

# Economic & Market Outlook

## Executive Summary

- ~ Overseas equities have materially outperformed U.S. stocks recently, and for the first time in years there is a plausible case that relative fundamentals abroad are improving.
- ~ With respect to AI, the market is struggling to price two possibilities at once: that the spending boom is overdone, or that the technology is disruptive enough to reshape software and knowledge work.
- ~ Private credit's recent stress appears relatively benign, but it reinforces our broader concern that direct lending may be less transparent and riskier than the industry has advertised.
- ~ The war in Iran matters because disruption in the Strait of Hormuz threatens a critical energy bottleneck, raising the risk of higher commodity prices, tighter financial conditions, and slower growth.
- ~ Stepping back, the quarter was a reminder that markets are being asked to absorb several major shocks at once, and that the associated volatility is not a malfunction, but the mechanism through which risk gets priced.

## Introduction

On April 1, we hosted a webinar for Annandale clients to share a handful of market observations. The discussion touched on the performance of overseas stocks, the state of AI, AI's impact on software and knowledge work, turmoil in private credit, and, of course, war in Iran. A recording of that webinar is available upon request. Here, we revisit those same topics in slightly more detail, without the constraints of a twenty-minute window. Feel free to skip to whatever topic you find the most interesting. We hope you enjoy the read.

### Topic 1: US vs. the Rest of the World

Before war broke out in Iran, something interesting was happening: overseas stocks were outperforming U.S. stocks by a wide margin. To be specific, overseas stocks were up 11.4% versus 0.7% for U.S. stocks through the first two months of the year. It was the strongest annual start for overseas stocks since 1995, and it came on the heels of 2025, when overseas stocks returned 33.2% compared to 17.9% for the U.S. From the start of 2025 to the outbreak of war, a period of one year and two months, overseas stocks outperformed U.S. stocks by almost thirty percentage points.

*US stock performance relative to the rest of the world (pre-Iran)*



Financial Times

This observation is notable because it may mark a departure from the long-term trend of U.S. market dominance. Of course, only time will tell.

Prior to the Great Financial Crisis (“GFC”), equity market leadership tended to oscillate. The U.S. would enjoy periods of relative outperformance, followed by periods in which overseas stocks led. The market behaved more like a seesaw. After the GFC, that rhythm changed. From year-end 2010 through year-end 2024, U.S. stocks returned 509.7%, or 13.8% compounded annually, compared to 93.7%, or 4.8% compounded annually, for overseas stocks. During this era, the idea of U.S. exceptionalism took hold, and many investors began asking: why invest overseas at all?

*U.S. vs ex-U.S. stock returns over rolling 3 and 5 year periods*



Dimensional Fund Advisors

With the benefit of hindsight, it is not hard to see how we arrived at that point.

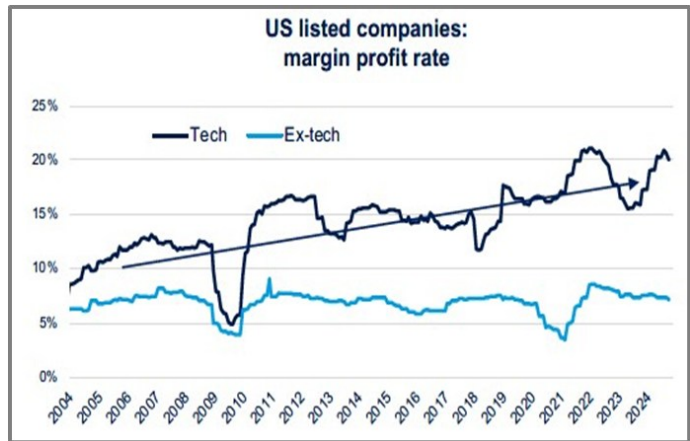
First and foremost, the U.S. equity market fundamentally outperformed its overseas counterparts. Post-GFC, U.S. corporate profitability inflected higher. That improvement was driven by a combination of market dynamism and good, old-fashioned luck. In 2010, the technology sector accounted for only 15.6% of the index. By 2024, it had grown to 30.1%. And that understates the shift, because it excludes businesses like Alphabet and Meta, which are classified as communication services rather than technology. Meanwhile, financials and energy, which once accounted for 16.4% and 11.7% of the index, fell to 12.2% and 3.3%, respectively. Over that period, the U.S. market moved away from lower-growth, lower-margin sectors and toward higher-growth, higher-margin sectors. Absent that mix shift, U.S. corporate profits still would have grown, but it would have been a far cry from the 7.8% annual earnings-per-share growth that was ultimately delivered.

*U.S. earnings with & without tech*



CPRAM, Datastream

*U.S. profit margins with & without tech*



CPRAM, Datastream

<see next page>

Meanwhile, overseas stocks never fully recovered from the damage they sustained during the Great Financial Crisis. From 2010 through 2024, both the United Kingdom and China saw marginally negative earnings growth in U.S. dollar terms. Developed Europe, excluding the United Kingdom, grew earnings at only 1.4% annually in U.S. dollar terms, while Japan, the standout, managed 4.0% annual growth. This should not come as much of a surprise. The period in question includes a material slowdown in the Chinese economy, Europe’s sovereign debt crisis, and years in which parts of the European continent were forced into austerity.

Lastly, the U.S. dollar played an important role, appreciating 36.0%, or 2.2% annually. In local currency terms, overseas earnings growth was better than the U.S. dollar figures suggest. You could add back that 2.2% as a rough proxy, but even then, the results remain a far cry from what we witnessed domestically.

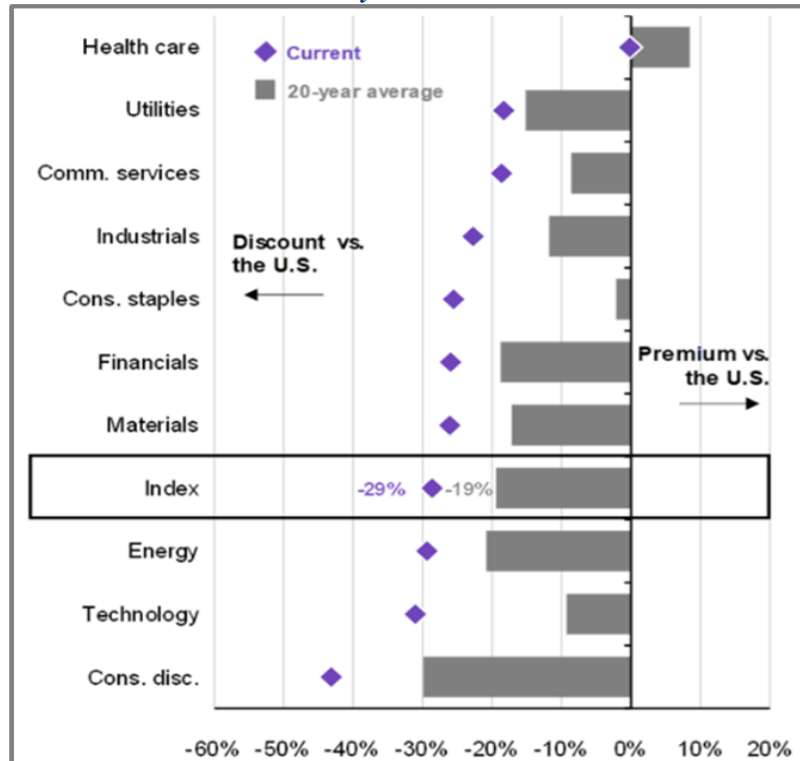
On the back of strong profit growth and rising profitability, investors capitalized U.S. stocks at ever higher valuations. From 2010 through 2025, expanding valuations contributed a whopping 4.0% per year to annual shareholder returns, while valuations abroad moved only marginally higher. By the end of 2024, overseas price-to-earnings multiples sat two standard deviations below their 20-year average. Astute investors will note that the U.S. valuation premium is likely justified, given the U.S. market’s higher level of profitability. We agree. The harder question is how much of that above-average profitability is already reflected in today’s prices. That is difficult to answer with precision, but one point is worth emphasizing: even after normalizing for sector composition, the valuation gap remains quite large. Dan Rasmussen of Verdad Capital tried to dissect this question and found that differences in profitability, measured as gross profits relative to total assets, explained only about one quarter of the valuation disconnect, while simply having a U.S. listing explained nearly half of the gap.

*Post-GFC divergence*



LSEG

*Forward P/E by sector: ex-U.S. to U.S.*



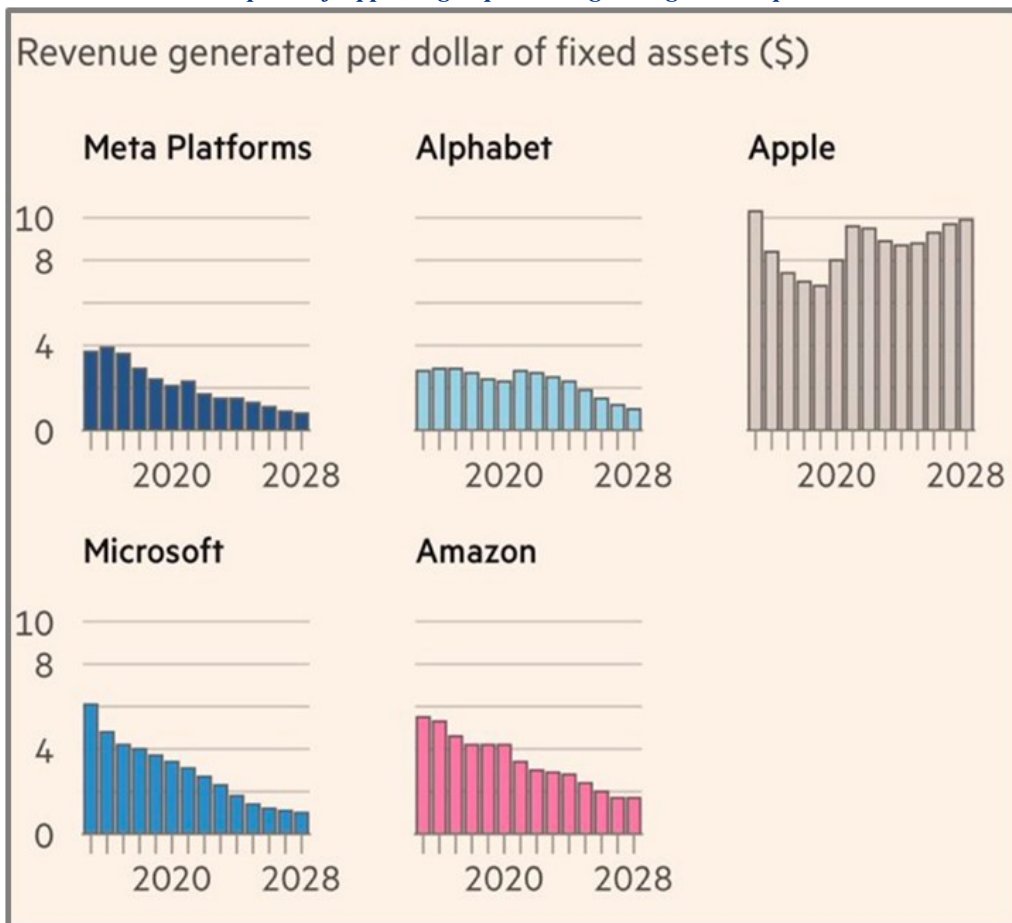
J.P. Morgan

The recent streak in overseas outperformance intrigues us for five reasons. First, it is the first real change in trend since 2010. Second, the change in trend coincides with U.S. equities trading at record valuation premiums relative to overseas stocks. Third, the very business models that drove U.S. earnings growth are now entering a period of uncertainty. Fourth, overseas earnings growth, which has been anemic for years, appears to be improving. Fifth, some of the policy and institutional headwinds that weighed on non-U.S. markets are beginning to ease. We have already covered the first two points, so let us focus on the latter three.

