November 2025

Market Outlook.

Are we in the middle of an AI bubble?

Executive Address

In this month's Market Outlook, the Commonwealth Private Investment Research Team (IRT) addresses topical questions confronting investors across the asset class spectrum.

Outperformance requires not only investors to be directionally correct on fundamentals but to also be correct on how those fundamentals are priced. We firmly believe in the importance of second level thinking when it comes to constructing portfolios. First-level thinking chronicles the obvious response. Second-level thinking considers the second and third order implications of an event.

Here, IRT takes a closer look at debt markets, including the cracks in the short-term US interest rate and private credit markets and whether recent defaults among US auto loans are the sign of systemic issues.

We also delve into the theme of artificial intelligence (AI) from an Australian investor's perspective and consider whether the global equity market is "in the middle of an AI bubble?".

Markets are safest when participants disagree; danger follows when groupthink prevails, and consensus becomes absolute. The search term "AI bubble" has surged online lately, suggesting investors are at least asking the right questions. The path forward won't be linear for AI, and investors can expect setbacks, corrections and bursts of volatility. Each correction will create openings for investors who stay focused on fundamentals rather than news headlines.

As at the end of October, markets are pricing in the successful monetisation of AI at scale for some of the largest global technology companies, which means that any disappointment down the track will trigger sharp repricing. Ultimately, the future returns from AI hinge on the dynamic between enablers (the cloud, software and semiconductor giants) and adopters (the business' deploying these tools). We believe the fortunes of the enablers and the adopters are likely to converge at some point.

This convergence could come from adopters catching up as monetisation takes hold or from enablers catching down if it doesn't. In a scenario whereby AI materially scales out into the broad economy to improve productivity – not all companies will benefit from higher profits.

Two types of adopters will emerge: those with pricing power and strong competitive moats that will use AI to deepen their advantages and expand margins. Those in fiercely competitive markets will also need to spend, but the efficiency gains they achieve will flow straight back to customers in the form of lower prices. Knowing, which is which, and tailoring your investments accordingly will be crucial. For example, automation has been a feature of the global auto industry over the last few decades, with the primary beneficiary being the consumer. Even so, those firms with a competitive advantage (such as a strong brand) will do better.

The world's most admired technology firms will continue to matter, but we think convergence is likely over the next five years as the focus shifts to the tangible benefactors of AI. Gains will depend less on being exposed to technology and more on understanding which companies can convert the promise of artificial intelligence into real productivity.

All this means taking a more active and engaged approach to equity investing specifically focussed on the durability of competitive advantage.

James Foot, Chief Investment Officer
Commonwealth Private

Are we in the middle of an AI bubble?

Key insights

- The current AI boom is underpinned by strong foundations.
- While some valuations appear stretched, strong return on equity, robust Capex, and sustained margin growth support the view that this is not yet a bubble.

The surge in AI investment has invited comparisons to past speculative manias such as the dot-com boom. Every technological revolution follows its own capital cycle. The dotcom boom showed how exuberance can get ahead of economics. While the current AI wave may be better funded and more grounded, the parallels are worth noting.

Global technology leaders notably Microsoft, Alphabet, and Nvidia are committing unprecedented sums to AI infrastructure. In 2024, Amazon, Meta, Microsoft, Alphabet, and Oracle spent $241b in Capex, with industry-wide AI-related Capex projected to exceed US$3trn over the next few years. As with smartphones, it will take time for the full range of applications to emerge, but once they do, the impact will compound quickly. Like most revolutions, when change finally arrives, it tends to happen gradually, then all at once.

AI is already delivering measurable productivity and efficiency gains across industries from faster, more accurate diagnostics in healthcare to enhanced fraud detection and compliance in financial services. In logistics and manufacturing, AI-driven systems are improving supply-chain efficiency, directly lifting margins and reducing costs. While AI has the potential to dramatically reduce drug discovery costs within healthcare and lower underwriting expenses in insurance.

