Quarterly Review and Outlook Using the CAPE Ratio

Q4 2026 – **Robert J. Shiller and Laurence Black**

"Are You Feeling the AGI?"

It's been an interesting time in the markets. Then again, when is it ever boring? Last quarter, the S&P 500 was mostly flat, but that doesn't tell the whole story. Behind the headlines, some parts of the market moved a lot. For example, momentum stocks, including AI-related companies like Micron, SanDisk, AMD, and Alphabet, have performed very well over the past few years. But last quarter, that trend slowed, and those stocks fell significantly.

We know AI has been one of the biggest stories in the public markets, but that story may be starting to change. For the past several years, excitement around AI has been driven by rapid advances in technology, major investments, rising valuations, and, of course, FOMO (Fear of Missing Out). In Silicon Valley, a popular question is: "Are you feeling the AGI?"[1]

But narratives evolve, and we are now seeing more caution enter the conversation. Safety concerns about AI technology and questions surrounding capital expenditure have exposed weaknesses in AI-related stocks in the last quarter. Another point we have noticed around AI is that the sentiment is not evenly spread across the globe. An IPSOS survey[2] shows that in developed markets, people are highly nervous about AI, while in emerging markets they are excited. Perhaps this is because in emerging markets people are excited about getting access to high-quality knowledge that could put them on par with the rest of the world, while those in developed markets are worried about losing jobs and AI taking over. Professor Shiller thinks that this fear and excitement around AI resemble a Gordian Knot[3] type of problem – we are excited by the ability of new tools to drive huge productivity gains and assist us in solving key problems, yet AI is creating paralyzing, complex issues for humanity to confront.

Another important development is the rapid improvement of lower-cost, open-source AI models, especially those from China. According to Artificial Analysis, a firm that tracks AI model capabilities, Chinese open-source models are increasingly closing the gap with the leading frontier models developed in the United States.[4] At the same time, the use of open-source models has grown significantly, rising from about 40% at the start of the year to roughly 80% by September 2026.[5] Despite having increasingly similar capabilities, there is still a large difference in how these companies are valued. Leading U.S. AI companies, such as OpenAI and Anthropic, have been valued at $852 billion and $965 billion, respectively,[6] while Chinese companies such as Moonshot and DeepSeek have valuations of $70 billion and $74 billion.[7] If these models continue to become more alike in their capabilities, investors may eventually have to reconsider this valuation gap.

As the gap in large language model (LLM) capabilities continues to close, an important question remains: will a few companies emerge as clear winners, or will AI models become a commodity? Many technologies that were once groundbreaking eventually became widely available, including railroads, electricity, radio, and broadband. In those cases, the biggest winners were often the companies that found effective ways to use the technology. The AI story may be heading in a similar direction. Instead of benefiting only a small group of technology companies, AI-driven productivity gains could spread across the broader economy and help support earnings in sectors that receive less attention today. This highlights the importance of diversification and avoiding too much concentration in a single theme or sector.

Another important point is that when OpenAI and Anthropic go public, large investors may need to sell some of the stocks they already own to buy shares in these companies. Typically, they will sell stock of similar companies, and this

may put further pressure on the technology sector.[8]

From a broader economic perspective, the U.S. economy remains strong. GDP continues to grow, and corporate earnings have remained solid, even with high oil prices and the 10-year Treasury yield rising above 5%. Some of that economic growth appears to be linked to ongoing investment in AI. This quarter, stocks in Europe and Japan outperformed U.S. stocks. One reason may be that their markets are less tied to the AI story and have lower valuations. Europe and Japan currently have CAPE ratios of 22.3 and 29.9, respectively, which may offer investors attractive opportunities and another reason to stay diversified. In comparison, the U.S. CAPE ratio remains elevated at 40.7, down slightly from 41.4 last quarter. At these valuation levels, companies will likely need to continue growing earnings to support further gains in the stock market.

Sources:

1: Eleos AI Researcher.

