QUARTERLY INVESTMENT OUTLOOK

OCTOBER 2025

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

EXECUTIVE SUMMARY

- US economic growth has slowed as policy uncertainty, depleted savings and higher borrowing costs have weighed on consumption and housing market activity
- Equity markets have hit new highs despite weaker economic signals, yet rate cuts and pro-growth policies support prospects for 2026
- Ongoing AI capex by tech leaders is boosting the US economy and has become a meaningful support for equity markets, raising questions about market excess and the risk of euphoria
- Whilst the magnitude of current capex has increased significantly, its persistence has not reached the levels witnessed in the late 1990s 'dotcom' bubble
- AI capex is primarily funded by operating cash flows for the largest 'hyperscalers[1]', underscoring financial health, yet persistently slower consumption may pressure free cash flow and sentiment
- The interconnectivity of major AI players means disruption in one could quickly shift investor sentiment across the sector
- AI remains a durable investment theme, yet strategic missteps or earnings disappointments could shift sentiment lower
- Our strategy favours balance and selectivity with more moderate 'big tech' allocations than the broad market, favouring global active managers and long-term AI beneficiaries

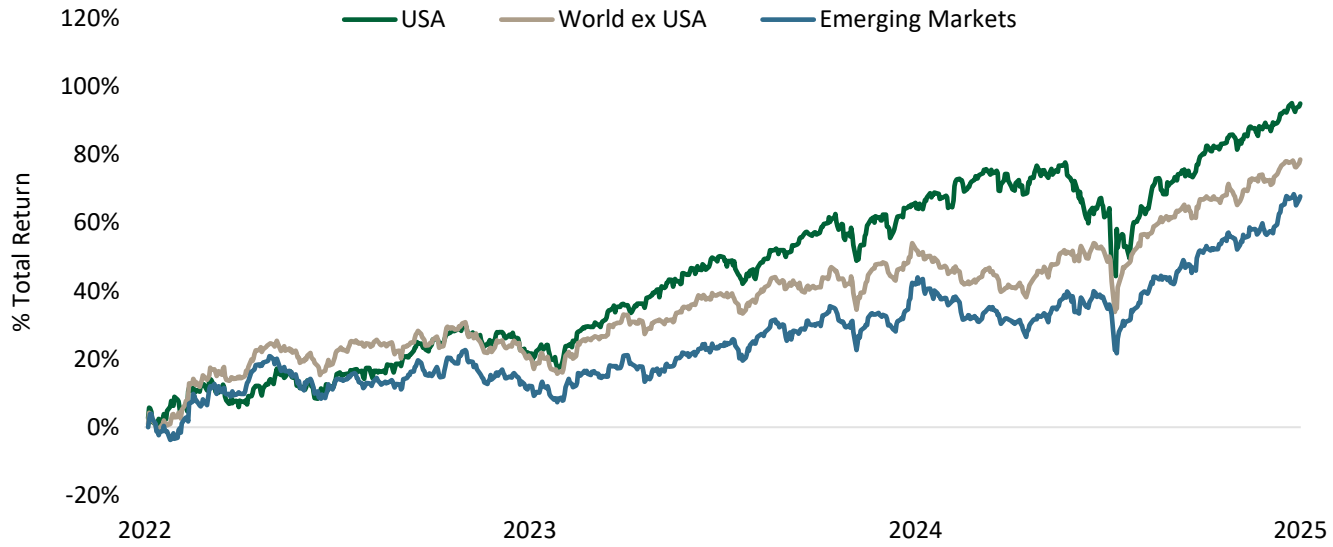
[1] *Hyperscalers include Alphabet, Amazon, Meta, and Microsoft who are collectively investing hundreds of billions of US Dollars into AI Infrastructure this year.*

INTRODUCTION

As 2025 enters its final quarter, it has become increasingly evident that activity within the US consumer sector has slowed significantly this year, driven by three key factors. First, the unpredictable imposition of tariffs in the first half of the year created substantial policy uncertainty, prompting businesses to delay both hiring and investment decisions. Second, the excess cash savings accumulated during the pandemic have now largely been depleted. Whilst these reserves previously supported robust consumer spending, current consumption is increasingly dependent on job creation and income growth, both of which are decelerating. Finally, long-term borrowing costs remain elevated, and this is weighing on housing activity and overall confidence levels.

The US economy is therefore characterised by modest consumption growth, soft job creation and a stagnant housing market. Yet, equity markets have recovered to new highs following a bout of tariff-related indigestion in April. So far in 2025, global equities are up 18.4% in US Dollars, led by the US in recent months, (*Chart 1*[2]) and sectors typically sensitive to the economic cycle, such as banks, semiconductors and industrials, have also been strong. Are investors being complacent, and underestimating recession risks in the world's largest economy?

