CRAFT YOUR LEGACY

SAPIENT

The Holy Grail, Revisited

Productivity, Patience, and the Cost of Capital

TOM PENCE
SENIOR PARTNER, WEALTH ADVISOR

September 2026

TO OUR CLIENTS AND PARTNERS,

When we sat down to write to you in January, we described the market's mood as a "fascinating paradox" given the rally that had run from April 2025 through a November fever pitch, followed almost immediately by a bear case built around AI capital expenditure.

We called that letter "The Great Decoupling," and we focused on three convictions: the bubble narrative, however loud, was decoupled from the data, the U.S. economy had entered a "Holy Grail" regime in which GDP could grow even as labor hours fell, and a policy overhang which included tariffs, Fed uncertainty, an impending change in Fed leadership was the real drag on markets, not the underlying fundamentals.

Eight months later, with the leaves beginning to turn, it is worth re-evaluating. Some of what we anticipated has largely played out in line with our expectations. Some of it has evolved in ways worth revisiting. And a few new questions about the cost of capital, the durability of corporate margins, and the widening gap between a handful of dominant technology companies and the rest of corporate America deserve a fresh look. This outlook picks up where we left off in January and addresses where the evidence has changed.

IN THIS LETTER

01 | From "Liberation Day" to a New Fed Chair

In January, we flagged the approaching first anniversary of "Liberation Day" tariffs as a milestone we expected to remove uncertainty from markets, and we flagged the May transition of the Federal Reserve Chair as a critical pivot for the direction of long-term bond yields.

Both developments arrived roughly on schedule as Kevin Warsh was sworn in as the Fed's new chair on May 22nd, ending months of speculation, and the tariff anniversary came and went without the inflationary shock many had feared.

But the intervening months brought their own test, one we did not fully anticipate in January. Early spring brought a spike in oil prices tied to the conflict with Iran, and inflation data ran hotter than the encouraging December print we had previously highlighted at year-end.

Since May, we have been urging clients to "fade" both the oil spike and the accompanying inflation scare, on the view that the U.S. economy is far less energy intensive than prior decades. We pointed towards efficiency gains, the renewable energy buildout, and domestic oil production as key considerations that structurally insulated the U.S. from the kind of oil-driven recession playbook that worked in the 1970s.

> That call has largely been vindicated: the energy shock proved transitory, and it did not derail the broader growth story that we had expected.

WHAT WE FLAGGED AND WHAT ARRIVED

EARLY SPRING
A spike in oil prices tied to the conflict with Iran

TARIFF ANNIVERSARY
Came and went without the inflationary shock many had feared

MAY 22
Kevin Warsh sworn in as the Fed's new chair

SINCE MAY
Urging clients to fade both the oil spike and the inflation scare

02 | The AI Buildout: Speculative Boom or Infrastructure Bedrock?

Our earlier letter also spent considerable time debunking the doomsday views expressed in Andrew Ross Sorkin's book "1929" that was released last October, along with consensus views that AI infrastructure spending resembled the speculative excess of past bubbles. We pointed to capex-to-free-cash-flow ratios that are well below dot-com era levels, a muted IPO market, and hyperscaler return-on-invested-capital figures north of 25%. That argument has only strengthened as more data has arrived.

The question clients ask us most often now is not whether AI spending is real, but whether it has simply run too far, too fast, and whether we are near the end of the cycle rather than the middle of it. The evidence increasingly suggests the latter. A common misread this summer has been that falling per-unit costs for AI computation were a signal of softening demand. History suggests the opposite: just as cheap long-distance calling did not shrink the phone industry but multiplied call volume many times over, falling compute costs and the increasing use of AI agents are causing businesses to run AI tools continuously rather than sparingly. According to one source, Open Router weekly token consumption has now increased from 10B tokens per week in January 2024 to 90T/week in August 2025, a 9000x increase, representing a scale of usage growth that dwarfs the growth in unit-pricing pressure.

