

Investment Strategy Insights:

Crunch time is approaching the AI boom

- Earnings expectations have taken over from PE multiple expansion as the main driver of US tech returns. But these expectations are now looking stretched and will once again be tested during US reporting season this month. Markets will be sensitive to any sign these lofty expectations will not be met, and announcements of further capex upgrades. But we don't expect reporting season to show the AI-led expansion is about to end.
- There is already a wide dispersion in longer-term earnings estimates, and this signals low conviction about earnings expectations, particularly beyond the next 12 months when capex plans need to deliver earnings growth.
- The good news is valuations are back around long-run average levels allowing the market to absorb a rise in yields that is not driven by higher policy rates. But rising yields due to tightening policy could disrupt earnings delivery and margins. It's not the P in the PE ratio that appears to be the problem; it's the E.
- The hyperscalers' big capex spending needs to deliver both a lift in earnings and an acceptable return. Capex rose initially because the number of projects or the scope of previously planned projects has increased. But now it is also rising due to increasing costs of AI infrastructure, and this is eating into future returns.
- Competitive tensions are also putting downward pressure on the custom AI service suppliers and the cloud storage providers. Small language models and open-weight models are increasingly offering businesses a cost-effective solution to their AI needs, undermining the large language model providers.

Prospective earnings are now driving returns

US reporting season begins next week with S&P 500 companies reporting Q2 earnings throughout July and August. The AI boom has been the engine of global equities for several years now and once again the earnings outlook of stocks leveraged to it will be scrutinised by the market.

Q1 reporting season showed that AI-exposed stocks generally beat the market's lofty expectations and this helped propel the rally in risk assets since April.

In Q1 reporting season the market was sensitive to how capex plans are being affected by cost pressures, and we expect this to be repeated as companies report Q2 earnings. Earnings for the quarter will naturally be important, but so too will guidance for the remainder of this year and for 2027.

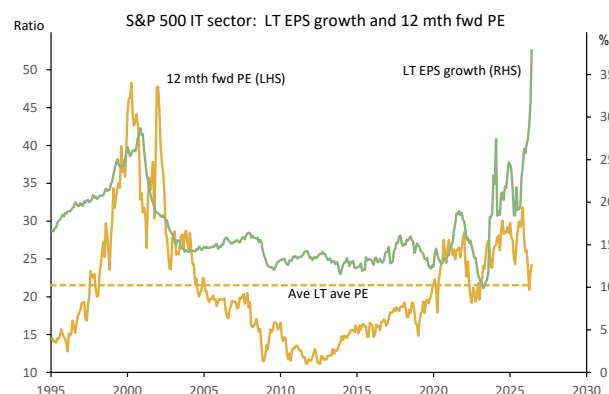
We remain positive on risk assets; despite the risks we highlight in this note.

- Near-term earnings momentum remains strong.
- Financial conditions remain supportive.
- Capex is being funded from strong balance sheets.
- AI leaders have mostly strong balance sheets, high margins and pricing power.
- Earnings beats are broad-based, and not just in IT.

ChatGPT was launched in November 2022 and for most of the period since then PE expansion, rather than stronger earnings expectations, has driven returns. However, that trend has been turned on its head this year. PE multiples for the US tech sector are now around the long-term average, and longer-term earnings growth expectations have risen rapidly to 37%, which is a record high for the sector.

During the dot-com boom of the late 1990s, valuations were significantly higher than they are today, but longer-term expected earnings growth peaked much lower (27%).

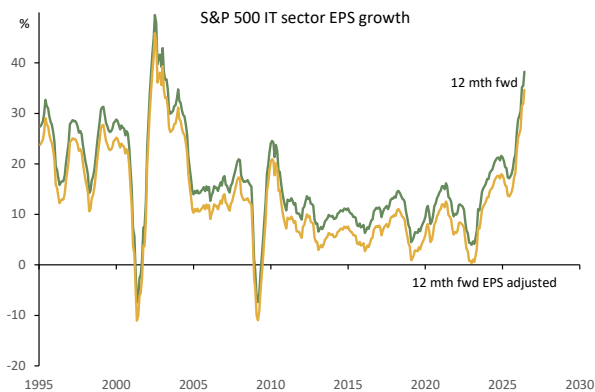
Longer-term earnings growth expectations are at a record high



Source: LSEG, MWM Research, July 2026

Expected earnings growth over the next 12 months has also risen rapidly this year. It is above the growth rate seen prior to the peak of the dot-com boom after adjusting for downgrades that normally occur 12 months before earnings are reported. The collapse and rebound in earnings growth around the dot-com boom reflect not only the collapse in tech earnings, but also the mild economic recession that occurred during the period.