2: Ipsos AI Monitor 2025

3: The Gordian Knot was an impossible knot created by King Gordius of Phrygia (near Turkey today), which an oracle prophesied could only be untied by the future ruler of Asia. Alexander the Great could not untie it but slashed through it with his sword, and he did conquer much of Asia. Today it symbolizes an intractable problem solved by bold, unconventional action.

4: Artificialanalysis.ai/models.

5: FT "How big is the open-model threat to AI Hyperscalers?" Sept 16, 2026.

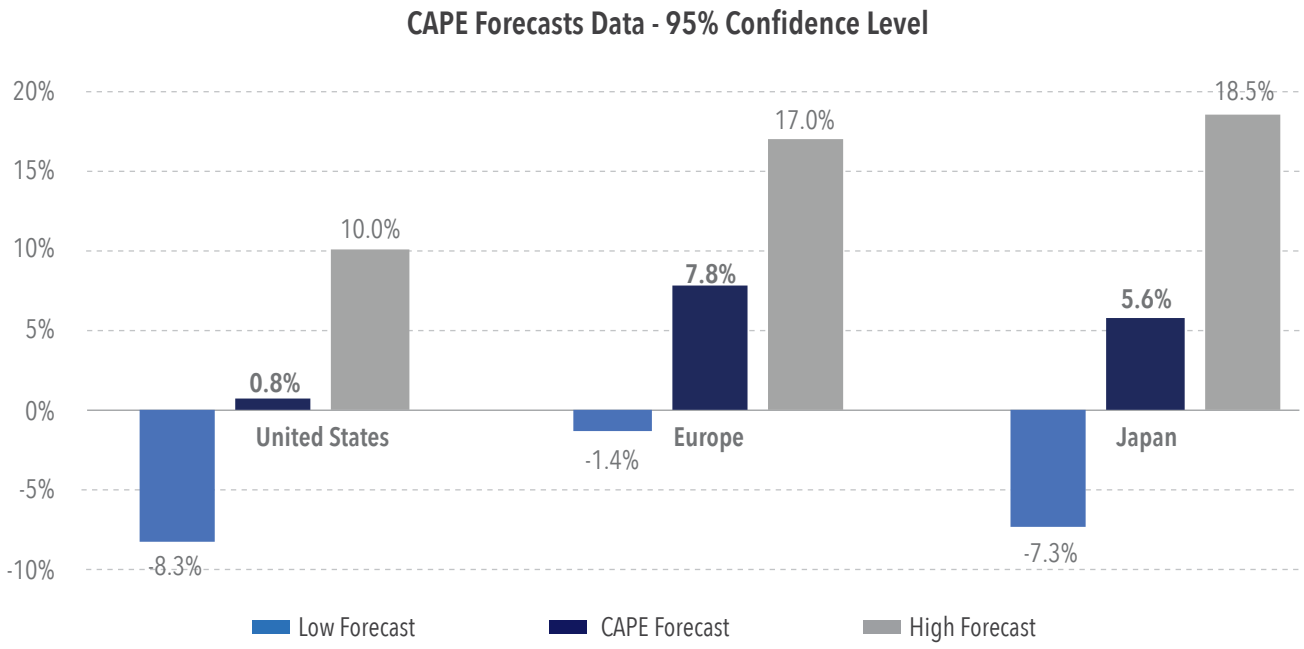
6: CNBC: Tech: OpenAI closes record-breaking $122 billion funding round as anticipation builds for IPO. Forbes: Anthropic IPO Could Hit $2 Trillion– And Put Public Investors Last. Sept 2026

7: Bloomberg: Moonshot AI Surpasses Funding Goal to Hit $35 Billion Value. WSJ: AI Startup DeepSeek Poised to Reach $74 Billion Valuation August 2026.

8: Paul Kedrosky: An AI IPO Impact Update: The AnthroPix Effect May Be $5-Trillion+

Key Findings: Our Forecasts based on the CAPE Ratio

These forecasts are shown in local currencies and are based on nominal returns. We provide a range that reflects a 95% prediction interval, which helps show the uncertainty around our forecasts. We use established methods to estimate future returns, but financial markets are highly unpredictable, which makes forecasting difficult. Unexpected events can also affect market performance and may cause actual results to be higher or lower than our forecasts.



