



Bubble or Bargain? Unpacking the AI Sell-Off as the Fed Pauses

Doug Johnson, CFA, Senior Investment Strategist at HCM Wealth Advisors and CPAs, recorded this market brief on Wednesday, October 28, just minutes before the Federal Reserve's 2:00 p.m. rate decision. He covered the Fed outlook, the recent volatility in AI-related stocks, and year-end expectations across asset classes, including the upcoming midterm elections.

The Fed decision

Johnson opened by noting the consensus expectation that the Fed would pause rather than hike, with December possibly a "live" meeting or a hike coming early next year. In his view, nothing fundamental has changed in what the Fed is watching. Inflation remains a concern mainly because energy prices are elevated due to the ongoing conflict in Iran. He doesn't expect a return to the \$130–\$135 oil seen at the start of the conflict, but thinks a range from the mid-\$90s up to \$105–\$110 is plausible as the war drags on and supply stays offline.

The Fed's bigger worry, he argued, would be stickier inflation showing up in wages, rents, and shelter, which are more embedded than energy prices. Oil would likely fall quickly on any headline of a resolution in Iran, and the Fed understands that rate hikes can't fix a supply-side shock. He also pointed out that real rates (nominal rates minus CPI or PCE inflation) are near 20-year highs, meaning policy is already somewhat restrictive. He noted that the Fed has never raised rates at an October meeting with midterms the following month.

During the recording, he confirmed the Fed held rates at 3.75%–4%, as expected. He anticipates guidance for perhaps one more hike in December or early next year. Historically, he explained, fast back-to-back hiking cycles are bad for equities, while slow, spaced-out hikes followed by a pause have been absorbed well by markets. The current situation looks more like the latter, and the major indices have held within a range for several months.

The AI trade

Johnson then turned to the AI sector, where some names have sold off sharply in recent weeks, with drawdowns of 50% to 60% in some popular stocks. He addressed three questions: whether the narrative is shifting, whether comparisons to 2000 are valid, and what is actually driving the selling.

He acknowledged the narrative may be shifting somewhat. Skeptics have called AI a bubble from the start, a view he considers overly dramatic, and he noted it would be unusual for a

bubble to burst when nearly everyone expects it. The original worry was that AI spending could never generate enough revenue to pay for itself. More recently, attention has moved to credit markets: bond spreads for Magnificent Seven and other AI companies that have borrowed heavily to fund capex have widened beyond their levels during the July sell-off, which followed the collapse of a leveraged hedge fund called Situational Awareness. Johnson said credit moves shouldn't be ignored, though he finds a default by these highly profitable companies hard to imagine. A related concern is whether enough capital exists to fund the entire AI buildout. If debt grows more expensive, companies may turn to equity financing, which dilutes shareholders.

On fundamentals, though, he remains confident. He cited Warren Pies of 3Fourteen Research, whose modeling shows demand for compute and GPUs remains very strong and data center construction remains on track, despite occasional headlines about canceled contracts. He said the semiconductor index is trading at valuations of one to two standard deviations below its mean, which is not typical of a bubble. Unlike 2000, when valuations were extreme and many companies had no earnings, today's AI leaders make real money. He called the 2000 comparisons "lazy" and too convenient. Recent earnings, including blowout results and strong guidance from SK Hynix, support the fundamental picture, though he conceded that price is the ultimate arbiter.

He attributed much of the outsized volatility to crowded positioning: when everyone tries to exit through the same narrow door, moves get exaggerated in both directions without the fundamentals necessarily breaking down. He also highlighted a chart from Fidelity's Jurrien Timmer showing that, over the past 50 days, AI stocks and the rest of the S&P 500 have had unusually low correlation and are trading almost independently. This is surprising given that the Mag 7 and semiconductors make up roughly 40% of the index's market cap. AI names have rebounded over the past week. Johnson expects skepticism toward the sector to persist, raising the bar for good news.

Midterms

Prediction markets currently favor Democrats to win the House, with the Senate close to a coin flip. Johnson stressed that HCM doesn't adjust portfolios based on predictions. Instead, the firm prepares for scenarios and reacts once events actually happen. A Democratic Congress with a Republican president would mean gridlock, which historically hasn't been bad for markets. He flagged two areas to watch. First, data centers are becoming a political flashpoint, similar to fracking in the 2010s, which could invite regulation and put more pressure on the AI trade. Second, Democratic support for maintaining benefit programs, especially health insurance, could worsen deficit concerns and push long-term Treasury yields higher.

Bonds, leadership, and seasonality

The 10-year Treasury has stabilized around 5%, and HCM continues to see bonds as attractive. Future yields will depend on growth, inflation, and the Fed. Johnson thinks the biggest downside move in yields would come from news that the war in Iran has ended, which would remove the energy component from inflation.

Market leadership keeps rotating between growth and value and between cyclicals and defensives, making direction hard to read. The market has been consolidating sideways for months, and longer consolidations tend to produce more violent breakouts. Earnings, fundamentals, and a possible Iran resolution favor an upside break. Defensive stocks outperforming cyclicals, a modestly hawkish Fed, and high real yields point to downside risk. Seasonality is supportive: under the four-year presidential cycle, the midterm year is usually the weakest and summer through October its weakest stretch. The market defied both this year, and it is now entering historically the strongest period of the cycle.

On market breadth, 2026 is on pace to be roughly the 8th narrowest year for the S&P 500 since 1950, with the index up about 13%–14%. Counterintuitively, narrow markets have typically coincided with strong index returns: 2023, 2024, and 2025 rank 2nd, 3rd, and 7th narrowest, while 1998 and 1999 rank 1st and 2nd. However, narrow years have sometimes preceded down years, such as 2000 (down 9%), 2002, and 1973 (down 14.3%). Shifts between cap-weighted and equal-weighted S&P performance have gone back and forth all year.

Portfolio positioning

HCM hasn't made significant changes and doesn't plan to without a reason. The firm has extended some bond maturities to lock in higher yields in case rates are near their peak. On the equity side, it is satisfied with its barbell of growth-oriented AI exposure on one end and cyclical and defensive value on the other. In the "debasement" sleeve, there may be year-end adjustments, particularly in commodities, to avoid large capital gains distributions. These would be administrative moves, with positions possibly repurchased in early 2027 if the thesis still holds.

Johnson closed by encouraging listeners to contact their advisors with questions and said the next brief will come in about two weeks, after the midterm results are in.