AI is fast becoming the ticket to compete. For companies, it will be essential to survival; for investors, the payoff will be far less uniform. Returns will depend on who captures value, not just who adopts the tools.

Nvidia's quarterly profit rose 56% year-on-year (YoY) in Q2 2025 on soaring AI demand. Microsoft's intelligent cloud segment grew 28%, while Alphabet's AI-driven businesses lifted revenue 34% YoY. Unlike the dot-com era, these firms are generating substantial cash flow and reinvesting it to expand capacity. Microsoft, Alphabet, and other industry leaders are already monetising AI through cloud, productivity, and advertising platforms, while broader sectors such as energy, retail, and transport are embedding AI to enhance performance. This depth of adoption underlines that AI is not speculative hype but a structural force driving long-term economic productivity and corporate earnings growth.

Even so, valuations across AI-linked equities are undeniably rich. As the Financial Times notes, even industry insiders such as Amazon's Jeff Bezos and OpenAI's Sam Altman concede that some froth exists. Goldman Sachs' chief global equity strategist, Peter Oppenheimer, offers a more nuanced view: "Not a bubble... yet." On a 12-month forward price/earnings basis, the "Magnificent Seven" look less stretched than firms during the 2000 tech bubble or Japan's 1989 boom. While the technology sector's price-to-book ratio now exceeds its 2000 peak, return on equity and profit margins are far higher, suggesting valuations are more defensible.

AI will not reshape markets overnight, but neither will it take a generation. Progress will come in bursts – advances, stumbles, adjustments – each bringing new risks and new opportunities. While short-term excesses may emerge, the combination of record Capex, robust earnings, and future productivity gains supports the view that AI represents a long-term structural growth story rather than a fleeting bubble.

For investors, the message is clear: AI may appear frothy, but the foundations are strong, whilst diversification and selectivity will be increasingly vital.

How do investors in Australian equities get exposed to AI?

Key insights

- The Australian equity market doesn't have the mega-cap tech companies directly linked to the AI theme, compared to the US.
- However, investors can still gain exposure through identifying the relevant enablers and adopters on the ASX.
- Active equity managers are better positioned than the passive ones in navigating thematics.

The US equity market, particularly the tech-heavy NASDAQ, has strongly outperformed most of its global peers, including our domestic ASX market. Over the 10 years to the end of September 2025, the annualised total return of the NASDAQ 100 Index was a stellar 20.2%, while our S&P/ASX 200 Index posted only half of that at 10.1%, albeit still a very solid number.

The Australian equity market has a different composition from that in the US, holding more mature businesses with generally slower growth profile, such as Finance and Resources, hence relatively lower returns. However, we argue that ASX listed companies are also exposed to, and expected to benefit from, the AI revolution. We believe AI is poised to be a transformative growth driver for many ASX-listed companies.

As highlighted in the section prior, a company can get exposed to AI as an enabler or adopter, or even both. Nvidia (through GPUs, Graphic Processing Units) is arguably the most successful AI enabler so far, followed by other tech giants, such as Microsoft, Alphabet, Meta, Amazon, which are also investing massively in infrastructure to support the computing power and/or developing AI models.

Data centre demand has seen explosive growth as part of the AI infrastructure. Select ASX-listed companies such as Goodman Group, NextDC, Macquarie Group, also have exposure in different stages of data centre development and operation, in Australia and globally.

The recent news about Macquarie Group selling Aligned Data Centres to a consortium including Nvidia and Microsoft is an example of how an Australian company could play in the AI enabler space. Additionally, to build and power up the fast-growing data centre fleet globally, resources become more critical than otherwise, hence a positive demand boost for Australian mining and energy players.