The advent of artificial intelligence is here, but its implications remain uncertain. The market increasingly views AI as both an enabler and a disruptor. Businesses built around selling software, information, and other high-margin services are often viewed as potential AI beneficiaries, but they are also exposed to the risk of disruption. By contrast, more asset-intensive businesses, such as manufacturers, industrials, and certain commodity-linked sectors, are generally viewed as less vulnerable. We will discuss this distinction in more detail later (see Topic 2), but relatively speaking, a greater portion of the S&P 500 is exposed to the perceived threats created by AI than is the case overseas.

This matters because a meaningful portion of America’s excess profitability comes from selling high-margin services and intangible products. Microsoft’s legacy model of selling software subscriptions now sits alongside a much more capital-intensive AI buildout. The same broad question applies to Alphabet’s search business, as well as to other platforms whose economics were built in a less compute-intensive world. Meta, Alphabet, and Microsoft previously enjoyed business models that were extraordinarily asset light. That is becoming less true. Their future revenue growth is increasingly tied to heavy data center spending, and that means more capital intensity. We do not yet know how all of this will shake out, and it would be foolish to overstate the conclusion. But it is fair to ask whether the very business models that propelled U.S. earnings growth over the last decade will be as profitable over the next one. If future revenue dollars require materially more capital to produce, then some portion of the U.S. market’s valuation premium deserves to come under pressure.

*With the exception of Apple, big-cap tech. is growing more capital intensive*



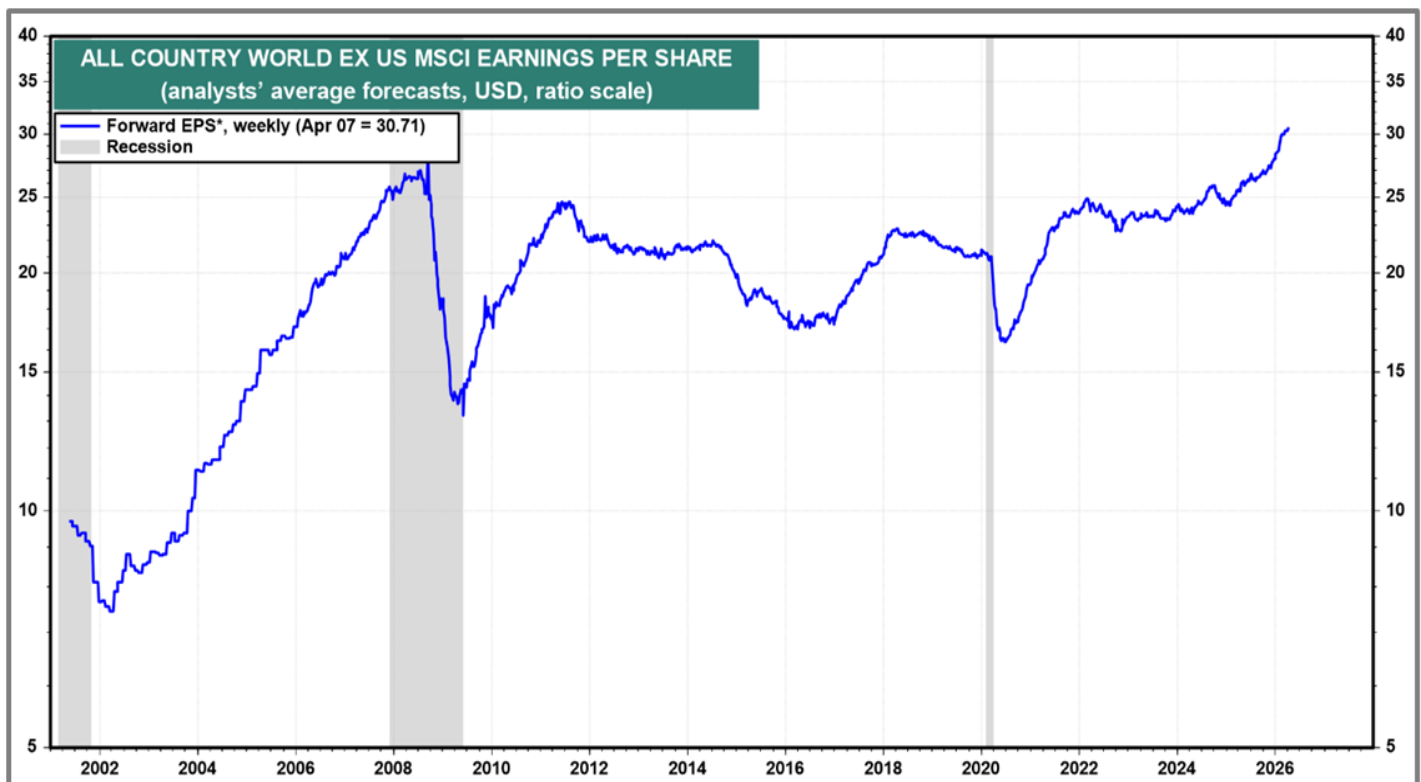
Financial Times

It is easy to dismiss the fundamental case for overseas stocks because the last decade and a half has been so disappointing. But that has not always been the case. From 2003 to 2010, emerging markets grew earnings at a 14.9% annual rate. Excluding China, emerging markets still grew earnings at 14.8% annually, more than twice the pace of the U.S. During that same period, European earnings per share grew at low double-digit rates, while Japan delivered 9.7% annual growth. In other words, there is nothing inherent about overseas markets that condemns them to permanently weak earnings growth. Their recent history has been poor, but it is not the only precedent.

More recently, and in part due to the policies of the Trump administration, we have seen meaningful changes abroad. European and Asian countries are ramping defense spending, a trend that should only be reinforced by instability in Iran and Trump's threats to leave NATO. Following the Draghi report, the European Commission acknowledged the costs imposed by excessive regulation and laid out a five-year roadmap aimed at reducing those burdens. The European banking system is no longer trapped in a zero- or negative-interest-rate environment. Japan, long constrained by a deeply conservative corporate culture, is pressuring companies to release cash hoards and articulate plans to improve profitability. None of these developments guarantee a sustained improvement in earnings, but together, they represent a more constructive backdrop than the one that prevailed for much of the last decade.

Beyond the policy discussion, the actual data has also improved. In Europe, 2026 earnings estimates have turned upward after seven straight months of downgrades. Earnings growth expectations for the European index now sit at 11.5% through 2027. In 2024, the profitability of the European banking sector surpassed that of the U.S. Likewise, earnings estimates for emerging market indices bottomed in mid-2025, and since then they have been steadily revised higher. That improvement has been driven in large part by hardware companies such as Taiwan Semiconductor, Samsung, and SK Hynix, which sit at the center of the AI buildout. On that note, the U.S. has made the strategic decision to throttle China's access to semiconductors and related know-how. As a result, China is investing heavily to build out its own semiconductor design and manufacturing capabilities. Put simply, the case for stronger non-U.S. earnings is no longer based solely on cheap valuations. It is increasingly supported by actual upward revisions, better cyclical data, and, in some regions, genuine policy support.

*Ex-U.S. earnings expectations are finally growing again*



The recent outperformance of overseas stocks could still prove to be a head fake. It is entirely possible that the last decade of U.S. dominance reasserts itself. Maybe the U.S.'s fortunes over the past decade are by design: lower regulatory hurdles, decentralization, and a strong rule of law. But investors who dismiss overseas markets solely because of what happened over the last decade and a half are drawing very strong conclusions from a period that may have been unusually favorable to the United States. Markets and economies are always in flux. For the first time in many years, there is at least a plausible case that relative fundamentals abroad are improving while some of the foundations of U.S. exceptionalism are becoming less certain. We will see.

### A Brief Diatribe

Before we venture into Topics 2, 3, and 4, we want to highlight the behavior of the S&P 500 year to date. The graphic below shows the percentage change in the index, with the white vertical line demarcating the start of the Iran war.

Looking only at the index, you might conclude that the first two months of 2026 were boring, given the market's range-bound behavior as it oscillated between 0% and 2%. Let us assure you they were anything but boring.

Under the surface, there was extreme dispersion and volatility. The continued progression of AI led to steep declines in software and business-services stocks. At the same time, the AI trade fractured, with mixed performance across hyperscalers and more traditional "picks and shovels" plays. Lastly, the private-credit ecosystem was inundated with multiple negative headlines, leading to massive declines in stocks like KKR, Apollo, Blue Owl, Ares, and Blackstone. The negative headlines even infiltrated the banking system to a lesser degree. Despite massive individual stock gyrations, the index held firm, giving the appearance of calm.

Then war broke out in Iran, leading to the closure of the Strait of Hormuz. The index reacted immediately, falling almost 8.0% peak to trough. The market suddenly became correlated, and news about the Strait appeared to be the only topic investors deemed worthy of discussion.