EPS growth 12 months forward has also accelerated



Source: LSEG, MWM Research, July 2026

It's difficult to say whether it's easier for investors to navigate an overvalued market or one where earnings expectations look stretched. During the dot-com boom, investors were confronted with both, and the broader US equity market saw a 45% drawdown as recessionary forces kicked in.

We warned at the start of the year that the AI hyperscalers would ultimately need to demonstrate their capex plans would provide shareholders with a reasonable return. However, the pendulum has now swung, with less pressure on valuations and more on the earnings outlook. In this environment it is important to note the following:

- *Higher bond yields are unlikely to disrupt returns.* Rising bond yields reduce valuations, so the stocks are in much better shape to absorb an increase in yields than they were last year.
- *The market will be sensitive to any disruption to earnings.* Analysts need to assess the potential for a disruption to earnings occurring in either the short-term or the longer-term. The foundation for any IT positive earnings growth trajectory is that the US economy keeps growing at around trend. Macro threats have come thick and fast over the last few years, but the economy has continued to expand and create jobs.
- *The massive IT capex program needs to generate earnings.* The domestic economy may hold up well, but if the capex being invested by the hyperscalers doesn't convert into a rapid lift in earnings growth then the US equity market could easily roll over.

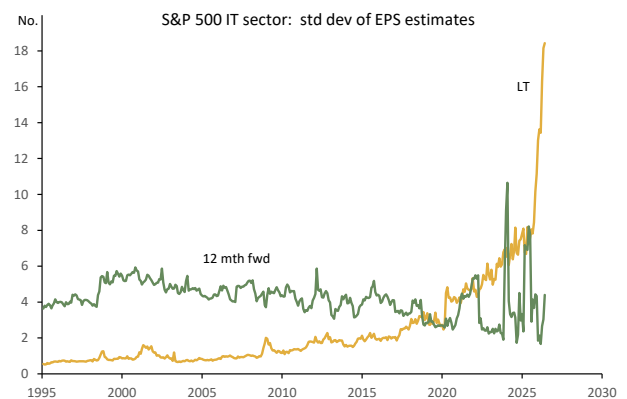
Assessing earnings risk

One way to assess the consensus earnings outlook at the index level is to calculate the variation in analysts' earnings estimates. A large variation indicates less certainty, while a small variation indicates more certainty.

It's also natural that there is more confidence about near-term than longer-term earnings, so the best way to do this is to calculate the variation (or standard deviation) of the earnings estimates for each period separately and compare it to history.

Uncertainty seems reasonably low for 12-month forward earnings, but extremely high for longer-term earnings. This uncertainty mainly reflects the outlook for earnings after the large capex programs of the hyperscalers are complete. Some analysts are more positive than others about the earnings growth outlook once this cash expense is booked onto the investing company's income statement as asset depreciation.

The risk is higher for longer-term earnings

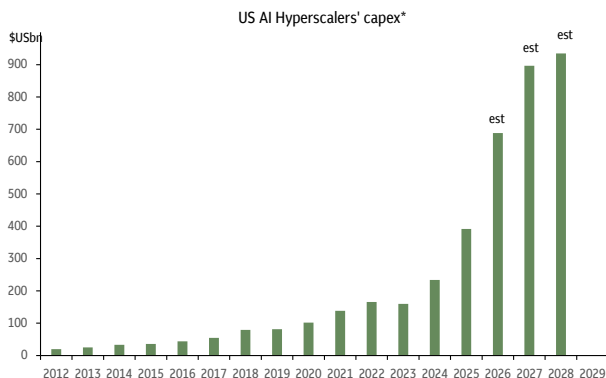


Source: LSEG, MWM Research, July 2026. The standard deviation (std dev) is a measure of the variability of analysts' earnings estimates for each stock covered in the index.

Growing the business can be difficult even when demand is red hot

Software providers creating and selling AI technology need to estimate future demand and compare this against their ability to meet it. The hyperscalers have estimated that demand will be strong, and to meet this demand, they'll need to invest around US\$900bn in both 2027 and 2028, after investing around US\$700bn in 2026.

Capex plans are rising

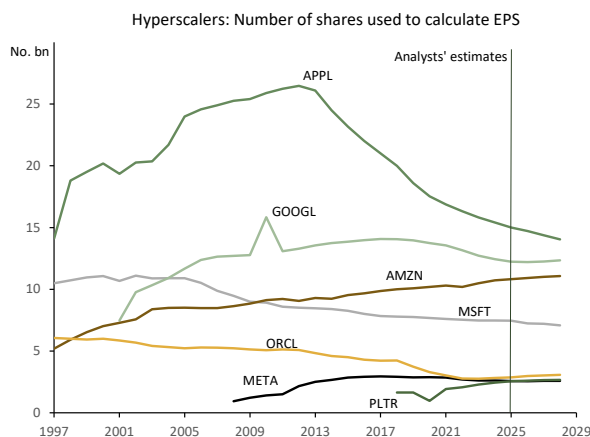


Source: LSEG, MWM Research, July 2026. * Hyperscalers include Microsoft, Apple, Google, Amazon, and Meta.

