand, are punished hard, as Caterpillar's 9.3% fall on results day shows.