CLARITY

A narrowing margin for error

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TIAA Wealth Management

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EXECUTIVE SUMMARY

- **Markets have less room for disappointment:** The AI trade reassessment, emerging credit market stress, and elevated inflation are testing investor conviction, though underlying fundamentals remain resilient and intact.
- **The AI story is recalibrating, not collapsing:** Expect greater dispersion and rotation between well-capitalized hyperscalers and more speculative, debt-heavy players. Long-term demand for compute and inference remains strong, with a substantial runway for broader AI adoption still ahead.
- **Inflation keeps the Fed cautious:** September CPI came in hotter than expected. The Fed held rates steady at its October meeting but maintained a hawkish tone, with a December increase still firmly on the table.
- **Credit and sovereign debt markets show selective stress:** High-yield spreads widened to roughly 330 basis points and French sovereign spreads rose on fiscal concerns, yet broader contagion risk across Europe and credit markets remains low for now.
- **Earnings and consumers remain the stabilizing force:** Q3 S&P 500 earnings growth is tracking between 25% and 30%, and retail sales continue to hold up despite rising rates and prices, though some moderation is expected in coming quarters.



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Over the past several months, investors have been rewarded for looking past emerging risks. Today, however, markets seem to be grappling with a different question: what happens when those risks move from the background to the foreground?

In recent conversations, I've noticed a common thread beneath what remains a generally resilient economic backdrop. Clients, too, are asking more probing questions about the durability of some of the market's biggest assumptions. Is the wave of artificial intelligence (AI)-related investment sustainable? Are credit markets adequately compensating investors for risk? What if inflation proves more persistent than expected? And what happens if interest rates stay higher for longer?

These are not entirely new concerns. What has changed is the degree to which markets are beginning to pay attention to them. Recent weeks have brought a reassessment of several themes that helped support investor confidence, including enthusiasm surrounding AI, the resilience of credit markets, and expectations for lower interest rates. The result has been greater volatility and a more discerning market environment.

Importantly, this is not a story of a weakening economy. Rather, it is a reminder that as valuations rise and optimism becomes more fully priced, the margin for error inevitably narrows. When expectations are high, markets become less forgiving of disappointment.

So where in the markets and economy are those margins beginning to narrow? Several developments stand out.

The AI trade: A reassessment, not a reversal

The reassessment underway is perhaps most visible in AI, a theme that has been among the largest drivers of market enthusiasm, performance, and capital investment over the past several years. Q3 earnings season has been a difficult stretch for big tech so far, and price action has been challenging, though context matters: investors have enjoyed substantial gains from the tech sector over the last few years, and the recent volatility reflects not a breakdown in the long-term outlook for AI-led productivity gains, but a growing scrutiny over the sustainability and cost of the swelling financial commitments required to build out AI infrastructure. That scrutiny has intensified alongside higher interest rates, political backlash, and growing competitive pressure from Chinese AI model developers. Lenders and bond investors are becoming less willing to finance the buildout on easy terms, demanding higher returns or more caution before funding it, and free cash flow concerns for big tech are beginning to emerge, adding to the sense that the cost of the buildout is now being weighed more carefully.

However, as money moves out of tech and semiconductors, investors are shifting into more defensive areas like consumer staples, healthcare, and other select sectors. Because the largest tech companies carry so much weight in market-cap-weighted indexes, their declines are dragging those benchmarks lower. But more value-oriented areas of the equity market have held up better, as capital spreads across more companies. Rising equity volatility has also pushed investors back into high-quality bonds, supported by attractive yields after the steep increase since August. This market environment serves as a reminder of the importance of thoughtful diversification both within (for example, a mix of growth and value stocks) and across (for example, a mix of equities and bonds) asset classes.

