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Making Sense

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**CONTACT**

**Blake Taylor | VP, Market and Economic Research Analyst**
blake.taylor@firstcitizens.com
919-716-7964

**Phillip Neuhart | SVP, Head of Market and Economic Research**
phillip.neuhart@firstcitizens.com
919-716-2403

**Brent Ciliano, CFA | SVP, Chief Investment Officer**
brent.ciliano@firstcitizens.com
919-716-2650

**Jack Pettit | Research Analyst**
jack.pettit@firstcitizens.com
919-986-3667


## 1. Enormous spending

At the beginning of 2026, investors already knew that hyperscaler firms planned to spend hundreds of billions of dollars building AI infrastructure. In recent months, those figures have continued to rise, with $8 trillion in expected spending over the next five years, levels that would have seemed implausible only a few years ago. The speed of this capex cycle is unprecedented. A few years after the railroad and canal manias took off in the 1800s and the electrification and dotcom buildouts launched in the 1900s, total annual spending had roughly doubled or tripled from prior levels. By contrast, AI hyperscalers are on track to spend over five times their 2023 capex this year ($850 billion) and around eight times that level in two years ($1.2 trillion). In prior investment booms, investors often saw tradeoffs between capex and future returns. But in today's AI buildout, markets are currently seeing both simultaneously. The key question now is whether companies can validate those expectations. During this earnings season, companies may need to show evidence these investments are on track to deliver significant revenues.

## 2. Enormous earnings

Earnings growth is driving today's bull market. At the start of the year, analysts expected S&P 500 earnings to grow at an above-average 15% pace in 2026. Heading into Q2 earnings season, this growth expectation has risen to 24%, with further upside possible.[i] As a result, despite the S&P 500 being up about 10% year to date, the price-to-forward earnings ratio is lower than it was six months ago. All this has happened without help from government fiscal policy or expectations of monetary easing. Skeptics are right to point out that today's equity indices remain concentrated and AI-related companies are the dominant source of earnings growth. But this isn't the full story. Earnings growth is broadening outside of the largest companies, with the equal-weighted S&P 500 index and small cap stocks outperforming large cap by a wide margin year to date. Higher earnings expectations of course will set a higher bar, and the ongoing Q2 earnings season will show if companies are on track to deliver. We expect the reaction to earnings releases to remain asymmetric, with markets punishing companies that miss by more than they reward companies that beat expectations.

## 3. Inflated mindset

Renewed hostilities in the Middle East complicate the benign inflation outlook that took hold in markets after the April 8 ceasefire announcement. Although oil prices plummeted to $68 – just $1 higher than before the Iran war – gasoline and diesel prices have stayed elevated as commercial inventories sit at ultralow levels. But even beyond energy prices, the last mile of inflation was already proving stickier than many investors and policymakers expected. Many experts are coming to terms with the two-regime inflation mindset. When inflation is low, few companies and consumers factor price hikes into their decision making. But once high inflation sets in, price adjustments become more routine and acceptable – if still painful. In addition, one supply shock after another – the steepest tariffs in a century, the largest oil supply shock on record, and an AI-driven supply-demand mismatch in computer products – has kept pricing strategies near the top of companies' to-do lists. Even if inflation rates are closer to central banks' 2% targets, years of elevated inflation have left many households struggling with the cumulative increase in living costs. For many households, the problem is no longer inflation itself but rather the permanently higher price level inflation created.

## 4. Hiking bias

Earlier this year, financial markets expected the Fed would deliver 2-3 additional 0.25% rate cuts. In a major turnaround, markets now expect the Federal Reserve to hike interest rates. We also think the next move is more likely a hike than a cut, but we still see the most likely outcome as the Fed staying on hold for now, especially given today's softer core inflation data. One reason the direction of policy matters is that the AI buildout is transitioning from a cash flow story into a financing story. Until recently, mega cap tech firms funded the ongoing capex cycle through their free cash flows. That is no longer exclusively the case. Investment spending is weighing on hyperscaler free cash flows, and the cycle is now increasingly dependent on external financing, including debt. Higher rates affect not only equity valuations but also the financing costs of the largest capital spending boom in generations. If today's hiking bias evolved into substantially higher rates, equities might be challenged in the near term. But in the longer term, in our view the most important question remains what happens with the trillions of dollars tech companies plan to invest in today's AI infrastructure – and whether those investments ultimately generate returns commensurate with their scale.

[i] Source: FactSet