

The Navigator

July 26

# Equity Views 2Q26: The AI debate – Separating fundamental momentum from price momentum

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Global equities delivered another strong quarter despite heightened volatility. The MSCI AC World Index (ACWI) rose +14.2% in 2Q (YTD: +11.7%), recovering sharply from the Iran-war correction before pausing modestly in June. Performance was driven primarily by AI beneficiaries and resilient corporate earnings. This quarter's commentary focuses on two key themes: the debate over a potential AI bubble, and where we still see earnings opportunities and upside in equity markets.

As AI continues to dominate market headlines, questions surrounding a potential AI bubble have inevitably resurfaced. Based on fundamentals, we believe that the public market is not yet in a bubble. First of all, AI adoption continues to accelerate across multiple metrics that we monitor, including the growth of the token-economy (figure 1), revenue expansion among AI “platform” companies (figure 2), and tangible productivity gains across an increasingly broad range of industries (figure 3).

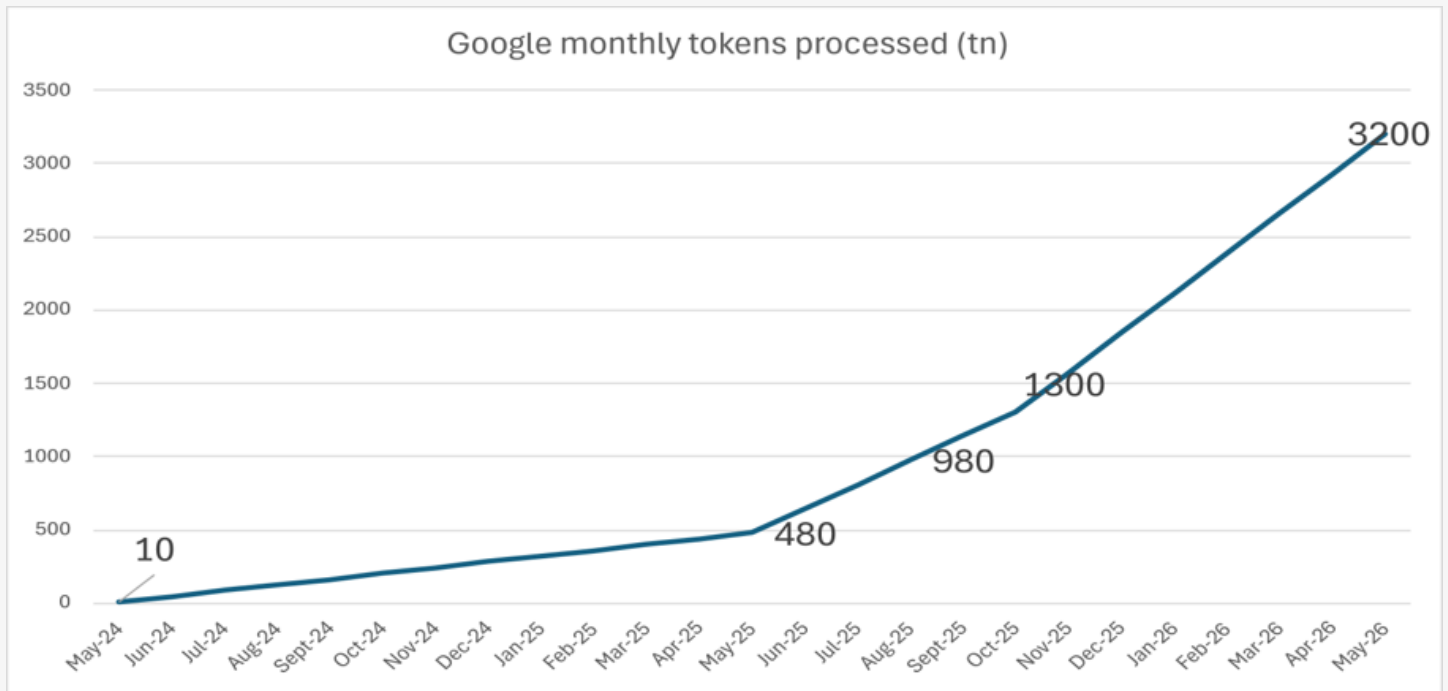


Figure 1. Google's monthly processed tokens have grown ~7x yoy. Source: Alphabet.