Chart 1: Equity markets have shrugged off economic and trade uncertainty



US Growth: An Improved Policy Mix

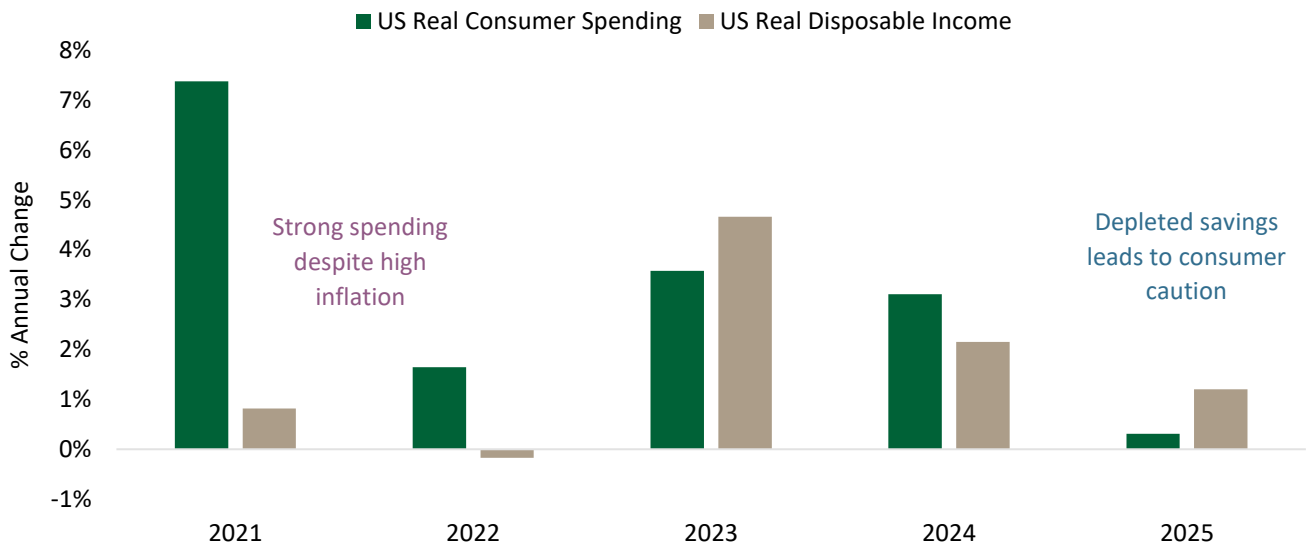
Following three years of strong consumer-led growth in the US economy from 2021-2024, our outlook turned more cautious 12 months ago. As we argued at that time, the outlook for 2025 included "*a much higher probability of a continued moderation in economic momentum*[3]*."* That moderation was duly compounded by Liberation Day tariffs, which temporarily derailed confidence in US assets earlier this year.

> The US business cycle remains in a phase of slower growth, yet recession risks appear limited.

A key consideration is the shift towards a more market-friendly policy mix for the coming year. Following three years of elevated borrowing costs that have suppressed activity in the housing market, the Federal Reserve has re-engaged in a rate cutting cycle, having paused between December 2024 and last month. The economy in 2025 is very different to the backdrop in 2021, when interest rates were increased sharply. Real consumer spending has flatlined this year (*Chart 2*[4]), as income growth has continued to slow, pandemic-era savings have been depleted and confidence has been sapped by tariff-related uncertainty.

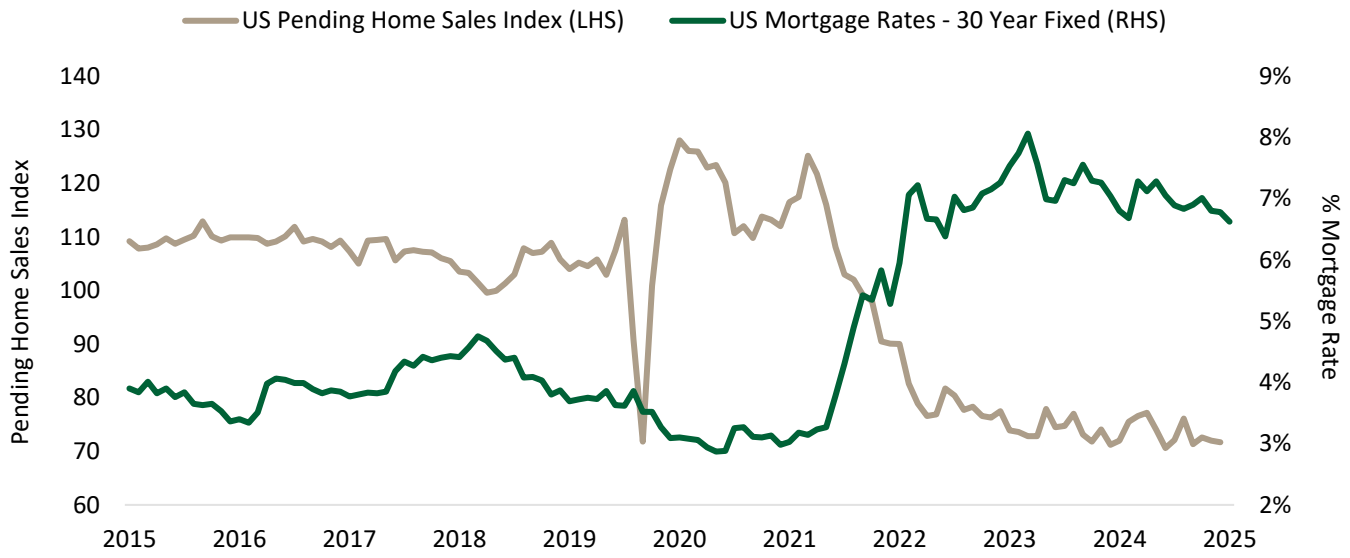
[2] *Source: Bloomberg, USD, MSCI indices, September 2025.*
[3] *Source: Stonehage Fleming Quarterly Investment Outlook, October 2024*
[4] *Source: Bloomberg, July 2025.*

