CIBC PRIVATE WEALTH



JAMES DIXON, CIM®: MACRO THOUGHTS – SEP 30, 2026

THE AI OPPORTUNITY IN THE EVOLVING CYCLE

EXECUTIVE SUMMARY

My broader equity thesis remains unchanged: I believe the US economy remains in a mid-cycle expansion, earnings should continue to support equities, and investors should remain positioned for further upside while increasingly emphasizing quality.

Artificial intelligence strengthens that thesis!

The scale of the AI investment cycle is extraordinary. Morgan Stanley estimates that major cloud providers could spend more than $1.4 trillion on AI infrastructure next year, while available compute capacity could roughly quadruple between 2025 and 2028. More importantly, its bottom-up work suggests potential returns on invested capital of approximately 25–50% across emerging AI business models.

This is critical! The AI debate is shifting from how much money is being spent to whether that spending can generate attractive economic returns. This early analysis suggests it can.

The recent Fed hike complicates—but does not undermine—the opportunity. I continue to argue limited scope for significantly more tightening from here unless inflation reaccelerates materially. This thesis is fueled by:

- Residential investment already feeling the impact of higher rates.
- The labor market is softer beneath the surface than the headline suggests. Enormous AI capital spending is furthermore not translating proportionately into employment growth.
- Substantial front-end Treasury financing increases the economy's sensitivity to elevated short-term rates.

For investors, the conclusion aligns with my existing positioning:

- Remain constructive on equities
- Maintain exposure to the secular AI investment cycle
- Demand quality—strong balance sheets, free cash flow and demonstrable returns on capital.

AI remains a major opportunity. The next phase will simply be more selective as opportunities broaden and quality is increasingly demanded by investors

1. FROM AI SPENDING TO AI RETURNS

The first phase of the AI cycle was dominated by infrastructure scarcity.

There were not enough advanced GPUs, data centers, networking capacity or power to satisfy demand. That scarcity created exceptional economics for the companies supplying the build-out.

The next phase will increasingly be about returns.

Morgan Stanley identifies three emerging AI business models.

1. **Renting compute.** Hyperscalers build data centers containing advanced GPUs and rent that capacity to customers. Morgan Stanley estimates that a large next-generation data center could generate approximately 30% ROIC (Return On Invested Capital), with potential outcomes ranging from the low-20% area to almost 40%.
2. **Ownership.** Combining ownership of the AI model with ownership of the underlying infrastructure. Here, Morgan Stanley estimates roughly 75% incremental operating margins and potential ROIC above 40%.
3. **Renting Infrastructure.** AI developers renting their infrastructure. Returns are lower because part of the economics accrues to the infrastructure provider, but Morgan Stanley still estimates approximately 30% incremental operating margins and 25% post-tax return potential.

These estimates provide an important counterargument to concerns that AI capital spending has simply become excessive.

Capital expenditure is not inherently value destructive. What matters is the return generated on that capital.

Key Insight: If AI investments can sustainably generate returns of 25–40% or more, the current build-out can create significant shareholder value even in a higher-rate environment.

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2. INFERENCE IS THE NEXT CATALYST

The AI cycle is also moving from training toward inference.

Training creates the model. Inference occurs every time that model is actually used.

This transition is important because training is concentrated and episodic, whereas inference has the potential to become recurring and pervasive.

Every AI-assisted software query, coding request, search, customer interaction and automated workflow requires compute. As AI becomes embedded across businesses and everyday life, inference could become the recurring revenue engine that validates today's infrastructure investment.

The economics will ultimately depend on two variables:

- Token pricing
- Token efficiency

I touched on this in the Jul 22 macro thoughts (AI'S STRESS TEST: THE SECULAR CYCLE REMAINS INTACT)

Competition should continue to reduce the price of AI. But semiconductor improvements, better networking, more efficient models and software optimization should simultaneously reduce the cost of delivering it.

That creates a potentially powerful economic flywheel:
Lower cost → lower prices → greater adoption → more inference → greater compute demand.

Key Insight: If efficiency improves faster than pricing declines, the AI ecosystem can simultaneously deliver lower costs to customers and attractive returns to capital providers.