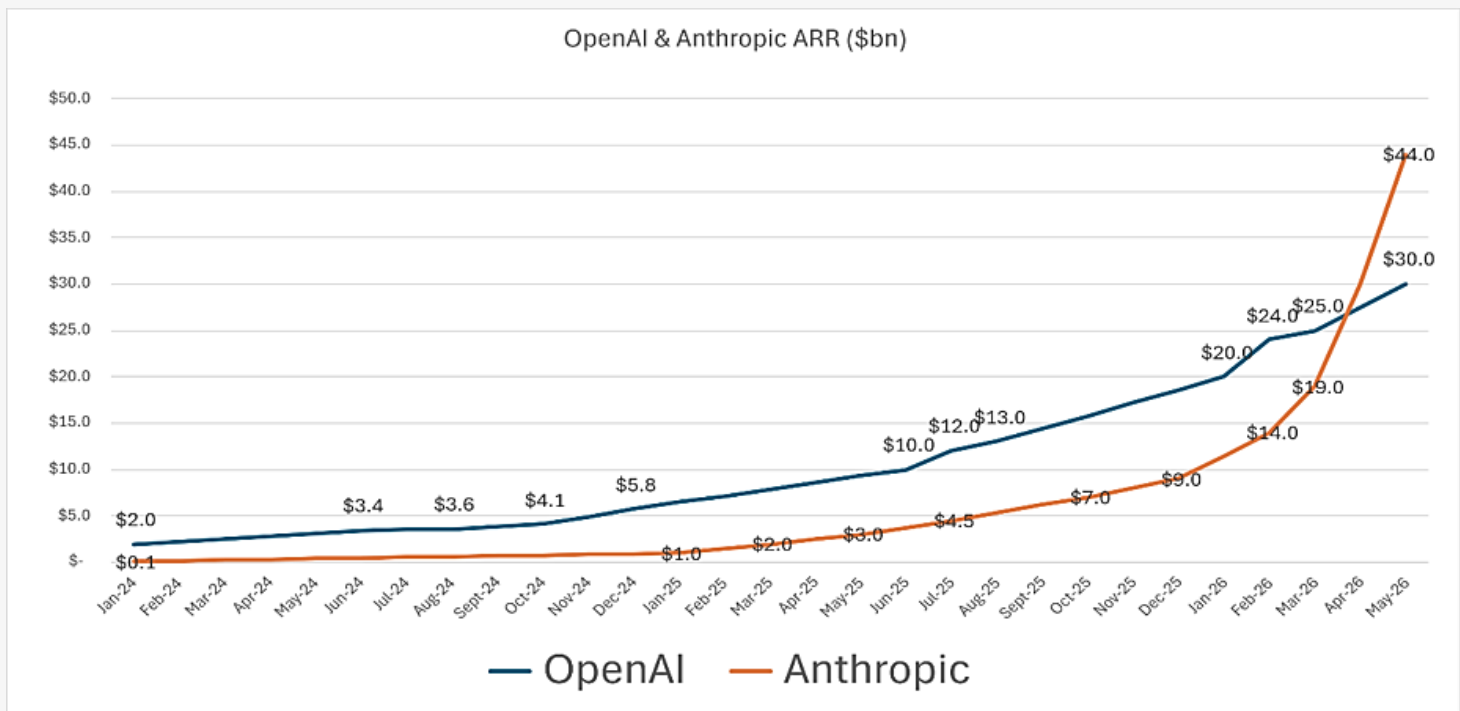


Figure 2. Anthropic's and OpenAI's annualized run-rates (ARR) are skyrocketing. Source: OpenAI, Anthropic, Financial Times, The Information, The New York Times, Reuters, Epoch AI.

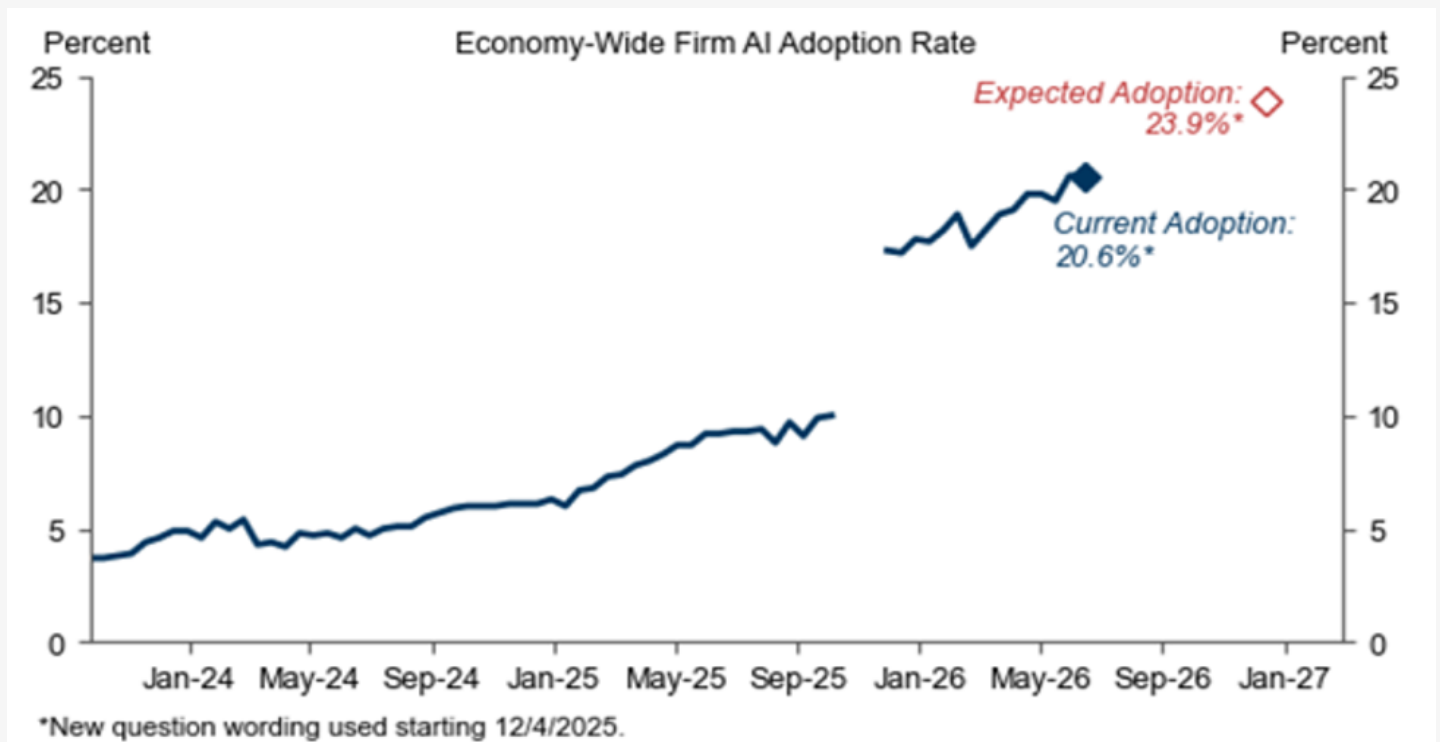


Figure 3. AI adoption continues to rise across industries. Source: Census Bureau, Goldman Sachs Research. The Census Bureau has rephrased its questions from asking about AI use in “producing goods and services” to asking about AI use in “any business functions” starting from the December 4, 2025 release.

Secondly, valuations in the public market are not at all detached from fundamentals and are well-supported by earnings growth. The broad market indices, the MSCI AC World and the S&P 500, are currently trading at fPE of 17.4x/19.9x respectively, underpinned by robust 2026–2027 EPS CAGR of +20.4% p.a and +19.1% p.a, alongside record corporate profit margins. Moreover, across the AI value chain, valuations also remain broadly reasonable.