Chart 2: US consumption growth has slowed as businesses reduce hiring



This year's slowing growth and modest inflation justifies lower interest rates, which in turn can support consumer confidence and rejuvenate activity in the housing market (Chart 3[5]).

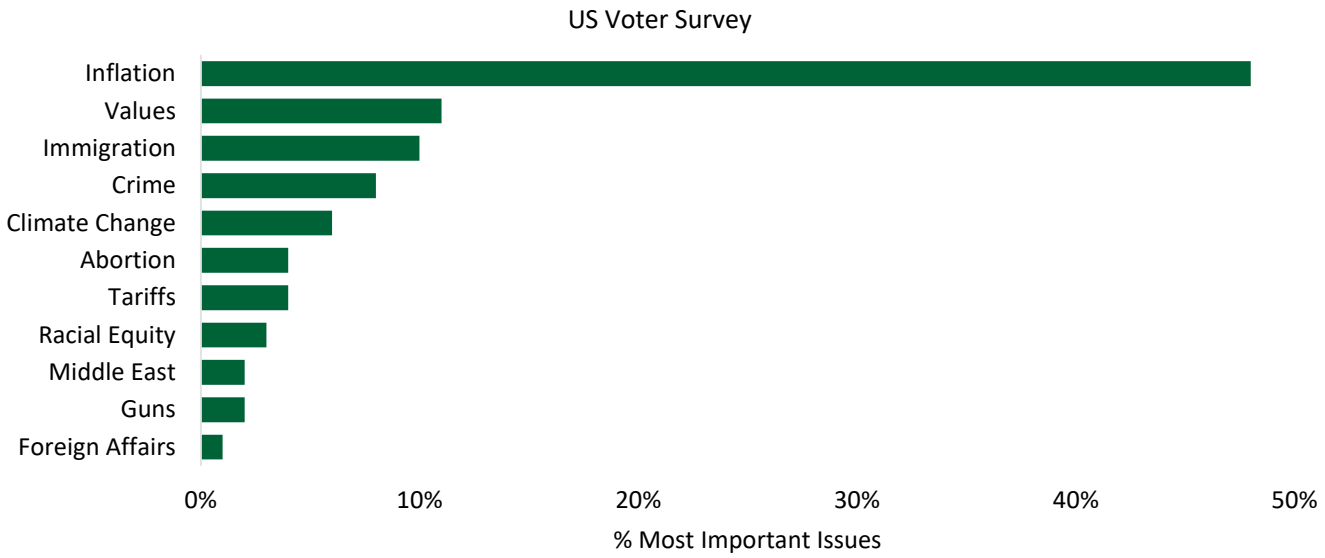
Chart 3: Interest rates are too high for the housing market



In addition, the US administration is set to pivot attention away from unpopular tariffs and instead focus on pro-growth policies, mindful of next year's midterm elections (*Chart 4*[6]). This dynamic could prove a meaningful tailwind for US growth in the months ahead. Trump's presidential campaign centred on promises to enhance living standards and tackle inflation, yet the initial nine months of his return to office have seen consumers burdened by new consumption taxes, namely tariffs on imported goods, and an uncertain climate for business. Already the pressure from within his party is leading to a change in approach.

[5] *Source: Bloomberg, August 2025.*
[6] *Source: Harvard Caps Harris Poll, August 2025.*

Chart 4: The US administration will pivot away from unpopular tariffs



However, the prospect of improving growth in the months to come is not the only theme driving equity markets today. An important feature of the recent period of market strength is the magnitude of capital expenditure (capex) being devoted to AI infrastructure by large US technology firms. The so-called 'hyperscalers' are investing significantly across physical data centres and cooling systems, chips (GPUs[7]), AI cloud services and broad AI R&D. Nvidia, the market leader in GPU design and manufacture that underpins AI infrastructure, has returned c. 330% in the past 2 years alone[8].