For the AI enablers to get a return for the invested capital, there must be use cases of AI by a wide range of industries as well as individuals that are willing to pay for the benefits derived from AI. Therefore, AI adopters are the ultimate driver of AI theme over the long run. Given the rapid evolution of AI models and computing power, there's a great uncertainty of its potential economic effect. Early evidence suggests that companies adopting AI are achieving productivity gains and efficiency improvements that can translate into competitive advantage and shareholder returns, while broader economic impacts remain positive and manageable.

There's a wide range of estimates for the productivity gains from AI, both via automation and augmentation of labour, according to a research report by JP Morgan. The report also noted that mid-skill/training roles in services sectors like finance (banks, insurers, etc.), real estate, professional/scientific/technical services, and IT/telcos, are most exposed to AI.

ASX-listed companies are embracing AI. Jobs and Skills Australia's report indicated that 57% of the ASX 200 companies mentioned AI-related investments in their annual reports in 2024, skewed towards the larger-cap companies. Our focus goes beyond mentions of AI. We don't pick stocks only because of a linkage to AI. Rather, we try to understand how the AI trend impacts a company's business model and growth outlook, as well as what has been factored into the share prices. Essentially, we go through a fundamental research process to assess any AI-related investment opportunities and threats, rather than making speculative bets. It's worth noting that our views on AI and its impact on the economy and businesses are evolving with new information becoming available to us.

Active managers, in our view, are better positioned to identify market trends, including the AI theme, given the active research and portfolio management approach.

How concerned should credit and risk markets be about the current strains in short-term US interest rate markets?

Key insights:

- Cracks in short-term US interest rate markets suggesting tighter liquidity, have previously been a pre cursor to credit market weakness.
- The IRT is watching to see if US money market strains persist, weakening credit markets.
- But the Federal Reserve has a track record of stabilising markets and our watchful fixed income managers have confirmed their portfolio settings are appropriate.
- Current conditions aren't in place that indicate these US money market strains, and idiosyncratic HY credit issues or "cockroaches", represent an elevated systemic risk.

Recently observed cracks in the short-term US interest rate markets have signalled a contraction in liquidity in these markets. Curiously, this comes at a time when the US economy and broader risk markets are supportive, and the Federal Reserve (Fed) is easing monetary policy via further rate cuts.

So, what's been happening? In mid-October, the Secured Overnight Funding Rate, being the benchmark short-term borrowing rate in the US, and similar to the Bank Bill Swap Rate (BBSW) in Australia, rose above the Fed Funds Rate. Historically, this is a rare occurrence. Around the same time, in accessing the Fed's short-term lending facility, US banks borrowed the largest amount over a two-day period from this facility since the COVID-19-led market dislocation.

What's driving this phenomenon given broader markets and economic conditions are supportive? Not one single factor seems to be the cause. Rather, IRT's analysis concludes these US money market pressures reflect a combination of factors, namely, the recent increase in issuance of short-dated US Treasury bills, the lower level of reserves held by US banks at the Fed, and the Fed's ongoing quantitative tightening programme (albeit the Fed has now advised that quantitative tightening will cease on 1 December). These elements, combined with emerging, but thus far, idiosyncratic issues in the US regional bank and HY credit sectors, may have also pushed investors to seek more liquidity by accessing the Fed liquidity facilities.

In the past, these US money market anomalies have often been a pre-cursor to material widening in credit margins, noting that indexed investment-grade (IG) USD and EUR credit spreads now stand at 27- and 17-year lows respectively –albeit IG credit spreads in AUD are not as tight. Hence, why we're watching these events closely.

Similarly, as we expect, our recent due diligence meetings with our fixed income managers have confirmed they're also monitoring these issues in the US closely and have either positioned their portfolios more defensively or believe their portfolio settings are already sufficiently defensive, while remaining flexible and selective. This is a key reason why we prefer active fixed income credit management.

If these US funding strains persist and then materially impact global credit markets, the Fed has a demonstrated track record of using key tools to stabilise markets. Already, the Fed has announced the end of quantitative tightening and may well pivot to balance sheet expansion next year and/or the use of repurchase operations to stabilise short-term interest rates. Of course, the Fed retains the ability to further ease cash rates if it deems necessary.