Hyperscalers trade at 13.4x fEV/EBITDA, close to -1sd of their 10-year range:

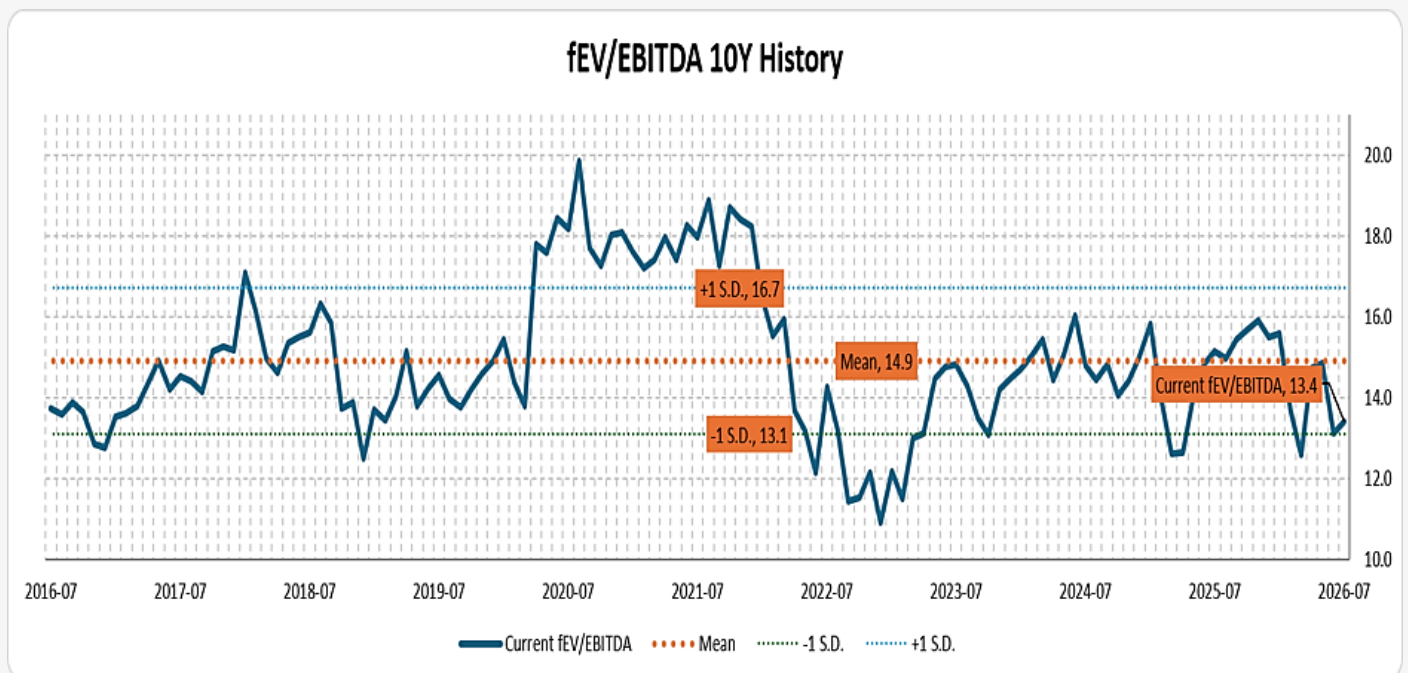


Figure 4. Hyperscalers' valuations (fEV/EBITDA) - 10-year range. Source: Visible Alpha, Covenant Capital.

Chipmakers trade at 24.6x, broadly in line with historical averages:

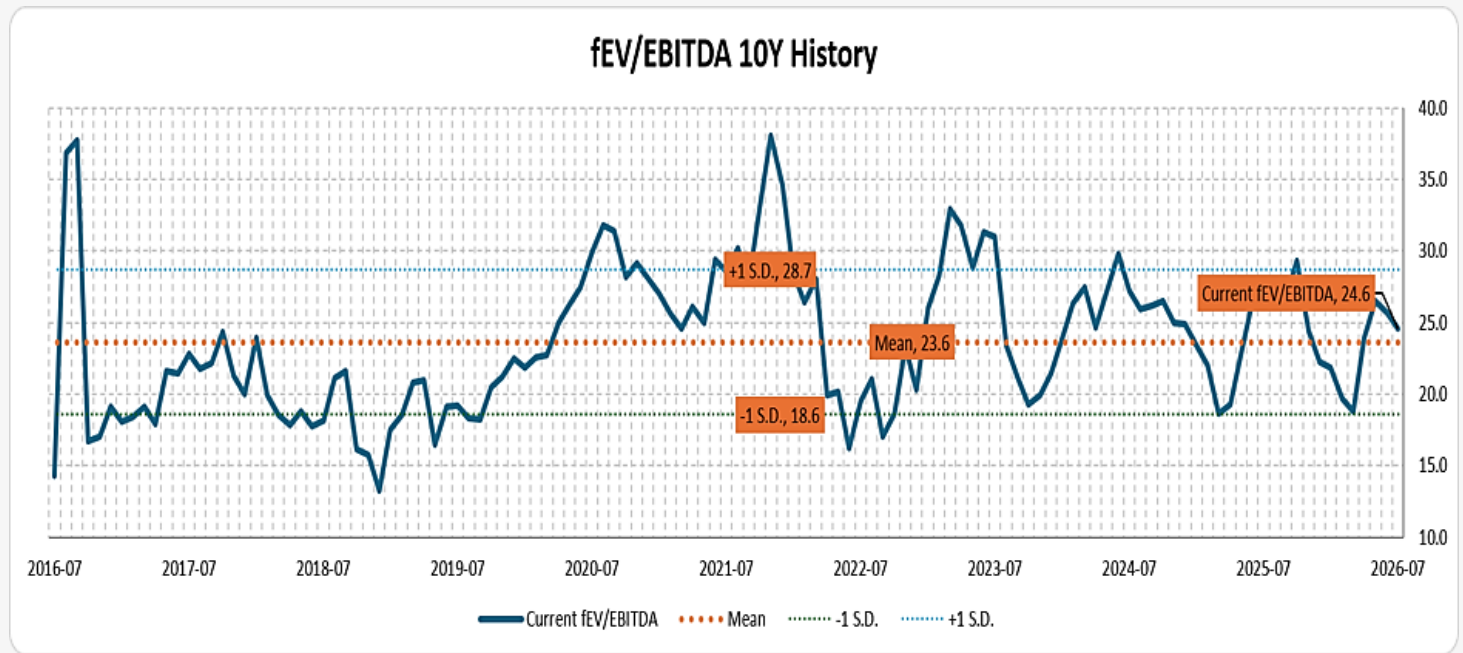


Figure 5. Chipmakers' valuations (fEV/EBITDA) - 10-year range. Source: Visible Alpha, Covenant Capital.