A commonly asked question is whether we are experiencing an AI-driven bubble, reminiscent of the late 1990's 'dot-com' crash. Are investors overestimating the persistence of profit growth for the sector's 'enablers' and underplaying economic and financial risks?

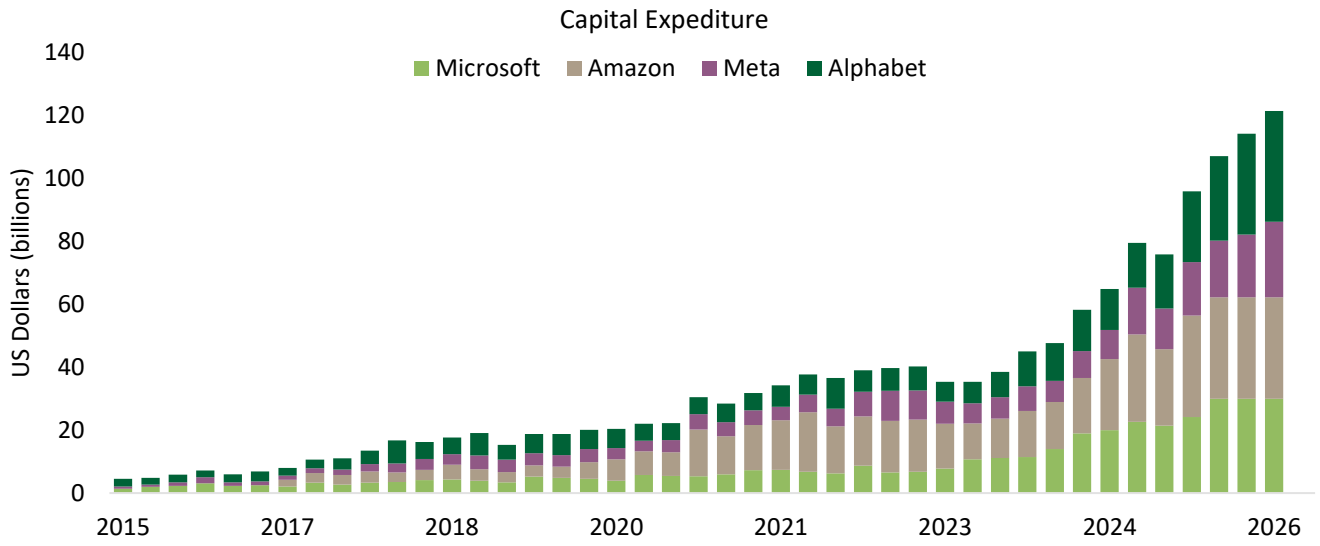
The AI Capex Cycle: Background

US technology firms have been at the forefront of industry disruption and innovation for decades, driving substantial gains across global markets. This dynamic has evolved in the past three years, when the release of OpenAI's ChatGPT in November 2022 marked the advent of a new AI-race.

In a short space of time, companies well known for their dominance in the consumer, media and software segments of the technology sector, such as Amazon, Alphabet, Meta and Microsoft, have pivoted to a capital-intensive strategy, in pursuit of 'AI services' market share. The numbers are staggering; most estimates suggest $300-350billion capex this year from these four firms alone (*Chart 5*[9]). As Sundar Pichai, CEO of Alphabet, recently argued on an earnings update call, "*the risk of under-investing in AI is dramatically greater than the risk of over-investing*[10]".

[7] *GPUs are Graphics Processing Units – specialised computer chips integral to high-performance AI tasks.*
[8] *Source: Bloomberg, USD, September 2025.*
[9] *Source: Bloomberg, SFIM calculations, June 2025. Includes forecasts to December 2025.*
[10] *Source: Alphabet Q2 2025 Earnings Call.*