Source: Data from Robert Shiller online data, MSCI, World Bank, and OECD.

A Note About Forecasting

These forecasts show expected annual returns over a 10-year period. They are designed to help investors make long-term decisions about how to allocate investments across different equity markets. They are not intended for market timing or for predicting short- or medium-term performance, since short-term market forecasts are often unreliable. The forecasts are presented as nominal annualized total returns in local currencies and should be used as a general guide, not a guarantee of future results. They do not attempt to measure the impact of unique events, such as COVID-19, political changes, or shifts in monetary policy. This is not because those events are unimportant, but because their effects are difficult to estimate with confidence.

We also include ranges, known as 95% prediction intervals, to show the uncertainty around our forecasts. Even these ranges have limitations because not all risks and future events can be measured or predicted. For example, some investors may believe the upper end of the 10-year return forecast for Japan is too high. They may argue that, after the market boom and decline of the 1980s and 1990s, Japanese investors are less likely to overvalue stocks in the future. However, there is no way to know for certain if that belief is correct because it depends on assumptions about how people will think and behave in the years ahead.

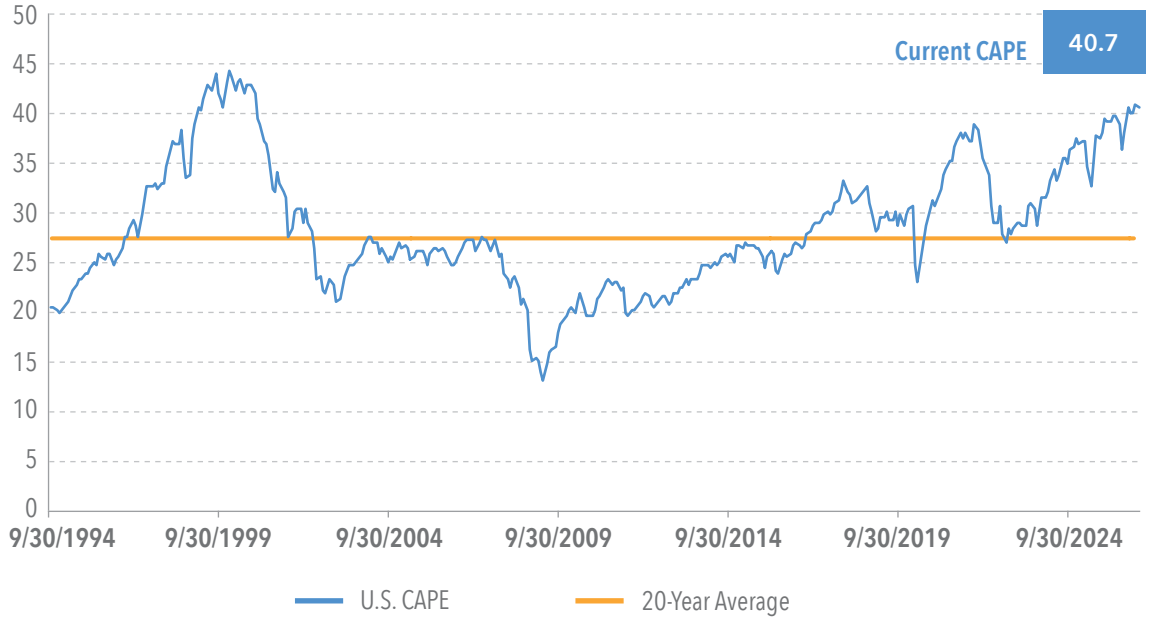
United States – Forecasts Based on the S&P 500 Index

The CAPE Ratio for the United States is 40.7, which is one of the highest levels on record. Based on this valuation, the expected annualized nominal total return over the next 10 years is 0.8%. Returns for the S&P 500 Price Return Index are expected to be negative over that period. We also provide a range of possible outcomes to reflect the uncertainty of these forecasts. Professor Shiller worked with Barclays to create the Shiller Barclays CAPE Family of Indices. These indexes use the CAPE Ratio to identify stocks and sectors that may be undervalued. Their goal is to capture the long-term benefits of value investing. Past performance does not guarantee future results. However, investors who buy and hold a value-based index for the long term could earn higher returns than our forecasts suggest if value stocks perform well.