While memory companies trade at only 4.8x, modestly above their long-term average:

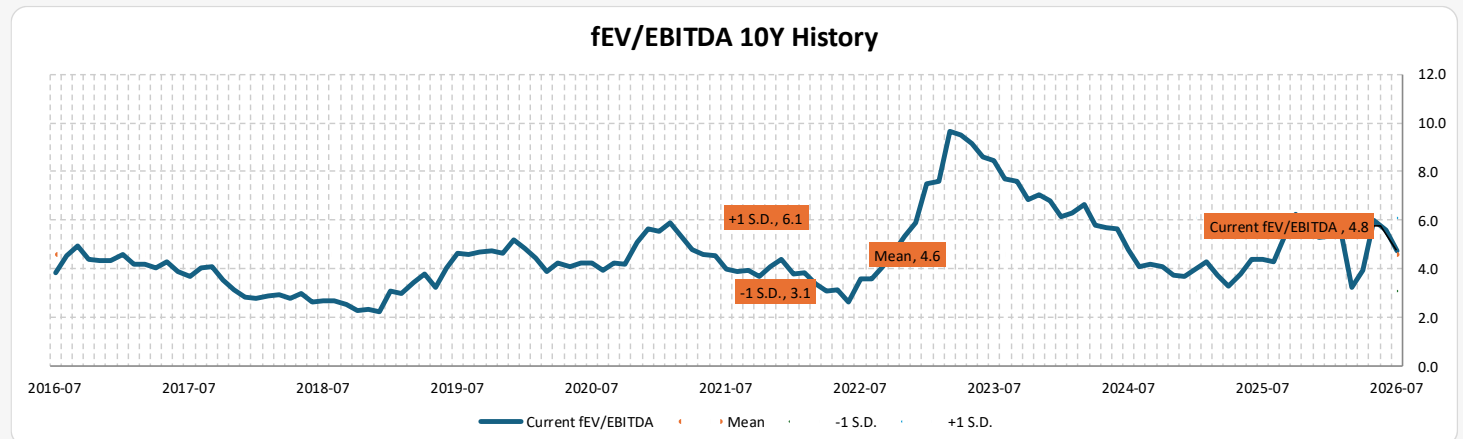


Figure 6. Memory's valuations (fEV/EBITDA) - 10-year range. Source: Visible Alpha, Covenant Capital.

The only segment where valuations appear relatively elevated is the pure-play networking and optical companies, reflecting emerging demands from datacenter's scale-across, accelerating adoption of silicon photonics (SiPh) and co-packaged optics (CPO), as well as hyper-growth experienced by several industry leaders:

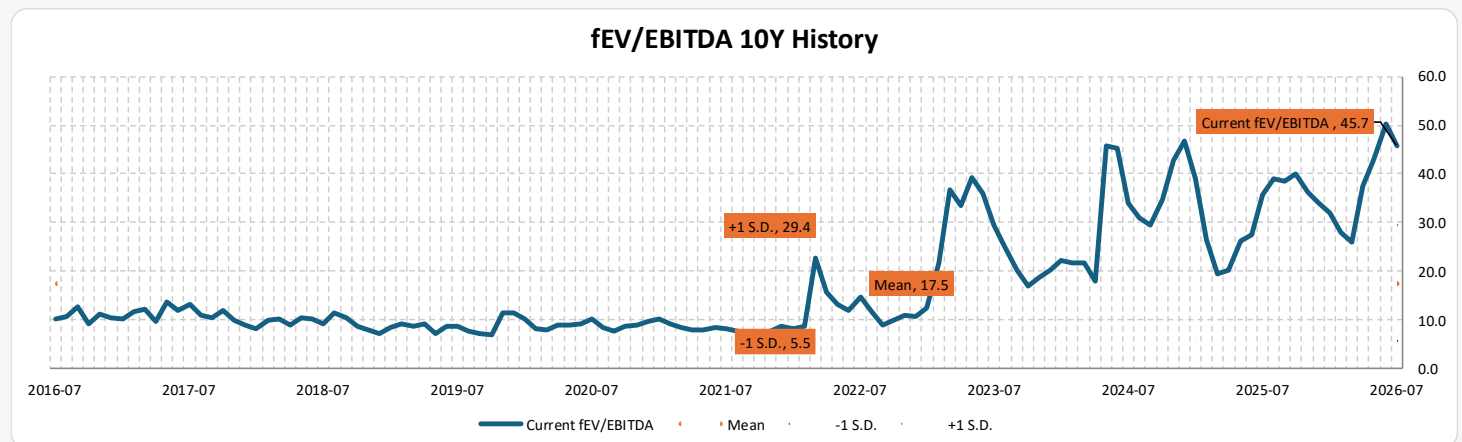


Figure 7. Networking/optical's valuations (fEV/EBITDA) - 10-year range. Source: Visible Alpha, Covenant Capital.

Secondly, we have previously argued that valuations in the private market have been frothier compared to the public market. As a new wave of AI-related IPOs, from SpaceX to anticipated listings of OpenAI and Anthropic, draws closer, investors have questioned the implications for public market valuations. Our view is that the valuation premium currently enjoyed by many private companies is more likely to compress after listing, converging towards the valuation multiples of established public peers, much like what Cerebras and Coreweave have experienced. So far, we have observed no significant shake-ups in the public market post these IPOs.