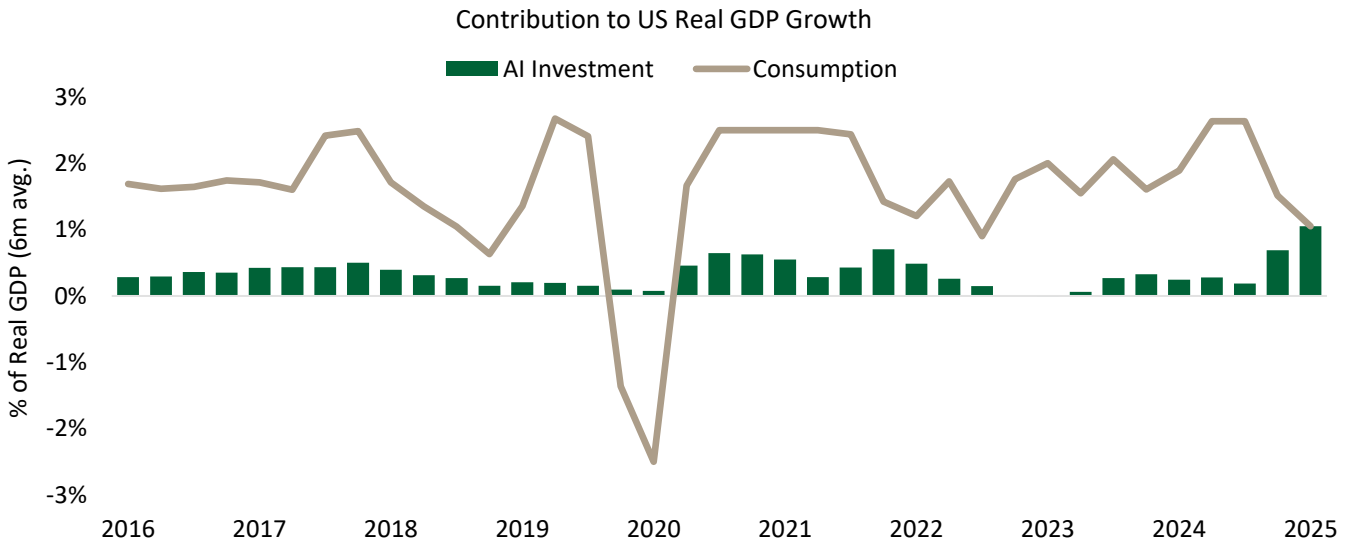
Chart 5: The AI capex cycle has accelerated substantially



Monitoring Signs of Stress: Economic Dependency

As consumer activity has softened this year, US growth has received a valuable boost from surging investment in software and information processing (*Chart 6*[11]).

Chart 6: AI investment has supported the US economy as consumption has slowed



For some investors and economists, this trend already signals a concerning economic reliance on AI capex. On some metrics, these concerns are justified: assuming hyperscaler capex reaches $350 billion this year, this would represent approximately 1.2% of the US's $29.2 trillion economy, comparable proportionally to the c. $120 billion in telecom capex during 2000, when GDP stood at around $10 trillion.

[11] *Source: Bloomberg, June 2025. AI investment is software and information processing. Pandemic extremes have been truncated for presentational purposes.*

However, the reality is more nuanced than the headline numbers suggest. Whilst the magnitude of current capex has increased significantly, its persistence has not reached the kind of levels we saw in the late 1990s. As Dario Perkins at global research firm TS Lombard recently argued, "*it makes more sense to focus on the overall cumulative increase in capital spending in each episode. And if we do that, we discover that the bulls have a point when they say the capex boom may be only just getting started.*" Perkins further notes that, in the late 1990s, inflation-adjusted tech capex grew by approximately 20% annually for five consecutive years - a sustained surge that contrasts with the current cycle, which has seen only a single year of comparable capex growth (*Chart 7*[12]).

Chart 7: Tech capex in the 1990s continued for several years

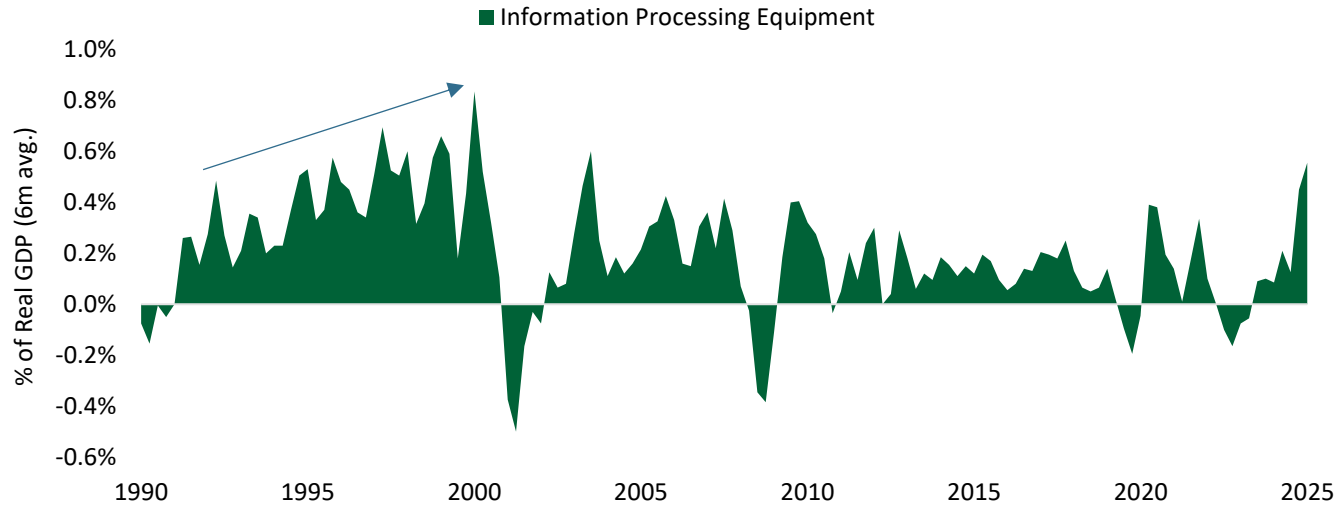
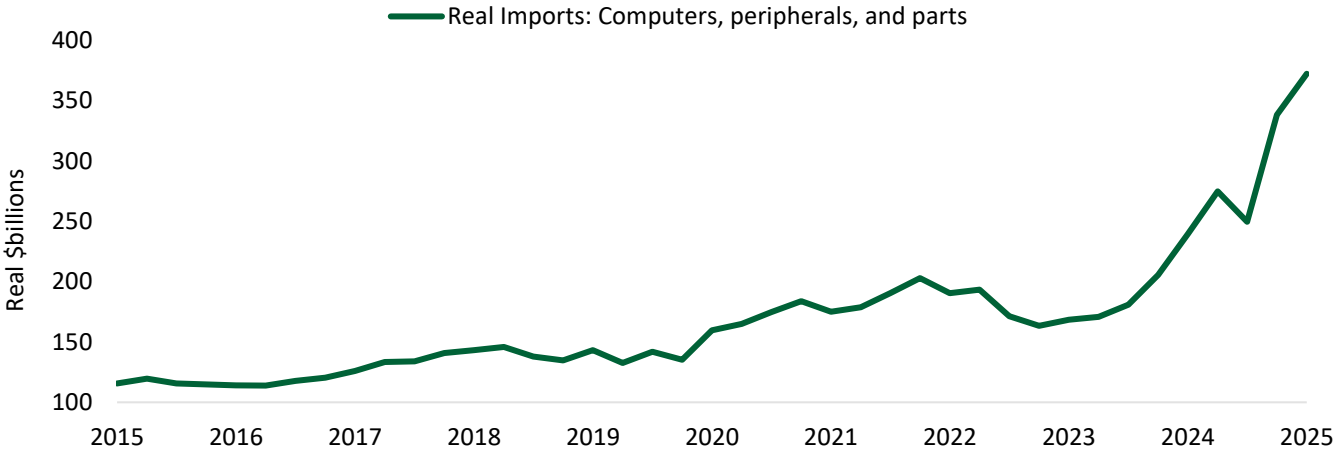


