



PRICES, EARNINGS AND CASHFLOW: THE AI STORMS BLOWS THROUGH!

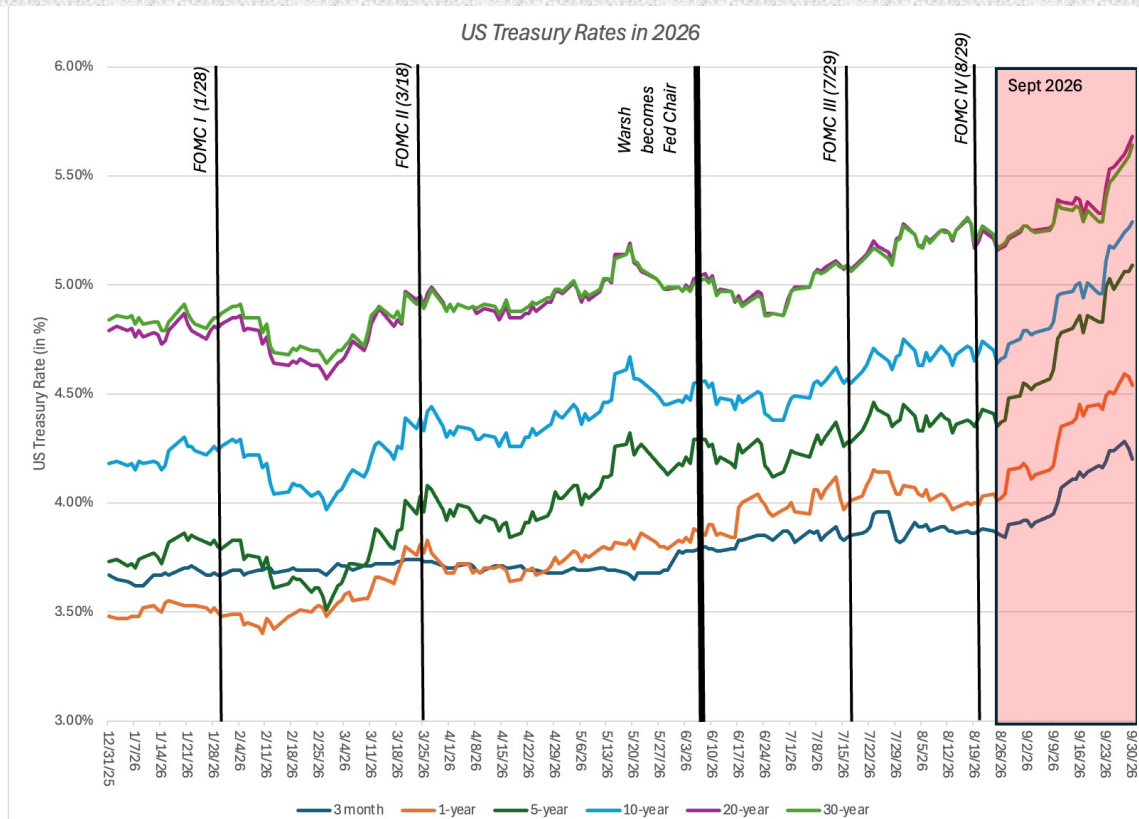
The Good, the Bad and the Ugly!

Aswath Damodaran

RATES UP, STOCKS STAY HIGH!