Figure 8. Coreweave's valuation (fEV/sales) has fallen post-IPO. Source: Bloomberg.

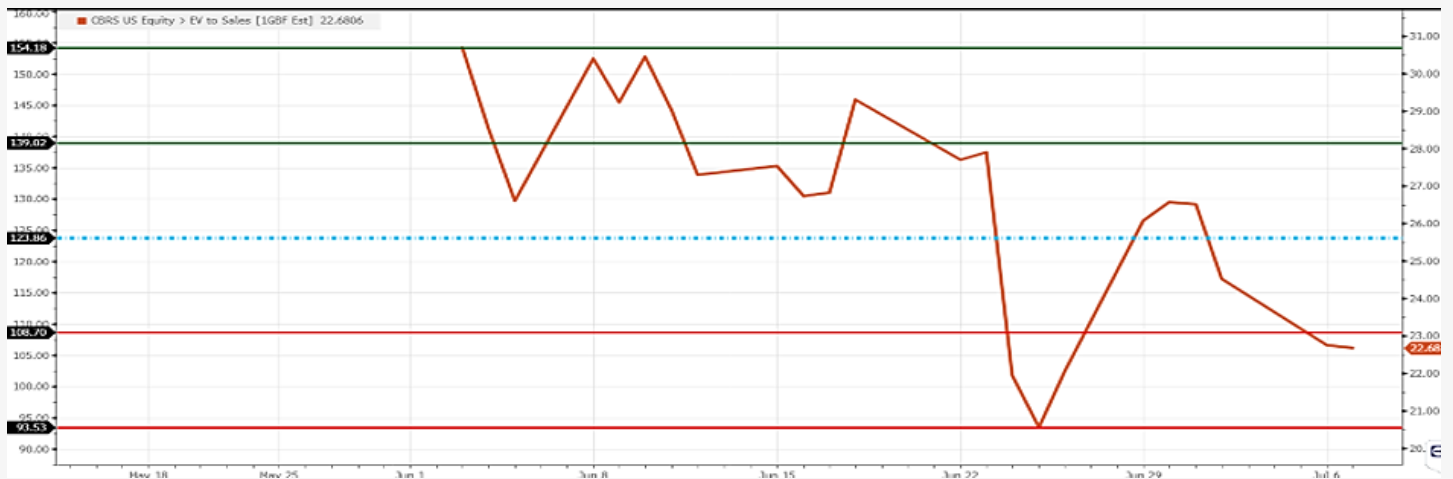


Figure 9. Cerebras's declining valuation (fEV/Sales) post-IPO. Source: Bloomberg.

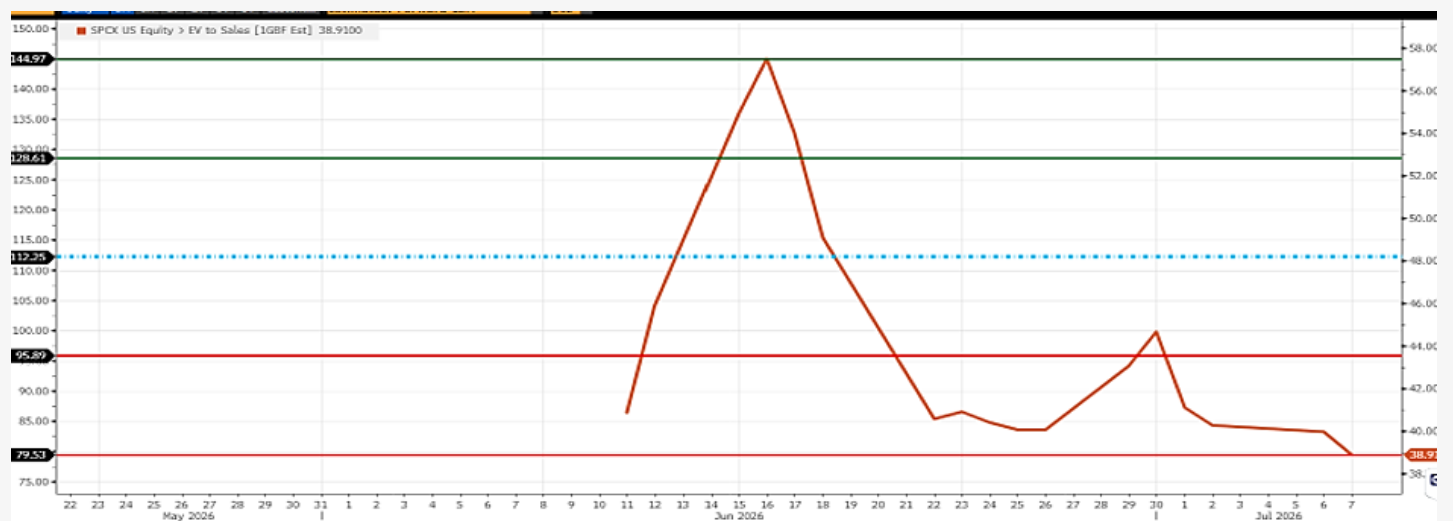


Figure 10. SpaceX's valuation (fEV/Sales) post-IPO. Source: Bloomberg.

Nevertheless, while “fundamental momentum” remains robust for our AI pick-and-shovel names, investors should not rule out meaningful reversals in “price momentum”, induced by the unwinding of crowded trades, macro noise, and persistent concerns about AI CapEx and ROI. History reminds us that even during periods of robust earnings growth, both the Semiconductor Index (SOX) and the Nasdaq have experienced drawdowns of 20-40% or more. The below figure shows that the Tech-heavy Nasdaq index often experiences large pullbacks in the last 10 years.





Figure 11. The Nasdaq index's major corrections from 2016. Source: Bloomberg.

However, with the exception of the Covid-induced selloff in 2020 and the Fed's tightening cycle in 2022 during which forward EPS declined by -11% and -12%, respectively, most other corrections saw stable earnings.