As it stands currently, conditions aren't in place that indicate these US money market and HY credit issues represent an elevated systemic risk. Per the Fed's recent commentary, US economic activity is expanding at a "moderate pace", the US economic outlook is benign (one of the strongest leading indicators of a more significant credit default cycle), and the large US banks continue to exhibit strong profitability and capital levels. This is demonstrated in their most recent quarterly earnings, thereby allowing them to keep pumping the life blood (debt funding) to US consumers and businesses alike.

Taking this further, we would need to observe a reversal of these key elements that then resulted in a larger number of US credit and/or bank problems where the root cause was economic, for us to consider an elevated systemic risk.

Do we have a cockroach problem?

Key insights:

- Questions have been raised whether risks in private credit are rising, as persistent demand drives credit spreads narrower and has the potential to cause underwriting standards to be relaxed.
- On balance, the fundamental credit backdrop appears reasonable, particularly for investors with a medium-to-long-term investment horizon, but not without risk.
- As with all investments, investors need to be risk aware and invest with experienced managers who give proper consideration to managing individual and portfolio risks.

Private credit markets have come back into focus recently, following the collapse of US companies First Brands and Tricolour. This has added scrutiny to a market which is already subject to public discussion as to whether the ongoing expansion of the asset class has led to an increasing risk profile that's not being properly acknowledged by the market.

This concern was framed by JP Morgan's CEO, Jamie Dimon, who observed "when you see one cockroach, there are probably more…" As we've previously discussed, credit spreads across both IG and high-yield markets have compressed to historically tight levels. This includes the predominantly high-yield private credit market.

This can be attributed to three main factors:

1. Demand for private credit investments is growing. Preqin estimates that global private credit market will grow from USD$2.1trn in 2024 to USD$4.5trn by the end of 2030, as investors look to capture the yield-premium to liquid highyield bonds, which may lead to competition for transactions and narrow credit spreads.
2. While there have been periods in recent history which have seen significant deterioration in credit underwriting standards (e.g. prior to the GFC), broadly speaking, underwriting standards have improved significantly since then.
3. We currently have a relatively benign outlook for inflation and corporate operating conditions, essentially meaning that systemic risk is not currently elevated.

This is supported by recent reporting by Moody's which has shown a decrease in bond and loan defaults over 2025 (assessed over rolling 12-month periods). As such, we don't believe the market is currently presenting out-sized systemic risk.

Nevertheless, the collapse of First Brands and Tricolour and the accompanying headlines have caused ripples in private credit markets and are a timely reminder that individual corporate defaults are endemic to high-yield credit investing. When cockroaches are seen in the kitchen, it's a reminder to tidy the house.

We aim to achieve that for our clients by carefully selecting well-resourced credit managers who have deep expertise over multiple credit cycles and can add value by minimising exposure to deteriorating credits (either individual, sector-specific, or broad economic drivers).

Additionally, after a prolonged credit spread tightening cycle, managers continue to face the dilemma as to how to balance between targeting strong near-term returns and managing to their risk objectives. Over time, good long-term performance depends as much on avoiding credit downgrades and defaults as it does on delivering yield over the short term.

Getting this risk reward balance right is one of the key responsibilities of a credit manager. Nevertheless, investors remain wary of the potential for a broad deterioration of credit conditions, as seen by the short-term sell offs in more liquid high-yield and structured credit markets over this year when economic data or policy statements cause outlook uncertainty.

Spreads re-tightened following these spikes, indicating the market's assessment that these markets continue to represent good value. We view this volatility as a reminder that investors are watching carefully and are not blind to risk.

In considering the above, the only certainty is that credit cockroaches will emerge from time to time, whether from poor business practices or poor credit underwriting. Being active and engaged is the key.