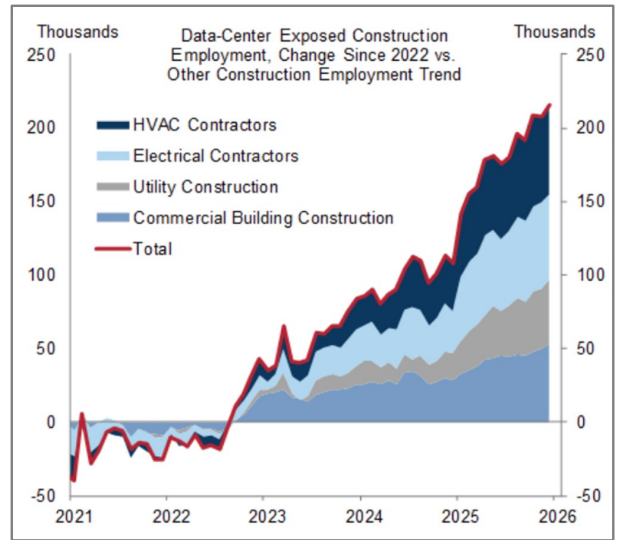
*S&P 500 before and after the onset of conflict (vertical white line)*



**Topic 2: The State of AI, Software, and Knowledge Work**

We have written about the state of AI in numerous commentaries. It is not a subject we can afford to ignore. In 2025, the U.S. spent \$400 billion to \$500 billion on data-center buildouts, about 1.5% of U.S. GDP. That may sound like a small number, but it is not. This level of spending was virtually nonexistent just a few years ago. The data is a quarter stale, but the St. Louis Fed estimates that AI-related investment added 0.97 percentage points to U.S. GDP growth in the first nine months of 2025. Said differently, AI-related investment accounted for almost 40% of U.S. GDP growth over that period. Our hunch is that even this understates the true impact, because it is difficult to capture second-order effects such as incremental power infrastructure and the demand flowing to electricians and other skilled labor. In 2026, Microsoft, Meta, Alphabet, and Amazon alone are projected to spend \$650 billion on capital equipment, equal to 2.1% of U.S. GDP

*Data-center exposed employment*

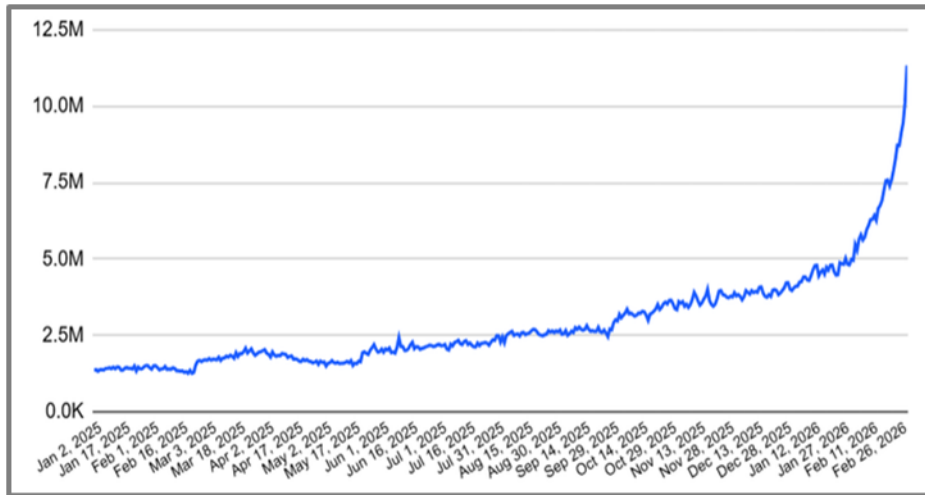


Goldman Sachs

Let’s frame the discussion another way. Consensus earnings growth for Q1 2026 is estimated at 13.2%. The biggest contributor is the Information Technology sector, which is expected to grow earnings by 45.1% year over year and account for 87% of index earnings growth. If you zero in further, semiconductors and semiconductor equipment stocks account for 48% of S&P 500 earnings growth. As noted earlier, the AI trade is much broader than semiconductors. It includes utilities, merchant power providers, electricians, HVAC suppliers, building products, and more. We have seen estimates suggesting that AI data-center buildout is responsible for more than 80% of U.S. earnings growth. The exact number is less important than the conclusion: the trajectory of AI spending has real implications for both the economy and the market.

On that note, a big development occurred in January, commonly referred to as the “Claude moment,” akin to the “ChatGPT moment.” The key shift is that AI stopped being just a chatbot.

*Daily active users of Claude*



Similarweb

Since the launch of ChatGPT, most people’s experience with AI has been conversational. You asked it a question, and it generated a response. More recently, models have been given harnesses that allow them to act. They can write code, inspect files, call outside software, iterate across steps, and take specific actions. Claude Code is one example, and OpenAI’s Codex is another. AI is no longer confined to a chat window.

That matters because the level of initiative required from the user has fallen. Previously, you might ask a chatbot for help writing code so an application could do XYZ, then still have to test the output, determine whether it worked, and diagnose where it had gone wrong. Harnesses reduce much of that friction. The prompt can increasingly be as simple as, “make this application do XYZ.”

Software is the clearest early example, but the implications extend much further. Google reports that more than 25% of all new code is now written by AI and then reviewed by engineers. Microsoft has cited 30%, and Amazon AWS as high as 75%. The New York Times recently ran a piece titled, “The Big Bang: AI Has Created a Code Overload.” We are not programmers, but we are already experimenting with AI to scrape financial data, tailor portfolio reports, and automate parts of our workflow.

*Websites, applications, and code repositories explode after “Claude moment”*



*Financial Times*

This is why the so-called “Claude moment” matters. It was not just another incremental improvement in benchmark scores, but a milestone marking the point at which many people realized models could become agents of production rather than merely conversational assistants. The output is still imperfect. Hallucinations remain. Compliance and security risks are real. But the aperture of economically relevant tasks has widened dramatically, while the initiative required to do something meaningful has fallen.

The hard part is figuring out what all of this means for the markets and the economy.

At a high level, the equity market appears to be wrestling with two different fears at the same time. The first is that infrastructure spending is too high and that the returns on capital will disappoint. In our webinar, we referred to this as the “bubble camp,” one we admittedly sympathize with. The second is that the capital outlay is justified because AI will, in fact, disrupt software and knowledge work in a very meaningful way. During the webinar, we referred to this as the “Citrini camp,” a nod to a dystopian essay that shook markets in late February.

We find it ironic that, during the first quarter, equities in both camps sold off together because the rationales seem mutually exclusive. If AI is really going to displace broad swaths of software and knowledge work, then the returns on data-center spending should be quite good. However, if the returns on data-center infrastructure are poor, then perhaps the threat to software and knowledge work is being overstated. Admittedly, markets do not always resolve contradictions immediately, and for much of this year it appears investors were attempting to price in both outcomes simultaneously. Perhaps there is no contradiction at all. Maybe the value is simply accruing elsewhere in the ecosystem.

*Pre-Iran: hyperscalers (white) & software (blue)*

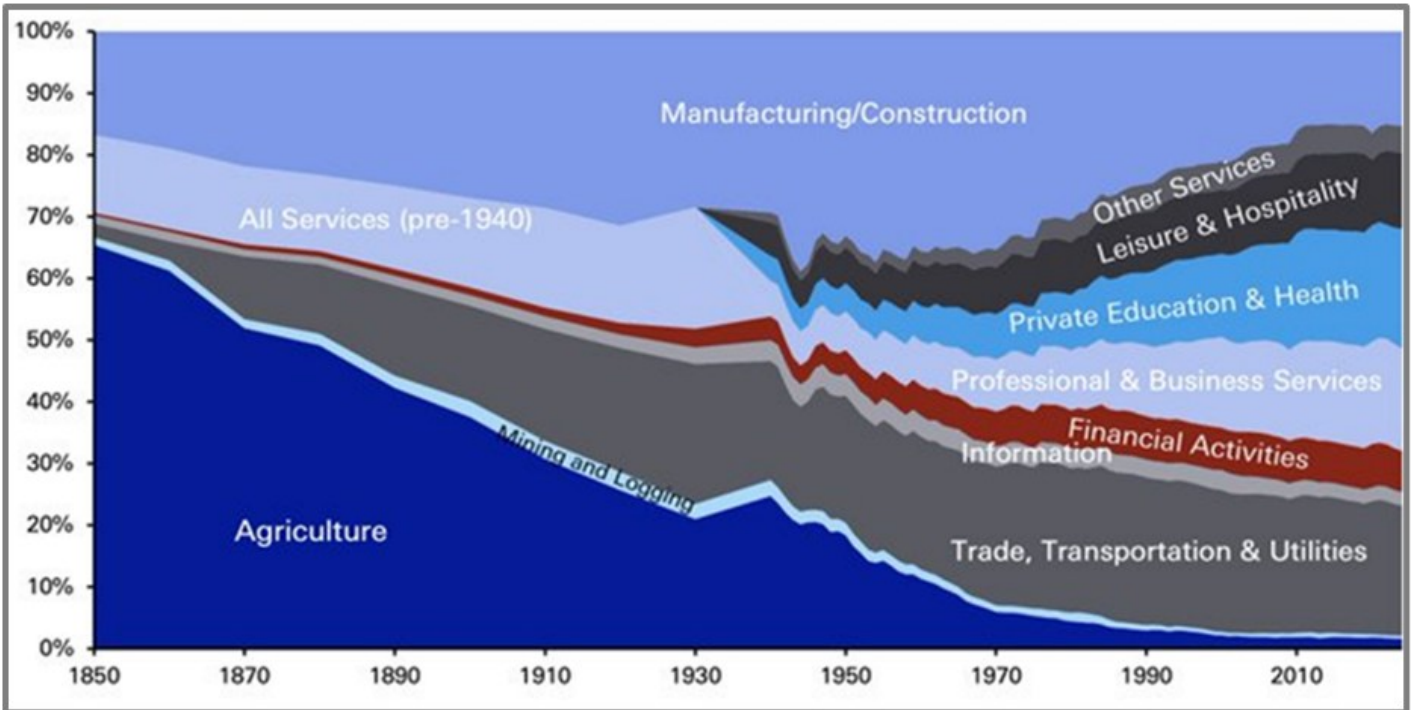


*Annandale Capital*

The idea that either the bubble camp or the Citrini camp could be correct is unsettling.

