

Theia Investments

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THEIA INVESTMENTS
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The glare of the indices

If today one looked only at the S&P500 index and the Nasdaq, one would think everything is fine.

The S&P500 index closed yesterday at **7,674** points, less than 2.0% from its all-time high, and the Nasdaq is not far off.

Yet, the US ten-year yesterday touched **5.34%** intraday, the highest level since 2002, before pulling back at the close.

Rates so high and the stock market at highs, how is that possible?

Probably, it's an illusion.

The S&P500 index and the Nasdaq are capitalization-weighted indices, where each stock counts in proportion to its market value.

Since the heaviest stocks are a handful of giants linked to artificial intelligence, with enormous capitalizations and brilliant performance, it is enough for them to rise to offset the declines of all the others.

It's a bit like judging the health of a building by looking only at the penthouse.

The lights are on and the view is splendid, but on the lower floors things are going very differently.

Just look at the **equal-weighted S&P500 index**, the version of the index in which each stock counts the same way.

Today, it is on track to close its **seventh consecutive week of decline**.

Since 1990 this has happened only two other times, in 2002, after the bursting of the dot-com bubble, and in 2022, in the midst of the Fed's tightening.

Not exactly two periods to remember with nostalgia.

So, let's go down the stairs.

The small caps of the **Russell 2000** are at **-8.5%** from the record of August 14 and are coming off the second worst quarter versus the S&P500 index since 1999, nearly ten percentage points behind.

Not surprising, because they are more indebted companies and over a third of the index is made up of so-called "zombie" companies, which struggle to pay the interest on their debt with what they earn.

The banks have entered a correction, with the US bank index down over -12% from the mid-August peak: **Capital One** **-20%** since the start of the year,



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Wells Fargo -14%, Citigroup -4.6% intraday yesterday.

Utility companies, the classic dividend refuge, are a step away from a bear market with a -17% from the February high.

In the third quarter only two companies out of thirty-one closed in positive territory.

The real estate sector follows the same path, with the main real estate funds having lost between 7% and 11% in a single month.

Furthermore, the basket of unprofitable tech stocks lost 11% in the third quarter, the second worst July-September since 2014.

The companies with the most fragile balance sheets posted the thinnest quarterly gain since the start of 2022, when the Fed began the most aggressive hiking cycle in a generation.

This is the picture of the stock market.

However, the flight from risk does not stop at equities.

Global corporate bond spreads widened by about 5 basis points over the week, the broadest move since March, and they are at their widest levels in

six months.

This morning, in Asia, premiums on high-quality issuance are rising by another 2-4 basis points.

It is the first crack in credit after months of record issuance.

Furthermore, government bonds are not helping.

France shows serious signs of tension.

The spread with the German Bund on the ten-year is above 117 basis points, futures contracts on the French bond are near their historic low, and contagion is starting to be seen elsewhere, with the two-year spread between Italy and Germany almost doubling yesterday to 55 basis points, the widest daily jump since 2020.

In Britain, the thirty-year briefly exceeded 6.0%.

In America, the problem is the excess supply, with a Treasury that must finance enormous deficits, while cloud operators are knocking on the same market with hundreds of billions in new debt.

What do the flows say?

Investors are not leaving the stock market, but they are selling everything that suffers from rates and are taking shelter in the Artificial Intelligence



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giants.

They are the shelter.

There are those who read this distortion as the sign of a bull market driven by a technological revolution and see the S&P500 index at **8,500 points** by year-end.

That may be.

But when everyone shelters under the same umbrella, the umbrella also becomes the most crowded and most fragile point of the market.

Now let's try to answer the question: **how long before even AI stocks, so resilient so far, start to give way?**

In the end, everything revolves around investments in Artificial Intelligence.

Cloud operators will spend about **800** billion dollars on infrastructure this year and, according to estimates from a leading investment bank, could reach **1,200** billion USD in 2027, financing over a third with new debt.

That spending fuels the earnings and valuations of AI-related stocks.

Those stocks fill the portfolios of American

households, directly or through indices, and that wealth supports consumption and, therefore, the economy.

It's a virtuous circle, as long as it holds.

The weak point is the **cost of capital**.

To repay just the depreciation of this year's investments alone, about **300** billion dollars in annual revenues from Artificial Intelligence would be needed, well beyond what is seen today.

With debt costing 5.0% and above, that threshold rises further.

There is a level of rates beyond which many projects stop making economic sense, and then cloud operators slow down.

At that point, **will the Artificial Intelligence narrative continue to drive the markets?**

The answer is not a given.

Either yields on the long end of the curve start to fall, helped by more conciliatory words from the Fed or weaker economic data, or the Artificial Intelligence narrative too will start to crack like many other corners of the market.

There are some signs of opening.



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The Fed vice chair, **Philip Jefferson**, said more time is needed before deciding on new hikes, following **John Williams'** "no urgency", but meanwhile oil (Brent) remains above **102** dollars a barrel, the dollar is heading toward its third week of gains, Asian stock markets toward their worst week since July, and European ones toward their worst since April.

Today, everything hinges on the **US labor market** report.

Paradoxically, a weak reading would be the best news for the penthouse, because it would take pressure off long-term yields.

A strong reading, after jobless claims fell to **197** thousand, would push the ten-year back toward 5.30-5.35% and would put to the test precisely the stocks that have so far kept the index standing.

In short, **don't be fooled by the index.**

Look at the stairs, not just the penthouse.



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