JANUARY 2024		AUGUST 2025	REPRESENTING A
10B	→	90T	9000x
Tokens per Week		Tokens per Week	Increase in Weekly Token Consumption

Just as important, the hyperscalers are no longer building out compute capacity on speculation. Quite to the contrary, enterprise customers have signed multi-year contracts worth hundreds of billions of dollars for future computing capacity. This is the kind of forward revenue visibility that simply did not exist during the dot-com buildout. We continue to think the most useful historical analogy is not 1999, but the transcontinental railroads or the electrification of America a century ago: enormous upfront capital poured into physical assets (in this case land, power infrastructure, advanced chip packaging) that will serve multiple generations as usage compounds. Because that physical capacity cannot be built overnight, the operators who already control it retain real pricing power. We would characterize this cycle as moving from its early construction phase into the middle innings of long-term, utility-like revenue generation. To be sure, capacity is still expanding, but on firmer footing than it was in January.

The bottlenecks we described in January, such as shortages of optical equipment, high-bandwidth memory, server manufacturing, and power grid components, have not disappeared. If anything, they have become the central constraint on how quickly this buildout can proceed. Land acquisition, power grid interconnection queues, gas turbine availability, and advanced memory packaging capacity are now the gating factors, rather than investor appetite or available capital. We view this as a healthy development, not a warning sign. Scarcity of physical inputs is precisely what supports the pricing power of the companies we own, and it represents a fundamentally different risk than the demand collapse that brought previous speculative cycles to an end.

03 | Not an Earnings Bubble – a Multiple Correction

Skeptics have adjusted their argument since January.

Having conceded that valuations do not look euphoric, some now argue that earnings themselves are in a bubble bound to burst. We think this confuses two different concepts. A bubble is a statement about *price* relative to fundamentals; but earnings are the fundamentals here. They represent real cash generated by real corporate activity, not a subjective claim about future value that can simply deflate with compressing sentiment and multiples.

The clearest evidence that markets have behaved rationally through this entire episode is that valuation multiples have *compressed* while profits have *surged*.

S&P 500 forward price-to-earnings ratios have fallen from roughly 23x to close to 20x over the past year, even as earnings growth has accelerated. That is precisely the "wall of worry" behavior we described in January; investors declining to extrapolate a continuation of strong profits rather than considering that we may be in a distinctly unique era of investment. Additionally, corporate leverage remains low. For the most part, many companies have been funding this buildout from cash flow, not debt, which is the same discipline we highlighted with the capex-to-free-cash-flow data back in January.

EVIDENCE OF MARKET RATIONALITY OVER THE PAST YEAR

Valuation Multiples

23x → 20x

S&P 500 Forward Price-to-Earnings Ratios

Corporate Earnings

Accelerated

Earnings Growth, Over the Same Period

> A bubble is a statement about *price* relative to fundamentals; but earnings are the fundamentals here.

04 | The Two-Speed Economy and the Limits of Productivity

Here is where we want to sharpen the picture we gave you in January.

We described a "Holy Grail" regime in which productivity could continue to climb, represented by rising GDP and falling hours worked. We viewed this as an unambiguous positive, a sign of an economy becoming more efficient rather than one heading toward recession. We still hold this belief, but after eight months of additional data since our January letter, it is clear this productivity dividend is not evenly distributed.

Aggregate corporate profit margins now sit near post-World War II highs, at roughly 14% of GDP.

A meaningful share of that came from decades of squeezing labor costs relative to output. While much of this came from the globalization era and the exporting of jobs to cheaper Asian countries, in recent years this same effect has resulted from companies having the ability to grow their output and revenues with less labor as we discussed in January. Margins cannot expand from labor efficiency indefinitely; companies have largely captured what is available here. This suggests that future earnings growth increasingly needs to come from broader-based top-line economic growth rather than further cost-cutting.

BY OUR ESTIMATE

85% and 90%

of traditional corporate America is still lagging behind.

DRIVEN BY

Elevated interest rates, slower money-supply growth, and shrinking federal deficit spending.