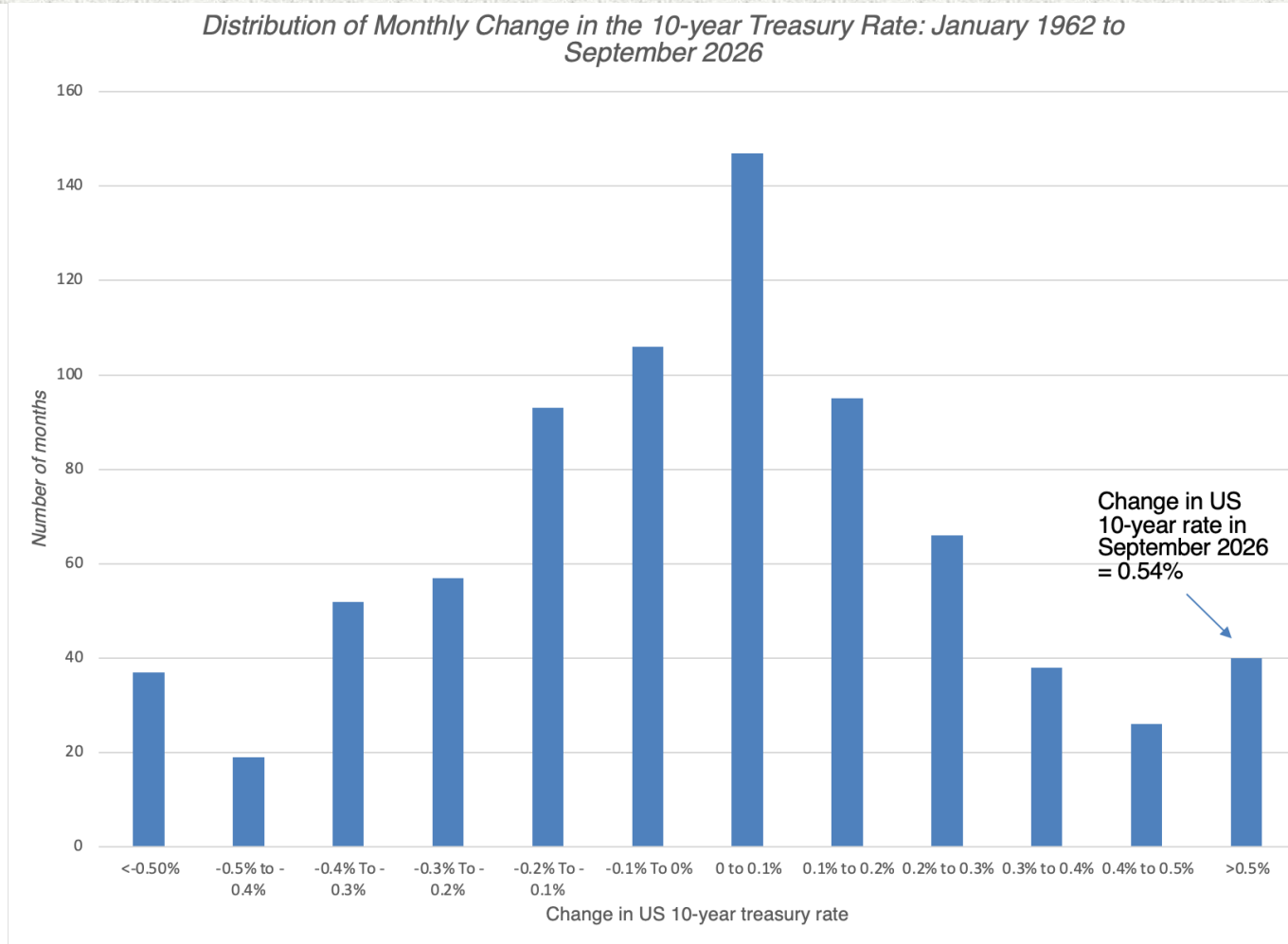
- In a post at the end of August 2026, I **talked about interest rates in 2026 and marveled at the capacity of equities, at least so far, to keep rising in the face of rising rates.**
- I argued that the resilience of stocks during the year can be **traced to higher-than-expected earnings** being reported by companies, and a concurrent increase in expected earnings in 2027 and 2028.
- Now that September 2026 is done for the record books, it is time to take stock and **dig a little deeper, especially since the month brought about one of the largest increase in treasury yield rates in recent memory**, and stock prices held their own. In this post, I want to examine the earnings at US companies, in the aggregate and by sector, trying to trace out where the increase is coming from, and how that increased earnings is playing out on corporate balance sheets and cash flows.

