

The AI Earnings Lump

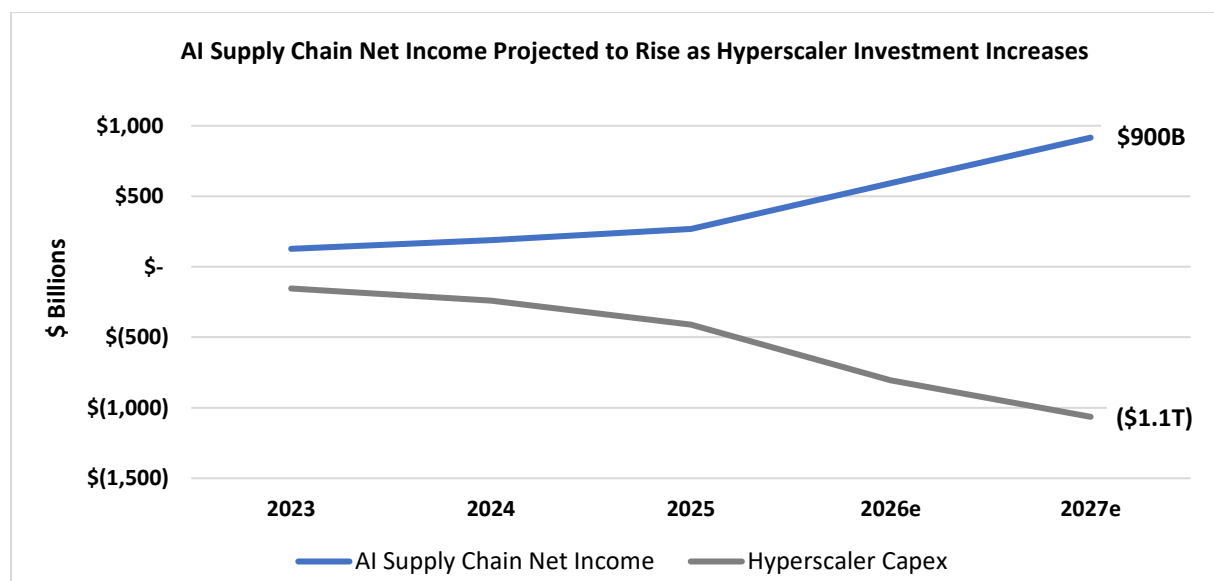
Equity markets settled back into modest gains in the 3rd quarter after their 2nd quarter Gen AI¹ risk-on surge. Rising rates, sovereign debt concerns, and emerging Gen AI skepticism made for a more cautious narrative.

Rising rates are unwelcome news for over-leveraged borrowers, which we are not. Nor do we think rates are high enough systemically to induce a recession just yet. Sovereign debt is a more complicated topic. We will address government finance at some point, but since it does not currently make the Top 5 Worries List for ACR portfolios, we will hold our powder dry for another day. Gen AI skepticism and risks, on the other hand, merit further discussion.