That matters because the economy underneath the AI buildout looks two-speed. A small group of technology leaders and power suppliers continue to boom. On the other hand, by our estimate, somewhere between 85% and 90% of traditional corporate America is still lagging behind, pressured by elevated interest rates, slower money-supply growth, and shrinking federal deficit spending. Producer prices are also running hotter than consumer prices, which squeezes companies without pricing power even as headline inflation looks tame relative to the past five years.

This is not a contradiction of the Holy Grail thesis; it is the thesis playing out unevenly, concentrated in the businesses building and monetizing the infrastructure rather than spread across the broader economy.

We think this is also why a cooling labor market has coexisted with a resilient equity market. It is not simply that the engine of growth has changed from consumer spending to business investment. It is that the businesses capturing the productivity gains are a narrow slice of the index, while the broader labor market bears the cost of that efficiency without yet sharing fully in its benefits. We expect that gap to narrow over time as AI adoption broadens beyond the "early innings" we described in January.

05 | Capital Scarcity, the Fed, and Interest Rates

We continue to point to global demographics (an aging US population saving more and consuming less) as a structural force that could create an excess of capital, pushing interest rates down over time, much as it has in Japan and parts of Europe.

We continue to believe that force is real and durable over the long run.

But the nearer-term picture we are watching this summer cuts the other way. The physical buildout now underway in AI data centers, grid modernization, semiconductor fabrication, reindustrialization, defense, and space exploration requires enormous capital simultaneously across multiple fronts, at a moment when U.S. national savings sit near record lows. When demand for physical capital outstrips domestic savings, borrowing costs tend to rise, increasing reliance on foreign capital and putting upward pressure on real interest rates. If policymakers respond by leaning on the Fed to expand the money supply, that risks feeding inflation rather than resolving the underlying scarcity. The Fed can create dollars, but it cannot create power plants, transmission lines, or silicon wafers. Rising federal debt adds further complications, as investors may demand a larger premium on Treasuries to compensate for that inflation risk.

We reconcile this with our January view the way we think about most demographic forces: as a multi-decade current running beneath a shorter-term cycle of scarcity. We still believe that the demographic tailwind toward lower rates is real, but we recognize that it will unfold over the coming years and decades. The capital demands of reindustrialization are being felt now, in months and quarters. Both can be true at once, and for the period immediately ahead, we think the scarcity dynamic is likely to dominate. This is precisely the kind of risk we highlighted in January when anticipating a change in leadership at the Fed. If Chair Warsh's Fed exhibits genuine independence and eases gradually as inflation cools, the path toward lower long-term yields we described is achievable. The prospect of a 10-year yield meaningfully below 4% remains a possibility but if policy leans more accommodative than the data warrants, the alternative path we flagged, toward 4.5% or higher, becomes more likely. We have been positioned for the former while staying prepared for the latter. However, Warsh's recent comments at Jackson hole suggest that for now, he is determined not to let inflation simmer for much longer.

TWO PATHS FOR THE 10-YEAR YIELD

Chair Warsh's Fed

- If Chair Warsh's Fed exhibits genuine independence and eases gradually as inflation cools, there is a prospect of a
  10-year yield meaningfully below 4%.
- If policy leans more accommodative than the data warrants, there is a prospect of a
  10-year yield toward 4.5% or higher.

06 | Global Crosscurrents, Leverage and the September Effect

January's letter also flagged two risks we said we would monitor closely rather than trade around: the strain on Europe from tariff realignment and intensifying Chinese competition, and a sharp rise in margin debt on U.S. equity portfolios. Both remain on our radar today, and neither has resolved the way our more central AI rollout and Fed storylines have unfolded.

European exporters are still navigating a difficult combination of costlier access to the U.S. market and intensifying Chinese competition inside their home markets, as European goods compete with Chinese exports that no longer flow as freely into the United States. We have not yet seen this evolve into the kind of drag on U.S. and global growth we flagged as a risk previously, but a weak Europe remains a headwind we would rather anticipate than react to, particularly given how interconnected global supply chains for the AI buildout have become. Additionally, the current trade war brewing with Canada only adds more complexity to the trade picture. One point that remains unambiguous to us is the ongoing commitment by many European countries to re-arm themselves with increased defense spending given the experiences of the war in Ukraine and the sometimes-dubious messaging of commitment and support by the U.S. Administration.