INTEREST RATES IN 2006: A SEPTEMBER UPDATE

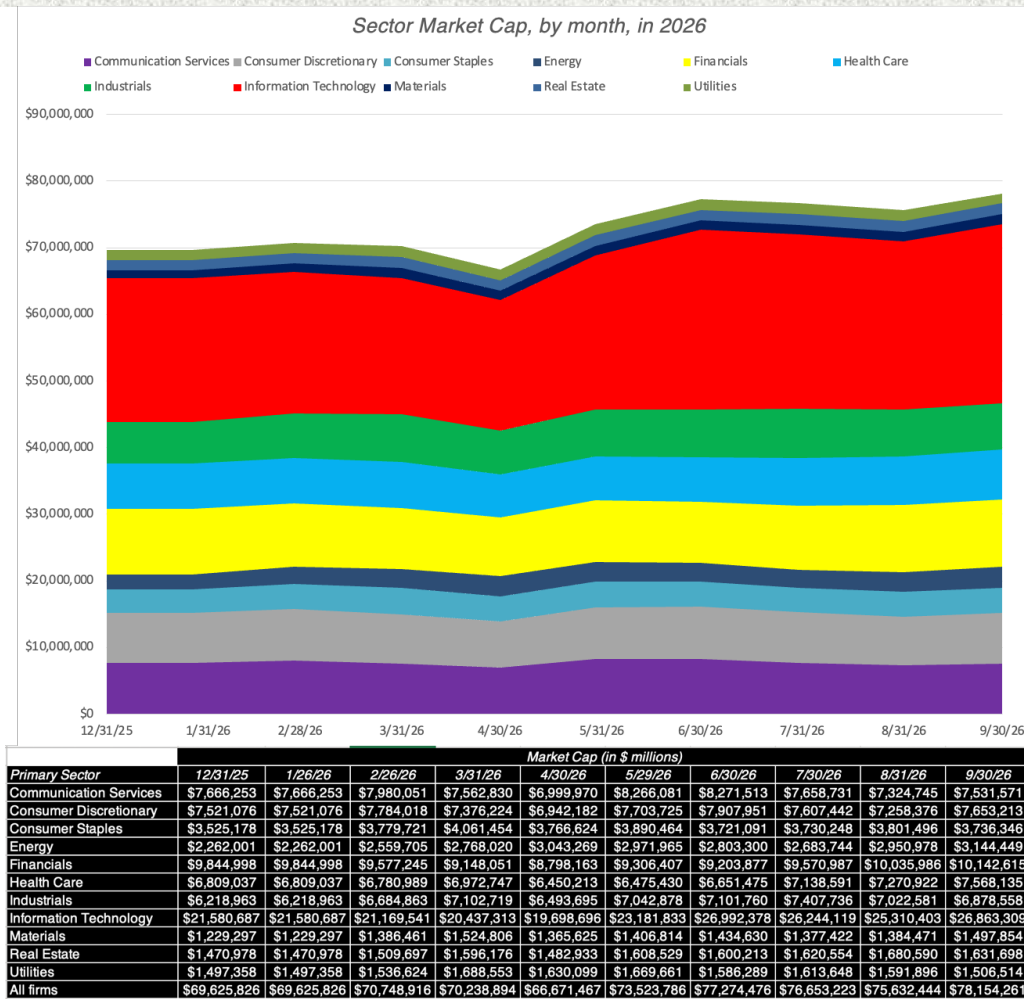


Date	3-month	1-year	5-year	10-year	20-year	30-year
12/31/26	3.67%	3.48%	3.73%	4.18%	4.79%	4.84%
3/31/26	3.70%	3.68%	3.92%	4.30%	4.88%	4.88%
6/30/26	3.87%	3.98%	4.19%	4.44%	4.93%	4.91%
8/31/26	3.91%	4.16%	4.49%	4.75%	5.24%	5.25%
Sep-26	4.20%	4.54%	5.09%	5.29%	5.68%	5.64%

THE SEPTEMBER RATE CHANGE IN CONTEXT...



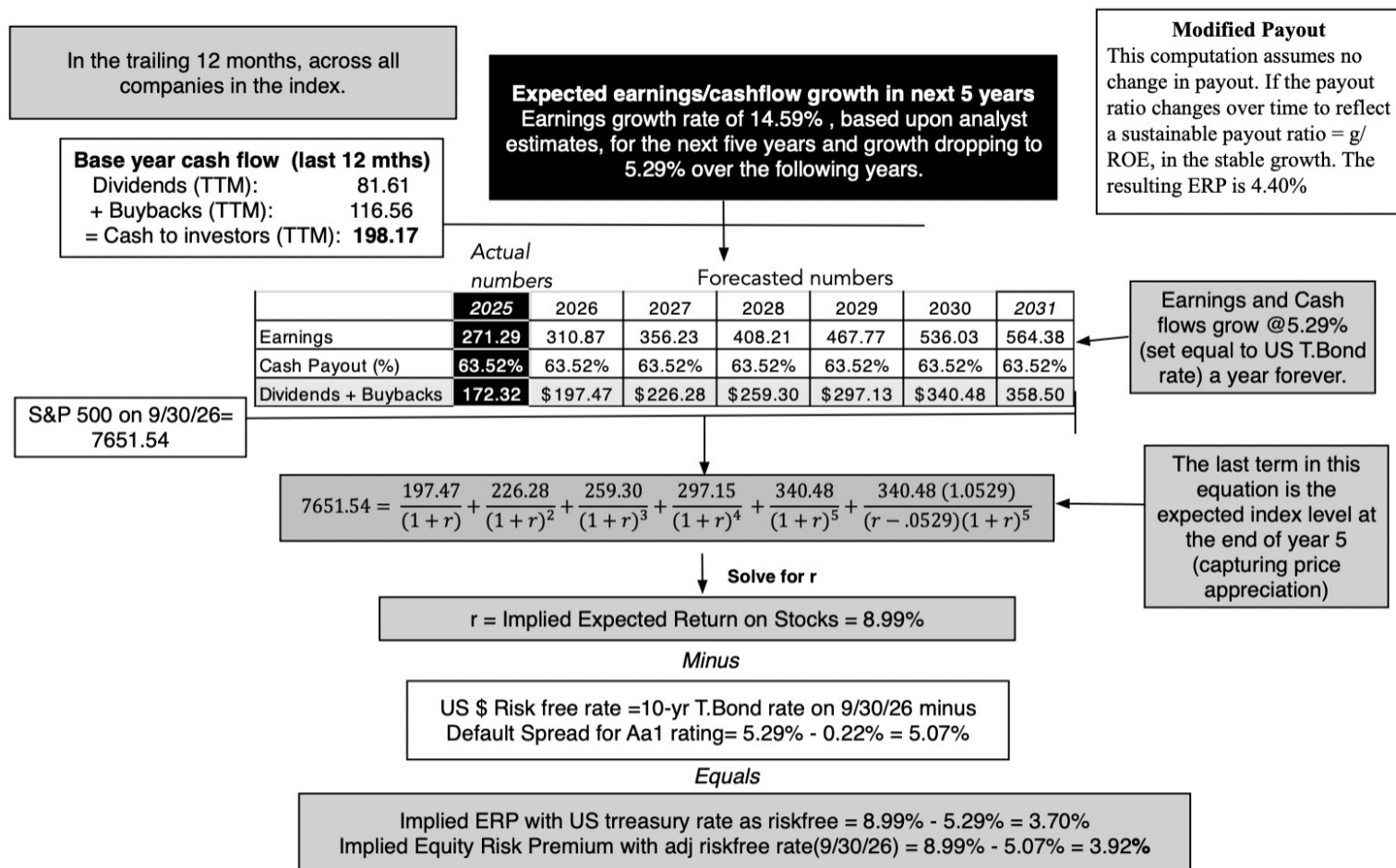
EQUITY RESILIENCE IN 2026



MARKET CAP, BY SECTOR, BY QUARTER...

