RATHBONES

Weekly Digest

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From AI enthusiasm to AI accountability

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AI enthusiasm is giving way to AI accountability, as investors ask whether the huge spending boom can turn promise into durable profits.

Quick take:

- AI still dominates the earnings story, but investors are becoming more selective about which companies deserve the benefit of the doubt.
- The investment boom remains powerful, yet greater use of borrowing and supplier-backed financing raises the stakes if demand disappoints.
- A broader market rally is encouraging, but the next test is whether AI spending can translate into lasting profits rather than higher expectations alone.

The defining feature of today's market is not enthusiasm for artificial intelligence. It's the growing insistence that profits justify enthusiasm.

Benjamin Graham's old observation that markets are voting machines in the short run and weighing machines in the long run feels increasingly relevant.

For much of the past two years, markets rewarded AI exposure first and asked questions later.

That phase is ending.

Strong earnings are still being rewarded, but expectations have risen with share prices. Increasingly, companies are being judged not by the scale of their AI spending but by whether that spending produces tangible economic returns.

That distinction matters because the AI investment cycle has become more important to markets than many investors appreciate.

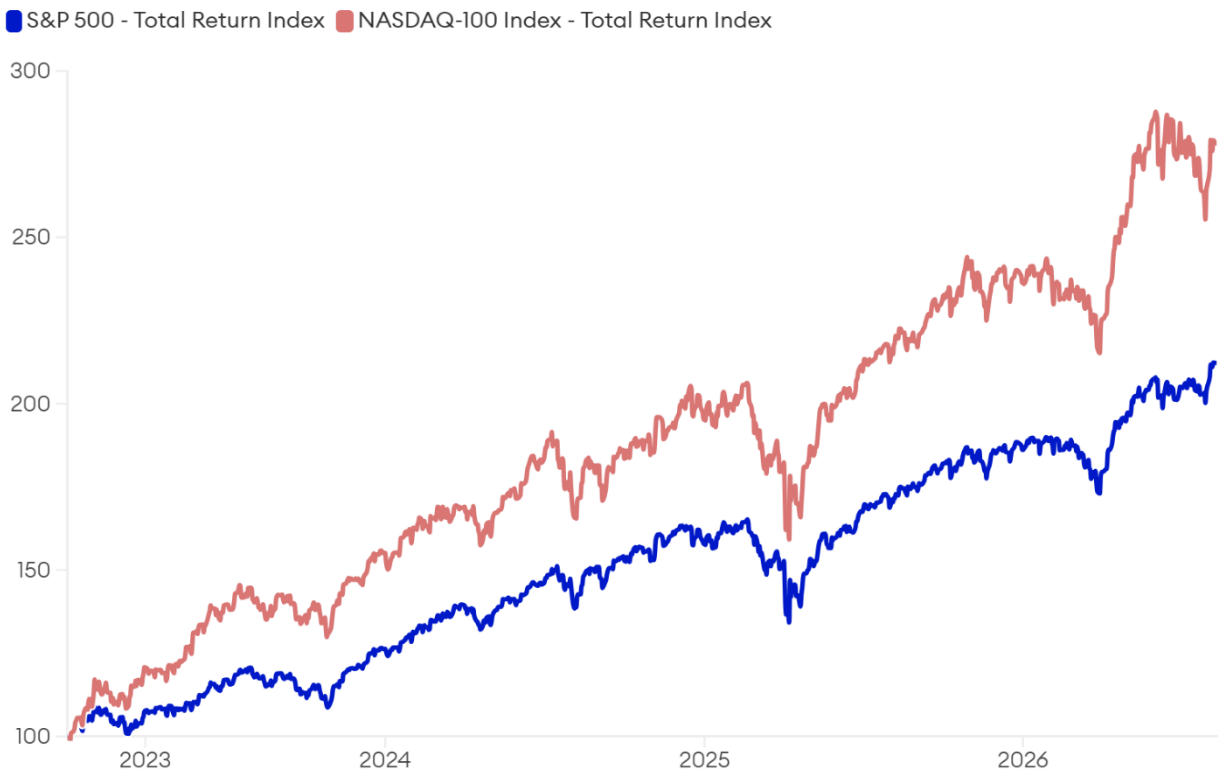
One of the striking features of the current earnings season is the degree to which profit growth is being driven by AI-related investment. Binky Chadha at Deutsche Bank has noted that AI beneficiaries contributed about half of S&P 500 earnings growth in the second quarter.

