

Corporate Fundamentals 2Q26; AI Debt Issuance Can't Stop Won't Stop

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Corporate Fundamentals Are in Good Shape

Corporate credit fundamentals enter the second quarter of 2026 on a solid footing. Macroeconomic factors are mostly benign, the consumer is in good shape and corporate balance sheets and cash flows are healthy and robust. However, there are areas of concern like eye-watering capital expenditures and debt issuance from Hyperscalers; the lingering conflict between the U.S./Israel and Iran and its effect on Treasury rates; and the wealth effect on consumption. Below we provide the outlook for corporate fundamentals over the next several quarters and provide more details about these concerns.

Consensus expects S&P 500 revenue to increase just under 10% and operating margins to expand by nearly 200 basis points from 1Q26 to 1Q27. Industries benefitting from the datacenter buildout are expected to achieve the highest top line growth again, but even when one excludes the Mag-7, revenue growth is expected to be a respectable 7%. More impressive in our opinion is the expected margin expansion. Excluding the IT sector, operating margins are expected to reach 15% in 1Q27, a 177bps expansion from 1Q26. Moreover, this expansion is broad - each of the major industry classifications are expected to show positive margin expansion over the next year. The market clearly expects corporate cash flows to remain healthy over the next year. What about balance sheets? Well, that's more nuanced.

Corporate Health AI Dependent

Capital spending for the S&P 500 increased by 33% in 1Q26, the fastest pace since the dot.com era. Capex estimates for the big five Hyperscalers (AMZN, GOOGL, MSFT, META, and ORCL) are up 40% YTD and are now expected to grow 80% in 2026 to nearly \$750 billion and then another 50% in 2027 to over \$1 trillion¹. Traditionally, these companies have funded their capital spending with internally generated cash flows and have had pristine balance sheets. However, in recent months they have relied on massive debt issuance. Year to date, Hyperscalers have issued \$132 billion of debt (\$157 billion including Nvidia's recent offering) in the U.S. or more than 12% of total corporate supply to meet those needs.

There are significant implications for issuance of this magnitude. At a high level, the overall credit rating quality of the issuers in the Bloomberg Barclays Index has improved. As Barclays highlights in Figure 1, Double-A YTD issuance made up 19% of total issuance compared to only 8% last year at this time. Moreover according to Morgan Stanley, the AI-related share of the IG index has doubled in the past year to 6%.

Figure 1

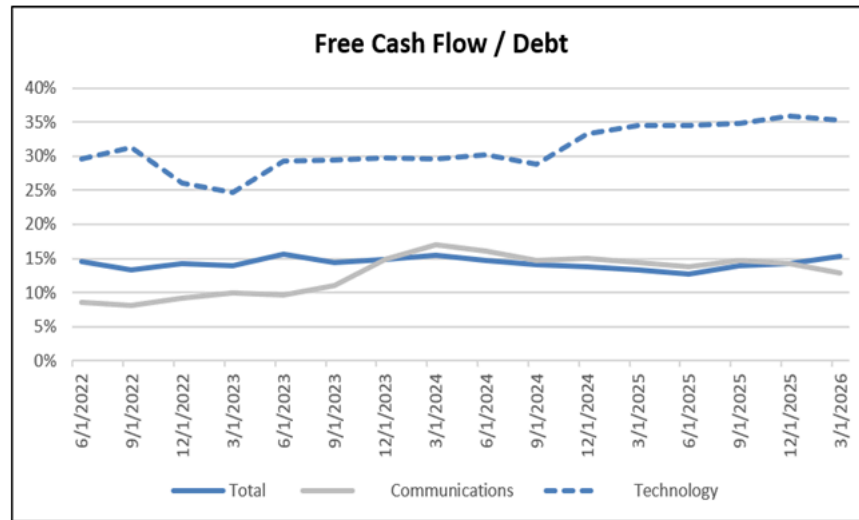
Rating	U.S. Issuance in Billions		Issuance as a % of Total		YOY %
	2025 YTD	2026 YTD	2025 YTD	2026 YTD	Change
Triple-A	\$5	\$0	1%	0%	-100%
Double-A	\$81	\$240	8%	19%	196%
Single-A	\$427	\$472	44%	37%	10%
Triple-B	\$429	\$520	44%	41%	21%
Five-B	<u>\$33</u>	<u>\$42</u>	<u>3%</u>	<u>3%</u>	<u>28%</u>
TOTAL	\$975	\$1,273	100%	100%	31%

Source: Barclays, July 10, 2026

Secondly, the Hyperscalers have been large contributors to the overall health of the Corporate sector in general given their significant free cash flow and relatively small amount of debt. That has changed dramatically in a short amount of time – we expect free cash flow from the Hyperscalers to decline substantially in the upcoming year given the very large capital expenditures and their debt to increase at the same time. Expect Figure 2 to look weaker in the next two quarters. So, the quality of the index ratings improves, but aggregate balance sheet health is very likely to weaken.