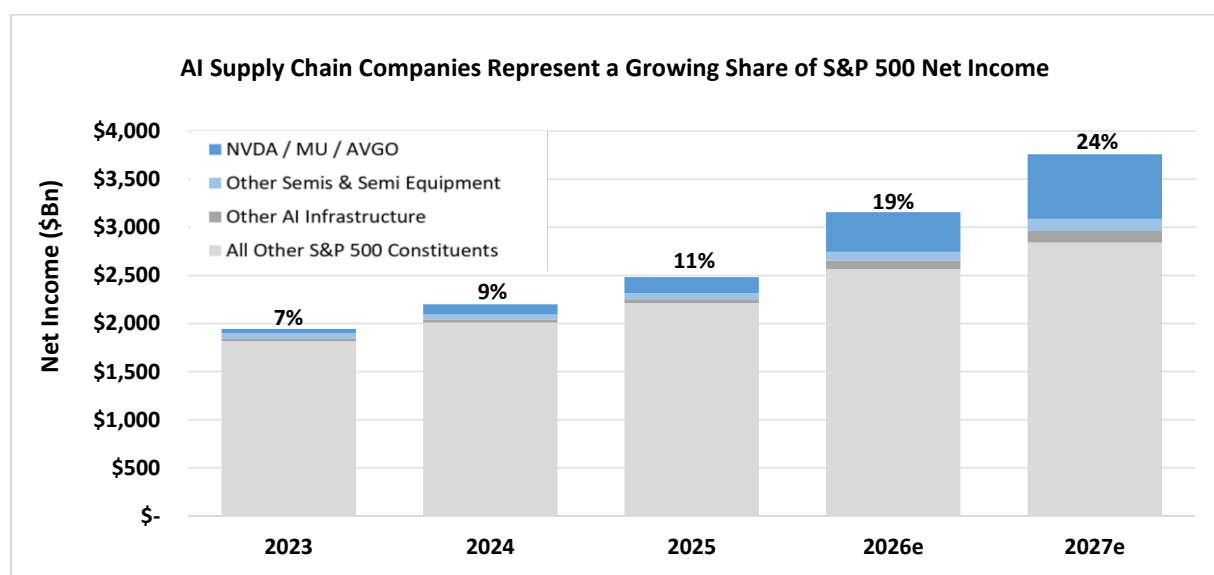
Gen AI may be producing the greatest technology hype cycle ever. The storyline is irresistible. Humankind has finally cracked the code on super-intelligence (defined here as a single source more intelligent than the smartest expert in every field). You can see it with your own two eyes. Punch a query into your favorite Gen AI chat – and voila! – an intelligent response from a subject matter expert appears. Or better yet, type in a few commands and become your own personal software company! And it will only get better. More “compute” *guarantees* greater intelligence. The hype masters are the most compelling aspect of the story. None other than the greatest engineering genius of our age is all-in to the tune of a multi-trillion-dollar valuation, along with a coterie of the richest, most successful technologists in the world. How dare little ‘ole you deign to be skeptical!

For scathing skepticism, you can explore two erudite, well-supported papers on AI by our own James Montier in [Curmudgeon’s Corner](#), with his third and final coming out any day now. The ACR investment team is roundly suspicious of super-intelligence claims, hyper growth forecasts, and fears of mass unemployment. But the story is not black and white. We believe Gen AI is a disruptive technology that will be built into enterprise workflows and consumer products for many years to come. Our hope is for a tailwind to productivity, though it is too soon to say how measurable the gains will be. As revolutionary as the Internet was, pinpointing the timing and level of its productivity gains is still difficult. In addition to cybersecurity risk, the economic risks of the Gen AI buildout are our greatest concern. They include over-building, a recessionary bust, and disappointing return on investment. James addresses these risks in his essays, and we will elaborate on them in our year-end commentary.

In this quarter’s commentary, we highlight how the historic Gen AI buildout is creating a one-time distortion in corporate profits. Our 2nd quarter commentary traced the yawning gap between earnings and free cash flow driven by the Gen AI capital expenditure spending boom. The charts on the following page provide additional context for this unprecedented conversion of costs into earnings.



Source: S&P Capital IQ and ACR Alpine Capital Research. S&P 500 constituents and data as of September 30, 2026. AI Supply Chain is an ACR-defined category consisting of companies in the S&P 500 Index classified by Capital IQ as Semiconductors & Semiconductor Equipment, as well as a select group of AI infrastructure companies identified by ACR Alpine Capital Research, including SanDisk, Dell Technologies, Caterpillar, Western Digital, Amphenol, GE Vernova, Hewlett Packard Enterprise, Eaton, Super Micro Computer, Corning, and Bloom Energy. These companies were selected by ACR Alpine Capital Research to represent a basket of companies outside the Semiconductor & Semiconductor Equipment industry with exposure to AI infrastructure markets, including data center, power, networking, storage, and related end markets. Hyperscalers include Amazon, Alphabet (Google), Microsoft, Meta Platforms, and Oracle.