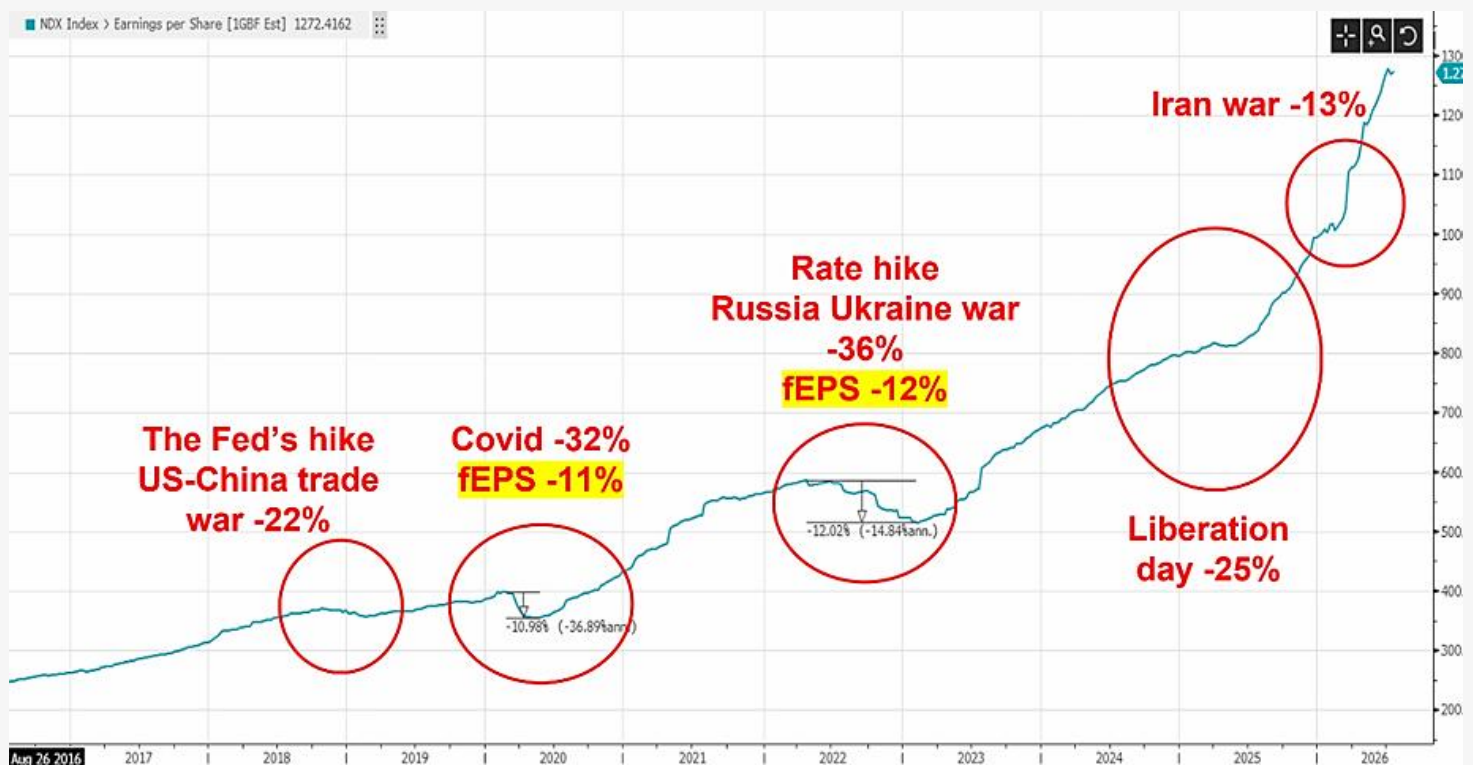


Figure 12. The Nasdaq index's forward EPS trend line. Source: Bloomberg.

Such volatility is a normal feature of secular growth investing rather than evidence of a broken investment thesis. This is a reminder for us to stay selective in our stock picks, focus on owning high-quality businesses with durable competitive advantages, maintain discipline around valuations and target prices, and actively adjust position sizing to manage downside risk.

Another key driver of the equity markets this quarter was the robust corporate earnings. The S&P 500's 1Q26 EPS tracked +28% yoy growth, a significant beat compared to +12% yoy growth expectation pre-earnings season. These results raised the MSCI AC World and S&P 500's FY2026 EPS yoy growth estimates to +24.2%/+23% yoy, respectively, from +13.6%/14% at the beginning of the year.

The main catalyst of earnings upgrades has been the continued surge in hyperscalers' AI CapEx. The 2026 CapEx estimate now stands at ~\$736bn, reflecting a sharp acceleration to +75.6% yoy growth, compared to the expectation of +33% growth earlier in the year.