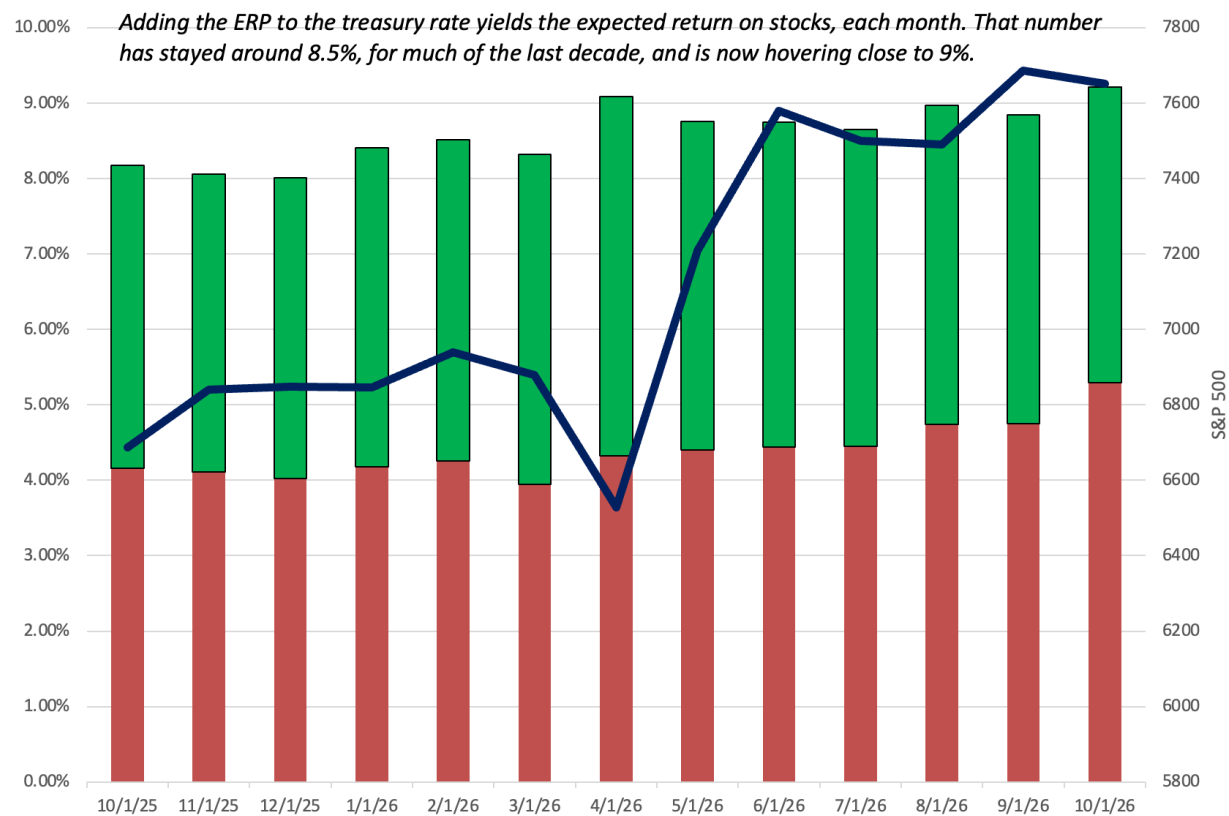
		Market capitalization (in \$ millions)					% of stocks up in 2026			
Primary Sector	# firms	12/31/25	3/31/26	6/30/26	9/30/26	Chg in 2026	Qtr 1	Qtr 2	Qtr 3	YTD
Communication Services	263	\$7,666,253	\$6,999,969	\$7,658,731	\$7,531,571	-1.76%	34.22%	47.15%	28.90%	37.26%
Consumer Discretionary	522	\$7,521,076	\$6,942,182	\$7,607,441	\$7,653,213	1.76%	33.52%	58.43%	26.44%	39.66%
Consumer Staples	251	\$3,525,178	\$3,766,623	\$3,730,248	\$3,736,346	5.99%	39.44%	41.43%	24.30%	33.47%
Energy	266	\$2,262,001	\$3,043,269	\$2,683,744	\$3,144,449	39.01%	72.56%	30.83%	44.74%	63.91%
Financials	1,042	\$9,844,998	\$8,798,163	\$9,570,987	\$10,142,615	3.02%	48.27%	72.74%	44.15%	62.86%
Health Care	1,085	\$6,809,037	\$6,450,212	\$7,138,535	\$7,568,135	11.15%	38.53%	58.34%	39.82%	47.56%
Industrials	735	\$6,218,963	\$6,493,695	\$7,407,736	\$6,878,558	10.61%	44.49%	61.77%	28.71%	46.53%
Information Technology	664	\$21,580,687	\$19,698,696	\$26,244,119	\$26,863,309	24.48%	35.39%	61.75%	37.80%	52.41%
Materials	242	\$1,229,297	\$1,365,625	\$1,377,422	\$1,497,854	21.85%	54.13%	45.04%	35.12%	48.35%
Real Estate	218	\$1,470,978	\$1,482,933	\$1,620,554	\$1,631,698	10.93%	44.04%	71.56%	19.27%	52.29%
Utilities	88	\$1,497,358	\$1,630,099	\$1,613,648	\$1,506,514	0.61%	71.59%	52.27%	20.45%	44.32%
All US stocks	5,376	\$69,625,826	\$66,671,465	\$76,653,165	\$78,154,261	12.25%	43.34%	59.17%	35.21%	50.04%

THE IMPLIED ERP FOR THE S&P 500 ON OCTOBER 1, 2026



AND OVER 2026...