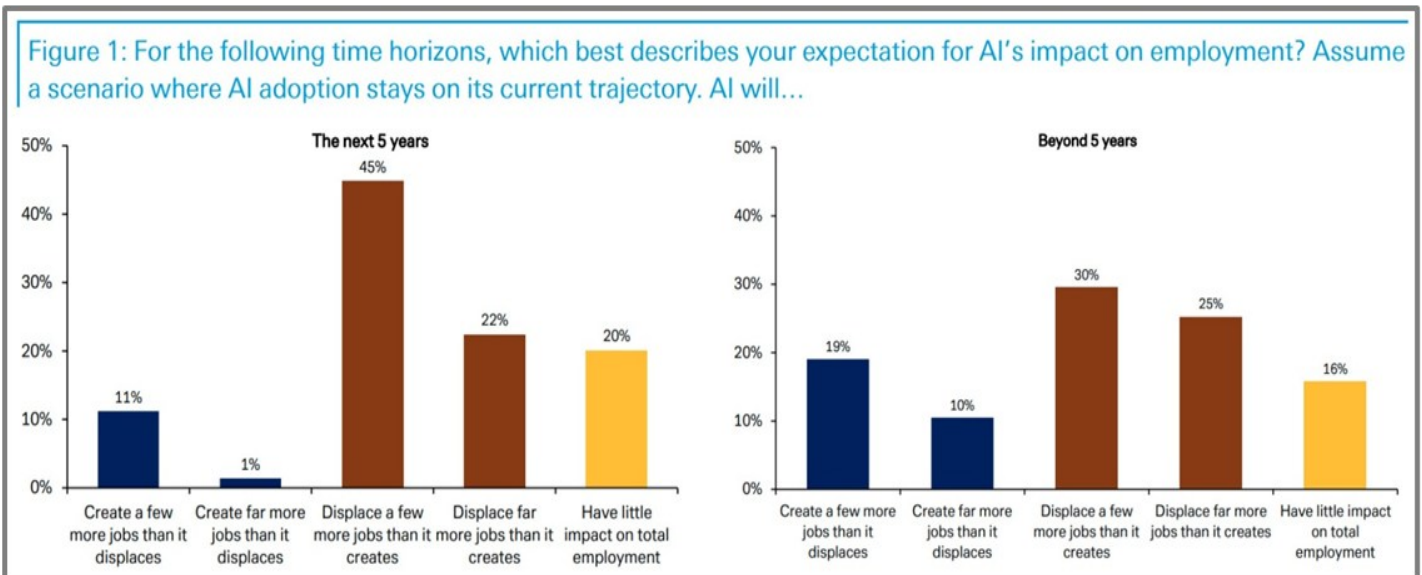
Let's start with the Citrini camp. The impact AI will have on the U.S. labor market is unknown. That said, the U.S. economy is likely to be the epicenter of change. We are not a country that makes things. Instead, we are, to an unusual degree, a country that sells high-margin knowledge work, as discussed in Topic 1: U.S. vs. the Rest of the World. Knowledge work simply refers to people who think for a living, doctors, lawyers, scientists, accountants, consultants, and financial analysts. To that end, the service sector accounts for 77% to 80% of U.S. GDP, and knowledge work, depending on your definition, accounts for 21% to 33% of U.S. jobs. The disparity between GDP contribution and job totals speaks to the profitability of these professions.

*Change in U.S. labor force composition*



Haver Analytics

*A.I. driven job displacement fears consistently show up in surveys*



Deutsche Bank

Software is the clearest early proof point of AI's impact. As stated earlier, Alphabet claims that 25% of all new code at the company is generated by AI. Software is the canary in the coal mine for multiple reasons. There are large code databases to train AI on. Reinforcement learning works especially well within the software ecosystem because you can verify whether the task was executed correctly. And the pioneers of AI happened to be software engineers; it is the language they speak. To date, software fundamentals have not deteriorated, but software stocks have, in anticipation of harder times to come.

*Adobe (ADBE) is valued at \$91 billion, less than 10x this year's expected earnings or free cash flow*

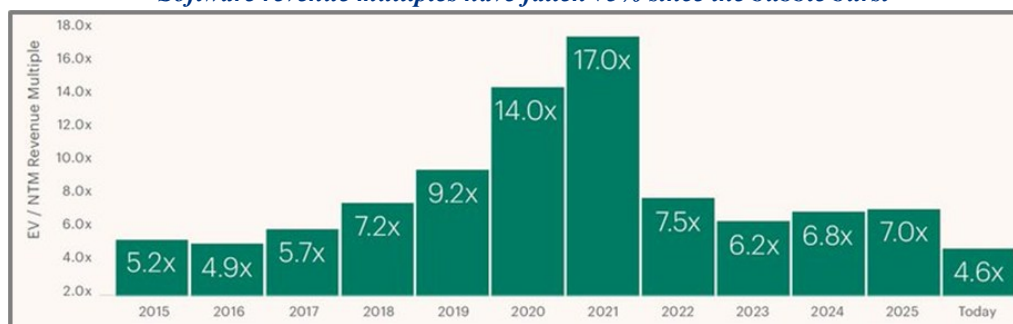
In Millions of USD	2022 Y	2023 Y	2024 Y	2025 Y	Current/LTM	2026 Y Est	2027 Y Est
12 Months Ending	12/02/2022	11/30/2023	11/30/2024	11/28/2025	02/27/2026	11/30/2026	11/30/2027
Market Capitalization	157,786.860	278,009.550	227,525.130	132,213.690	91,086.470		
- Cash & Equivalents	6,096.000	7,842.000	7,886.000	6,595.000	6,890.000		
+ Preferred & Other	0.000	0.000	0.000	0.000	0.000		
+ Total Debt	4,633.000	4,080.000	6,056.000	6,648.000	6,656.000		
Enterprise Value	156,323.860	274,247.550	225,695.130	132,266.690	90,852.470		
Revenue, Adj	17,606.000	19,409.000	21,505.000	23,769.000	24,453.000	26,063.829	28,431.941
Growth %, YoY	11.536	10.241	10.799	10.528	10.963	9.655	9.086
Gross Profit, Adj	15,441.000	17,055.000	19,103.000	21,218.000	21,860.000	23,389.419	25,465.352
Margin %	87.703	87.872	88.831	89.268	89.396	89.739	89.566
EBITDA, Adj	7,101.000	7,799.000	8,767.000	9,617.000	9,737.000	12,267.167	13,348.824
Margin %	40.333	40.182	40.767	40.460	39.819	47.066	46.950
Net Income, Adj	4,797.021	5,544.725	6,387.401	7,095.998	7,236.164	9,481.133	10,385.310
Margin %	27.247	28.568	29.702	29.854	29.592	36.377	36.527
EPS, Adj	10.187	12.074	14.199	16.620	17.240	23.513	26.436
Growth %, YoY	1.945	18.526	17.594	17.056	13.691	41.471	12.431
Cash from Operations	7,838.000	7,302.000	8,056.000	10,031.000	10,507.000		
Capital Expenditures	-442.000	-360.000	-183.000	-179.000	-190.000	-269.231	-316.269
Free Cash Flow	7,396.000	6,942.000	7,873.000	9,852.000	10,317.000	10,431.798	11,336.944

Annandale Capital, Bloomberg

The AI maximalists will argue that, in a post-AI world, enterprises will be able to dispense with expensive software suites and create bespoke solutions that better fit their needs. This argument seems like a stretch, given the costs of maintaining software and ensuring that security and compliance risks are covered. That said, it is hard to imagine the competitive environment for software improving anytime soon, given the ease with which new entrants and incumbent players can launch new applications. Revenue streams may also come under pressure if AI truly reduces the headcount required to accomplish a given task. Lastly, the very platform from which we conduct our business may shift from a legacy software application, like Microsoft Office, to an AI harness, like Claude Code or Cowork.

The timing of the AI scare could not have been more inopportune. As recently as 2021, the software sector was in a bubble or, as Marc Andreessen would put it, software was "eating the world." The bubble imploded during the 2022 hiking cycle, but headcounts across the industry remain bloated. Now software companies are competing with AI model makers for a share of enterprise budgets. A 2026 survey by Redpoint Ventures found that 54% of Chief Information Officers were actively pursuing software-vendor consolidation, and 45% said AI budgets were replacing software budgets. It would not shock us if we saw a wave of layoffs across the software industry under the guise of AI that had little to do with AI at all. Block, Inc.'s 40% to 50% workforce reduction might be one such example.

*Software revenue multiples have fallen 73% since the bubble burst*



Apollo

Prior to war breaking out with Iran, AI disruption fears had erased \$1.6 trillion in market capitalization across the software sector. And the carnage extended well beyond software into service-oriented businesses more broadly. Our hunch is that the Citrini narrative has gone too far. Commercial insurance brokerages like AON and Marsh McLennan fell almost 10% intraday on news that OpenAI had partnered with a home-insurance platform, which seems devoid of rationality. But for now, we appear to be in a “shoot first, ask questions later” market. Below is a montage of charts to help contextualize AI disruption fears beyond the software complex. The performance displayed pre-dates conflict in Iran.

*Visa -14% peak-to-trough*



Annandale Capital, Bloomberg

*S&P Global -31% peak-to-trough*



Annandale Capital, Bloomberg

*Brown & Brown -18% peak-to-trough*



Annandale Capital, Bloomberg

*Nasdaq -22% peak-to-trough*



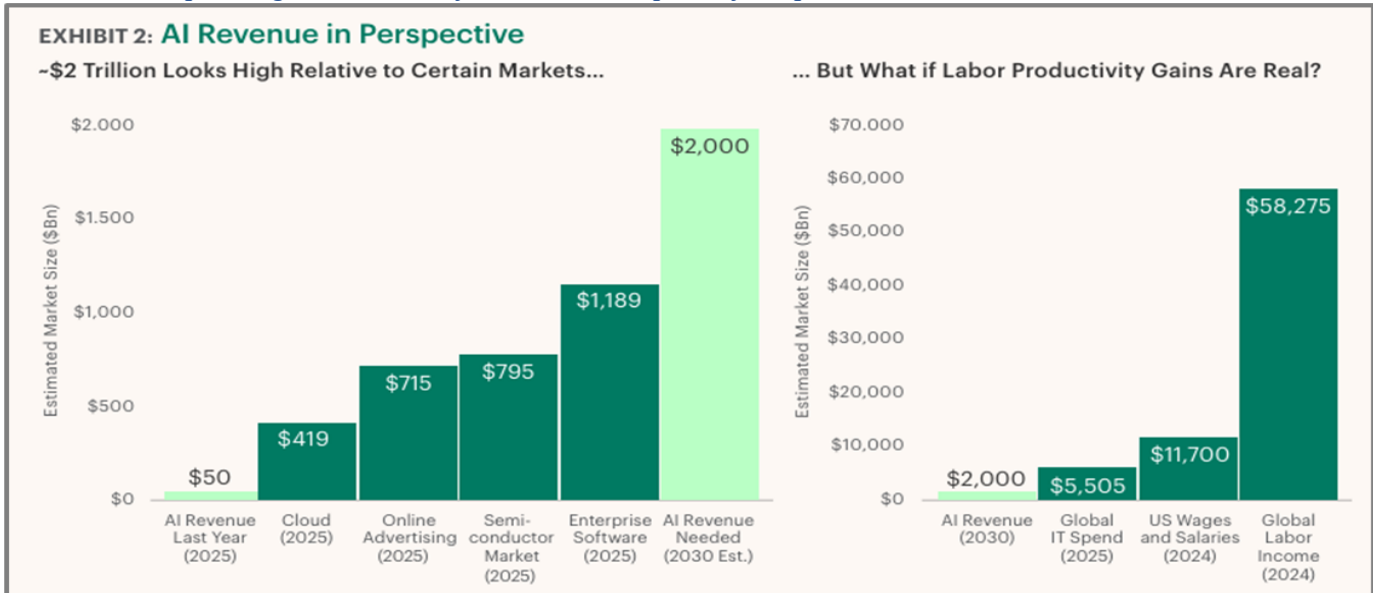
Annandale Capital, Bloomberg

The other side of this debate is the bubble camp, which argues that the revenues generated by AI will not justify the capital spent.