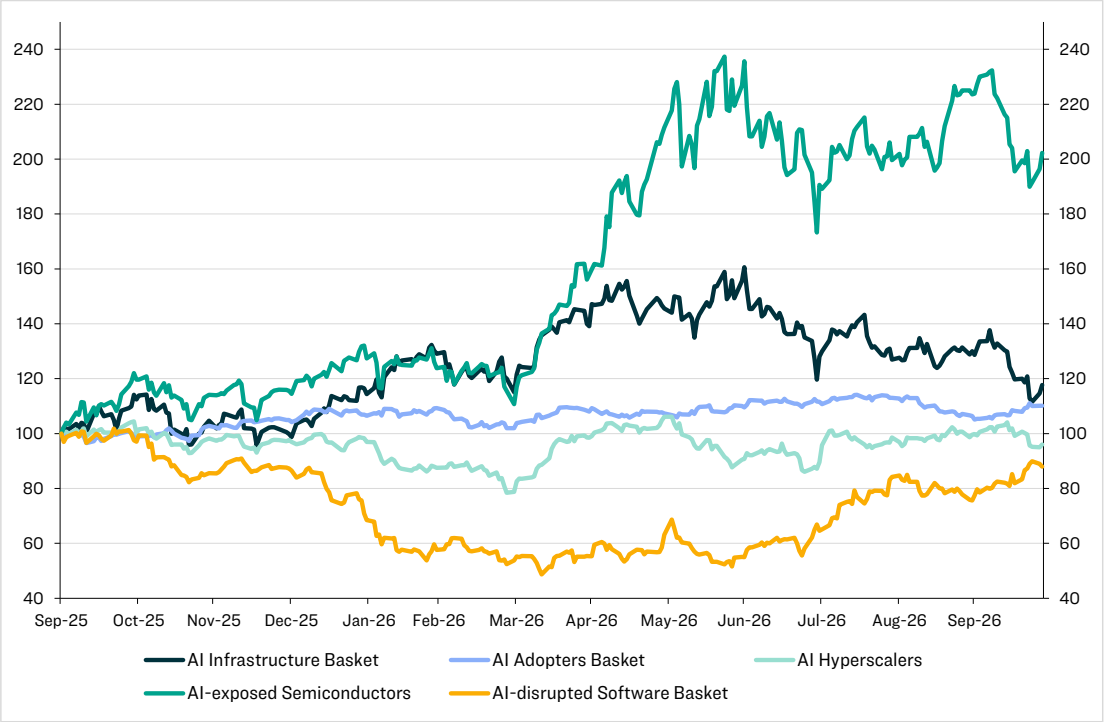
It is worth drawing a distinction between the long-term AI thesis and the near-term fundamentals of individual AI-related companies. These are two different conversations. We can continue to believe that AI will prove transformative for productivity and the broader economy, while also recognizing that not every company riding the AI wave will generate attractive investment returns.

As investors become more selective, performance is increasingly driven by company-specific fundamentals rather than broad enthusiasm for the AI theme (Figure 1). They are increasingly separating companies with durable competitive advantages, sustainable cash flows, and credible paths to returns on capital from those built on riskier, more speculative business models. We expect this next phase of the AI trade to continue with greater dispersion and rotation among winners and losers, along with continued volatility. This dynamic is also showing up in credit markets, where we are seeing a bifurcation between hyperscalers[1] with strong balance sheets and lower-rated, more capital-intensive issuers that are more exposed to rising borrowing costs.

To be clear, we do not view these developments as marking the end of the AI investment cycle. Demand for compute[2] remains robust, and the runway for broader adoption across the economy still looks substantial. But investors' sharper focus on the sustainability of current capex projections and related funding needs is likely to represent a source of periodic volatility until profitability and productivity benefits emerge more distinctively.

FIGURE 1

Investors are increasingly focused on intensifying winners and losers in the AI space (indexed performance).



Source: Bloomberg, UBS Equity Basket, TIAA Wealth Chief Investment Office. Data through 10/27/2026.

The global bond market: Credit stress and sovereign strain

The same shift toward greater scrutiny is also beginning to surface in bond markets. Two distinct but related storylines are currently playing out in global bond markets: a repricing of credit risk tied to the AI buildout and renewed fiscal strain in European sovereign debt. Together, they illustrate how quickly sentiment can shift after an extended period of unusually tight spreads.

For most of this year and last, credit spreads remained historically tight,[3] particularly in high yield bonds. That dynamic has only begun to shift over the past month. High-yield spreads have widened to roughly 325 basis points (bps), about 80 bps above recent lows, while investment-grade spreads sit around 87 bps. By historical standards, both remain relatively contained, but the direction of travel matters. The CCC-rated[4] segment of the high-yield market, the riskiest tier, has climbed to four-year highs in both yields and spreads, reflecting mounting dispersion beneath the surface of an otherwise orderly market.