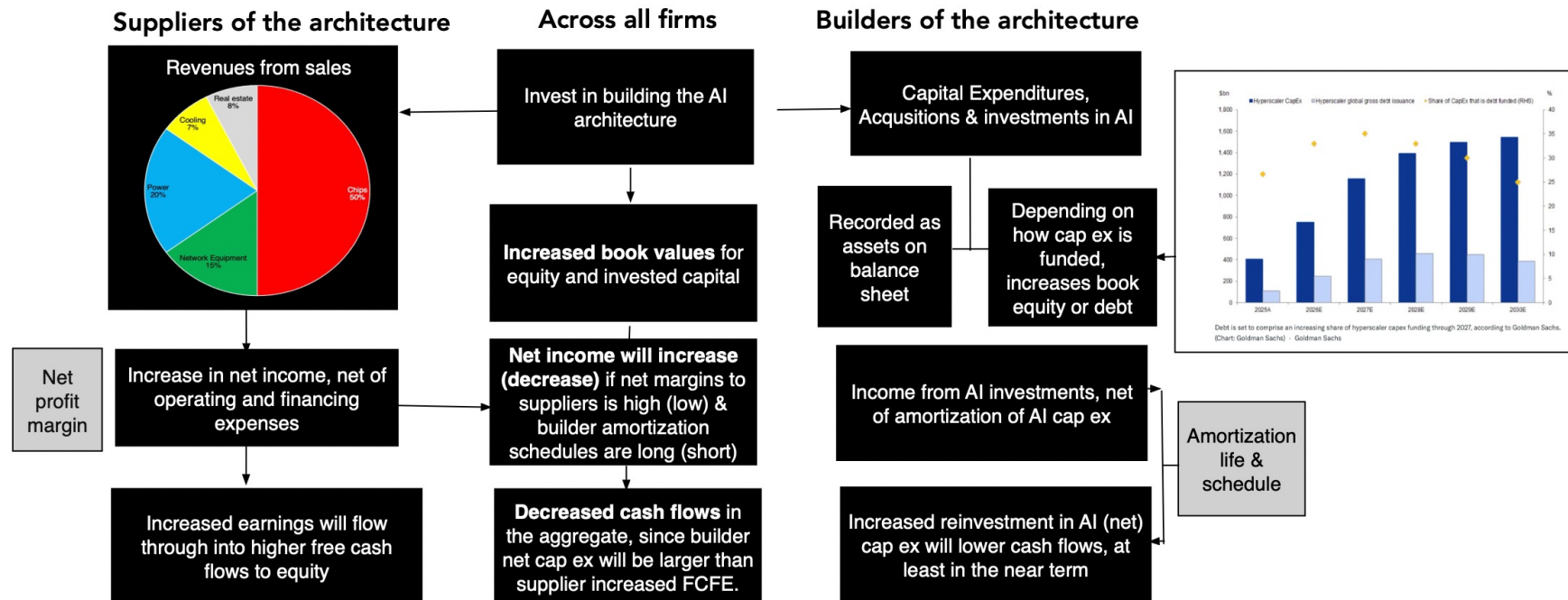
The S&P 500 : ERP and Expected Return - Last 12 months



	1-Oct-25	1-Nov-25	1-Dec-25	1-Jan-26	1-Feb-26	1-Mar-26	1-Apr-26	1-May-26	1-Jun-26	1-Jul-26	1-Aug-26	1-Sep-26	1-Oct-26
ERP	4.01%	3.95%	3.99%	4.23%	4.25%	4.37%	4.77%	4.36%	4.31%	4.20%	4.23%	4.09%	3.92%
10-year US Treasury	4.16%	4.11%	4.02%	4.18%	4.26%	3.95%	4.32%	4.40%	4.44%	4.45%	4.74%	4.75%	5.29%
S&P 500	6688	6840	6849	6846	6939	6879	6528	7209	7580	7499	7490	7686	7652

THE AI CAP EX BOOM: ACCOUNTING AND FINANCIAL CONSEQUENCES

Companies see hope and potential in the AI business



1. THE CAP EX IN THE STORY

		Cap Ex					Change in Cap Ex in 2026			
Primary Sector	Number of firms	CY 2024	CY 2025	LTM	CQ2 2025	CQ2 2026	LTM minus CY 2025	% Change	CQ2 2026 minus CQ2 2025	% Change
Communication Services	263	\$182,478	\$221,558	\$325,585	\$61,823	\$100,159	\$104,027	46.95%	\$38,336	62.01%
Consumer Discretionary	522	\$185,862	\$235,429	\$283,957	\$56,286	\$84,469	\$48,528	20.61%	\$28,183	50.07%
Consumer Staples	251	\$78,822	\$82,038	\$86,380	\$19,677	\$21,546	\$4,342	5.29%	\$1,869	9.50%
Energy	266	\$177,524	\$203,159	\$209,403	\$49,195	\$56,387	\$6,244	3.07%	\$7,192	14.62%
Financials	1,042	\$62,945	\$69,519	\$75,119	\$16,265	\$19,263	\$5,600	8.05%	\$2,998	18.43%
Health Care	1,085	\$67,695	\$72,284	\$75,060	\$15,772	\$18,647	\$2,776	3.84%	\$2,875	18.23%
Industrials	735	\$131,792	\$132,957	\$138,493	\$34,493	\$35,438	\$5,536	4.16%	\$945	2.74%
Information Technology	664	\$169,573	\$231,650	\$310,294	\$52,306	\$94,089	\$78,644	33.95%	\$41,783	79.88%
Materials	242	\$52,390	\$50,882	\$48,343	\$11,770	\$10,738	-\$2,539	-4.99%	-\$1,032	-8.77%
Real Estate	218	\$9,157	\$10,520	\$10,943	\$2,302	\$2,409	\$423	4.02%	\$107	4.64%
Utilities	88	\$197,843	\$228,384	\$251,259	\$54,147	\$64,257	\$22,875	10.02%	\$10,110	18.67%
All US stocks	5,376	\$1,316,079	\$1,438,381	\$1,814,835	\$374,036	\$507,403	\$376,454	26.17%	\$133,367	35.66%

