OPINION

Three ugly truths that are keeping me up at night these days

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Investors have been funding a lot of their stock purchases with large amounts of margin debt.

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Do you want to know what keeps me up at night? Three things.

First, market exuberance in the face of governments around the world issuing bonds without any plan to raise taxes or cut spending down the road. Second, investor exuberance financing their stock purchases with lots of margin debt. And third, a wave of borrowing by normally debt-free exuberant technology companies investing in artificial intelligence that is spreading massively across private and public debt markets.

Market participants delude themselves in thinking that economic and financial events are "different this time," believing that the relationship of these events to fundamentals has been altered either by technology, financial innovation, government intervention, the rise of emerging economies and so on. They are never different. Markets and the economy gyrate from one extreme position to the next driven by the cycle of overoptimism and overpessimism to which consumers, investors, corporate managers and other market participants are susceptible. Asset prices and the economy always revert to intrinsic value – the value which is driven by fundamentals.

Economies and countries around the world have now reached a wall. Public debt cannot continue to climb in this fashion – especially in times of economic prosperity. Higher debt levels increase the risk of fiscal crises (what if there is a recession?) and hurt economic growth. Public debt must be paid down, and governments know this.

But there is no apparent plan for it.

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One way to bring some sanity to the public debt is to raise taxes. We have heard a lot about the taxation issue recently, but in the opposite direction – namely, that governments are proposing cutting as opposed to raising taxes. Another option to rein in debt is to cut spending – good luck with this. And finally, another option is to fire up the money-printing presses and, in the process, create inflation and reduce public debt in real terms.

For political reasons, the last option may be the most viable and the solution of least resistance. This aligns well with my recent writings on the possibility of high future inflation and a world with slow growth and higher inflation.

For investors this has serious implications. The value of paper currencies will be worth less and holding bonds (except for real return bonds, which are indexed against inflation) and cash in one's portfolio will not make one secure and wealthy.

Stocks will do better, particularly those of companies in good businesses with global reach that have pricing power. And so is gold, which will be a good hedge against adverse short-term events, such as unexpected inflation or geopolitical developments, even though gold has not been historically a good long-term investment.

And while this is unfolding, investors have been funding a lot of their stock purchases with large amounts of margin debt. Margin debt in September in the United States rose by 6.3 per cent or by US$67-billion from August to a record $1.13-trillion. This **total** is more than **than at** any other time in the history of financial markets. And all this at a time when U.S. stock valuations have been hitting all-time highs based on all kind of multiples – higher than in 1929, higher than in 1965, and higher than in 1999 and when the Buffett indicator is now around 220 per cent, higher than even during the dot-com peak. Maybe this is why Warren Buffett, just as he did in the late 1990s near the peak of the dot-com boom, is sitting on huge amounts of cash.

Which brings me to irrational exuberance by AI-related technology companies. Remember the stories of late 1990s that most stocks were not overvalued and only a small, concentrated part of the market was overvalued? This is the narrative right now, too.

The telecom infrastructure in the dot-com era needed to be built out, but at a great cost. Progress was slow and revenues lagged and the whole industry eventually imploded. Lucent and Nortel gave money to customers to buy their equipment, only to face write-offs when bankruptcies hit the industry. Scaringly similar, nowadays, four of Nvidia's customers generated 46 per cent of its sales, while just three accounted for 56 per cent of accounts receivable at the end of July.

It is true that companies nowadays have proven track records of growth and cash flow generation, when in the late 90s this was not the case for most of them. But the other argument that proponents of a bull market put forth – namely, that these companies have solid balance sheets – is questionable.

What we have now is that companies which used to be light on capital expenditures are now becoming heavy on capex and that companies which used to have little or no debt are now heavily indebted. A wave of debt-raising by tech companies investing in AI has been blanketing across the private and public debt markets.

And it is not just on-balance sheet debt; it is also off-balance sheet debt through special purpose vehicles; does anyone remember Enron? Meta, for example, has debt sitting off-balance sheet. Moreover, Morgan Stanley structured, according to Bloomberg, US$30-billion in debt sitting in special purpose vehicles. And this is on top of another US$30-billion debt Meta issued. And Meta is not the only AI-related company that has been doing these kinds of deals. Oracle is in the same boat.

Morgan Stanley estimates that companies like Amazon, Meta, Oracle, Microsoft and Alphabet will need to spend a combined US$2.9-trillion on AI infrastructure by 2028, with US$1.4-trillion coming from debt. Which begs the question: what if these hyperscalers do not earn as much revenue as expected over the next few years? And who is holding all their debt? The lack of transparency of many of these deals has made it difficult for the financial markets to meaningfully assess their potential risks and rewards.

Every cycle looks different until it does not. And so is momentum investing – it works until it does not. As was the case with portfolio insurance, it worked until it did not work in the late 80s. There is little doubt in my mind that a reckoning is nigh. It is unavoidable and the result of investors, the markets and the governments believing that "this time is different."

All this is why I'm having a lot of sleepless nights.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, Western University. His latest book is Value Investing: From Theory to Practice.

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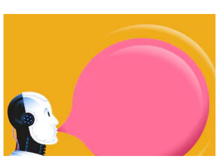

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