Credit spreads, which measure the additional yield investors demand to own corporate bonds rather than U.S. Treasuries, can widen for a variety of reasons, often driven by shifts in sentiment rather than a single data point. Three developments could push spreads wider from here that investors should watch:

1. **Continued deterioration in risk sentiment,** particularly as it relates to AI-linked credit, where highly leveraged companies are already feeling the pinch of rising financing costs.

2. **A buyer strike in corporate debt markets,** especially for AI-related debt issuance, which has been a significant source of new supply.

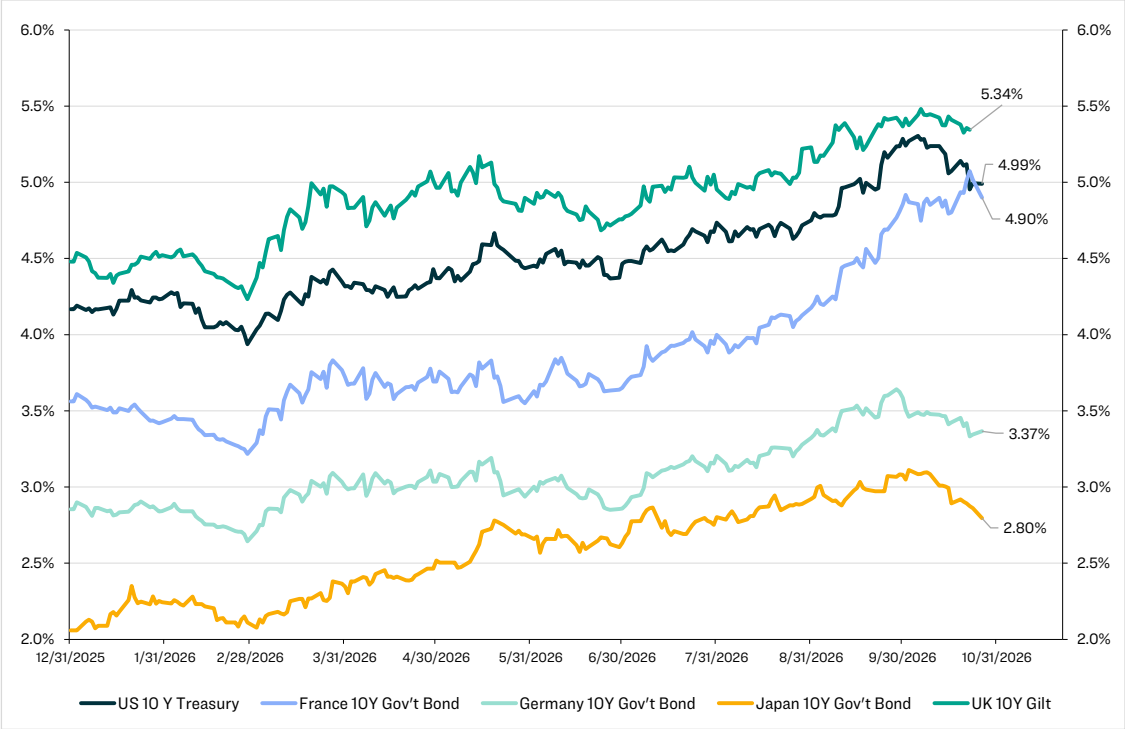
3. **A weakening economic outlook driven by labor market deterioration or a pullback in consumer spending.** Credit spreads often detect stress before it becomes visible in broader economic data, which is why they serve as such an important early indicator for asset allocators.

On the sovereign side, French government debt has come under pressure, driven by concerns about budget deficits and longer-term fiscal sustainability. The question on investors' minds is not really about France in isolation, but whether these fiscal strains could spread to the rest of Europe (Figure 2).

Our view is that a continent-wide sovereign debt crisis remains unlikely for four reasons. First, the European Central Bank retains meaningful tools, including its bond-buying programs, to contain contagion risk. Second, the European banking system—through which the 2011 debt crisis propagated across the old continent—is significantly better capitalization today than it was 15 years ago. Third, political support for countries leaving the Eurozone has declined significantly compared to prior periods of stress. Fourth, the once-prominent discussion around parallel currencies has largely faded from the political conversation.

FIGURE 2

10-year government bond yields (%) have risen year-to-date (YTD).



Source: Bloomberg, TIAA Wealth Chief Investment Office. Data from 12/31/2025 – 10/26/2026.