2. CAP EX FUNDING, AND BOOK CAPITAL

		Common Equity				Total Debt				Invested Capital			
Primary Sector	Number of firms	Q2 2025	Q2 2026	\$ Change	% Change	Q2 2025	Q2 2026	\$ Change	% Change	Q2 2025	Q2 2026	\$ Change	% Change
Communication Services	263	\$1,274,231	\$1,580,837	\$306,606	24.06%	\$1,101,319	\$1,267,534	\$166,216	15.09%	\$2,108,306	\$2,581,127	\$472,821	22.43%
Consumer Discretionary	522	\$954,416	\$1,187,136	\$232,720	24.38%	\$1,514,674	\$1,614,369	\$99,695	6.58%	\$2,078,385	\$2,410,799	\$332,415	15.99%
Consumer Staples	251	\$586,028	\$612,598	\$26,570	4.53%	\$690,884	\$701,993	\$11,109	1.61%	\$1,155,202	\$1,192,881	\$37,679	3.26%
Energy	266	\$1,108,044	\$1,236,277	\$128,233	11.57%	\$740,826	\$823,094	\$82,269	11.10%	\$1,770,813	\$1,981,315	\$210,502	11.89%
Financials	1,042	\$3,980,014	\$4,287,891	\$307,877	7.74%	\$14,494,917	\$15,553,778	\$1,058,860	7.31%	\$10,742,817	\$12,109,555	\$1,366,738	12.72%
Health Care	1,085	\$1,299,320	\$1,358,438	\$59,118	4.55%	\$1,200,624	\$1,285,673	\$85,049	7.08%	\$2,054,106	\$2,198,273	\$144,167	7.02%
Industrials	735	\$1,113,385	\$1,190,395	\$77,010	6.92%	\$1,344,556	\$1,383,011	\$38,455	2.86%	\$2,169,111	\$2,284,576	\$115,465	5.32%
Information Technology	664	\$1,721,952	\$2,237,667	\$515,715	29.95%	\$1,052,131	\$1,249,836	\$197,705	18.79%	\$2,163,030	\$2,876,450	\$713,420	32.98%
Materials	242	\$411,775	\$436,005	\$24,230	5.88%	\$299,883	\$312,580	\$12,696	4.23%	\$649,475	\$686,402	\$36,927	5.69%
Real Estate	218	\$592,546	\$612,067	\$19,521	3.29%	\$714,042	\$734,603	\$20,560	2.88%	\$1,256,561	\$1,296,643	\$40,082	3.19%
Utilities	88	\$624,774	\$701,681	\$76,907	12.31%	\$1,109,825	\$1,251,086	\$141,261	12.73%	\$1,709,644	\$1,927,812	\$218,168	12.76%
All US stocks	5,376	\$13,666,484	\$15,440,992	\$1,774,508	12.98%	\$24,263,681	\$26,177,556	\$1,913,875	7.89%	\$27,857,451	\$31,545,833	\$3,688,383	13.24%