It's worth noting that the hyperscalers we analysed have generally strong balance sheets with most having negative net debt. Oracle is the exception; the stock currently has US\$106bn in net debt and analysts expect this to increase by 60% to US\$164bn by 2029.

The capex will be funded by a combination of equity issuance and free cashflow. Analysts generally expect equity issuance to increase over the next few years, although Apple and Microsoft are the exceptions; their shares on issue are expected to fall slightly.

Equity issuance is generally increasing

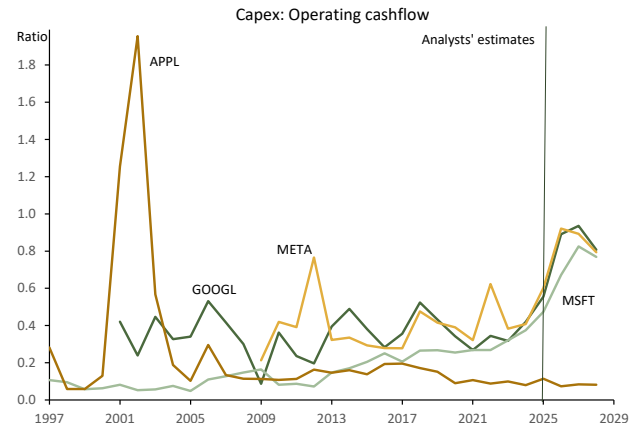


Source: LSEG, MWM Research, July 2026.

Tech companies generally find it difficult to raise debt because the collateral offered to debt investors is a product, which tends to have a relatively short economic life. By comparison, it's much easier to raise debt when issuance is backed by physical assets such as infrastructure and real estate.

Analysts expect the big hyperscalers to invest around 80% of their operating cashflow in capex. Apple is the exception, with analysts expecting only 10% of its operating cashflow to be dedicated to capex.

The hyperscalers are taking the risk

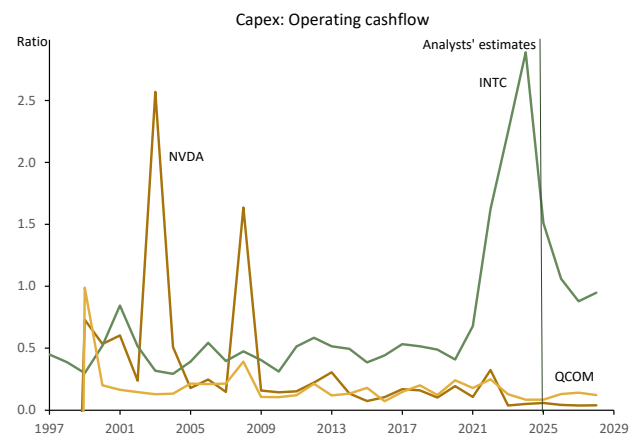


Source: LSEG, MWM Research, July 2026.

The companies taking less risk in the capex boom are providing the hyperscalers with the processing units, and chips needed to create their AI models.

These businesses are generally investing only around 10% of their operating cashflow. Intel is the exception. It invested more than 2.5 times its operating cashflow in advanced equipment purchases, business restructuring and on projects already started. Its capex is expected to remain high as a ratio of operating cashflow over the next few years.

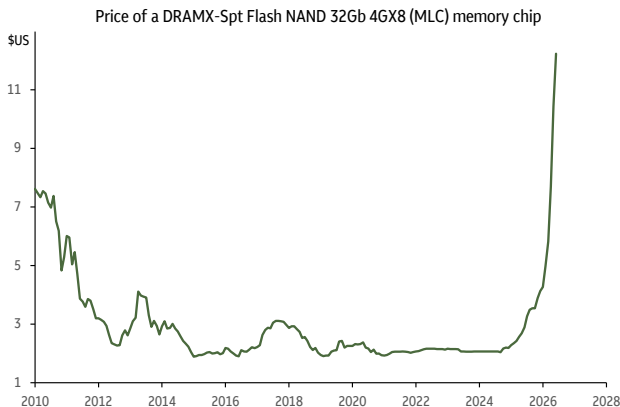
Infrastructure providers have generally low capex



Source: LSEG, July 2026.

However, capex of an estimated US\$700bn in 2026 is strong enough to lift the price of memory chips, so price pressures are only likely to intensify further if capex plans for 2027 and 2028 are realised. Furthermore, these rapid price increases aren't just confined to memory chips, with all other areas of the AI supply chain under price pressure, and price pressure on these components is raising the capex bill.