Here are the most recent numbers. For 2026, Amazon plans to spend \$200 billion, with a smaller portion going to its retail division. Alphabet plans to spend \$175 billion to \$185 billion. Meta, \$115 billion to \$135 billion. Microsoft, roughly \$140 billion to \$150 billion. Oracle, \$50 billion. That is about \$700 billion in annual capital spending across the five largest players. Last year, the number was closer to half a trillion. By the end of 2026, cumulative spending on AI data center buildout should fall somewhere between \$1.4 trillion and \$1.7 trillion. By 2030, estimates call for roughly \$3 trillion of cumulative spending in the United States alone. Globally, the figures range from \$4 to \$7 trillion.

Apollo writes, “we estimate that the market is currently expecting \$4 trillion to \$5 trillion of digital infrastructure investment by 2030. For this investment to deliver an acceptable return, we further estimate that annual AI revenue must climb to a range of \$1.5 trillion to \$2.0 trillion by 2030.” Apollo is effectively arguing that every dollar of capital spending needs to generate \$0.40 of annual recurring revenue. Unfortunately, the firm does not disclose its math, but the conclusion makes intuitive sense. If net operating profit after tax (“NOPAT”) margins range from 25% to 35% of revenue, then the return on invested capital would fall between 10% and 14%. For reference, in 2025, Amazon AWS and Google Cloud sported NOPAT margins of 28.0% and 18.7%, respectively. We should caveat that a low-teens return on invested capital would represent a disappointing outcome relative to the hyperscalers’ historical profitability. The bubble camp is not arguing about the efficacy of AI, but rather the plausibility that enough revenue can be generated to justify the capital spent.

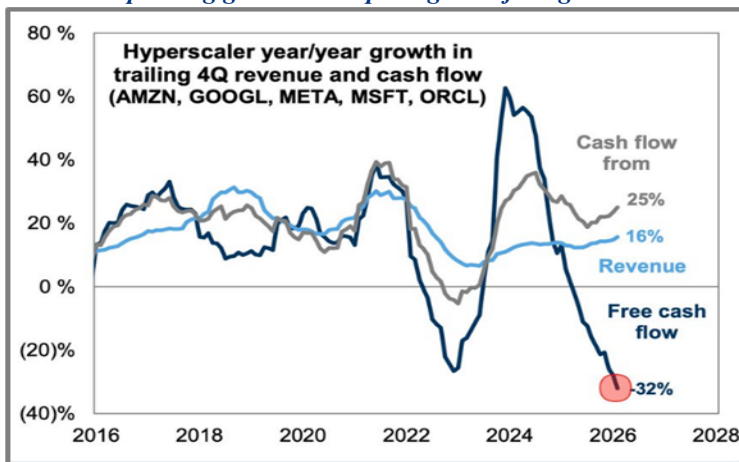
*Apollo argues \$2 trillion of AI revenue is required if we spend \$4 to \$5 trillion on datacenters*



Apollo

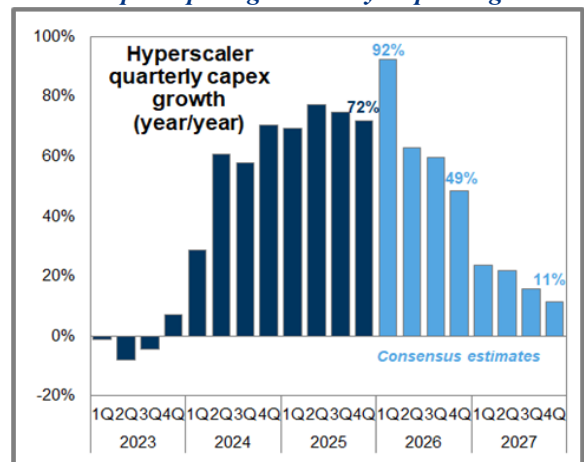
There is another small wrinkle the market is wrestling with. Amazon, Alphabet, Meta, Microsoft, and Oracle, the major hyperscalers, historically generated far more cash than they could redeploy into their businesses. For certain companies, that is no longer true. Wall Street expects Oracle to outspend its operating cash flow for the next five years. Amazon is expected to do the same in 2026. Meta’s free cash flow, defined as operating cash flow less capital expenditures, was \$54 billion in 2024 but is estimated to be only \$8.1 billion this year. Alphabet’s free cash flow peaked at \$73 billion in 2025 but is estimated to be only \$21.2 billion this year. Wall Street is now wondering whether these companies have the willpower to keep growing capital expenditures at these rates. They could, of course, rely more heavily on debt financing, as Oracle has, but the debt markets will likely want greater certainty around data-center profitability.

*Spending growth is outpacing cash flow growth*



Goldman Sachs

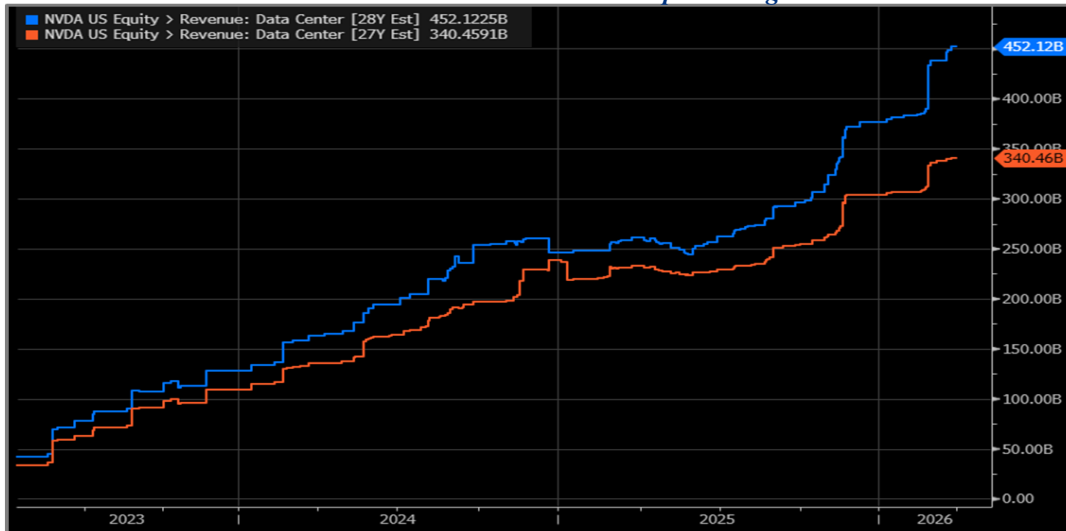
*Capital spend growth may be peaking*



Goldman Sachs

We have noted the perplexing sell-off in both hyperscalers and AI-exposed industries, but it did not stop there. Companies that supply power, like Constellation Energy, and chip designers at the center of the AI trade, like Nvidia, Broadcom, and AMD, also got hit. The only AI safe havens were memory suppliers and select industrials. Nvidia's inability to rally is intriguing, because data-center capital-expenditure estimates keep climbing, and with them, its projected revenue. For example, when the year began, Nvidia's projected fiscal 2028 data-center revenue was \$375 billion, but more recent estimates place it at \$452 billion. That forecast for fiscal 2028 jumped 20.5%, yet the stock was down 6.5% for the quarter, or 5.0% before Iran.

#### *Nvidia data-center sales estimates keep climbing*



*Annandale Capital, Bloomberg*

Nvidia, the “original AI trade,” now trades at only 16.9x next year's projected earnings and 14.9x the following year's. That valuation multiple looks insanely cheap, but that is only true if capital expenditures continue to grow. If capital expenditures fall or simply stall out, Nvidia's margins will compress, making the stock far more expensive. That is the AI trade in a nutshell: on the one hand, everyone is worried that the capital cycle will end, but at the same time, they are scared to own any company exposed to the technology's power.

As users of AI and students of the market, we can sympathize with both concerns. It is a lot to contemplate. Seemingly out of AI exhaustion, we witnessed truly bizarre behavior develop during the first quarter. After the “Claude moment,” companies seen as immune from the effects of AI, good or bad, caught a strong bid. Capital-intensive businesses, like consumer product manufacturers, also traded higher. It felt like the market had grown tired of thinking and just wanted to buy something unrelated.

#### *Random headlines*



Axios

<https://www.axios.com> › Business

### "Anything but AI" is giving rise to the "Halo trade"

Feb 24, 2026 — The anything but AI trade is catching on, as investors hunt for companies unlikely to be wiped out by an Anthropic plug-in or ChatGPT — think ... [Read more](#)

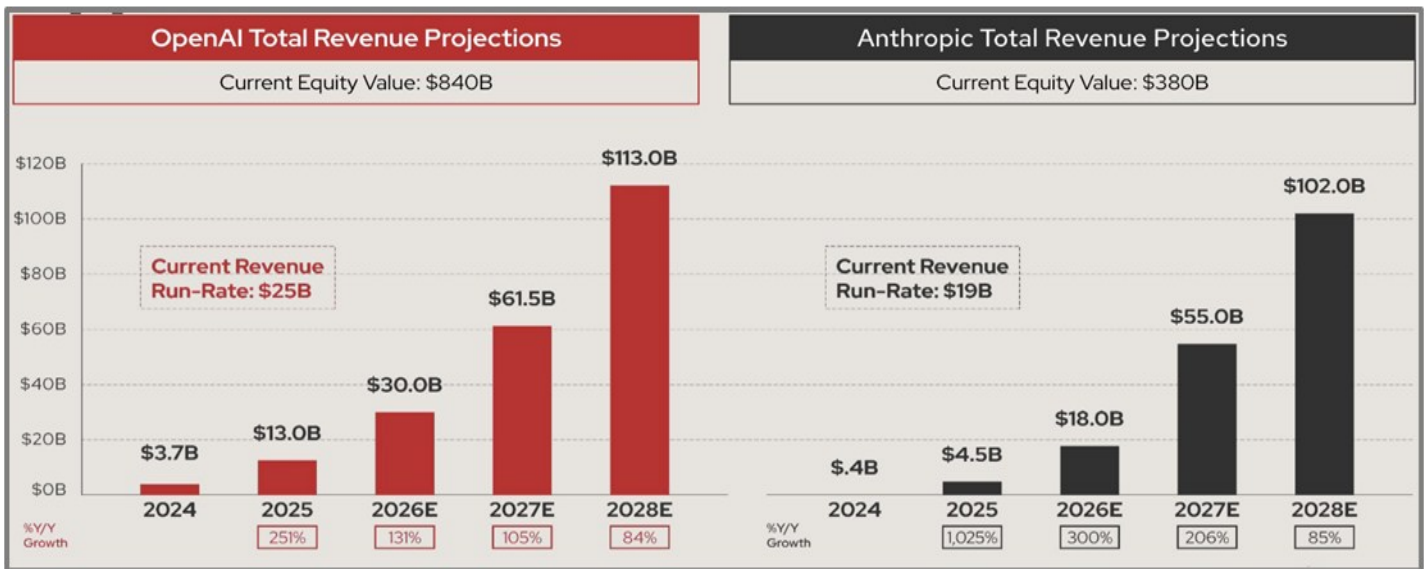
### Wall Street is looking to invest in anything but AI