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3. AI REINFORCES THE MID-CYCLE EXPANSION

Over the last two months I have underscored the shift in the economic cycle from recovery to expansion which has driven my thesis on a greater focus on quality. (Refer to macro: Aug 5; Aug 26; & Sep 23).

This AI narrative fits directly into my broader mid-cycle thesis.

In these prior macro thoughts, I argued that the economy has moved beyond the early-cycle recovery phase to the mid-cycle expansion. AI provides an additional source of capital formation, productivity and earnings growth which fuels that narrative and could help extend the cycle.

Important, is the distinction between the current expansion phase of the cycle vs traditional expansion phases. This is because today, the investment boom (fueled by AI) while extraordinarily capital intensive is notably comparatively less labor intensive.

Trillions of dollars can be committed to GPUs, data centers, networking equipment, electrical infrastructure and power generation without creating a proportionate increase in employment.

That helps explain an unusual divergence developing within the US economy. AI-related investment remains exceptionally strong, while residential investment and other rate-sensitive areas are considerably softer. The labor market also appears less robust beneath the headline unemployment rate. For context, August's jump in payrolls was mostly the result of seasonal adjustment problems (The three-month average rise of 71K, is a better guide to the trend).

This does not contradict my constructive equity view! It is simply important to digest so that we can make educated discissions as we navigate the stage of the cycle.

Key Insight: AI can support investment, productivity, corporate earnings and GDP even without producing a traditional employment boom.

This potentially allows economic growth to continue while reducing some of the inflationary pressures normally associated with an extended expansion.

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4. LIMITS TO FURTHER TIGHTENING

The recent Fed hike has understandably raised questions about whether higher rates could disrupt the AI investment cycle and broader equity market. For context tech equities, are traditionally particularly sensitive to rate policy. This is because they are growth equities and hence long duration in nature.

I see this risk as manageable!

The largest hyperscalers generate substantial free cash flow and have exceptionally strong balance sheets. If (per Morgans Stanley's projections) an AI infrastructure project can generate returns of 25–40%, a modest increase in the risk-free rate is unlikely to prevent that investment.

The impact of higher rates is considerably greater elsewhere.

- Housing remains highly sensitive to mortgage rates.
- Smaller businesses and consumers are more dependent on credit.
- The labor market is already showing signs of moderation beneath the headline numbers.

This creates an important policy asymmetry: Additional hikes may do relatively little to slow AI capital expenditure while imposing increasingly significant pressure on the rest of the economy.

Treasury financing adds another consideration. Large financing requirements, including substantial issuance at the front end of the curve, mean elevated short-term rates transmit relatively quickly into government interest expense as debt is refinanced.

Importantly, none of this means the Fed cannot tighten again. Inflation—particularly through energy or geopolitical developments—remains the principal risk. However, absent a meaningful renewed inflation acceleration, I believe the room for a prolonged additional hiking cycle is limited.

That is an important distinction for equities!

Key Insight: Stabilization in rates alongside continued economic growth and strong AI investment would remain consistent with the constructive mid-cycle environment I have previously outlined.

5. WHY QUALITY MATTERS EVEN MORE

This is where the AI thesis intersects most directly with my recent work on quality.

The first stage of the AI cycle rewarded exposure. The next stage should increasingly reward execution.

Investors will increasingly become less willing to reward a company simply because it is spending heavily on AI. Instead questions will be asked about whether that spending produces revenue, margin expansion, free cash flow and attractive ROIC.

Higher rates accelerate that transition.

Companies capable of funding AI investment internally are structurally advantaged. In contrast, businesses dependent on expensive external financing face a much higher hurdle.

I therefore continue to favor the characteristics I have emphasized throughout the mid-cycle transition:

- Strong balance sheets.
- High free cash flow.
- Durable margins.
- Pricing power.
- High returns on invested capital.

Key Insight: AI does not replace the quality thesis. It reinforces it!

6. THE OPPORTUNITY: FROM INFRASTRUCTURE TO PRODUCTIVITY

The first beneficiaries of AI were the companies supplying compute.

