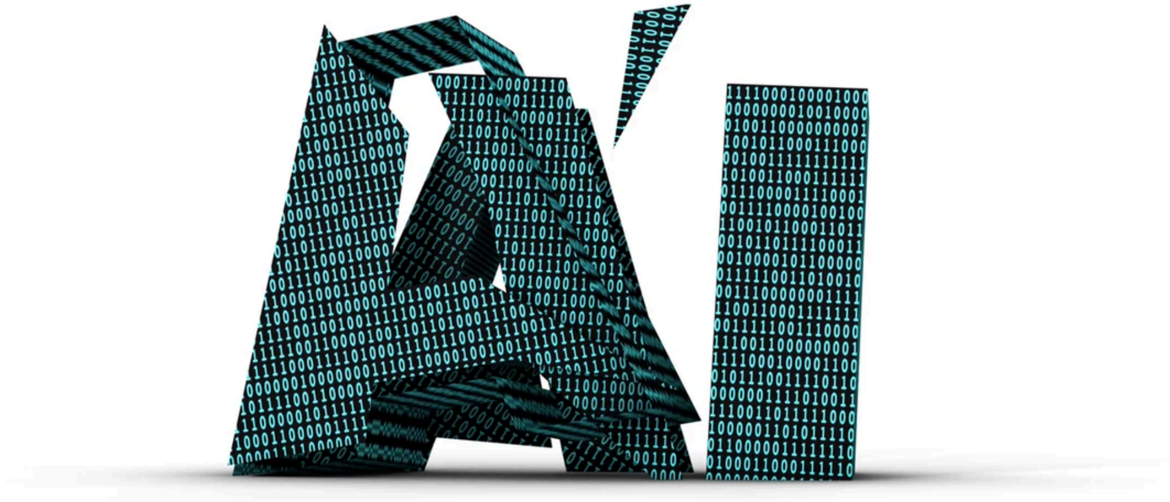

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Thesis Summary

The AI bull market has a structural problem, and it's beginning to show.

Microsoft (MSFT), Amazon (AMZN) and Alphabet (GOOGL) are guiding toward a combined $565 billion in capital expenditure this year.

That number is up more than 60% from already-historic 2025 levels.

But their cash flow is no longer covering it; they are raising cash, and the market is actually punishing them for it.

For now, loose financial conditions and tight credit spreads are propelling this AI cycle higher and higher.

But what happens when credit tightens, AI spending stops, and earnings estimates fall flat?

We're beginning to see this play out, and it's not pretty

From Cash Machines to Bond Issuers

Microsoft, Amazon, and Alphabet have been high-margin cash flow machines over the last decade, but not anymore.

Cash flow no longer covers their spending, and it's even going negative in some cases.

Estimates from Morgan Stanley suggest that hyperscalers will borrow around $400 billion in 2026 alone, pushing total issuance of high-grade US corporate bonds to a record $2.25 trillion for the year.

A year ago, that might have been celebrated, and even if investors are still cheering AI spending, the price action over the last month speaks for itself.

Hyperscaler price actions (SA)

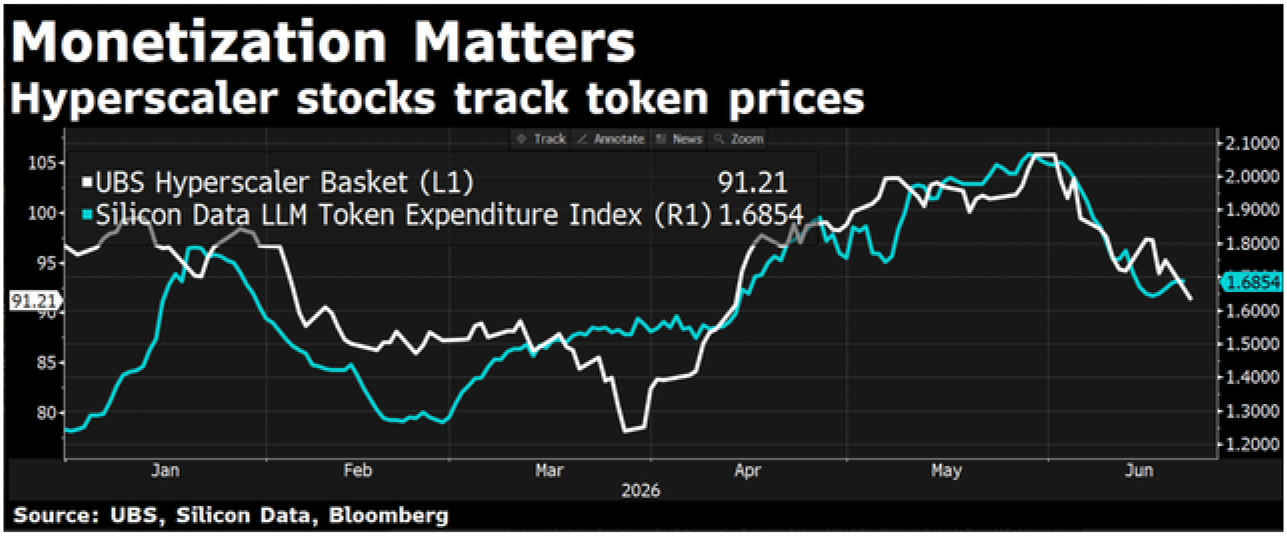
AMZN and MSFT are down 12% and GOOGL 8%. This certainly seems odd, since we could argue that these are the main beneficiaries of AI, but that's not quite true, is it?

The main beneficiaries right now are the picks-and-shovels plays, building out AI.

This is real spending and real earnings going from the hyperscalers to the likes of Micron (MU) or Advanced Micro Devices (AMD).

