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MARKET MUSINGS

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THIRD QUARTER 2025 MARKET REVIEW: IS AI A BUBBLE?

Rush Zarrabian, CFA®
Corbett Road
Managing Partner, Portfolio Manager



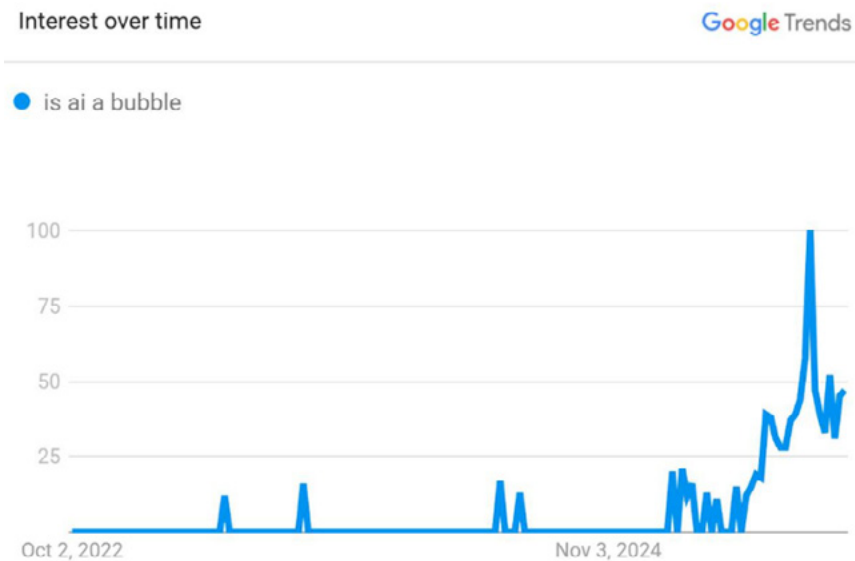
SUMMARY

- Enthusiasm over advancements in artificial intelligence has fueled a significant stock rally, but in our view, it is not a bubble—at least not yet. While AI has clearly captured investor attention, today’s market leaders are far more profitable and better capitalized than tech names during past bubbles. Speculation exists, but widespread skepticism and strong fundamentals—like earnings, margins, and cash flow—are helping anchor valuations. History shows that not all booms end in busts, and even when they do, timing the top is notoriously difficult. For long-term investors, staying disciplined and diversified remains the smarter path than trying to guess when the momentum will peak.
- Q3 saw broad gains, led by a rebound in risk assets. Most asset classes posted strong returns as markets continued to recover from early-year tariff pressures. Small-cap stocks and emerging markets—typically the most volatile major asset classes—led the way with double-digit gains. Gold also surged and is on track for its best year since 1979.
- **macrocast**[™] remains modestly positive, indicating a low risk of a recessionary bear market. Our current **microcast**[™] signal remains at an aggressive allocation. Both models continue to suggest a positive outlook for risk assets.

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EVERYONE IS ASKING **IF AI IS A BUBBLE**

Whenever a trend catches fire in the stock market, one question always follows: “Is it a bubble?” As we approach the 3-year anniversary of the launch of ChatGPT, this question has come up a lot more lately:



To answer that question, it helps to revisit the classic ingredients of a market bubble to see how today’s AI-driven rally measures up:

1. **A Big Story:** A new technology or idea that convinces investors this time is different.
 - ✔ Yes. AI has been the dominant market theme for nearly three years, capturing imagination and capital alike.
2. **Easy Money:** A flood of credit and savings that fuels rapid price gains.
 - ⊖ Mixed. Liquidity is flowing in parts of the market, but conditions are far from the ultra-loose environment of recent years.
3. **Herd Behavior & FOMO:** Investors chasing returns simply because others are.
 - ⊖ Mixed. There’s excitement, but not the kind of frenzy seen in early 2021, and certainly nowhere near the levels of the dotcom bubble.
4. **Detached Valuations:** Prices wildly out of step with earnings or fundamentals.
 - ✘ Not yet. Today’s leading AI companies show strong revenue growth, wide margins, and robust free cash flow—factors that still support current valuations.
5. **“Prices Only Go Up” Mindset:** Blind optimism and the belief that risk no longer matters.
 - ✘ Not yet. In fact, investor sentiment remains cautious, with plenty of skepticism still in the mix.