¹ Morgan Stanley; Internet North America; July 12, 2026

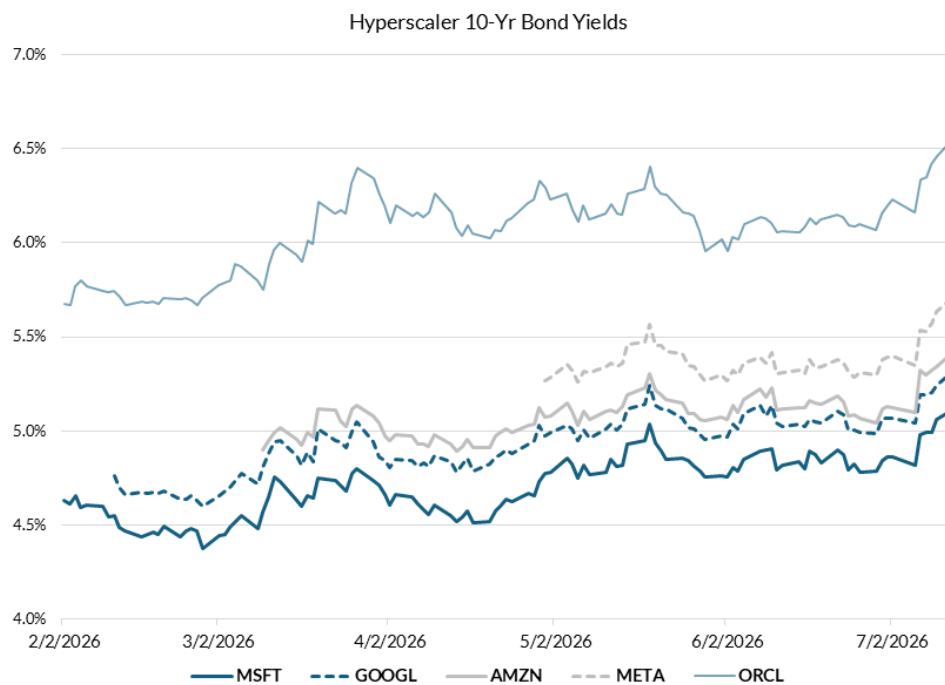
Figure 2



Source: AAM & Bloomberg

Fixed income market participants have in recent weeks priced in the risk of companies with weaker credit profiles becoming serial issuers to fund the AI-arms race. Spreads relative to Treasury bonds have widened, new issue concessions are increasing and order book sizes relative to issue sizes have compressed. These conditions, along with higher interest rates, have led to a higher cost of capital for the Hyperscalers – we estimate that the weighted average cost of debt for this group has increased between 30bps and 80bps year to date (Figure 3).