That said, this situation may take time to resolve, and French spreads could widen further, particularly if a standoff develops between France and the European Union over fiscal policy. At this stage, we view broader European contagion as more of a tail risk to monitor than an imminent threat to the base case.

Viewed together, credit and sovereign debt markets are sending a consistent message: Investors are becoming more discriminating about risk after a prolonged period of complacency, but the broader bond market remains reasonably priced rather than dislocated. There is meaningful dispersion within pockets—CCC-rated issuers domestically and French spreads internationally—but neither has yet translated into the kind of broad-based repricing that would signal a deeper crisis.

The Federal Reserve (Fed) and the inflation problem

Inflation remains investors' primary preoccupation, and for good reason. Recent inflation data has come in hotter than expected: September CPI registered 3.7% year-over-year (YoY), core CPI remains elevated at 2.6% YoY, and producer prices also surprised to the upside.

While it would be a mistake to overreact to a single month of data, the broader message is unambiguous: inflation remains the dominant concern for both markets and the Fed. There is some encouraging news beneath the surface, however. Inflation expectations remain well-anchored, and wage growth has continued to moderate, both of which help limit the risk of a more entrenched inflationary spiral.

The Fed held rates steady at its October meeting while maintaining a hawkish tone and continuing to signal the possibility of a December increase. The key takeaway for investors is straightforward: Interest rates are likely to remain elevated until inflation moves closer to the Fed's comfort zone, or until economic growth begins to normalize.

Earnings and the consumer: Still the counterweight

Balancing these risks is a simple but important fact: corporate earnings remain resilient, and consumers continue to spend. That resilience is a key reason equity markets remain near all-time highs despite the crosscurrents described above.

Third-quarter earnings season is shaping up to deliver another round of strong profit growth, with S&P 500 earnings growth projected in the range of 25% to 30%. But earnings expectations have been revised significantly higher over the past few months, leaving little room for investors to be positively surprised. This has proved especially relevant within the AI and tech ecosystem, where somewhat disappointing results compared to hefty projections have caused substantial volatility. Particularly, investors have frowned upon the ever-rising investment commitments made by large tech companies and their impact on cash flow generation and profitability. This is likely to remain a key theme throughout the ongoing earnings season and beyond, as investors reward companies that show a clearer path towards improving returns on investment and sustainable cash flow dynamics.

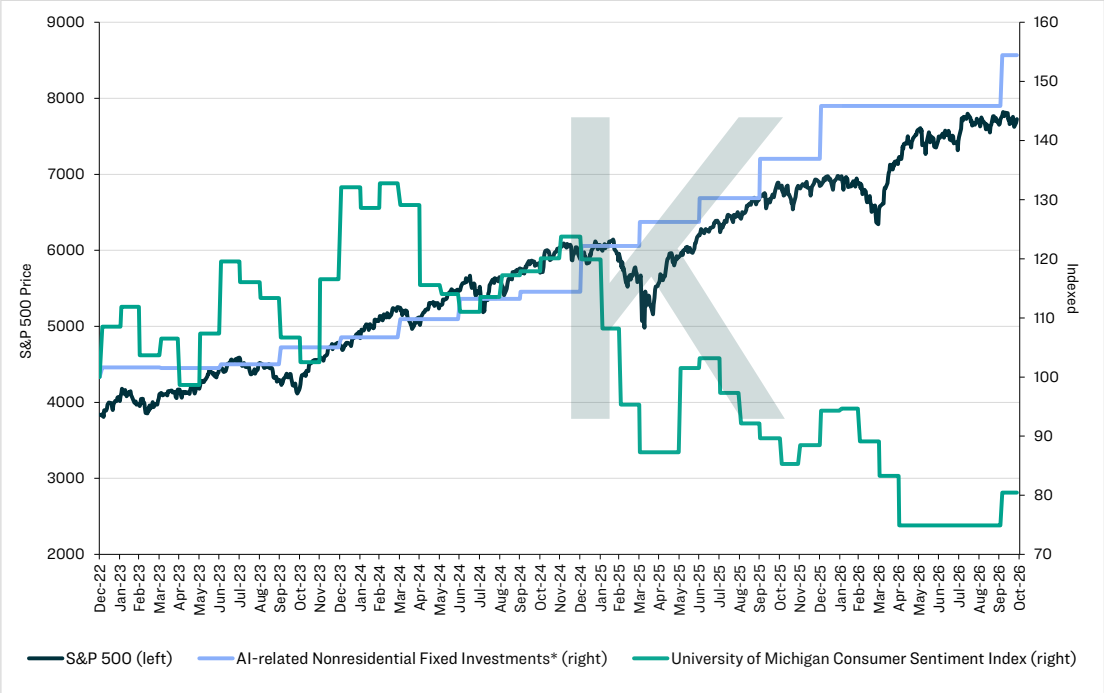
Consumer spending has also held up well. Retail sales rose 0.9% month-over-month (MoM) in September, following a 1.3% MoM gain in August. Some of that increase was tied to energy prices, but the broader picture is one of consumers remaining resilient despite higher borrowing costs and elevated prices.