Feb 24, 2026 — Last week, Goldman Sachs introduced an everything-but-AI index, allowing investors to buy into, well, everything except AI in one neat package. [Read more](#)

Google

Before we close our discussion of the State of AI, Software, and Knowledge Work, we want to highlight a recent Michael Mauboussin interview on the Excess Returns podcast. Michael was asked to put OpenAI's revenue growth and projections into context. OpenAI is one of the two leading model companies and the largest driver of AI data-center revenue. As he put it, "OpenAI... in 2024, did revenues of \$3.7 billion and they were forecasting for 2029 \$145 billion. So that's a 108% compound annual growth rate. And the question then becomes, like, how many companies of that size have ever grown 108% compounded annually for five years? So for our reference class, we went back to every US public company since 1950... you have about 18,900 things you can examine, and the answer is no company had ever done it before... it turns out the average annual growth rate was around 7%, the standard deviation around 10.6%." In OpenAI's defense, it grew roughly 240% to 250% in 2025, and recent reporting claims the company is generating around \$25 billion in annualized run-rate revenue. OpenAI, or Anthropic, may very well set the record in Michael's database, but the need to underwrite the unprecedented is what makes AI so difficult to handicap.

### OpenAI & Anthropic Revenue Projections



The Information

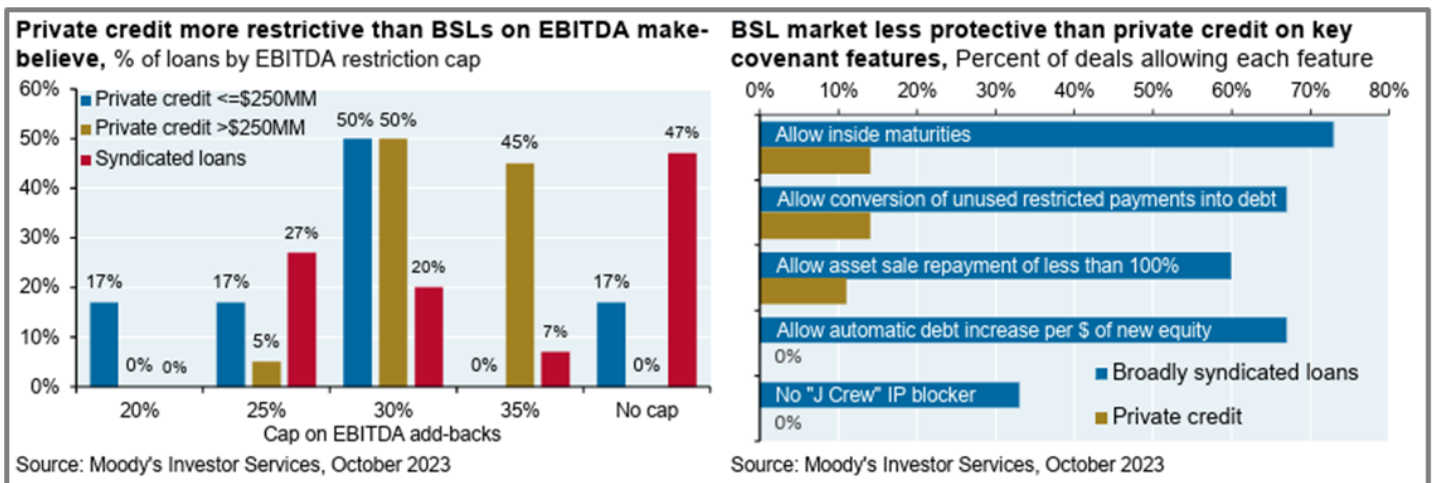
### Topic 3: Private Credit

Prior to Iran, private credit was dominating headlines. The negative press is well deserved, but it has largely focused on benign technical issues; issues that were, in our view, entirely avoidable. The bigger question is how private credit will fare during a period of true economic stress.

Here is the required background. From 2007 to 2025, private credit markets grew tenfold, from \$250 billion to \$2.5 trillion. Private credit is a loose term, encompassing direct lending, asset-backed lending, distressed debt, and so on. Today's headlines are focused on the direct-lending market, which is principally used by private equity sponsors for debt financings. Historically, buyout debt financing was the territory of banks and the syndicated debt markets, but today it belongs to direct lenders. For perspective, in 2014 roughly 45% of all middle-market buyouts were financed with syndicated debt, but today direct lending accounts for roughly 90% of all financing activity. The direct-lending market has grown. A lot.

The premise behind direct lending was straightforward. It simplified the borrowing process. By avoiding syndication, the borrower could work directly with a single lender to tailor a loan to its needs, often in a single unitranche. Certainty of closing and speed of execution also improved. The lender benefited from larger spreads, meaning more yield, and greater control. The historical data supports that premise. In 2023, direct loans carried yield spreads of 200 to 250 basis points over the syndicated debt markets. Furthermore, almost half of all syndicated debt lacked caps on EBITDA add-backs, and key covenant protections were also missing.

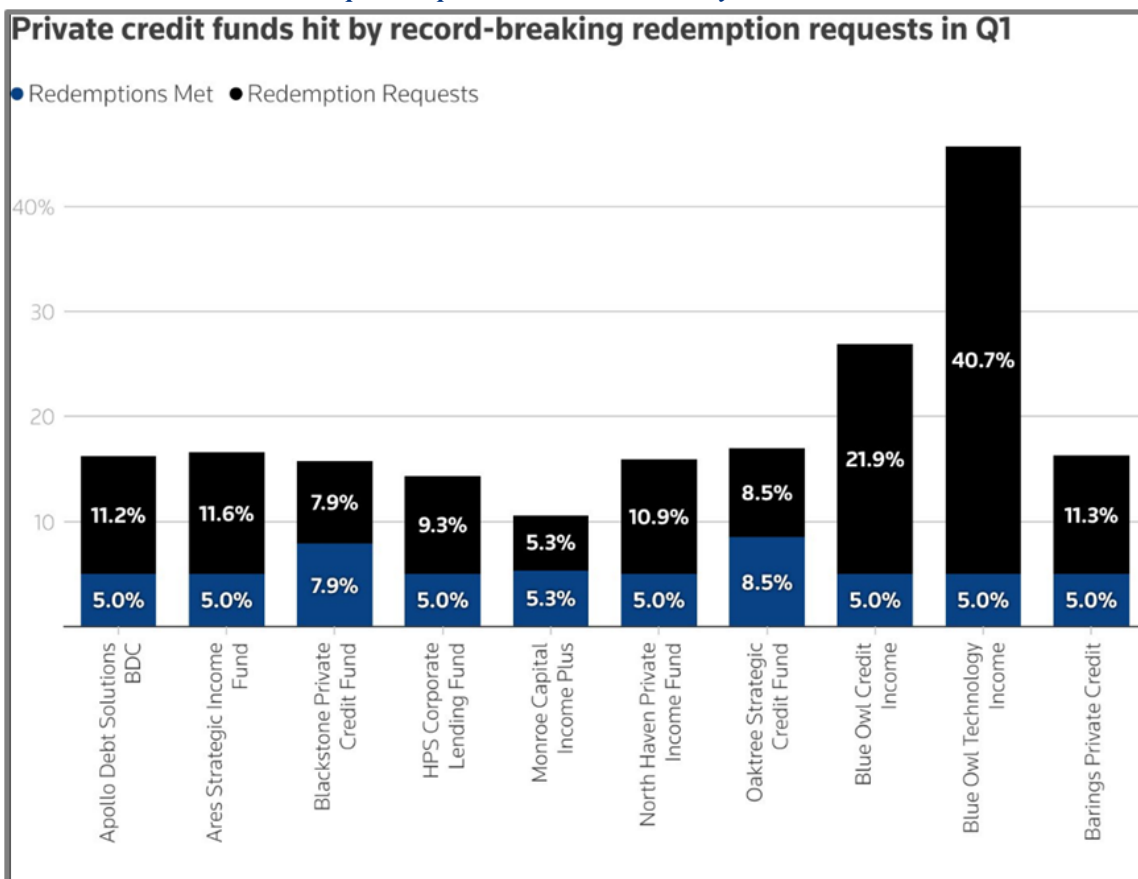
*Private credit underwriting standards vs. broadly syndicated loans*



JP Morgan, Moody's

The forced error that threw private credit into the spotlight had nothing to do with credit stress, but was instead a classic liquidity mismatch. The world's largest private-credit sponsors, Apollo, KKR, Blackstone, Blue Owl, and Ares, are also publicly traded corporations and, like most businesses, are incentivized to grow. Retail investors represented the next untapped growth market, and to reach them, direct lenders created semi-liquid vehicles that advisors could sell to accredited investors. The two most common form factors were non-traded business development companies ("BDCs") and interval funds. Interval funds are required to buy back up to 5% of their shares outstanding at net asset value during quarterly redemption windows. Non-traded BDCs have similar liquidity features, but their boards have the discretion to suspend such repurchases. Retail investors were effectively pitched the "benefits" of private credit with the added bonus of semi-regular liquidity.

*Redemption requests were more than they could handle*



Reuters

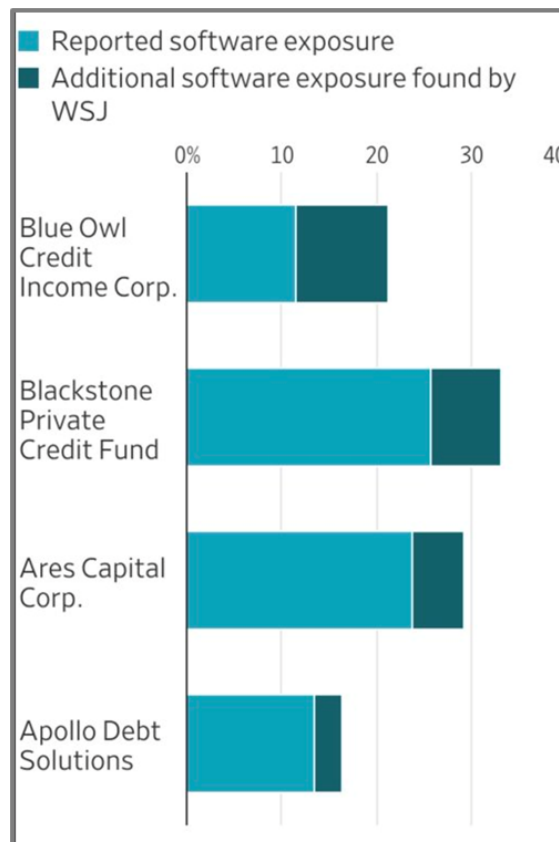
In bull markets, that liquidity is easy to engineer. For example, Apollo Debt Solutions offered a minimum of 5% quarterly liquidity, or 20% annually. Against this potential liability, the fund carried a weighted-average debt maturity of 5.5 years. That implies 18.2% of principal should be repaid annually. On top of principal repayments, you have hefty interest payments and the ability to borrow if needed. Unfortunately, it is not a structure that will work in every environment, particularly one in which requested redemptions reach 16% of net asset value in a quarter. In our view, it was a question of when, not if, these structures would be tested. Now that redemption gates have gone up, we would expect to see more investors head for the exits. The counterexample would be BREIT, Blackstone's real estate vehicle, which faced similar pressures in 2023 but is now back to normal operations. Either way, this is not a situation where you want to be the last man standing, because if the lender is forced to sell assets, the best assets will be sold first.