Price of computer chips has risen sharply.



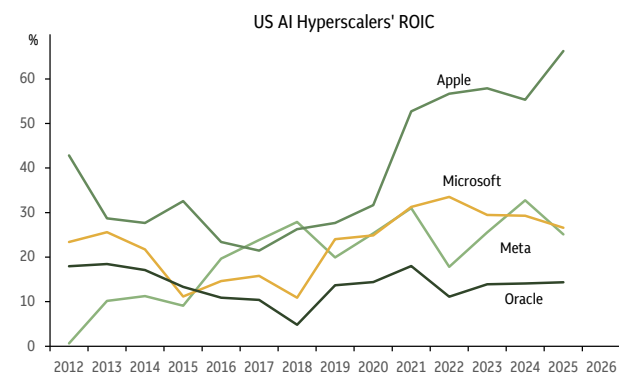
Source: LSEG, MWM Research, July 2026. The chip stores a maximum of 4GB of data and is used in smartphones and digital devices.

The great capex bet

The economics of the return on capex is crucial. It will ultimately define the longer-term outlook for not only stocks participating in the boom, but probably the direction of global equities as well.

Firms taking the risk of investing operating cashflow into asset growth will have return objectives. Apple and Meta have achieved a return on invested capital of around 25% last year. Apple achieved 60% and it has been increasing strongly since the pandemic, while Oracle has seen a more modest return on capital of around 10% over the past 13 years.

The return must stack up



Source: LSEG, July 2026.

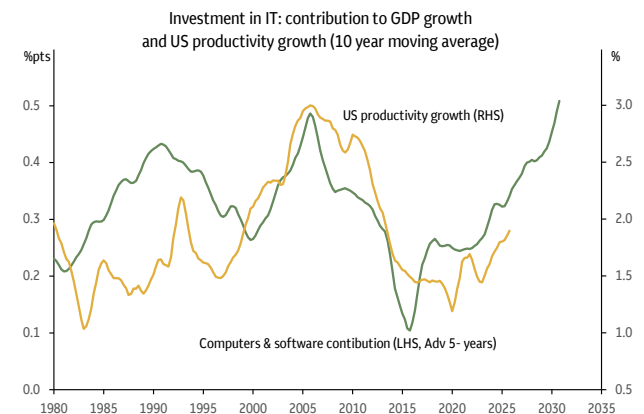
But the return depends on corporates' willingness to pay to use AI. There are broadly two groups that provide businesses with this service.

- 1) *The hyperscalers.* Microsoft, Meta, Google, Amazon and Oracle own the cloud infrastructure, web ecosystems, base AI models, devices, and AI Application Programming Interfaces (APIs) to build powerful AI tools on their devices. They also develop their own data centres to power computing capacity. The service uses a subscription model.

- 2) *AI service providers.* Open AI and Anthropic are AI research labs building targeted solutions for businesses and industries and charge users on a pay as you go basis based on their AI usage. For example, one word of output costs one token, which on the Claude Fable 5 model is currently around US\$10/million tokens. But the US AI service providers are under competitive pressure from less expensive Chinese AI models such as Baidu, Alibaba, and DeepSeek.

Businesses will be looking for an adequate return from their investment in AI and one way to measure this at the macroeconomic level is productivity growth. But it will likely take time to see the productivity benefits being realised. For example, during the dot-com boom of the late 1990s there was a modest pickup in productivity growth until the boom ended. But most of the gains occurred around 5 years after the peak in investment.

The return must stack up



Source: LSEG, July 2026.

Investors need to consider the likelihood that the productivity gains from the capex of the hyperscalers may not become visible until well after the capex is complete and at that time an impatient market may think the gains are never going to come.

Businesses may think the same and cut expenditure leaving the hyperscalers and AI service providers high and dry having spent hundreds of billions of dollars of capex.

Already, anecdotes suggest many firms are questioning their AI expenditure. Stripped-back small language models and open-weight models rather than large language models often suit many businesses and cost significantly less than large language models offered by the AI service providers. An open-weight model is one that can be downloaded and run on a company's own servers, rather than having all the work done in data centres run by AI companies or cloud computing providers.

Economics could easily take over putting pressure on the EPS growth of the hyperscalers as well, leaving their stock prices exposed. AI service providers are already seeing strong competition and rising capex costs. It is also a sign of AI exuberance that both the hyperscalers and service providers are increasingly drawing on equity funding.

The boom is clearly maturing, but we don't think the cycle has peaked. It wouldn't be surprising if the upcoming reporting season once again reinforced the optimism in forward earnings like last reporting season.

Riding booms is great while they last; timing when to exit is arguably more important.

Macquarie WM Investment Strategy Team

This Report was finalised on 6 July 2026.

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