Chart 8: Imported components reduce AI's contribution to US growth



It is also noteworthy that a significant proportion of AI capex is attributed to imported components (*Chart 8*[13]). To meet AI's high performance and efficiency requirements, 'hyperscalers' need to import critical enabling components, primarily sourced from Taiwan and Japan, due to their dominance in advanced manufacturing. Whilst there are long term initiatives to onshore key aspects of the supply chain, long term contracts and the sheer scale of current requirements mean this will be a gradual process. Once the negative impact of rising imports is accounted for, the true economic impact of AI investment in the US is somewhat lower than the headline numbers suggest.

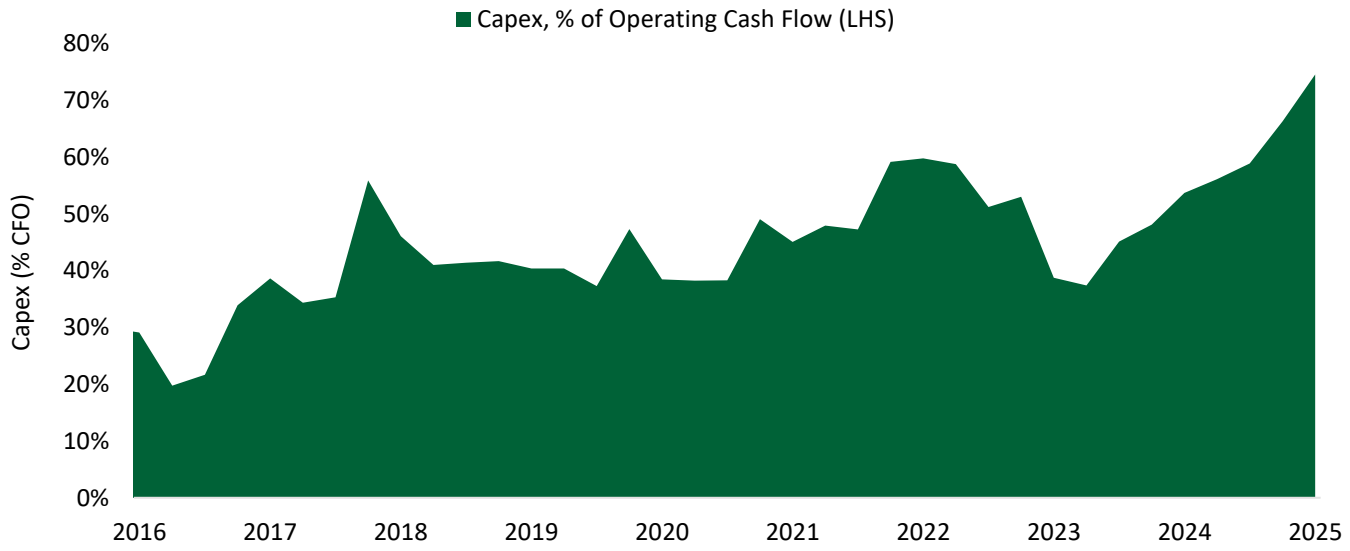
[12] *Source: Bloomberg, June 2025.*
[13] *Source: Federal Reserve Bank of St. Louis, June 2025.*

AI Capex Cycle: A Modern Equivalent of 1990's Telecoms?