The good news is that this issue seems to be relatively benign. Yes, it will affect the cost of borrowing for private equity sponsors. Yes, it represents a tightening of financial conditions in the U.S. That said, non-traded BDCs total only \$127 billion in net assets, a small fraction of the direct-lending market, and institutional investors still dominate private credit. Furthermore, unlike during the GFC, these loans are not levered multiple times over by the banking system. Regulations limit BDCs to two times debt-to-equity, and prior to today's liquidity crunch, debt and equity were roughly equivalent. The clearest lesson here is that illiquid assets should not be sold in liquid structures.

That said, we do think the private-credit industry faces real fundamental challenges.

First, there is an opacity and messaging problem. Because many of the loans are directly negotiated, rather than sold to a syndicate, there are fewer checks and balances on loan marks. True default rates are hard to measure, because loans can be amended during periods of stress. On multiple occasions, private credit loans have been marked from par to zero, virtually overnight. On the messaging front, the industry has worked to control negative headlines, and in doing so, has blatantly deceived investors. One such example is the industries' attempts to downplay their exposure to the software sector. For instance, direct lenders, such as Blue Owl, would classify a healthcare software application as a healthcare loan, so they could downplay their overall exposure. The bottom line is that it has become difficult to take any information at face value.

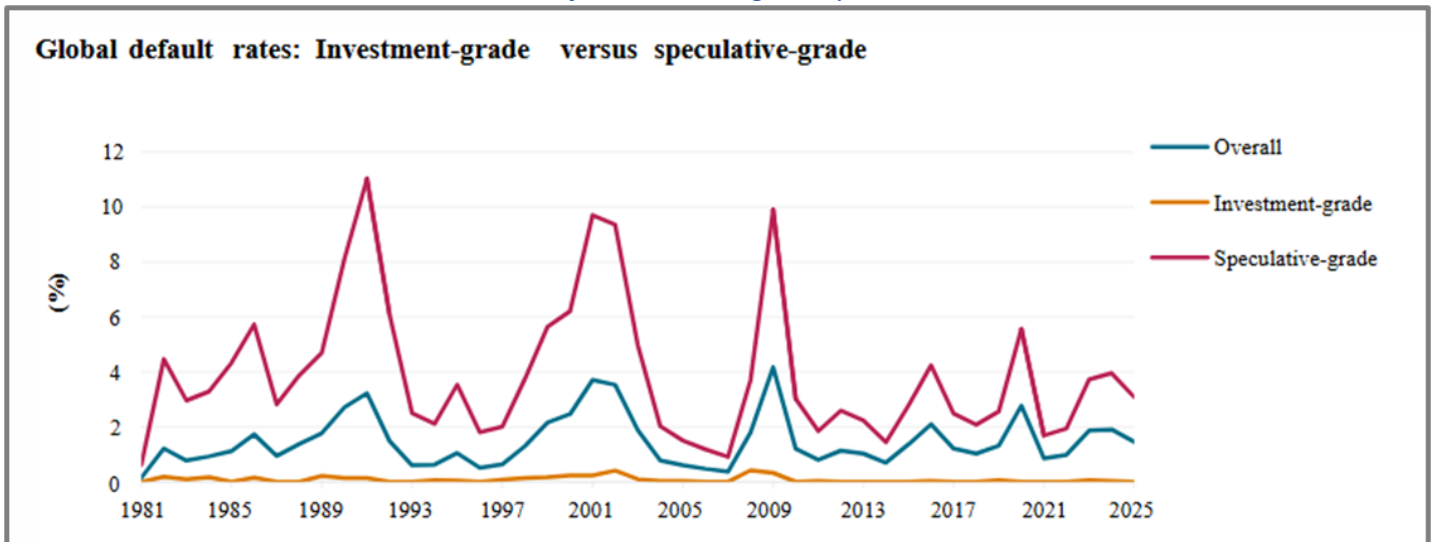
#### *Software exposure is more than what's reported*



WSJ

More importantly, the underlying loans may be far riskier than advertised. Marketed leverage ratios tend to hover around 5x debt-to-EBITDA. However, data from a recent S&P Global study suggests actual leverage ratios are higher. In 2022 and 2024, the median leverage ratio for upper-middle-market buyouts was 7.7x and 8.5x, respectively. Median leverage ratios for lower-middle-market buyouts ranged from a high of 7.5x in 2021 to a low of 5.2x in 2024. We also know that direct lenders give borrowers leeway in their calculation of EBITDA, allowing them to add back expected cost or revenue synergies. Caps on synergy add-backs often do not appear in loan documentation until the add-back inflates EBITDA by 20% or more. At least half of all lenders allow for 30% or greater EBITDA inflation. This is a long-winded way of saying that the leverage profile of direct loans is high, likely falling somewhere between single-B and triple-C-rated debt, or speculative to highly-speculative debt. Hopefully, private credit's experience proves more conservative, but on average, 16.9% of single-B credits default over a five-year period, far more than what the private-credit industry tends to market. Let us hope the loans look nothing like CCC credits.

#### *Default rates through the cycle*



S&P Global

Our long-standing view has been that the direct-lending market was one credit cycle away from real stress. The industry's low to nonexistent loss rates were largely a function of the environment in which it had been operating, namely the pinnacle of the private-equity market. In the fullness of time, direct-lending default rates may come to resemble those of speculative to highly-speculative debt. If anything, the industry is lucky that its first real speed bump is a liquidity crisis rather than an economic one.

For years, we have intentionally shied away from direct lending, limiting our exposure to a single manager that does not traffic in sponsor-backed debt and whose underwriting we feel confident in. We will, of course, make mistakes from time to time, but chasing an asset class simply because everyone else is doing it is unlikely to be among them. If anything, we tend to be too skeptical.

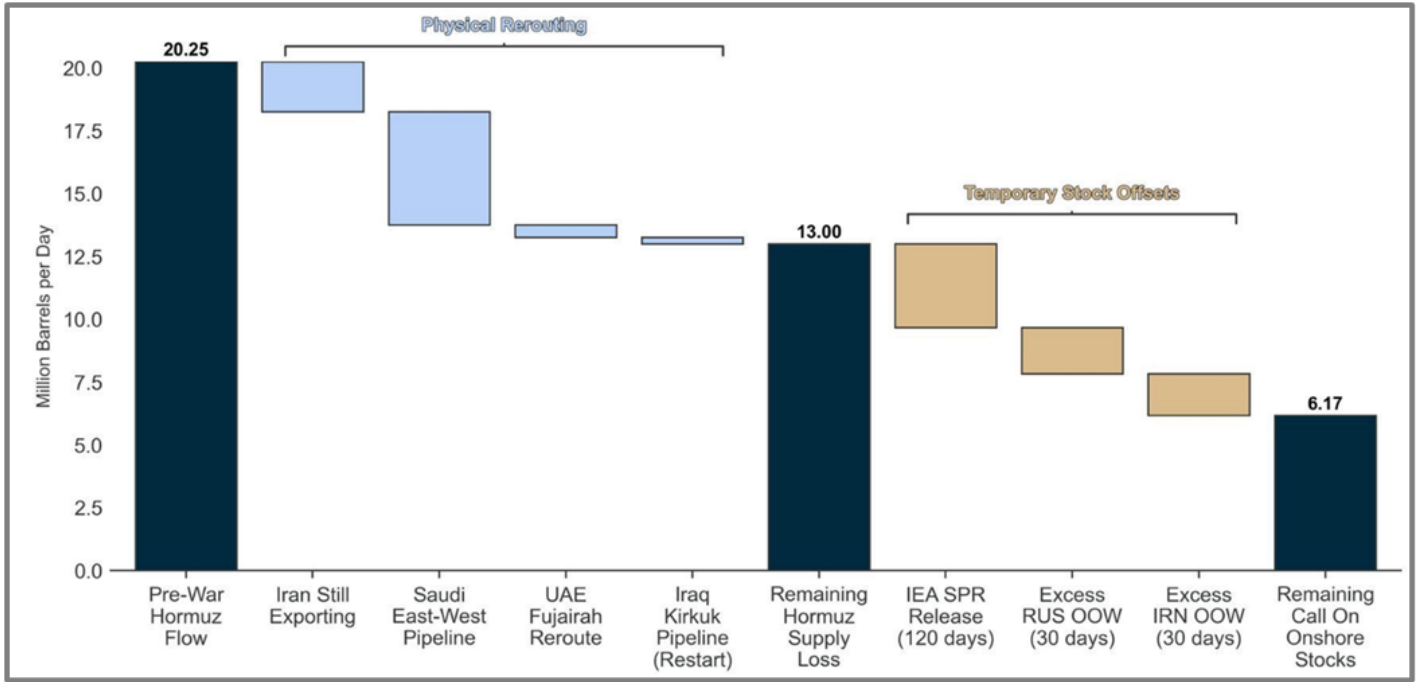
#### **Topic 4: Iran**

Frankly, this is the topic for which we have the least to offer, but its potential economic impact is large.

From an economic standpoint, the key fact is not simply that we are at war with Iran. It is that the conflict has disrupted the Strait of Hormuz, one of the most important arteries in the energy ecosystem. In 2024, roughly 20 million barrels of crude oil per day moved through the strait, equal to 20% of global demand. Similarly, it disrupted Qatar and the UAE's ability to export liquefied natural gas ("LNG"). The two countries combined account for approximately one-fifth of total exports. On top of the energy complex, a third of the world's traded urea (nitrogen fertilizer) moves through the Strait. This is why the issue matters far beyond the Middle East.