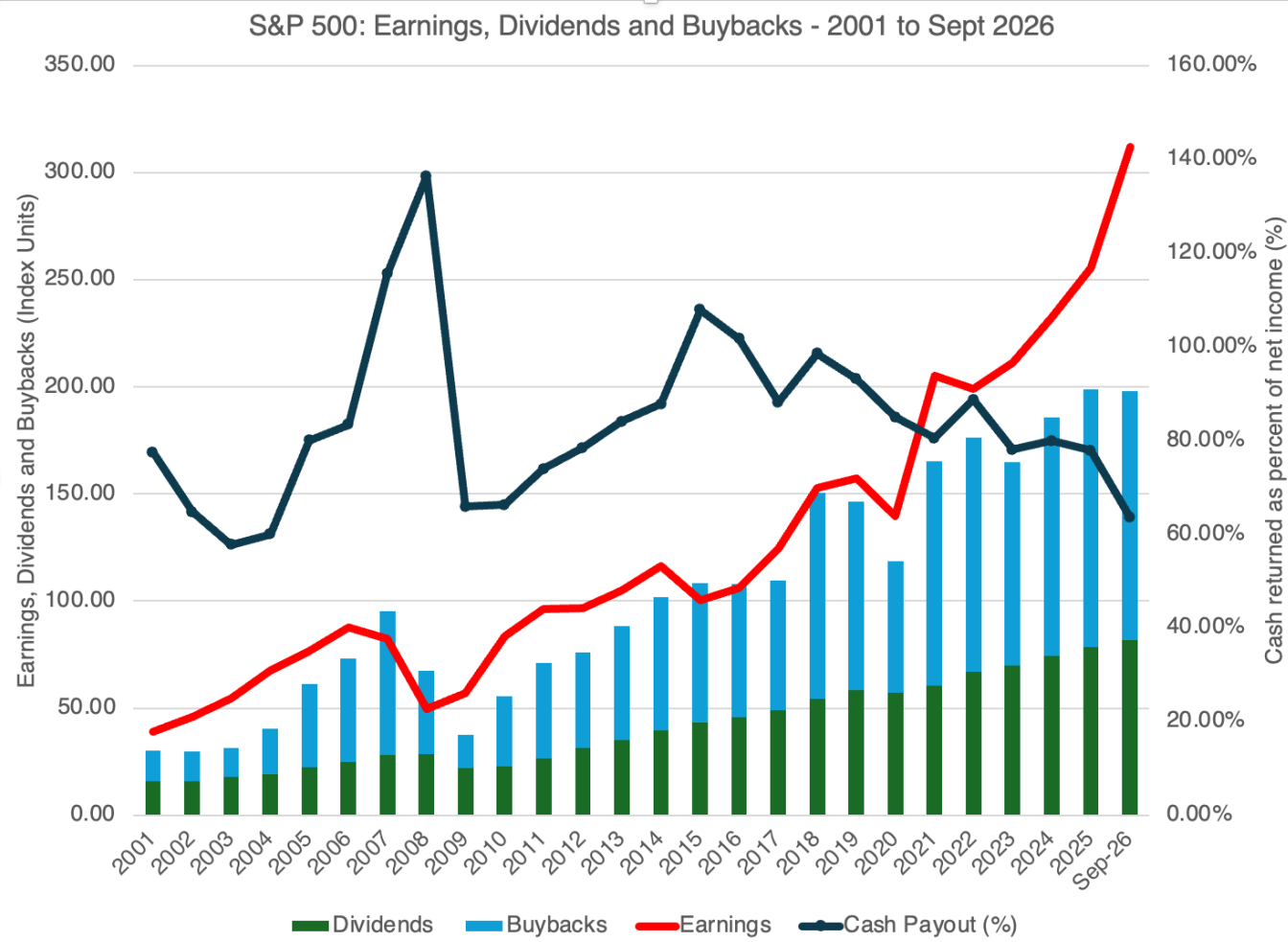
3. THE EARNINGS EFFECT

		Net Income				Q1 2026 vs Q1 2025		Q2 2026 vs Q2 2025		LTM vs CY 2025	
Primary Sector	# firms	CY 2025	Q1 2026	Q2 2026	LTM	\$ change	% with higher income	\$ change	% with higher income	\$ change	% with higher income
Communication Services	263	\$270,383	\$106,859	\$160,316	\$386,147	\$37,506	41.83%	\$77,672.93	36.50%	\$115,764.79	40.68%
Consumer Discretionary	522	\$186,080	\$64,417	\$103,046	\$255,052	\$18,924	47.13%	\$51,007.53	49.62%	\$68,971.78	50.96%
Consumer Staples	251	\$120,037	\$33,806	\$29,664	\$124,978	\$4,004	39.04%	\$2,103.59	34.26%	\$4,940.97	35.86%
Energy	266	\$133,911	\$24,495	\$84,290	\$179,033	-\$4,330	34.21%	\$49,465.86	50.38%	\$45,121.63	42.11%
Financials	1,042	\$562,784	\$143,831	\$188,315	\$652,341	\$29,930	63.63%	\$59,641.74	64.49%	\$89,556.69	63.63%
Health Care	1,085	\$143,167	\$39,255	\$33,412	\$130,210	-\$7,928	43.04%	-\$3,995.48	42.03%	-\$12,956.53	42.67%
Industrials	735	\$193,124	\$47,819	\$64,537	\$207,943	\$3,753	44.76%	\$12,104.23	46.12%	\$14,819.60	47.76%
Information Technology	664	\$531,028	\$183,279	\$201,918	\$727,036	\$82,247	46.54%	\$76,810.99	48.34%	\$196,007.80	48.34%
Materials	242	\$25,765	\$15,644	\$13,947	\$38,501	\$10,468	37.19%	\$2,259.62	36.78%	\$12,735.81	38.02%
Real Estate	218	\$39,109	\$10,871	\$9,149	\$40,966	\$4,333	53.21%	-\$2,336.01	55.05%	\$1,857.09	55.96%
Utilities	88	\$67,601	\$21,668	\$15,698	\$72,994	\$1,960	65.91%	\$3,441.73	63.64%	\$5,393.28	63.64%
All US stocks	5,376	\$2,272,988	\$691,945	\$904,291	\$2,815,201	\$180,865	47.94%	\$328,176.74	48.88%	\$542,212.92	49.16%

