TOCQUEVILLE

Situational Awareness

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The stock market recently embarked on the 9th longest bull market since 1928.[1] Don't pop the champagne just yet, experience teaches us to maintain a heightened level of vigilance; a subtle shift in market dynamics is underway. Tocqueville has navigated market cycles for forty years, and several members of our management committee have overseen portfolios for far longer. When bull markets advance for extended periods, history shows that investors routinely become overly complacent regarding risk management, and this cycle is unlikely to be an exception.

An example of this dynamic occurred recently when Situational Awareness, a hedge fund founded by 24-year-old former OpenAI employee Leopold Aschenbrenner, imploded. Aschenbrenner named the fund after a seminal white paper he wrote on the potential future of AI, yet he never previously had

experience managing institutional capital. The fund then committed the dynamic duo of poor risk management: taking on massive leverage and establishing hyper-concentrated positions to amplify returns. When technology stocks pulled back over the summer, margin calls followed. As liquidations accelerated, roughly $35 billion of the fund's $45 billion in assets vanished in weeks, marking one of the fastest monthly drawdowns in hedge fund history.[2]

The ironic name of the fund serves as a timely reminder. In reviewing today's global macroeconomic conditions, investors must exercise rigorous situational awareness regarding asset allocation, portfolio positioning, and liquidity management. Below are several emerging pressure points the market might not be discounting enough.

The Geopolitical Backdrop

At the time of this writing, conditions around the Strait of Hormuz remain severely constrained, and war in the Middle East region continues to escalate and spread. Oil prices continue to hover near $100 per barrel, driving spikes in gasoline and diesel costs. Concurrently, the U.S. Strategic Petroleum Reserve has been drawn down to 283 million barrels of oil, near a 43-year low.[3] The Iranian regime appears in no hurry to strike a resolution. The war has proven to be a political nightmare for the Trump administration, especially heading into midterm elections. Current expectations lean toward a split government, with the Democrats projected to reclaim the House, and pick up some seats in the Senate, causing a split government for the lame duck session of Trump's presidency.

This raises a fundamental question: How long can consumer activity and defense spending be sustained against a backdrop of elevated inflation? While an exact timeline is impossible to predict, we suspect that without the past 15 years of the U.S. shale revolution, which transformed the nation from a net oil importer to a net exporter, recessionary pressures would already be visible.

Yield Curve Pressures

In September, bonds capped off their worst month in years, as a policy tug-of-war took place between the Federal Reserve and the U.S. Treasury. At the short end of the yield curve, the Fed has grown more aggressive to suppress inflation, by raising rates, and signaling more to come. Meanwhile, the Treasury's long-dated bond purchases aim to cap long-term yields to make housing more affordable. This policy tension has generated confusion in fixed-income markets, helping to push yields higher across the curve and triggering significant volatility in broad bond benchmarks, such as the Bloomberg Aggregate Bond Index, which is negative for the year. The US 10 year finished the month at 5.3%, marking the highest level since 2022.[4]

This environment carries echoes of 2022, when rapid rate hikes, driven by the Fed playing catch up to

control inflation, sparked widespread equity drawdowns and recession fears (a rare calendar year in which both stocks and bonds posted negative returns). Had OpenAI not launched ChatGPT in late 2022 to ignite a mega-cap tech rally, equity index declines could have proven substantially deeper than the S&P 500's -18% return. Today, even as forward price-to-earnings multiples have moderated toward approximately 19x, equity markets, until recently, appear curiously dismissive of rising yields. Higher borrowing costs ultimately squeeze corporate margins, slow economic momentum, and position fixed income as a competitive alternative to equities, a reality markets cannot ignore indefinitely.

All Cycles Come to an End

Economic history is defined by transformative capital expenditure booms:

- **Late 1800s:** Railroad expansion
- **1900–1930:** National grid electrification
- **Mid-1950s**:1970s: Interstate highway construction
- **Late 1990s:** Telecom, internet, and fiber-optic buildout
- **2003–2007:** Housing boom
- **2010–2019:** U.S. shale energy revolution

Each wave advanced the real economy, yet each eventually gave way to speculative excess, overleverage, and overbuilt capacity. When momentum slowed, the subsequent unwinding proved painful. Today, the capital expenditure supporting the AI ecosystem represents a low-single-digit percentage of the $30 trillion U.S. GDP—a staggering figure. Supply chain providers across the tech stack report that demand remains stronger for longer than early estimates projected. However, 160 years of market history confirm that capital cycles eventually mature and mean-revert, often violently. We expect this cycle to be no different, but what we don't know is when the music will stop playing?

Concentration and the "Second Derivative"

Previous Tocqueville commentaries have highlighted the historic concentration of the S&P 500, particularly within the mega-cap tech sector. Today, that concentration centers on the broader AI infrastructure buildout, with some reports estimating that up to nearly 60% of the market cap of the companies in the S&P 500 market capitalization has indirect or direct exposure to AI expenditure.[5] When this investment cycle inevitably normalizes, late cycle speculators taking on excess risk face potential severe downside. However, we believe that the broader risk lies in the secondary impact on consumer spending via the "Wealth Effect."

Much has been written about the “K” shaped economy. Those with resources have been spending through this inflationary cycle, which has been heavily underwritten by appreciating asset values, including equity portfolios and home prices. A selloff in the broader stock market, led by a pullback in AI spending, triggers a pullback in tech stocks, could cause a sharp contraction in asset valuations, and potentially lead to a curtailment of consumer spending, which could negatively impact the economy.

Portfolio Strategy: Position Horizontally > Vertically

In this environment, we are cautious about committing aggressively to any single asset class, since there are pitfalls abound in each.

- **Equities:** Large-cap equities remain supported by solid underlying earnings growth if AI infrastructure spending persists. Small-cap and international equities trade at appealing valuation discounts relative to U.S. large-caps, though both carry distinct structural headwinds.
- **Fixed Income:** Bonds yields are higher, making them slightly more of a competitor to the marginal asset allocation dollar, but long-term returns may simply represent a return to historical averages.
- **Cash:** Useful for short-term liquidity, but historically inadequate as a long-term capital preservation engine.
- **Private Equity & Alternatives:** Present select opportunities but require investors to accept extended illiquidity.

Rather than making concentrated, high-conviction bets, current conditions favor casting a wide net, using a balanced, broadly diversified approach, prioritizing liquidity, downside protection, and disciplined risk management across the entire portfolio. Given the bull market rally, it is easy to forget that bear markets are a recurring feature of an investment cycle, not an anomaly.

Oh, a penny for Charlie Munger’s thoughts when he heard the news of the Situational Awareness hedge fund implosion.

John Petrides

Sources:

[1] Bespoke Investment Group, *Bull Market Confirmed*, 10/6/26

[2]

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[3] https://tradingeconomics.com/united-states/strategic-petroleum-reserve-crude-oil-stocks

[4] https://www.comparethecloud.net/news/ai-linked-companies-now-account-for-62-of-sp-500-market-cap-as-economy-wide-expansion-continues

[5] https://www.reuters.com/world/china/global-markets-global-markets-2026-10-01/

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Mr. Petrides received his M.B.A. from Pace University School of Business in 2005, and his B.A. from Fairfield University in 1999. Mr. Petrides served as an AmeriCorps Volunteer from 1999-2000.

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