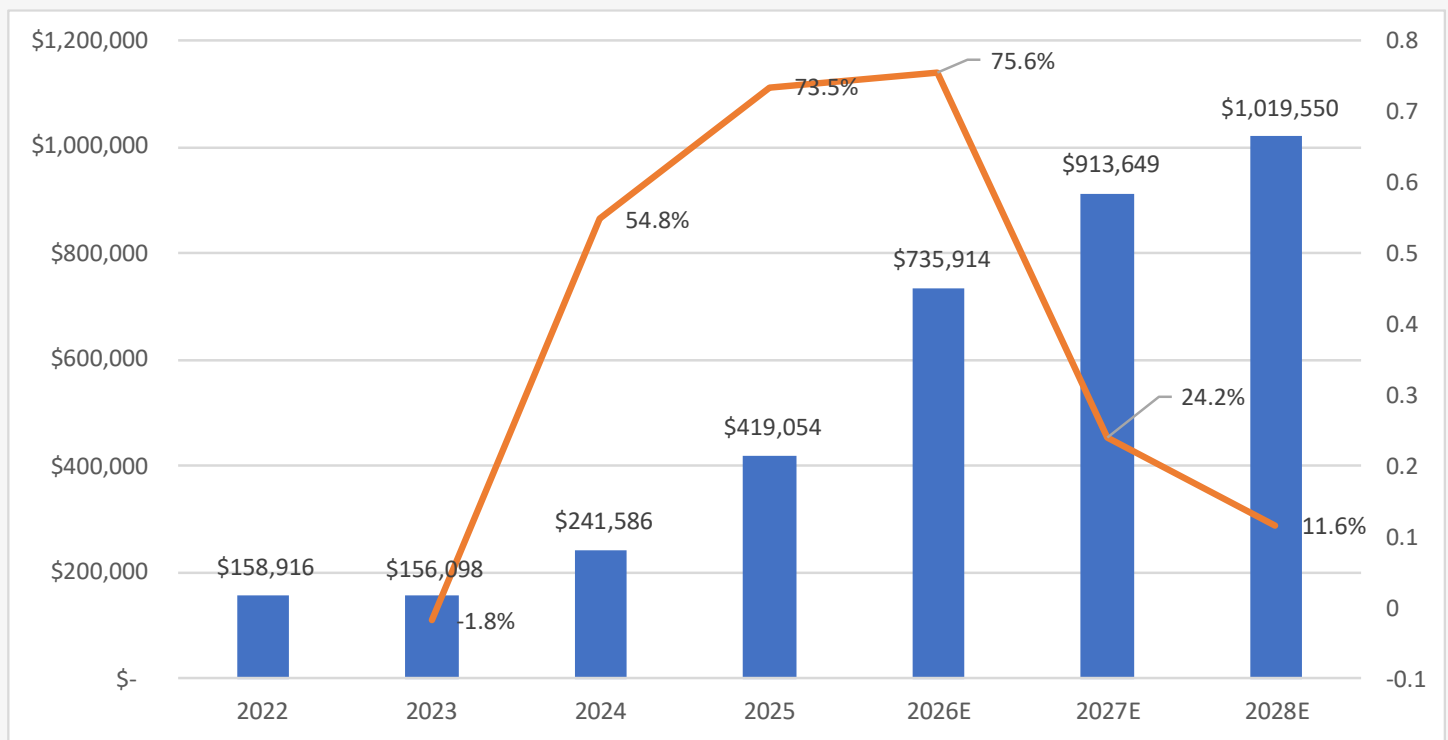


Figure 13. Hyperscalers' CapEx estimates (in \$mn) and yoy growth. Source: Visible Alpha.

One important takeaway from the earnings season is the accelerating growth across hyperscalers' cloud businesses: Alphabet's GCP +63% yoy, Microsoft's Azure +40% yoy, and Amazon's AWS +28% yoy. Additionally, these companies have debunked the market's belief that their margins would compress heavily thanks to AI investments. GCP and AWS delivered 400-600 bps beat on their cloud margins, prompting analysts to upgrade their margin forecast meaningfully.



This trend continues to benefit our infrastructure plays, particularly semiconductor and infrastructure software companies. In the recent years, we have positioned to benefit from AI's “scale-up”, “scale-out” and “scale-across” trends:



Figure 14. From Scale-up & Scale-out to Scale-across. Source: Covenant Capital.

... and across different segments: ASIC chipmakers (Broadcom, Marvell), memory (Micron), semi-equipment (ASML) and networking/optical (Asteria Lab, Lumentum) as the AI CapEx continued to translate into their free cash flow (FCF):

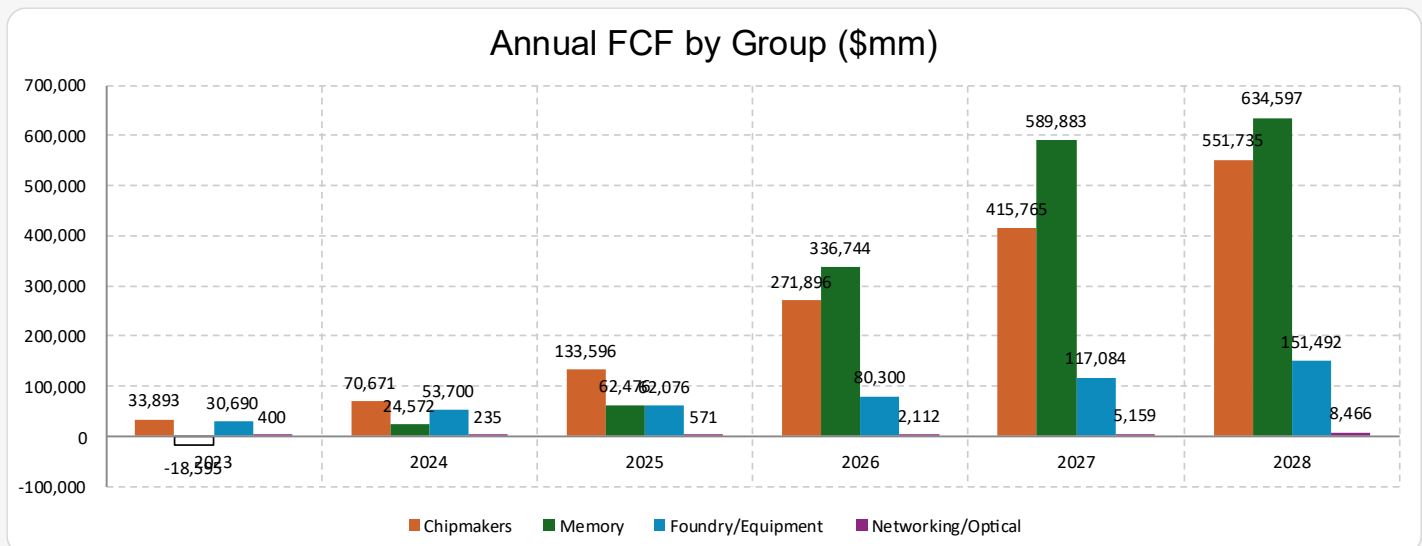


Figure 15. FCF trends across semiconductor's subsegments (in \$mn). 2026, 2027, and 2028 figures are estimates. Source: Visible Alpha.