4. THE CASH FLOWS EFFECT

		Dividends				Buybacks				Stock Issuances			
Primary Sector	No of firms	CY 2025	Qtr 1, 2026	Qtr 2, 2026	LTM	CY 2025	Qtr 1, 2026	Qtr 2, 2026	LTM	CY 2025	Qtr 1, 2026	Qtr 2, 2026	LTM
Communication Services	263	\$49,257	\$14,462	\$13,129	\$52,246	\$150,411	\$31,237	\$22,229	\$114,478	\$10,364	\$1,039	\$31,191	\$36,923
Consumer Discretionary	522	\$48,040	\$12,575	\$12,424	\$48,437	\$94,143	\$28,705	\$29,904	\$105,765	\$10,915	\$2,184	\$3,295	\$12,681
Consumer Staples	251	\$80,454	\$20,467	\$20,223	\$83,986	\$45,363	\$7,825	\$9,909	\$41,782	\$3,295	\$1,321	\$515	\$3,175
Energy	266	\$86,624	\$22,456	\$21,859	\$87,193	\$65,529	\$13,489	\$21,343	\$66,202	\$10,901	\$2,240	\$2,311	\$7,227
Financials	1,042	\$163,724	\$53,306	\$39,725	\$170,524	\$278,122	\$104,048	\$82,676	\$336,787	\$63,241	\$4,372	\$4,022	\$36,173
Health Care	1,085	\$92,199	\$23,323	\$23,863	\$93,306	\$96,215	\$32,021	\$29,003	\$107,608	\$60,280	\$16,014	\$16,784	\$77,104
Industrials	735	\$71,338	\$19,131	\$18,661	\$72,854	\$117,008	\$40,760	\$28,538	\$118,194	\$32,664	\$10,378	\$7,556	\$36,420
Information Technology	664	\$101,977	\$26,842	\$47,583	\$125,896	\$324,492	\$110,465	\$99,751	\$377,843	\$87,522	\$21,624	\$20,252	\$102,209
Materials	242	\$22,239	\$5,938	\$5,289	\$22,941	\$17,260	\$5,574	\$6,165	\$19,420	\$7,095	\$2,485	\$653	\$8,527
Real Estate	218	\$55,879	\$14,792	\$14,155	\$56,582	\$9,060	\$5,319	\$3,723	\$13,921	\$30,795	\$5,050	\$11,536	\$32,480
Utilities	88	\$41,739	\$11,057	\$10,952	\$42,790	\$3,193	\$1,251	\$3,126	\$5,541	\$21,362	\$4,730	\$6,102	\$25,711
All US stocks	5,376	\$813,470	\$224,349	\$227,865	\$856,756	\$1,200,796	\$380,695	\$336,366	\$1,307,542	\$338,434	\$71,438	\$104,216	\$378,629

PLAYING OUT ACROSS THE MARKET?



IF THE AI BOOM IS REAL...

- The earnings at the AI builders should rise to include the earnings from the AI investment.
 - That increase in earnings will manifest as higher value, if the return on capital on the incremental AI exceeds the cost of capital.
 - If the increase in earnings delivers a return on capital less than the cost of capital, the value of the builders will get written down, in the market (though not in the books).
- The cashflows at the builders should improve over time, as earnings start to come in and cap ex starts to level off, moving towards the amortization and creating a smaller net cap ex effect.
- The builders, even if successful, will emerge from this process as much more capital intensive than they were before the AI cap ex.

IF AI FIZZLES AS A BUSINESS...

- The **earnings at AI builders will stay lower for the long term**, as the promised earnings from the AI cap ex never materialize.
- The accountants will revisit the AI investments and **there will be write offs, labeled one-time or extraordinary, but still of large magnitude**. These write offs will lower the book equity and invested capital (effectively removing the AI mistake from the books).
- If the AI cap ex was **funded disproportionately with debt**, there **will be defaults and distress** on the part of the borrowers and pain for the lenders (banks and private credit)
- The **cashflows at the AI builders that survive may recover**, but only if their existing businesses continue to generate the earnings and cash flows that they did.
- The **market will exact its own pain** by repricing these companies not only to **reflect the money lost on the AI cap ex but also the lost trust in management**.

INVESTOR PERSPECTIVES ON AI

- **Go all in on the AI story winning (and doing it soon):** The first bet, and one that some investors are making, is that AI is an unstoppable force, destined to change the way we live and work, with AI businesses reaping the benefits of the disruption. It is a plausible story, albeit one that raises significant questions about the economic and social costs of disruption, with disagreements about the speed and extent of the disruption.
- **Go with the market consensus:** At the moment, at least, the market seems to be building in the expectation that AI will be a major disruption that will give rise to large and valuable businesses and it is picking its winners. For better or worse, many have already chosen this path implicitly in their pension funds and savings, getting partial exposure to this story with an S&P 500 fund, and more complete exposure if you buy a total market fund for US equities.
- **Trust the AI story but verify:** There are many reasons to be skeptical about the AI story, and for some that skepticism may be replaced by the belief that AI will not make it as a viable business, you can steer your new investing away from the AI space, investing in businesses that are least likely to be altered by AI (food processing and leisure) and in geographies where AI is less likely to be a threat, such as the EU (perhaps because of regulation) and parts of Asia (because AI is too expensive to replace human labor)>
- **Crash out on the AI story:** If your belief that AI will fail hardens into a conviction that it will happen, and that it will do so quickly, you can try to actively cash in on the story, you should, at the minimum, reducing your exposure to equities, especially in the US, by selling holdings and putting that money into cash, or, if you are more risk taking, selling short on the companies that have seen their pricing surge on the AI story.

WHERE I STAND..

- **I am personally going with the "market consensus" choice for the bulk of my portfolio**, since I do hold five of the Mag Seven (all except Tesla and Nvidia) and four of those companies are heavy investors in AI cap ex, but **the new money added to my portfolio has gone into cash** (short term treasuries, yielding 4%) for much of the last year, leaving my portfolios more cash-laden than usual.
- I have left money on the table undoubtedly by doing so, but it **has helped me sleep better at night**, and my advice to you is that you find a pathway in the AI jungle that helps you pass the sleep test as well.
- **The income you will earn in your occupation, over the rest of your working life, is human capital**, and to the extent that you believe that AI is coming for your job, it behooves you to direct your financial capital away from the businesses most exposed to AI disruption to balance your overall wealth.