History is awash with examples of failed capex cycles, as capacity is overbuilt in the anticipation of productivity and growth that arrived either too late or not at all. A common analogy is the telecoms capex cycle, and ultimate collapse, of the late 1990's. As a well-regarded semiconductor analyst wrote in 2023, "*Over $500 billion was invested between 1996 and 2001, mostly financed with debt. The boom was driven by the belief that internet traffic would grow exponentially, and companies needed to build capacity ahead of demand*[14]".

Rather than attempting to predict the end of the AI capex cycle, an alternative approach may be to monitor key indicators of financial health. These markers can reveal whether this surge in capital spending is sustainable, or if signs of strain are beginning to emerge on the key players. Importantly, hyperscalers are primarily relying on operating cash flow to finance capex, rather than issuing high levels of debt (*Chart 9*[15]). The lack of excessive leverage associated with this capex cycle is a key point of difference with the 1990's bubble.

Chart 9: Operating cash flow remains strong enough to support capex



While individual companies may present unique circumstances, our assessment of largest investors in AI infrastructure indicates that, collectively, these firms continue to demonstrate robust financial health.

Reasons for Caution: Uncertainty Meets Disruption

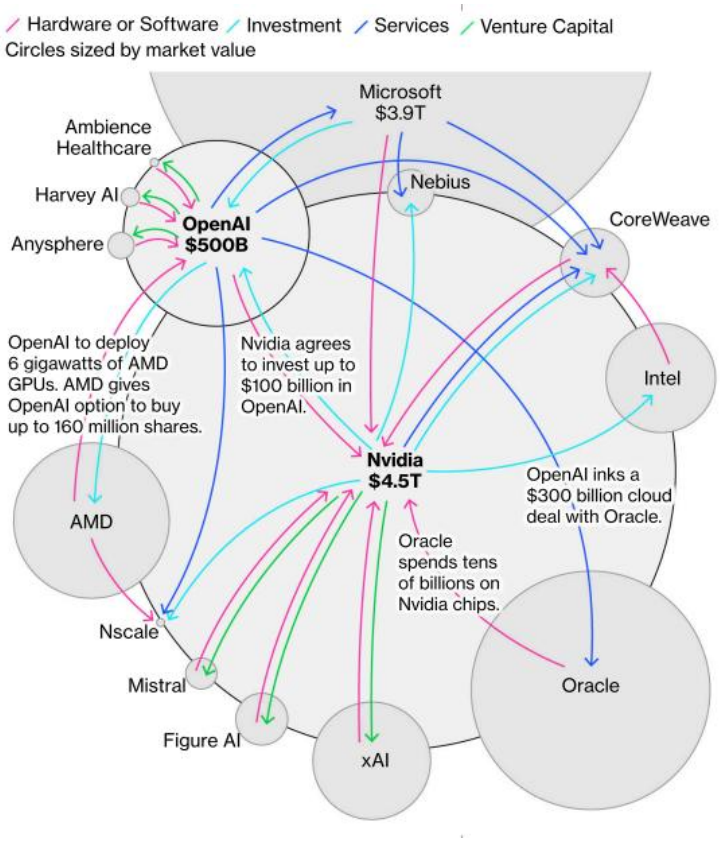
AI has reached a pivotal juncture. Whilst there is scant evidence that the US economy is overly dependent AI capital spending and development, or that financial risks are bubbling over, this does not preclude a sharp decline in their share prices. It is wise to approach this explosive growth trend with an appropriate element of caution and scrutiny.

A potential source of concern is how exposed the equity market is to this theme. Approximately 35% of the US market comprises the leading firms engaged in AI enablement, such as data centres, model development, and the design and manufacture of specialist semiconductor chips.

[14] *Source: "Lessons from History: The Rise and Fall of the Telecom Bubble", Doug O'Laughlin, October 2023.*
[15] *Source: Bloomberg, June 2025.*

Furthermore, the intricate web of relationships among the leading players is particularly striking, as a succession of recent 'related party' transactions underscores the industry's interconnectivity. Nvidia, the leader in GPU chip innovation and production, has recently committed $100 billion to OpenAI, the developer behind ChatGPT, themselves predominantly owned by Microsoft, who are investing hundreds of billions of dollars over time into AI infrastructure. Microsoft, in turn, procures cloud computing services from Oracle, a significant Nvidia chip client. Notably, Nvidia also holds a stake in CoreWeave, which is supplying AI infrastructure back to OpenAI. These relationships reinforce the tightly knit network that mutually underpins the AI ecosystem (*Chart 10*[16]). It is not hard to see how a deterioration for one key player could derail investor sentiment for the AI story overall.