But will the benefits revert back to the hyperscalers eventually? That's something the market is not so sure about.

And this is also supported by recent trends in token spending, which has been coming down, and correlates strongly with the stock price of the hyperscalers.



Token Spending vs. Hyperscaler price actions (Silicon Data, Bloomberg)

As AI spending begins to take a toll on companies, they are looking to optimize it, cut down token spending, and move towards more efficient options.

The Mechanism That Breaks It: Credit Spreads

The issue here is that hyperscalers are the source of funding for AI, so they are the first domino that falls in a potential AI apocalypse.

We're now moving into the stage where CAPEX is being funded by debt, and this can be sustained for some time.

Right now, investment-grade spreads remain tight, and there's a significant appetite for hyperscaler bonds.

High yield credit spreads (FRED)

When risk appetite shifts, whether from a recession signal, a geopolitical shock, or simply a market that shifts its narrative, then credit spreads explode higher.

This is where AI becomes a macro story.

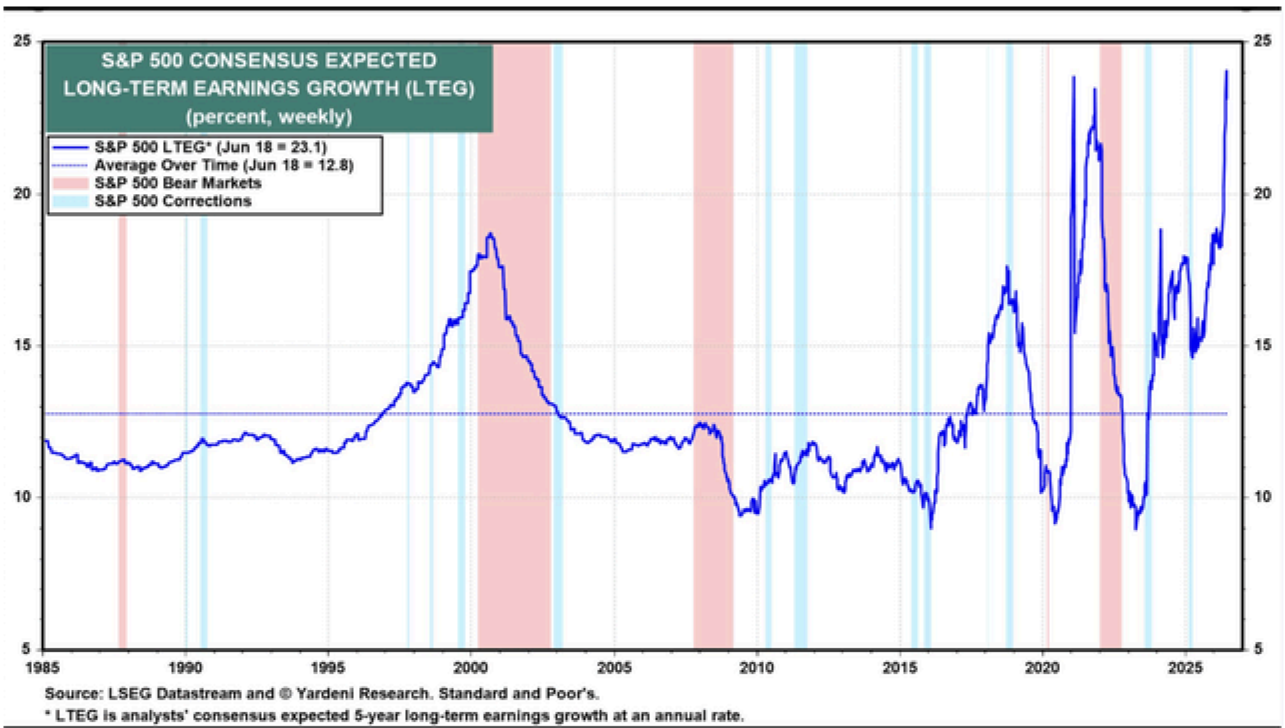
Roughly half of the Fed's members are now arguing for at least one rate hike before year-end.

And the stocks that make up most of the S&P 500 are now carrying double or even triple the debt they once held.

This time, the credit cycle matters a lot more to equities than previously.

Bonds First, Earnings Second

But the real crash won't happen because Google has to pay some more on its bonds; it happens because Google stops issuing bonds, cuts down CAPEX, and earnings estimates fall flat.



Earnings Estimates (LSEG)

Analysts expect earnings to compound at 24% over the next five years, and they have never been this optimistic before in history.

Much of this optimism is grounded in the AI trade, but history actually shows that analysts are quite poor at predicting earnings over the medium and long-term.

Of course Micron and Sandisk (SNDK) look cheap based on forward earnings expectations, but expectations change all the time.

In this case, we've laid out the exact mechanism of how these earnings could fall apart.

What Should Investors Do?

This isn't a call to sell everything and hide in cash.

The AI buildout is real, the technology is transformative, and the hyperscalers aren't going bankrupt.

But the risk/reward has definitely shifted.

The upside from here requires AI monetization to accelerate, credit conditions to stay loose, and the Fed to cooperate.

Credit spreads are the primary signal to watch. As long as investment-grade spreads stay tight, the debt machine keeps running, and the cycle extends.

The moment spreads begin moving, it's time to move away from AI, and perhaps into bonds and cash.

For now though, it makes sense to trim hyperscalers, while staying invested in the direct AI bottleneck and picks-and-shovels stocks.

Final Thoughts

All in all, I believe the market is giving us some clear warning signs that the AI trade is running out of steam.

The problem is this could keep going for years, but once the panic starts, the comedown will be fast and furious.

Investors have to stay disciplined and manage risk accordingly. Keep some selective AI exposure, take profits judiciously and also explore hedges as the risk keeps mounting.

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