More broadly, the 10 largest contributors accounted for almost three-quarters of total growth. Semiconductor manufacturers, memory producers, networking companies, power suppliers and data centre operators have all benefited from an extraordinary wave of investment spending.

This helps explain why earnings have remained resilient despite softer signals from other parts of the economy. Since the current bull market began in late 2022, roughly three-quarters of global equity returns can be explained by earnings growth rather than investors simply paying higher valuations for the same profits, based on expected profits over the next 12 months.

Technology has led the rally

Technology-heavy US equities have outpaced the broader US market since late 2022, raising the bar for future earnings delivery.



Source: FactSet, Rathbones. data as at 11 Aug 2026. Total return indices rebased to 100 at 2 Jan 2023.

The value of investments can go down as well as up and you could get back less than you invested. Past performance is not a reliable indicator of future performance. This information should not be taken as financial advice or a recommendation.

That is encouraging: markets supported by earnings are generally healthier than those driven purely by optimism.

The question, however, is how much of those earnings ultimately depends upon the continuation of the AI investment boom itself.

A tale of two economies

One useful way to understand the current environment is to view it as a K-shaped economy. The upper branch consists of businesses benefiting directly from the AI investment cycle: semiconductors, data centres, power infrastructure and cloud computing. The lower branch is more subdued. Hiring has slowed, housing remains weak, and manufacturing is mixed. The result is not a broad-based boom, but an economy in which growth is concentrated in a narrow set of activities linked to technology, infrastructure and productivity.

This helps explain why equities have climbed despite unremarkable economic data: investors are focusing on where profits are being generated.

Encouragingly, leadership is beginning to broaden into financials, industrials, and parts of Europe. That gives markets a healthier foundation rather than dependence on a handful of AI winners.

Reflexivity and the AI cycle

The most important question for investors may not be whether the economy slows. It may be whether the AI investment cycle slows.

George Soros's idea of reflexivity is useful here: market prices do not just reflect reality; they can shape it. Rising prices encourage investment and reinforce the trend. Falling prices can reverse the loop.

That matters because today's market is unusually dependent on a single investment theme: high share prices support capital expenditure, capital expenditure supports earnings, and earnings, in turn, support share prices.

The late-1990s technology boom offers a warning. It didn't end because the recession arrived first. Confidence weakened, share prices fell relative to expected profits, capital spending slowed, and economic weakness followed.

Forecasts for cumulative AI infrastructure investment now exceed $5 trillion by the end of the decade, making this one of the largest waves of corporate spending on long-term infrastructure in modern history. While investors remain willing to fund the build-out, that spending supports earnings growth, employment, infrastructure demand, and broader activity.

If investors lose faith in the long-term economics of the AI build-out, the consequences could extend beyond share prices. Lower valuations would make financing more expensive, capital raising harder, and investment plans more vulnerable. Markets wouldn't merely be reacting to economic weakness; they could help cause it. That is not the most likely near-term outcome, but it's the principal vulnerability.

The AI build-out meets financial reality

The AI story is no longer simply about technological possibility. It's increasingly about capital allocation – how companies decide where to invest their money.

Like previous investment booms – railways, telecommunications and the internet – AI requires financing. What matters is the quality of that financing and whether the returns justify the capital employed.

Some recent developments suggest that parts of the AI ecosystem are becoming more financially interconnected. Debt issuance – companies raising money by borrowing – linked to AI infrastructure has grown rapidly, while more sophisticated financing arrangements are emerging throughout the supply chain. Multi-year purchase commitments, vendor financing, and debt-funded data-centre expansion can all reinforce the cycle as demand expectations rise. Still, they may also amplify disappointment if demand falls short.

That may prove rational if demand evolves as expected, but it creates vulnerability if expectations change.

Vendor financing and leverage – borrowing or other financing used to support investment – tend to look safest when growth is abundant. They become more visible when growth disappoints.

Recent earnings reports suggest that investment spending is still translating into real revenues and profits. Yet the market is becoming more discerning. Investors increasingly want evidence that spending today will generate attractive returns tomorrow.

This is not necessarily a sign of weakness; it's evidence that the investment cycle is maturing.