That opportunity remains significant. Semiconductors, advanced memory, networking, data centers, electrical equipment, power generation and hyperscale cloud platforms remain foundational to the build-out.

But the opportunity should continue to broaden.

The next group of winners will be companies capable of monetizing AI through software, applications and services.

Beyond them lies potentially the largest opportunity of all: companies that use AI to increase productivity.

AI can reduce software-development costs, automate administrative work, improve customer service, optimize supply chains, accelerate research and allow businesses to generate more output per employee.

This could ultimately broaden the benefits well beyond technology into financial services, healthcare, industrials and other information-intensive sectors. This is why I have been slowly adjusting my healthcare underweight and have strategically retained an overweight to industrials among others.

The investment question is evolving from: "Who is building AI?" to: "Who can generate the greatest incremental free cash flow from using it?"

Key insight: While opportunity remains significant with suppliers of AI compute, the transition is broadening. Focus must however remain on quality (the cornerstone of my investment thesis)!

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7. RISKS TO THE THESIS

My thesis is not without risks. These can be summarized as follows:

1. **Overcapacity**. The most important risk is overcapacity. AI infrastructure must ultimately achieve sufficient utilization to justify today's enormous investment.
2. **Token pricing.** If AI prices fall faster than efficiency improves, returns could compress.
3. **Power.** Power availability remains a physical constraint. Data centers cannot scale without sufficient generation, transmission and grid infrastructure.
4. **Rates**. Higher rates also remain a risk, particularly for leveraged infrastructure providers. A meaningful reacceleration in inflation could force the Fed into more tightening than I anticipate.
5. **Monetization must follow investment**. Businesses and consumers must be willing to pay enough for AI products and services to support the capital beneath them.

Key insight: These risks are acceptable given the current framework, but reinforce the importance of selectivity to manage risk.

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8. PORTFOLIO IMPLICATIONS

UHNW investors should continue to view AI as a multi-year capital and productivity cycle within a broader mid-cycle equity expansion.

Within the cycle phase opportunities are broadening across three notable layers:

1. **Infrastructure.** Compute, semiconductors, networking, data centers, electrical infrastructure and power.
2. **Monetization**. Companies capable of translating AI adoption into recurring revenues and attractive incremental margins.
3. **Productivity beneficiaries**. Established businesses that use AI to increase revenue per employee, lower costs and expand margins.

Across all three, quality should remain the filter. The combination I continue to favor is:
Structural growth + high ROIC + strong free cash flow + manageable leverage.

This is consistent with my broader equity positioning and remains the cornerstone of my framework.

Key Insight: Remain constructive on the market, but as the cycle matures, expect the dispersion between high- and low-quality businesses to increase. AI should be no different!

CONCLUSION

My broader investment thesis remains intact.

I continue to believe the US economy is experiencing a mid-cycle expansion rather than approaching the end of the cycle, and I therefore remain constructive on equities. AI represents one of the most important structural supports to maintain that optimism.

The first stage of the AI cycle required enormous amounts of capital. The next stage will determine whether that capital earns an adequate return. Early evidence is encouraging.

Morgan Stanley's work suggests potential returns on invested capital of approximately 25–50% across emerging AI business models. If those economics prove sustainable, today's extraordinary infrastructure spending should translate into significant future earnings and cash flow.

At the same time, the macro environment may be more supportive than the recent Fed hike suggests. AI investment remains strong, but residential investment and the labor market are considerably more rate sensitive. AI capital spending itself creates relatively few jobs compared with its enormous scale, while substantial Treasury financing requirements increase sensitivity to elevated short-term rates.

I therefore see limited room for significantly more tightening absent a material reacceleration in inflation.

The result could be a powerful combination for equities: continued economic expansion, moderating monetary restraint, an enormous AI capital cycle and the emergence of genuine productivity gains.

But as I have emphasized in my recent work, the maturation of the cycle changes what investors should own. The early phase rewarded beta. The next phase should reward quality. The same principle applies to AI!

The opportunity is no longer simply to own companies exposed to artificial intelligence. It is to own high-quality businesses capable of converting that exposure into durable earnings, free cash flow and ROCI.

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