UNITED STATES FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (S&P 500 Total Return Index)	0.8%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	10.0%
Lower Range of Expected Nominal Total Returns* (95% Confidence Level)	-8.3%
Approximate Expected Nominal Price Returns* (S&P 500 Price Return Index)	Less than zero

*using the CAPE Ratio

Historical U.S. CAPE Ratio



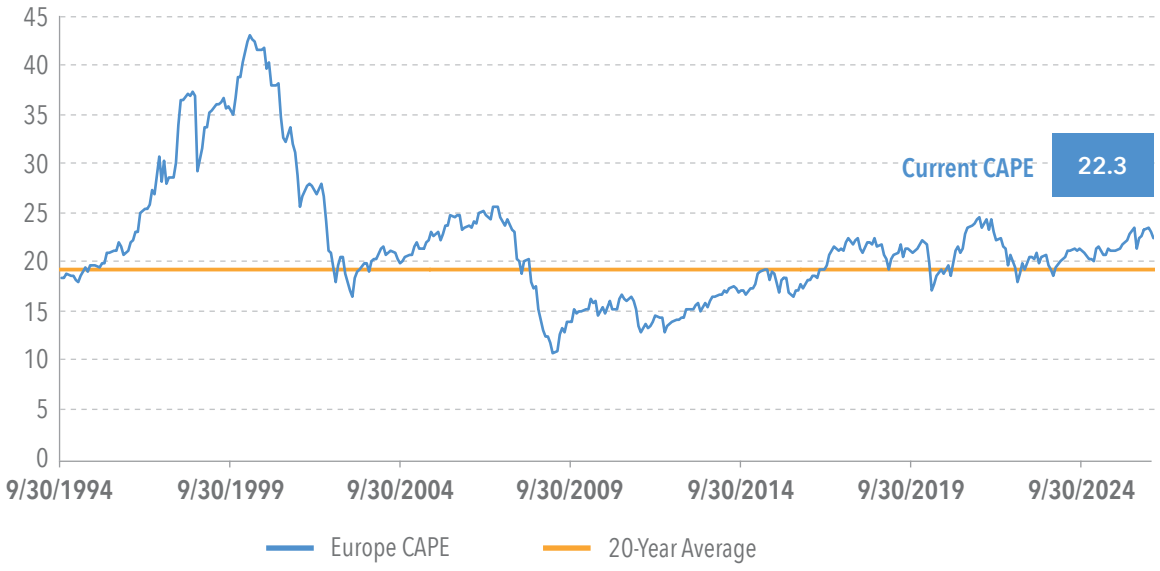
Europe – Forecasts Based on the MSCI Europe Index

The CAPE Ratio for Europe is 22.3, and the expected annualized nominal total return over the next 10 years is 7.8% as of the end of this quarter. Returns for the MSCI Europe Price Return Index are expected to be about 4.9%. This estimate is based on the index's historical dividend yield and assumes those dividend levels remain similar over the next 10 years. We also provide a range of possible outcomes to reflect the uncertainty of these forecasts.

EUROPE FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (MSCI Europe Total Return Index)	7.8%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	17%
Lower Range of Expected Nominal Total Returns* (95% Confidence Level)	-1.4%
Approximate Expected Nominal Price Returns (MSCI Europe Price Return Index)	4.9%