A healthier market

The most striking feature of today's market is not persistent enthusiasm for AI, but that the enthusiasm is becoming more discriminating.

Investors are rewarding evidence rather than ambition, profits rather than promises, and execution rather than aspiration.

The current cycle still appears to have solid foundations. But those foundations are tied to one of the largest capital investment programmes the corporate world has undertaken. The question is no longer whether AI will matter. It's whether the economics of AI can meet the expectations already embedded in markets.

For investors, the next phase of the AI trade will be judged less by the scale of ambition than by the discipline of capital allocation and the durability of returns.

Weekly Digest

Regional highlights

UK. Things were extremely quiet on the data front in the UK over the past week. Final Purchasing Managers' Index (PMI) surveys for July confirmed what the preliminary data told us a few weeks ago – that the UK economy made a reasonable start to Q3, albeit potentially helped by a temporary boost from the weather and the World Cup.

Beyond this, the only data of note came from the REC and KPMG Report on Jobs, which is a survey of around 400 recruitment and employment consultancies. It provided some positive news for the UK labour market, which has been weakening for some time. Most notably, it found permanent staff placements stabilising for the first time in 46 months. The survey also signalled the first increase in temporary vacancies in two years, and the smallest decline in permanent vacancies in 22 months. We will wait to see a few more data points or evidence from elsewhere before drawing firm conclusions. But at the margin, this is evidence that the UK labour market may no longer be loosening. That would have implications for the Bank of England, where doves have been citing labour market conditions as a factor behind their votes to keep interest rates on hold.

US. The big economic news from the US last week was the July employment report. Nonfarm payrolls came in well below expectations, declining by 23,000 last month compared to a consensus forecast of an 80,000 gain. However, we aren't reading too much into this particular data point. For one, the weakness was primarily driven by a 53,000 decline in local government education payrolls, which is known to be volatile in July. Private sector payrolls still increased by 30,000. What's more, there were plenty of other data released last week that continued to suggest the US labour market is broadly stable. The latest Job Openings and Labor Turnover Survey showed rates of job openings, hirings, and quits all little changed and higher than earlier in 2026. Jobless claims are still subdued, and major layoff announcements fell to a two-year low.

Beyond the labour market, we also had two of the earliest indicators of economic growth in July – the ISM surveys. The services index ticked up from 54.0 to 54.1 (where 50 is consistent with flat activity). That's in line with what we've been seeing throughout 2026 and stronger than the average over the three years prior. Meanwhile, the manufacturing index jumped from 53.3 to 55.6 – a four-year high. Taken together, they suggest the US economy had a decent start to Q3.

Europe. Economic news flow on the continent was also relatively subdued over the past week. A smattering of June industrial production data from the largest economies were mixed, with manufacturing activity holding up in Germany and France, and contracting in Italy and Spain. The German data are positive, given that we have seen tentative signs of improvement in the embattled manufacturing sector lately, such as a rebound in factory orders and an uptick in the manufacturing PMI survey. That said, there are still reasons for caution – we have seen head fakes in these data before in recent years, while the low water levels in the Rhine will be a temporary headwind too. Even so, this is something we will be monitoring in the months ahead.

Elsewhere, eurozone retail sales data for June disappointed with a 0.3% month-on-month fall. But upward revisions to the May data meant that sales still increased by 0.2% over Q2 as a whole. While that's nothing to write home about in absolute terms, it does suggest that European consumers have been relatively resilient to the latest energy price shock. There was further evidence of resilience at the start of this week, with the Sentix investor confidence survey returning to its January level. The assessment of current economic conditions improved by the largest margin in six months.

China. The latest data from China showed a slight easing of trade growth. After reaching a four-year high of 27% year-on-year in June, growth in exports slowed to 24% last month. Import growth also fell back, from 36% in June to 28% in July. However, there was some typhoon disruption at Chinese ports last month, and the big picture is that Chinese trade is still booming, supported by global demand for AI-related electronic goods and green technology. Notably, semiconductor exports have been growing at a rate north of 110% year-on-year for three consecutive months now.

These sectors are providing an increasingly important offset to headwinds elsewhere in China's economy, with the headwinds reinforced by inflation data released over the weekend. While a decline in global oil prices was the main factor behind falls in headline consumer and producer price indices in July, a more granular look at the data reveals that underlying deflationary pressures remain entrenched amid weak consumer demand.

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