LOOKING BACK: WHAT REAL BUBBLES LOOKS LIKE

History shows bubbles often follow a similar pattern: a surge in prices over a relatively short period of time followed by equally sharp declines (table from Bank of America):

Table 1: History of great market bulls & crashes

Historic bubbles – rise & decline, duration, valuation, and policy

Bubble	Index	Start	Peak	Rise	Decline	Velocity	Duration (years)	Peak-to-trough (yrs)	Valuation (P/E)	Bond yield	Policy rate	
Mississippi Co.	CAC All-Tradable	7/31/1718	1/31/1720	2955%	-95%	73%	1.5	1.7	n/a	↑	↑	
South Sea Co.	South Sea Co.	2/2/1720	6/25/1720	707%	-89%	188%	0.4	0.5	n/a	↑	↑	
Roaring 20s	Dow Jones	3/30/1926	9/3/1929	153%	-53%	21%	3.4	2.8	19x	↑	↑	
Nifty Fifty	Blue-chip NYSE stocks	9/30/1966	12/31/1972	153%	-53%	9%	6.3	1.7	54x	→	→	
Gold	Gold (\$/oz)	4/27/1978	1/21/1980	428%	-65%	142%	1.7	2.4	n/a	↑	↑	
Black Monday	Dow Jones	9/20/1985	8/25/1987	111%	-41%	21%	1.9	0.2	19x	↑	↑	
Japan	Nikkei 225	10/23/1986	12/29/1989	149%	-64%	12%	3.2	2.6	67x	↑	↑	
Dotcom	Nasdaq	9/23/1998	3/10/2000	192%	-73%	55%	1.5	1.5	65x	↑	↑	
Saudi Arabia	Tadawul	5/27/2004	2/26/2006	316%	-67%	28%	1.8	1.3	124x	↑	↑	
China	Shanghai	6/6/2005	10/16/2007	513%	-73%	37%	2.4	1.0	53x	↑	→	
Govt bonds	Negative-yielding debt	7/31/2014	12/11/2020	+\$18.4trn	-\$18.3trn	33%	6.4	n/a	n/a	→	→	
Tech Disruptors	ARKK	3/18/2020	2/16/2021	384%	-82%	64%	0.9	1.9	n/a	↑	→	
FAANG	NYSE FANG	3/18/2020	11/4/2021	229%	-49%	15%	1.6	1.0	60x	↑	→	
Crypto	Bitcoin	3/13/2020	11/10/2021	1662%	-78%	49%	1.7	1.0	n/a	↑	→	
Average - all bubbles				612%	-68%	53%	2.5	1.5	58x			
Average - equity bubbles since 1900				244%	-62%	29%	2.5	1.6	58x			
Magnificent 7				3/10/2023	-	225%	-	20%	2.5	-	39x	→

Source: BofA Global Investment Strategy, Frehen (2012), Bloomberg, Global Financial Data; rise & decline measured approx. 2 years from peak.

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While the examples above are arguably cherry picked for maximum effect, history also tells you:

- Yes, some bubbles crash hard.
- Others fizzle out gradually.
- And some — like the early internet and railways — end up justified by future growth.

In other words, not all bubbles are created equal. The key difference lies in what's fueling the surge. Is it stock market enthusiasm or credit market excess?

- **Unleveraged equity bubbles**—like the dot-com boom, the Nifty Fifty era, and today's tech disruptors—can wipe out wealth but rarely crush the economy.
- **Leveraged bubbles**—housing, credit, sovereign debt—are far more dangerous. When they burst, they damage household balance sheets and threaten the broader financial system. The best-known examples are the Global Financial Crisis and the Great Depression.

Today's AI-fueled rally looks more like the former. If it pops, it could hurt, but it's unlikely to trigger systemic failure. To date, the bulk of the investments in AI have come from the cash flows of some of the largest and most profitable companies in the world—Amazon, Alphabet, Microsoft, and Meta. Still, this is a dynamic we will be watching closely as the AI buildout matures.

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WHAT ARE THE NUMBERS SUGGESTING?

The closest parallel to today's AI boom is the late-1990s dot-com era. The comparison makes sense. Both revolved around transformative changes in computing, communication, and commerce, and both captured the public imagination. But there's another reason the analogy resonates: many of today's investors lived through that era. They remember the rush, the hype, and the subsequent crash. That's very different from, say, the railroad boom of 150 years ago, which exists only in history books.

If we draw a direct comparison with the dot-com era, the numbers suggest we're not yet in bubble territory.

Today's leading AI companies are far more profitable than the average tech firm in 1999. Their valuations are underpinned by real earnings, healthy margins, and strong free cash flow. And while prices have certainly risen, they remain well below the extremes seen in past bubbles. The table below, from Goldman Sachs, compares the index weightings and forward P/E ratios to the peak of the dotcom bubble in the year 2000, as well as a couple of other well-known speculative peaks over the past 50 years:

Exhibit 7: Dominant companies today are not as expensive as those in previous 'bubble' periods in history