Figure 3



Source: AAM & Bloomberg

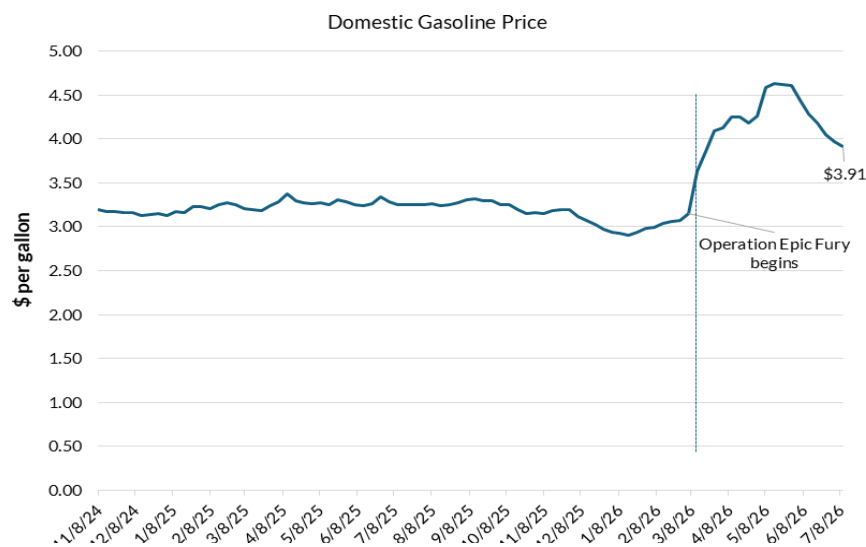
Key items we continue to monitor as it relates to the AI / datacenter buildout are adoption rates, productivity gains, margin expansion of adopters and return on investment. We are comfortable with adoption rates so far. AI adoption by firms rose to 21% among US establishments (with adoption expected to rise to 24% in the next 6 months) according to the Census Bureau's Business Trends and Outlook Survey (BTOS). Information, professional services, finance, and education firms continue to lead adoption. Productivity gains, according to academic studies, appear to be meaningfully positive at about 23%². What is less clear at this point is margin expansion of adopters and returns on the substantial investment by the Hyperscalers. According to Goldman Sachs, there is no statistical relationship between margin change over the last three years with AI exposure. We believe that relationship needs to considerably improve to justify token spend by companies using AI. Finally, we look forward to the returns of Hyperscalers subsequent to the meaningful money spent in 2026.

Escalating Conflict in the Middle East Muddies the Rates Picture

In the last 90 days, crude oil prices rallied 20%, collapsed 30%, rebounded 15% and now sit at just \$80 per barrel. Those of you that attended AAM's client conference were prepared for this volatility. Lieutenant General David Bellon pointed out that we should all expect ongoing flare-ups between the U.S., Iran, Israel and Hezbollah in the near-term and a resumption of full-scale fighting at some point. The latest tit-for-tat between the countries has resulted in a U.S. Naval blockade against Iran. Lieutenant General Bellon suggested we monitor U.S. aircraft carrier movements in advance of a potential increase in hostilities, which could influence crude supplies.

What really matters to consumers though is the price of gasoline, diesel and jet fuel. Gasoline is now just under \$4 per gallon or 25% above its pre-conflict level. We suspect that it will remain near or above that level in the next several quarters given the new blockade put in place, the historically high refining utilization rates (85% currently compared to 81% historically) and the 6 million barrels per day of refining capacity that is off-line in Russia and the Middle East due to conflict.