*using the CAPE Ratio

Historical Europe CAPE Ratio



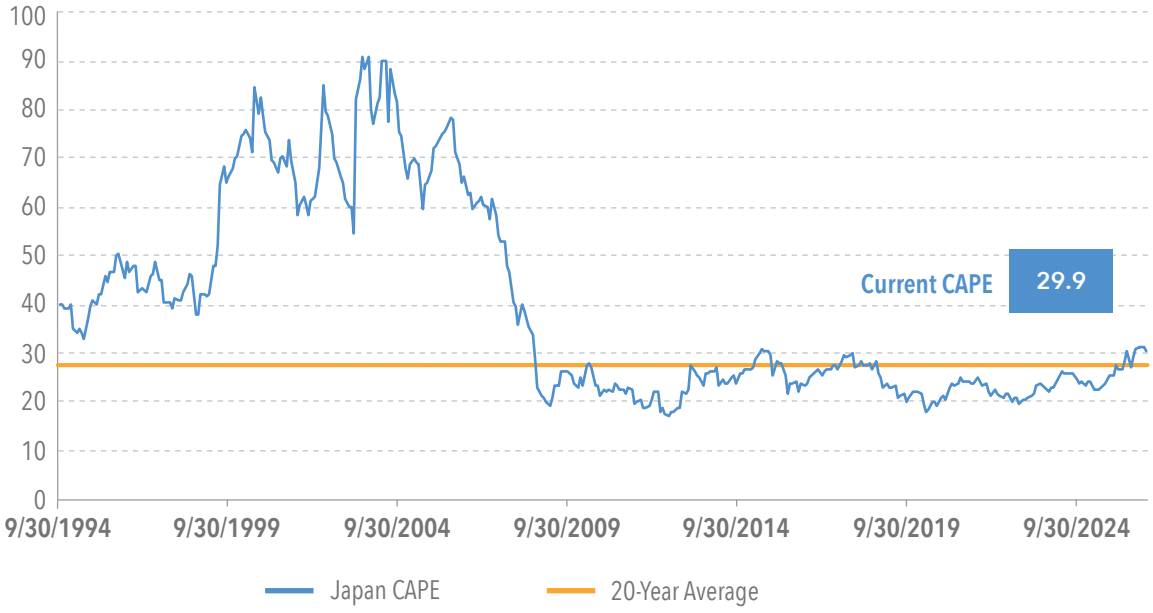
Japan – Forecasts Based on the MSCI Japan Index

The CAPE Ratio for Japan is 29.9, and the expected annualized nominal total return over the next 10 years is 5.6%. Returns for the MSCI Japan Price Return Index are expected to be 3.7%. This forecast is based on historical dividend yield data from Bloomberg and assumes dividend yields remain similar over the next 10 years. We also provide a range of possible outcomes to reflect the uncertainty of these forecasts. It is important to note that our forecasts include Japan's asset bubble of the 1980s, which may cause some of these estimates to be higher than they otherwise would be.

JAPAN FORECAST RETURNS	EXPECTED ANNUALIZED RETURNS
Expected Nominal Total Returns* (MSCI Japan Total Return Index)	5.6%
Upper Range of Expected Nominal Total Returns* (95% Confidence Level)	18.5%
Lower Range of Expected Nominal Total Returns * (95% Confidence Level)	-7.3%
Approximate Expected Nominal Price Returns (MSCI Japan Price Return Index)	3.7%

*using the CAPE Ratio

Historical Japan CAPE Ratio



Approach to Forecasting

We outline our approach to forecasting in this section. Firstly, we predict the nominal total returns based on the CAPE Ratio, as developed by Robert Shiller and John Campbell in their paper "Stock Prices, Earnings and Expected Dividends." To generate the forecast, we regress ten-year nominal returns on the prevailing CAPE level. We also show ranges for each country's forecasted returns to indicate the uncertainty around our forecasts.

Professor Shiller noted that returns are influenced both by the CAPE and an estimated long-term interest rate in the 3rd Edition of ***Irrational Exuberance***. We expect that in years to come the science of narrative economics, with the expansion of our use of digitized text and artificial intelligence to look for specific indicators of public spreading of ideas, will be used to narrow our prediction intervals. They may be able to develop a time series of evidence on how the public will be thinking about multiple relevant economic narratives, such as about the intense COVID-19 pandemic narrative with its politicized connection to other narratives, or about the prospects for world war, or about climate change, to improve our forecasts of economic variables. Now, however, we use the CAPE ratio, suggesting overpricing or underpricing, to help us predict the markets.

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