	Size		Valuation	
	Market weight	Market Cap (\$ Bn)	*24m fwd P/E	*24m fwd EV/Sales
Magnificent 7 (2025)				
NVIDIA	7.8%	4509	26.1	14.5
Microsoft	6.8%	3929	27.2	10.2
Apple	6.6%	3809	29.1	8.3
Alphabet	4.9%	2822	20.8	2.8
Amazon	4.1%	2356	24.9	2.8
Meta Platforms	2.7%	1552	21.2	6.0
Tesla	2.6%	1507	135.2	11.6
Magnificent 7 (2025) Aggregate	35.6%	20485	26.8	6.1
Tech Bubble Leaders (2000)				
Microsoft	4.5%	581	53.2	19.2
Cisco Systems	4.2%	543	101.7	17.5
Intel	3.6%	465	42.1	11.5
Oracle	1.9%	245	84.6	19.0
IBM	1.7%	218	23.5	2.3
Lucent	1.6%	206	37.9	4.1
Nortel Networks	1.5%	199	86.4	6.4
Tech Bubble Leaders (2000) Aggregate	19.0%	2457	52.0	8.2
Japan Financial Bubble (1989)				
Nippon Telegraph and Telephone	6.9%	157	100.1	
Industrial Bank Of Japan	4.6%	105	154.2	
Sumitomo Mitsui Banking	3.4%	77	49.2	
Bank of Tokyo-Mitsubishi	3.3%	75	49.8	
Fuji Bank	3.1%	71	52.8	
Dai-Ichi Kangyo Bank	2.9%	65	44.0	
Sakura Bank	2.8%	62	62.1	
Japan Financial Bubble (1989) Aggregate	27.0%	613	67.0	
Nifty 50 (1973)				
IBM	7.1%	48	35.5	
Eastman Kodak	3.6%	24	43.5	
Sears Roebuck	2.7%	18	29.2	
General Electric	2.0%	13	23.4	
Xerox	1.8%	12	45.8	
3M	1.4%	10	39.0	
Procter & Gamble	1.4%	9	29.8	
Nifty 50 (1973) Aggregate	19.9%	135	34.3	

*Actual (LTM) P/E and EV/Sales data from 02/01/1973 for Nifty 50. **LTM P/E data and EV/Sales from 27/12/1989 for Japan Financial Bubble. ***24m fwd P/E and EV/Sales data from 24/03/2000 for Tech Bubble.

Source: Datastream, Factset, Goldman Sachs Global Investment Research

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The data suggests the current Big Tech valuations are not as pronounced as previous periods of market euphoria.

With that said, just because today's market leaders aren't as stretched, this doesn't mean stocks can't correct. In fact, **the S&P 500 has had four separate 20% declines over the past seven years**—but none were driven by classic bubble dynamics. The 2022 selloff came closest, but it was fueled by inflation, aggressive Fed tightening, and geopolitical shocks, not runaway speculation.

WHERE ARE WE **IN THE CURRENT CYCLE?**

Every market cycle is different, even when driven by similar themes.

While the rally since late 2022 has been strong, we are nowhere near the explosive returns seen during the late 1990s. Investor sentiment remains cautious, and market leadership, while concentrated, is underpinned by earnings.

Take a look at these numbers comparing the current Nasdaq rally to the dot-com era (from Urban Carmel):

In the past year, NDX is up 20%. Past 2 years, it's up 50%.

In the dot com era, NDX went up 100% in the final year, up 250% the final two years and up an astounding 600% the last 4 years.



While the rally since the October 2022 bottom has been impressive, it's still not in the same league.

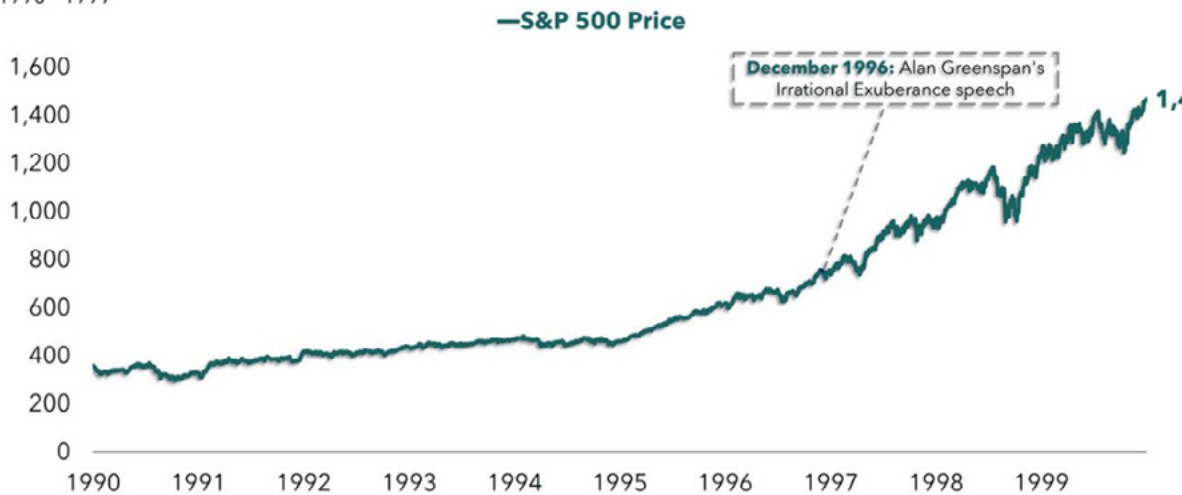
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HOW SHOULD INVESTORS NAVIGATE THIS ENVIRONMENT?