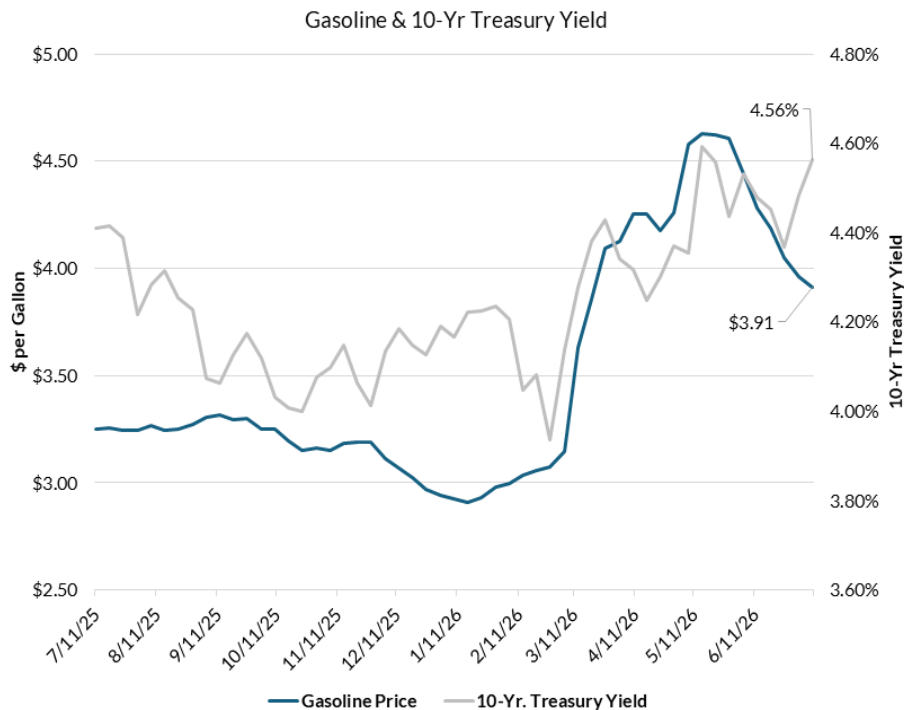
Figure 4



We believe that oil and refined product prices at these levels are manageable both in terms of inflation and growth. We use a rule of thumb that for each 10% change in oil price on a sustained basis results in an increase of 4 basis points on core inflation. We also assume that a 10% change in oil on a sustained basis results in -10 basis point change in economic growth. Therefore the 20%-30% change we have observed in energy prices should not materially affect inflation or economic growth in the near term. However, if conditions in the Middle East deteriorate and energy prices were to reach and sustainably remain at April 2026 levels, we would likely see higher inflation and weaker growth.

How would Treasury yields react to this situation? Historically, the relationship between gasoline prices and the Treasury yield is weak – an R2 of around 6% over the last 20 years. However, if the past year the relationship between the two has increased pretty dramatically – an R2 of more than 55% (Figure 5). This is concerning because it could influence one of the biggest fundamental tailwinds we have observed over the past 5 years – the Wealth Effect.

Figure 5



Source: AAM, EIA & Bloomberg

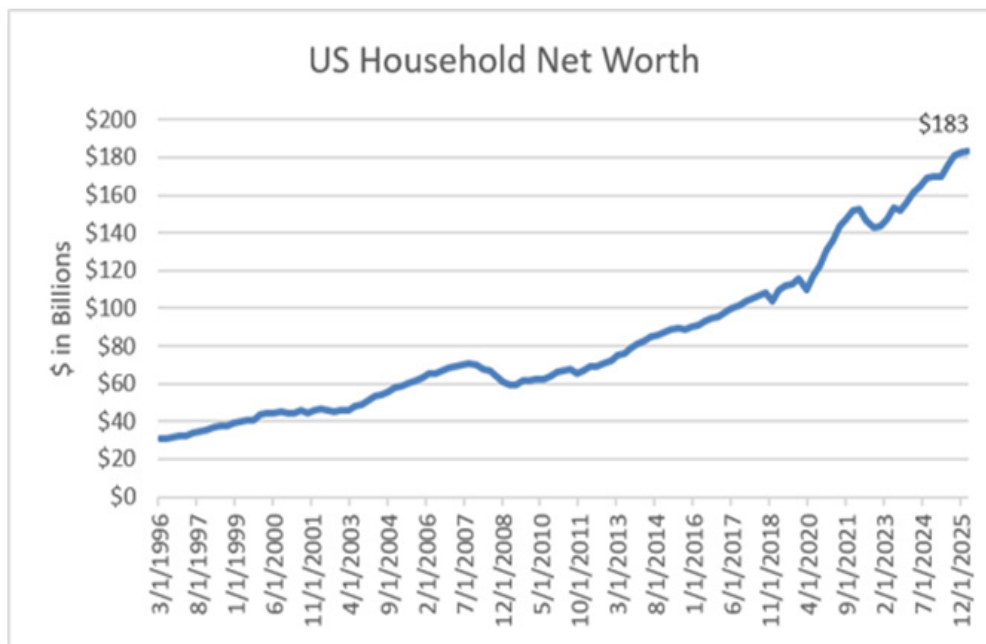
The Wealth Effect

We are monitoring how the increased capital needs from Hyperscalers combined with the risk of higher for longer Treasury rates could influence the potent Wealth effect and its influence on consumer spending. From 2019 through 2025, household net worth grew by \$67 trillion (Figure 6), with half coming from increased equity valuation, one third from higher housing values and the remainder from other items like pensions. According to our analysis, for every dollar change in equity values, consumption shifts by 2.5%, which is largely driven by those individuals in the highest decile of

income. This is reflected in recent discretionary card spending, with those individuals in the top 5% of income increasing their spending by almost 8%.

This trend of the wealthiest spending and supporting the economy remains firmly in place. Of the leading signals we screen, nearly all of them are flashing green. However, we also observe that the affluent are trading down in terms of where they shop and what they purchase – they are chasing value, which is a late-cycle tell. This along with eroding consumer confidence has our attention. Were there to be a sustained equity drawdown (not our forecast, but something we incorporate into our economic scenario planning), we believe there is risk of a reversal of the wealth effect tailwind – one that could curtail economic growth by more than 0.5%.

Figure 6



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