Chart 10: The interdependency of the AI ecosystem could amplify a deterioration in sentiment



Summary: Implications for Investment Strategy

Our clearest takeaways from this analysis are twofold: first, that the AI theme is here to stay. We are not seeing the levels of euphoria, economic dependency or financial excess that would lead us to conclude that the leading companies represent unreasonable investments as part of a long-term strategy. Second, however, the absence of an explicit 'bubble' does not rule out the potential for sentiment to shift lower. For example, the potential for declining free cash flows, driven by continued capex growth and slower consumption growth, could rattle investors' nerves.

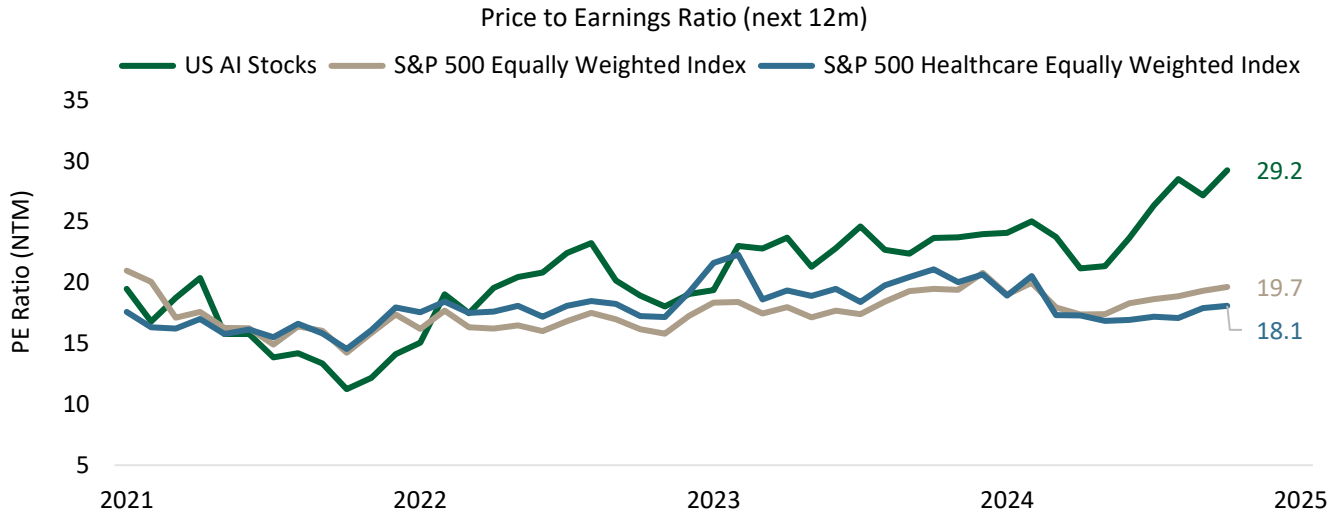
[16] *Source: Bloomberg, October 2025.*

Leading runners in the AI race could also make strategic missteps in the fight to gain market share, leading to a broader period of weakness for the technology sector. There is clear precedent here. In 2021, Meta (previously Facebook) rebranded in its pivot to the 'Metaverse', a virtual space accessed through headsets and wearables, which failed to attract user interest and led to a 77% decline in their share price.

Our investment strategy therefore prioritises balance and selectivity; despite the enticing revenue and share price growth in recent months, our portfolios maintain a more modest allocation to AI enablers and hyperscalers than the broader global market, recognising the uncertainty detailed above.

Instead, we emphasise sectors that are increasingly benefiting from AI integration and are well positioned to deliver sustained earnings growth over time. Healthcare is a good example of defensive 'growth at reasonable price', with notably lower valuation multiples than the AI leaders (*Chart 11*)[17].

Chart 11: AI enablers' valuations are extended compared to adopters



We argued in our July 2025 Investment Outlook letter that "*the portfolio strategies that succeeded over the past 15 years must now adapt to thrive in a new era. This calls for a gradual, conviction-led evolution of our strategy, aligned with long-term opportunities as they arise.*" Following thorough due diligence of their stock selection processes and capabilities, we have added two additional global active managers to our portfolios this year, reducing investment in mega-cap US equities. The GMO Quality Investment and Jupiter (NZS) Global Unconstrained Growth strategies offer complementary active investment styles, accessing companies with strong fundamentals and a prudent valuation mindset. We remain vigilant to further enhancements that will complement these holdings and bring further differentiation to our portfolios.

Stonehage Fleming Investment Management
Chief Investment Officer Group
14 October 2025

[17] *Source: Bloomberg, September 2025. US AI: average of Alphabet, Amazon, Microsoft, Meta, Oracle.*

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