The most prudent method for handling uncertainty is through discipline, not guesswork. While you don't want to chase performance, stepping aside too early can also be costly. When Fed Chair Alan Greenspan warned of "irrational exuberance" in late 1996, **the market more than doubled over the next 3.5 years** (from Ben Carlson):

S&P 500 Price During the 1990's

Following Greenspan's speech, the S&P 500 delivered a cumulative price return of 97% through the end of the 1990s 1990 - 1999



Even after the dot-com crash, when the S&P 500 dropped nearly 50% and the Nasdaq 100 plunged a staggering 83%, long-term returns over the decade starting in 1995 remained solid. This is why blindly "taking chips off the table" just because things feel expensive can be costly (chart from Bespoke):



At the same time, it is important not to discount the value of a globally diversified approach. If an AI-driven rally were to deflate, portfolios with less concentration in Big Tech and broader exposure across Europe, small caps, and emerging markets would likely prove more resilient.

And in any future bear market, **tactical flexibility will also be critical**. The ability to adjust risk exposure meaningfully in response to changing market conditions, using a systematic process, can help manage volatility and preserve capital.

THIRD QUARTER ASSET CLASS REVIEW: A GLOBAL RISK ON RALLY

The following table highlights major asset class returns from the third quarter of the year (from Charles Schwab):

	BENCHMARK	Q3 2025	YTD
U.S. Large-Cap Stocks	S&P 500® Index	8.1%	14.8%
U.S. Small-Cap Stocks	Russell 2000® Index	12.4%	10.4%
International Developed Stocks	MSCI EAFE Index	4.8%	25.7%
Emerging Market Stocks	MSCI Emerging Markets Index	10.9%	28.1%
U.S. Bonds	Bloomberg US Aggregate Bond Index	2.0%	6.1%
Treasury Inflation Protected Securities	Bloomberg US Treasury Inflation Protected Securities (TIPS) Index	2.1%	6.9%
High Yield Bonds	Bloomberg US Corporate High Yield Bond Index	2.5%	7.2%
International Developed Bonds	Bloomberg Global Treasury ex-US Index	-0.8%	9.7%
Commodities	S&P GSCI Index	4.1%	6.1%
REITS	Dow Jones U.S. Select REIT Index	5.1%	4.5%

Some additional insights from the above table:

- 1. In Q3, nearly every major asset class posted gains.** Equity indices rallied strongly, with returns ranging from 4.8% to 12.4%.
- 2. The “riskiest” segments led the charge.** Small-cap and emerging market stocks—historically, the most volatile major asset classes—both surged by double digits. While small caps still trail year to date, emerging markets are up nearly 30%, driven by a weaker dollar and a rebound in China, which remains the index’s largest component.
- 3. Developed international stocks lagged in Q3 but are up 25% year to date.** The MSCI EAFE Index—which tracks Europe, Australia, and Japan—posted gains for the quarter but trailed other major equity benchmarks. Still, they are up over 25% year to date, which marks a strong rebound after rising just 4% in 2024 and significantly underperforming U.S. markets.
- 4. Bonds enjoyed another strong quarter.** The U.S. aggregate bond index was up 2% and is up 6% year to date. This is the best performance for bonds through Q3 since 2020.
- 5. Gold is having a historic run.** Gold (not shown in the table) surged nearly 12% in September alone and is up an extraordinary 46% year to date, the metal’s best performance since 1979! While gold is often viewed as an inflation hedge, this year it has acted more as a shield against dollar weakness and rising geopolitical risk.

In summary, the AI-driven rally has clearly captured investor attention. While some worry about a bubble, the fundamentals tell a different story: strong earnings, healthy cash flows, and valuations that, so far, reflect real business strength. History reminds us that not every boom ends in a bust—some mark the beginning of lasting transformation. Even if your view is that AI is a bubble, and even if the rally does deflate, bubbles are notoriously hard to time, and markets often end up higher than when concerns first emerge. With disciplined risk management and broad diversification, investors are well-positioned to take part in the opportunity while staying resilient through whatever comes next.

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CORBETT ROAD

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THANK YOU

McLean, VA
7901 Jones Branch Dr, Suite 800
McLean, VA 22102

Toll Free: 844.878.4897
info@croadcap.com
www.corbettroadcapital.com