Closer to home, the elevated margin debt we highlighted in January (which was near the highest share of GDP seen in modern markets) is a reminder that investor leverage tends to amplify moves in both directions. Combined with the growing share of trading volume driven by short-term, quantitative, and hedge fund flows, we would not be surprised by bouts of sentiment-driven volatility that have little to do with the underlying earnings and productivity trends described above. This risk only increases as we enter the seasonally volatile months of September and October. We see this as a reason for discipline in position sizing and diversification, not as a reason to abandon the structural thesis that has served portfolios well since the start of the year.

ON THE WATCHLIST

01 Europe

The strain on Europe from tariff realignment and intensifying Chinese competition.

02 Leverage

A sharp rise in margin debt on U.S. equity portfolios, near the highest share of GDP seen in modern markets.

07 | Portfolio Strategy: the Barbell Endures

Our portfolio positioning has not changed materially since January, only in emphasis.

We continue to run a deliberate barbell: high-conviction exposure to the hyperscalers, semiconductor leaders, and industrial power suppliers building the physical infrastructure of this cycle, balanced against resilient consumer businesses, selectively repriced enterprise software names, and defense and logistics leaders that do not depend on the AI narrative to perform. We have recently increased our consideration of opportunities in healthcare and commodities as well.

A DELIBERATE BARBELL

The hyperscalers, semiconductor leaders, and industrial power suppliers building the physical infrastructure of this cycle	Resilient consumer businesses, selectively repriced enterprise software names, and defense and logistics leaders

Given the two-speed economy and the capital-scarcity dynamics described above, our portfolio is anchored by three pillars:

Mission-Critical Infrastructure

We maintain conviction in the technology platforms, chipmakers, and grid operators that own the physical bottlenecks of this buildout. These are the businesses generating the returns on invested capital and cash-flow margins that we have long highlighted.

Quality and Pricing Power

To manage the risk of higher-for-longer borrowing costs and persistent producer-price pressure, we favor high-return companies with low debt and the demonstrated ability to pass rising input costs through to customers, rather than absorb them.

Balanced Growth

We continue pairing infrastructure and technology exposure with defensive compounders in retail, transport, healthcare, and select software platforms. We view this as prudent ballast for a market we still expect to be volatile, and increasingly dominated by short-term, algorithmic flows rather than fundamentals-driven investors.

Conclusion

As we have progressed through the first eight months of the year, we are struck by how much of the structural case has held up: the bubble narrative remains, in our view, decoupled from the underlying data.

The hyperscalers continue to generate returns that look nothing like speculative excess, and the Fed transition we flagged as a pivot point has arrived and is beginning to shape the next leg of the rate cycle. What has changed is less the destination than the terrain along the way. Most notably, a summer energy scare that came and went, a widening gap between a booming technological core and a traditional economy running closer to stall speed, and a nearer-term capital scarcity that complicates the longer demographic tailwind we described at the start of the year.

We thought that the path through 2026 would likely be volatile, driven by a market increasingly dominated by short-term participants and algorithmic flows, which has been validated so far.

We also said that for the long-term investor, the productivity story and the fading of policy uncertainty provided a clear path forward. Eight months in, we believe that remains the case. However, “clear” does not mean uniform. Therefore, discipline in security selection now matters more than it did when the tide was lifting nearly every boat. As always, we will continue to execute that mandate on your behalf with vigilance.

Thank you, as always, for your continued trust and partnership. Please do not hesitate to reach out to our team with questions or to discuss how these themes apply to your portfolio.

Warm regards,

Tom Pence
Senior Partner, Wealth Advisory

Sapient Capital · (317) 719-0157
info@sapientcapital.com
Indianapolis · New York · Miami
Chicago · Los Angeles