But for now, it appears we still are in a K-shaped economy (Figure 3). A K-shaped economy describes an environment in which different segments of the economy move in sharply different directions. On one side are high-income households and industries benefiting from the AI-driven

manufacturing boom, supported by strong equity market performance and continued investment in artificial intelligence infrastructure. On the other are small businesses and many low- to middle-income consumers, who continue to face pressure from higher costs, borrowing rates, and weakening consumer sentiment. Looking ahead to 2027, whether this divergence widens or begins to narrow will likely depend on three key factors: the successful transition of AI from heavy infrastructure spending to widespread business adoption, the path of inflation, and the extent to which equity market gains continue to support higher-end consumer spending and confidence.

FIGURE 3

A K-shaped economy implies an economy where wealth and economic growth diverge significantly between high-income and low-income groups.



Source: Bloomberg, Bureau of Economic Analysis, University of Michigan, TIAA Wealth Chief Investment Office. Data through 10/27/2026.

It is likely that broad consumer spending will slow in the coming quarters as prior tax-related benefits fade, financial market volatility weighs on household wealth effects, and the cumulative pressure of higher prices and rates continues to bear on family budgets. However signs of broad-based weakness in consumer spending or corporate earnings that would meaningfully raise our level of concern are not there, but we are watching closely for warning signals emerging from credit markets, bond markets, and equity volatility.

Bottom line

So where does this leave investors? Markets are navigating a more demanding environment than they were just a few months ago, one where inflation refuses to cooperate, the AI trade is being re-examined and re-sorted into winners and losers, and credit investors are starting to ask tougher questions after a long stretch of complacency. Yet, underlying fundamentals remain generally supportive. Corporate earnings are strong, consumers are still spending, and the AI buildout—while facing a more discerning market—shows little sign of losing its long-term momentum, with hyperscalers projecting a further rise in capital expenditures next year.

The real test ahead is whether this remains a healthy recalibration or tips into something more disruptive. We'll be watching a short list of signals closely: credit spreads widening further, consumer spending turning down in earnest, disappointing earnings trends from the hyperscalers,

or inflation expectations breaking loose from their current anchor. Some of these signals like credit spreads and technology earnings have caused investors to recalibrate their risk stance.

We expect the AI trade to evolve in the medium term. The buildout phase has dominated until now but is facing investor skepticism and pushback, given the enormous amount of capital raised and still lack of definitive clarity on returns on this capital. At the same time, investors are beginning to worry once again about the disruptive impact of this technology on traditional business models such as advertising, e-commerce and search, which happen to be core businesses for the hyperscalers. The AI infrastructure buildout will continue because demand is accelerating and the transformative impact of this technology from a consumer, business, economic, national security, and geopolitical perspective is acknowledged and understood. Going forward, spending on AI will likely become more deliberate, focused on specific uses, and developed with time and effort so local communities are brought along. The regulatory environment will begin to take shape including self-regulation by AI developers, industry guardrails, and a framework for some level of information sharing between the U.S. and China on potential dangers. This could slow the pace of spending to more rational levels but not derail the growth and proliferation of the technology.

Endnotes:

[1] A hyperscaler is a company that provides cloud computing, networking, and storage services at a massive, globally distributed scale.

[2] Total computational resources—mainly CPUs, GPUs, TPUs, memory, and storage—used to train and run machine learning models.

[3] "Tight" or narrow spreads mean that corporate bonds are paying only a small amount of extra yield over government bonds.

[4] CCC-rated issuers are companies, sovereigns, or financial entities with debt rated in the CCC category by agencies. This rating sits at the lowest rung of the speculative-grade bond and leveraged loan market and indicates an outsized vulnerability to adverse economic or operational conditions.

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