Nonetheless, we did not maintain exposure to CPUs after closing our AMD and Arm holdings positions in 2025. Given the view that Agentic AI requires 3-5x the CPU cores to GPU ratio compared to traditional AI training, we estimate that the TAM (total addressable market) of AI CPUs could exceed \$125bn by 2030, up from a mere <\$10bn in 2025. In light of this, we have turned more constructive on AMD's prospects.

While we have written extensively about semiconductors in the recent quarters, the sharp rebound in our preferred software holdings also deserves attention. The bearish "SaaS apocalypse" narrative was initially ignited by concerns that AI would replace software seats and disrupt workflow automation, structurally weakening growth across the sector. While this threat remains valid for certain vulnerable incumbents, this quarter's earnings demonstrated the "Jevons Paradox" - the idea that greater efficiency from technological advances will increase, rather than reduce, overall consumption - is indeed taking place. Instead of the expected slowdown and seat contraction, our software companies (Snowflake, Datadog, and MongoDB) showcased clear revenue reacceleration with Snowflake and Datadog's revenues reaccelerating to the "30% growth" band.

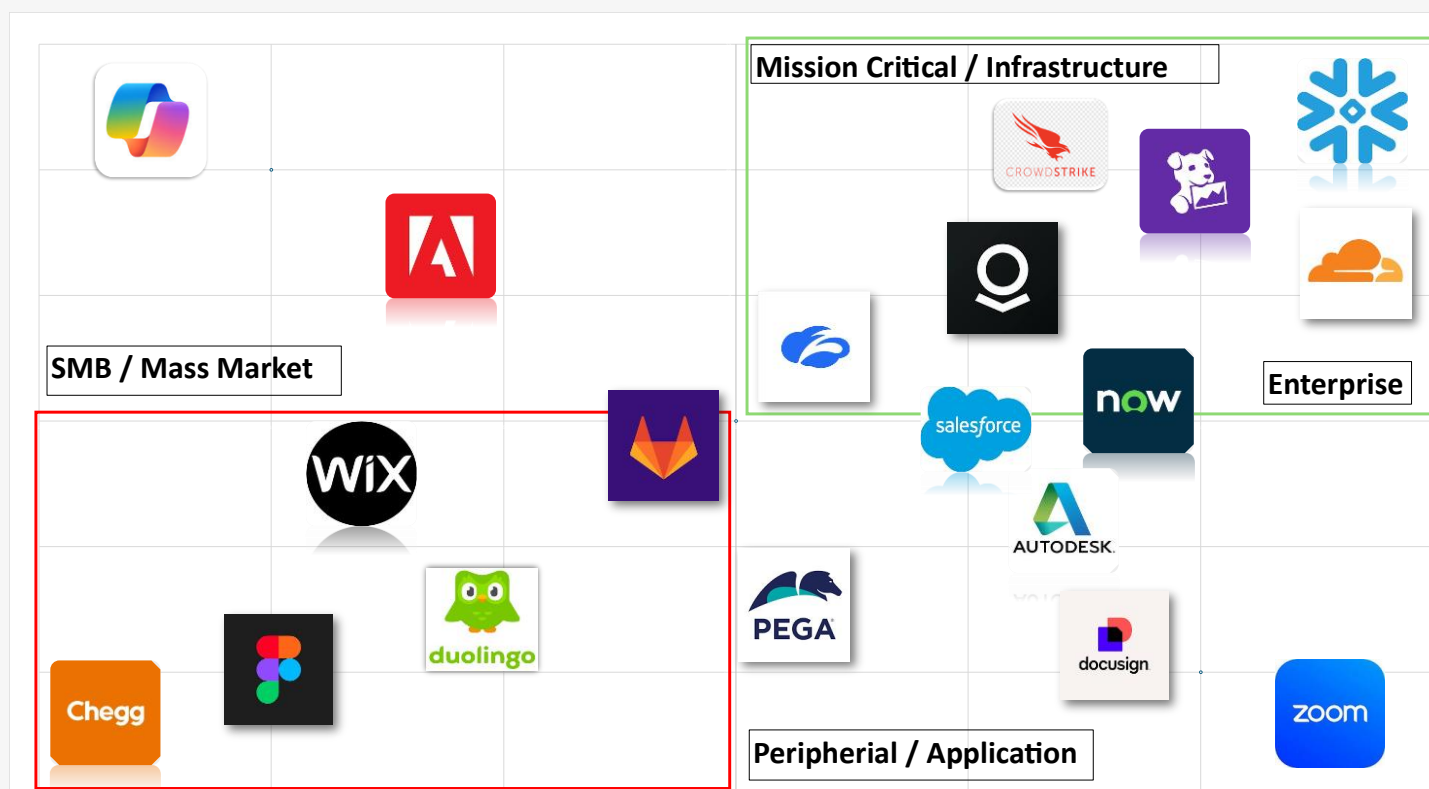


Figure 16. Stock selection in key, as Mission Critical, Infrastructure, and Enterprise software remains our hunting ground. Source: Covenant Capital.

Snowflake was one of the primary casualties of the initial SaaS apocalypse sentiment, weighed down by the market perception that new AI architectures might bypass traditional database management layers entirely. Nonetheless, the company successfully regained the growth momentum of its core business by integrating native Cortex AI capabilities, its suite of fully managed Large Language Models (LLMs) and machine learning tools, directly into the platform. Rather than cannibalizing usage, these AI-driven coding and analytics tools lowered the barrier to entry, spurring greater application development and ultimately driving higher overall data consumption within the Snowflake platform.

As investors, our job is not to predict every market rotation or macro noise, but to identify enduring trends and allocate capital to businesses that compound value over many years. The AI revolution is unlikely to be free of corrections or disappointments, yet the pace of innovation, enterprise adoption, and earnings growth suggests that we remain in the early innings of a much longer journey. By staying anchored to fundamentals rather than sentiment, we believe periods of volatility will continue to present opportunities rather than reasons for a capitulation.

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