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Trust and Wealth Management

QUARTERLY MARKET INSIGHTS – THIRD QUARTER 2025

To the Clients and Friends of Hilltop Bank Trust and Wealth Management:

For some folks, it is the ultimate prize to have something to which you contributed named after you. Many successful people like William Wrigley Jr., Cornelius Vanderbilt, or T. Boone Pickens, have even paid significant sums of money for such an honor. For others, like Ferdinand von Zeppelin, John Montagu, or Caspar Collins, the association came about more organically.

Perhaps no group is more prolific at naming things after themselves, or having things named after them by others, than economists. From whole schools of theory like Keynesianism or Marxism, to ideas like the Taylor rule or the Laffer curve, there may not be a more eponymous profession. One of those so blessed was Hyman Minsky, a late American professor who studied financial market fragility and economic cycles. Minsky is best known for his financial instability hypotheses, from which we get something called the Minsky moment.

His hypothesis was that an important mechanism that pushes economies from stability into crisis is the accumulation of debt in the private sector. That is, the seeds of future instability are planted during periods of relative calm, in the form of leverage and risk-taking. Of course, in order to have debt, you have to have borrowers, and he described three types, arriving in phases.

First, in the "hedge phase" after a crisis and recovery, borrowers will be cautious and take out minimal loans that they are confident of repaying. Next, you will arrive at the "speculative borrowing phase" where confidence is high and loans may be issued to borrowers who can only pay the interest, but will need to sell the collateral in order to pay back the principal. Here, the thinking goes that the collateral will have increased in value over that time (think stocks or real estate), allowing for a profit even after the loan is repaid. Finally, you will arrive at the "Ponzi phase" (another eponym, though more infamous), where self-assured borrowers reach a new level of speculation, relying on appreciation of the collateral to pay not only the principal, but the interest too.

The longer this goes on, and the more debt that builds up, the more dangerous the cycle becomes. Eventually, there will be some collateral that fails to appreciate enough, and a hole will be poked in the entire enterprise. A good example comes from the housing crisis, where borrowers took out teaser rates on mortgages they couldn't afford. For a while, when those rates reset, the houses would be worth enough extra that the borrower could just refinance and take out equity to pay the interest. That worked until it didn't. A Minsky moment. The collapse of Lehman Brothers.

I'll digress now and state that I don't think we are nearing such a moment now. That being said, if we squint, it's possible to see a similar set of circumstances to those that have led us there in the past – exuberance about a new development, vast sums invested in its future, but insufficient immediate cash flow, and layers of debt that may obfuscate the amount of leverage in the system. Specifically, what's on my mind is the massive buildout of data centers which are now contributing more to GDP growth than the 70% of our economy that comes from consumer spending.

At the end of the second quarter of this year, the U.S. had around 522 hyperscale data centers. These are massive facilities that house the huge number of servers and chips needed to support all the technology in our lives. According to some reports, another 280 such centers are expected to come online over the next three years. Just this month, we have seen announcements for a 1.5-gigawatt data center near Casper and a 302-megawatt facility near Cheyenne. (For reference, a gigawatt is one billion watts, or enough to power about three-quarters of a million homes). One Wall Street bank estimates that among the largest hyperscaler companies (Google, Meta, Oracle, etc.), capital expenditures will increase from $154 billion in 2023 to $368 billion by the end of this year, and $432 billion by the end of 2026. They have raised these projections each of the last three years.

As you'll know, the impetus for these massive investments has been the rollout of generative AI. While we have discussed AI in these pages before, it was mostly around what to expect when hype-machines start running, and how not to get too excited when they do, or too negative if they outrun the actual ability of the new technology, before it may eventually live up to its promise.

This time around, the question is more specific and perhaps of more interest to us as financial market observers rather than technologists. At its core, it is essentially who is going to pay for these massive capital expenditures, and how?

To be sure, the hyperscalers are large companies, good businesses with healthy margins and hundreds of billions of dollars in cash on hand. As of this writing, they have a collective market capitalization of over $20 trillion. The way they've gotten there has been by being asset-light, with a focus on scalability.

For example, once Google develops its search engine, it doesn't cost them much extra to let a user do one search or twenty. Actually, they would prefer you do twenty because they generate additional ad revenue from each one. Similarly, once Meta bought Instagram, it didn't have to pay influencers to fill it with content users want to see. Just slip in an ad here and there. Historically, these companies have capitalized on the value of networks, software, and intellectual property rather than hard assets like the chips and servers that go into data centers.

The asset-light nature of these companies, however, is quickly changing. Capital expenditures in the technology sector are growing rapidly as they build out these massive data centers, outpacing even their growing incomes. Very little of that growing income is actually coming from generative AI. It seems likely that without another technological breakthrough, they will not be able to fund the unlimited expansion through their other businesses.

The next, most obvious financing option, is to fund it with debt. Which brings us back to Minsky, and why I say that while we don't appear to be near a moment, they are worth keeping in mind.

A shift toward debt financing for the AI buildout is, in fact, underway. Goldman Sachs notes that there have been $20 billion of bonds issued for data center deals this year, and AI companies have issued $141 billion in other corporate credit. JP Morgan reports that AI companies now make up 14% of the total high-grade credit market, surpassing banks as the largest sector.

While there's nothing wrong with using debt, we are starting to see deal terms that suggest we are entering a speculative borrowing phase. For example, data center developments backed by junk bonds, cash flows from individual projects diced up into the same kind of collateralized debt obligations we saw in the housing crisis, and the use of special purpose vehicles that keep the debt off the hyperscaler's own balance sheet. What's more, many of these bonds won't mature for twenty-five years, while NVIDIA releases new chips every two. If that's the collateral, what's it going to be worth at maturity? In the meantime, is there really such an unlimited demand for computing power that rental rates for it won't go down?

On the other side of the transaction, rather than just banks and bondholders funding the debt, it is often conducted by less-regulated non-bank financial institutions or private credit, which is its own explosively growing business. As opposed to relying on depositors to fund loans, like a traditional bank, these firms take investor money, leverage it with other borrowed funds, and then lend it out themselves. Adding further layers of leverage to the system.

While we remain in the early innings of this development boom, the speed and enthusiasm of the build-out are reminiscent of other infrastructure booms like fiber optic in the 1990s, or even the railroad boom a century ago. While those booms left behind assets that proved useful in the future (e.g., Netflix likely wouldn't exist without all those high-speed connections), the path was littered with failed investments.

This is all far from inevitable; we are not so far past other Minsky moments to have forgotten they exist. Talk of such a bubble, is in fact itself reaching bubble proportions. Before we approach one, we may find ourselves constrained by any combination of prudence, memory, or even physical limits on the amount of power supply available.

That being said, I believe it's helpful for us to consider risks preemptively. That is, by contemplating what may go wrong, we can prepare for it both logically and emotionally, despite our inability to perfectly predict it. We can keep in mind that we invest, generally, over multiple business cycles, and avoid chasing recent returns or rushing to the sidelines at the first sign of trouble. Thinking of Minsky, we can try to discern what phase we're in without falling in to the temptation of trying to time the market.

Best,

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