The scale of the bottleneck is what makes the shock difficult to offset. It's hard to reroute 20 to 30% of global commodity flows. The EIA estimates that Saudi Arabia and the UAE together have only about 2.6 million barrels per day of pipeline capacity that could bypass the strait. This is meaningful, but inconsequential to the gap that has been created. The EIA estimated that Iraq, Saudi Arabia, Kuwait, the UAE, Qatar, and Bahrain had collectively shut in 7.5 million barrels per day of crude production in March and that shut-ins would rise to 9.1 million barrels per day in April, should the strait remain closed.

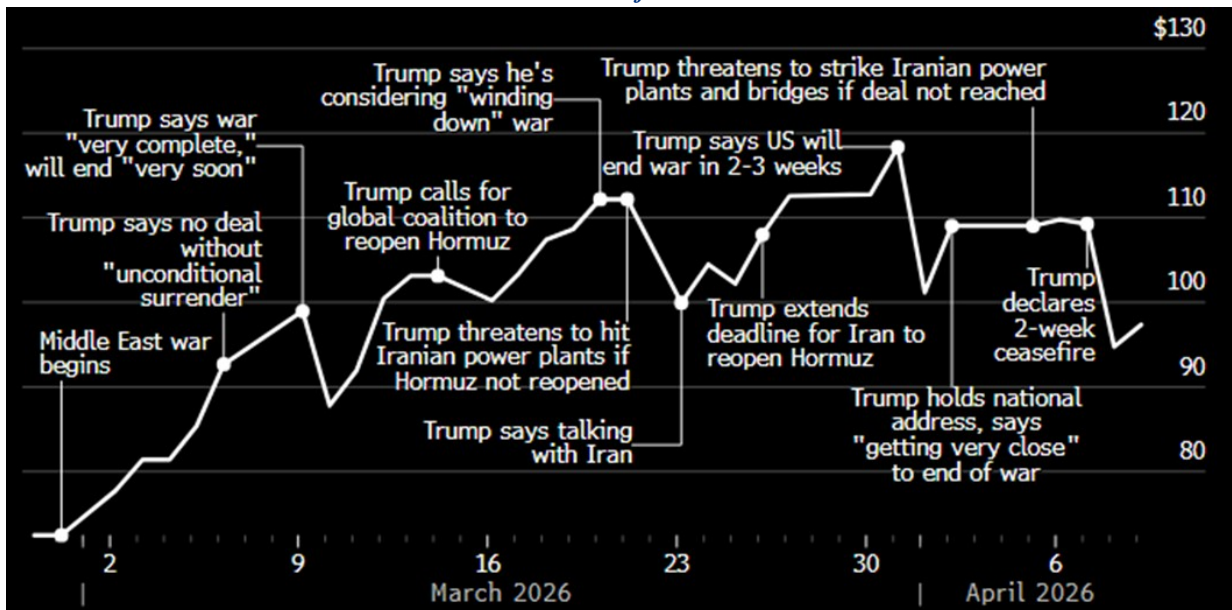
*Plugging the 20 million barrel/day hole*



Commodity Context

The market strain is visible in how oil is priced. The futures curve has moved into steep backwardation, with near-term barrels priced well above later deliveries, a classic sign that the market is more concerned about immediate scarcity than long-run supply. To that end, near term Brent crude is trading around \$95.9 per barrel, but the physical market is far tighter. Per Reuters reporting, immediate delivery into Europe is approaching \$150 per barrel. Until the Strait is reopened or more supply is rerouted, refiners will be forced to pay extraordinary premiums for their feedstock.

*Brent futures*



Bloomberg

Where oil prices go from here is a wild guess. It is a function of how quickly capacity comes back online. The most recent EIA forecast argues that dated Brent will peak at \$115 a barrel and fall to \$88 a barrel by the fourth quarter. The basis of their assumption is that the conflict doesn't persist past April, and capacity is restored by year end. In the table below, you can see their shut-in estimates, just divide the estimate by 100,000 to equate the shock in percentage terms, but like we said earlier, it's all a wild guess.

*EIA: When shut in production will return*

**Table 1. Estimated Strait of Hormuz closure-related disruptions in crude oil production (thousand barrels per day)**

Country	Production	Estimated	Forecast	Forecast	Forecast	Forecast	Forecast
	Feb-26	Shut-ins Mar-26	Shut-ins Apr-26	Shut-ins May-26	Shut-ins Jun-26	Shut-ins 3Q26	Shut-ins 4Q26
Kuwait	2,560	1,250					
UAE	3,600	1,110					
Iraq	4,370	2,820					
Qatar	616	316					
Bahrain	193	130					
Saudi Arabia	10,400	1,900					
<b>Total</b>	<b>21,739</b>	<b>7,526</b>	<b>9,096</b>	<b>6,713</b>	<b>4,947</b>	<b>2,173</b>	<b>168</b>

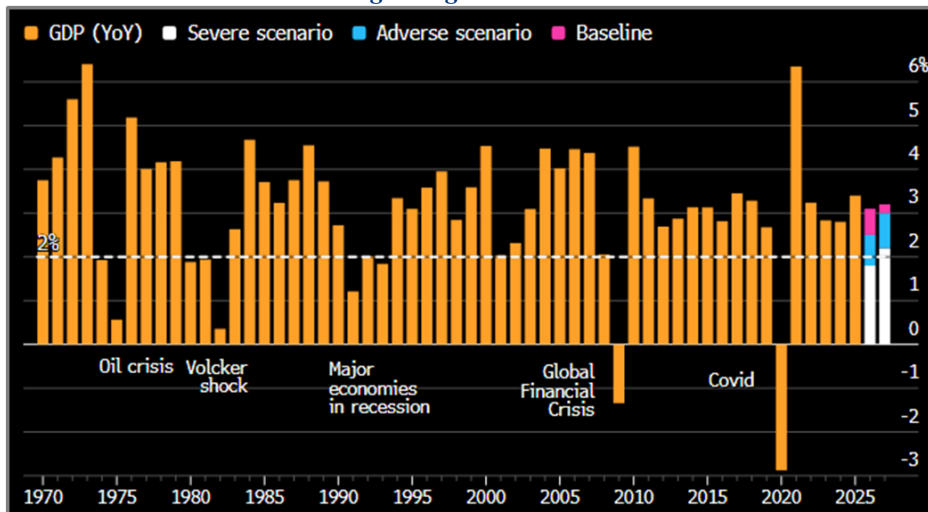
We only forecast aggregate disruptions for future months

EIA

The regional exposure is also uneven. The EIA estimates that 84% of the crude oil and condensate moving through Hormuz in 2024 went to Asia, with China, India, Japan, and South Korea accounting for 69% of total Hormuz crude and condensate flows. Those economies are therefore much more directly exposed to a prolonged disruption than the United States. By comparison, the U.S. imported only about 0.5 million barrels per day of crude and condensate from Persian Gulf countries through Hormuz in 2024, equal to 7% of U.S. crude imports and just 2% of U.S. petroleum liquids consumption. That does not make the U.S. immune, because oil is globally priced, but it does mean the direct physical exposure is much smaller here than in Asia, or Europe who is dependent upon LNG. In the meantime, countries are burning through reserve stockpiles and in some instance, placing restrictions on consumption

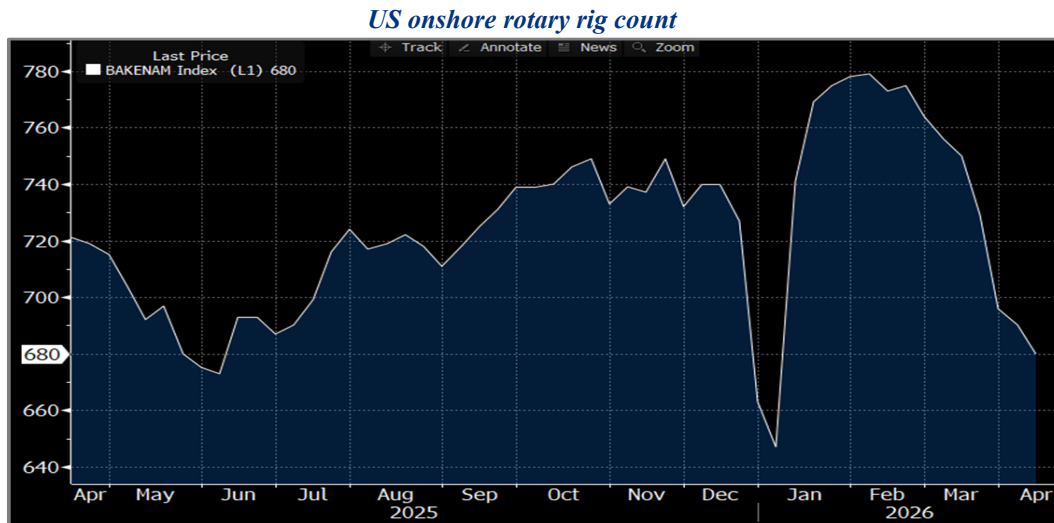
Estimating the ultimate economic toll is where confidence tends to outrun knowledge. In theory, the exercise is simple: estimate how long the Strait remains impaired, translate that into commodity prices, and then map those prices into inflation and growth. In practice, each step rests on assumptions that can change quickly. The EIA still projects U.S. real GDP growth of roughly 2.4% in 2026, but that forecast assumes the conflict begins to ease and that energy flows gradually normalize. The IMF is more cautious at the global level. It recently cut its 2026 world growth forecast to 3.1% from 3.3%, and in more severe scenarios sees growth falling to 2.5% or even 2.0%. The point is not that one forecast is right and the others are wrong. It is that the range of outcomes is unusually wide because the duration of the disruption matters as much as the size of the initial shock

*IMF global growth scenarios*



Bloomberg

What does seem clearer is that the global commodity complex has less flexibility than many investors assume. U.S. crude production is still expected to average roughly 13.5 million barrels per day in 2026, but the rig count remains below year-ago levels, and U.S. LNG export capacity is already running near full utilization. In other words, higher prices do not guarantee a fast supply response. Reserve stockpiles can soften the blow, and demand can be rationed at the margin, but neither is a substitute for restoring normal flows through Hormuz. That is why this matters economically: not because the world is out of energy, but because a meaningful share of it is trying to move through a bottleneck with limited spare capacity around it.



## Conclusion

It has been a busy quarter, one that would have been eventful enough with any one of these developments in isolation. To see the unwinding of a private credit trade, the fracturing of the AI narrative, and the outbreak of war in Iran occur within a ninety-day window is a lot, and it's a vivid reminder that markets do not operate in a vacuum.

In an odd way, the flurry of activity is comforting. It is far scarier to imagine a market where prospective risks are never priced in and volatility doesn't exist. Collective anxiety is a good thing. Corrections are not a bug in the system, but rather a feature.

Equities offer superior long-term returns precisely because investors demand compensation for uncertainty. Volatility is simply the price of admission.

As always, we appreciate the trust you have placed in us. Feel free to reach out with any questions.

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