Source: S&P Capital IQ and ACR Alpine Capital Research. S&P 500 constituents and data as of September 30, 2026. AI Supply Chain is an ACR-defined category consisting of companies classified by Capital IQ as Semiconductors & Semiconductor Equipment and a select group of AI infrastructure companies identified by ACR Alpine Capital Research as listed in the source disclosure above. NVDA, MU, and AVGO are classified within the Semiconductors & Semiconductor Equipment industry and are shown separately to illustrate their contribution to AI Supply Chain earnings.

The top chart shows the relationship between AI capital expenditures and AI supply chain net income. The bottom chart shows the estimated contribution to earnings this and next year. It is an accounting fact that these capital expenditures will become future depreciation charges which will lower reported hyperscaler earnings. Should the capital expenditures boom slow, a future index earnings double whammy would be in store as Gen AI supply chain profits recede. We will explore the consequences of over-building and potential asset write-downs in our year-end commentary.

S&P 500 Earnings Estimates	2026e	2027e
As Reported Earnings	\$3.1T	\$3.5T
Operating Earnings	\$3.2T	\$3.8T
AI Supply Chain Operating Earnings	\$600B	\$900B
Contribution to Operating Earnings	19%	24%
Contribution to Operating Earnings Growth	48%	54%

Source: Capital IQ and ACR Alpine Capital Research. Analysis is based on the S&P 500 constituent set and data as of September 30, 2026. AI Supply Chain is an ACR-defined category as described in the chart source notes. Operating Earnings and As Reported Earnings are based on Cap IQ definitions. Contribution to Operating Earnings represents AI Supply Chain Operating Earnings as a percentage of aggregate S&P 500 Operating Earnings. Contribution to Operating Earnings Growth reflects the percentage of year-over-year S&P 500 Operating Earnings growth attributable to AI Supply Chain Operating Earnings growth.

The table highlights both the Gen AI Supply Chain estimated contribution to earnings and the even more stunning contribution to earnings growth. Included in 2026 As Reported Earnings are an additional \$200 billion of estimated paper profits of firms like Google who have written up their Anthropic investment. If corporate earnings are forecasted to grow without AI, why worry about temporary excess profit growth? There are two reasons. The first is to be mindful of the reversal of these trends and the dynamics this could entail. The second is to understand that even though reported P/E ratios are historically high, they are even higher than shown due to the current temporary distortion in earnings.

This leads us to what we think is the greatest risk for investors – high equity prices relative to sustainable underlying profits. Value investors like us have been crying wolf on valuations for years and have been wrong as cyclically adjusted P/E ratios continue to rise rather than fall. Yet our intent is not to call tops or bottoms. It is to contain a risk while still generating a respectable return. The bad news is the more “wrong” we are in the shorter term, the more painfully right we are likely to be in the longer term. Our goal is to protect ACR clients from such an outcome by maintaining portfolios with vastly different valuation characteristics from the market. The Gen AI boom may extend the secular bull market longer and further than we think, but whether we are in the 5th or 9th inning of this great hype cycle, we will continue managing risk for a day of reckoning while seeking a satisfactory return.

Nick Tompras
October 2026

End Note

1. For clarity, we use “Gen AI” to distinguish the form of artificial intelligence that entered widespread public use with ChatGPT’s release in November 2022. Gen AI models encode patterns learned from training data in statistical parameters and use those patterns to synthesize text, images, or code, rather than simply retrieving stored records or applying explicit rules. Their outputs are newly composed and typically probabilistic, so responses to the same request can vary. Earlier AI and machine learning generally focused on classification, prediction, or optimization, although they also employed statistical methods. We believe many applications require combining Gen AI with verified records and other computational methods to improve reliability which limits Gen AI as a general intelligence tool.

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