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Three Smart Questions (and Three Answers That Aspire to Be Worthy) to Uncover the Pulse of the Markets

Dear Client,

After carefully reading and reflecting on the work of several colleagues in the field —whose insights I acknowledge with genuine appreciation— I have sought to organize here the ideas that have helped me the most in understanding the current state of the markets. I will do so in the form of questions and answers.

The questions are the ones you most often ask me —thoughtful and well-framed, without a doubt— while the answers simply try to be worthy of them.

1. Is the consumer still holding up?

(-) A softening U.S. labor market, recent reports of loan-related fraud, growing concerns about shadow banking, and tariff pressures have all reignited doubts about consumer strength —especially among lower-income households. This is reflected in weaker earnings forecasts for Consumer Discretionary and Consumer Staples, two of the four sectors expected to show EPS declines in 3Q. In particular, Consumer Discretionary could post a ~2% YoY decline, its first since 4Q 2022. Combined with slower hiring, these factors could weigh on spending in the months ahead, particularly among lower-income consumers. We therefore maintain a cautious stance toward consumer-oriented sectors.

(+) **Still, signs of resilience persist**: (1) on the retail side, major banks report healthy credit and debit card activity; (2) airlines continue to see robust travel demand; and (3) at the higher end, LVMH has posted its strongest U.S. sales growth since 2023.

2. Can technology continue to lead?

Amid growing debate over a potential *tech bubble*, 3Q earnings will be critical in assessing the real health of the AI and technology investment cycle.

(+) So far, since 2022, full-year earnings for the MAGMAN group have surged 140%, versus just 7% for the rest of the index. Given the group's protective moat, margin discipline, and strong order books, **we see little reason for that to change**. Current estimates call for +18% EPS growth in MAGMAN, marking their 11th consecutive quarter of outperforming the broader market (estimated at +4%).

(+) Early overseas results from ASML and TSMC confirm that **the AI-related supply chain remains solid**. China's recent move to soften its stance after threatening restrictions on rare-earth exports —and the U.S. counter-response threatening to exclude China from the global chip chain— has also eased tensions and invites cautious optimism.

(+) Guidance from software firms and major data-center operators will be key to identifying the next phase of the cycle. For now, **the outlook remains favorable for the enabling segments of this transition**: *Electronic Design Automation (EDA), IP cores and* *chip architecture, memory and storage, pure-play foundries, front-end and back-end manufacturing, silicon wafers, ultra-pure chemicals, and advanced packaging*. We view these as the structural winners of the coming decade —and perhaps the source of the next “Magnificent.”

(+) **In our humble opinion, there is no capex bubble in compute**: (1) Historically, every wave of investment in compute has proven insufficient, with all available capacity absorbed by demand. (2) Today, we have placed reasoning —or cognitive capability— within reach of machines, and consequently, within our own reach; a leap that multiplies the demand for compute by several orders of magnitude. (3) What we see is not excess, but a race to expand reasoning and computation to solve problems previously beyond our computational reach. Whoever succeeds first will naturally hold the leadership position. History supports this: Intel defined an era by mastering the microprocessor; Microsoft led the operating-system revolution by standardizing first; Nvidia foresaw the rise of parallel computing before anyone else, and now its barriers to entry are formidable. In this new race —that of AI-assisted reasoning and extreme compute— leadership will again belong to those who arrive first.

(+) In conclusion, we expect the Technology sector to continue outperforming the S&P 500 through end-2026, with margins nearly twice as high (27% vs 13%) and shareholder-friendly policies (higher dividends and buybacks supported by the OBBA). **We remain overweight Technology in discretionary mandates**.

(+) Broader **momentum also supports the index**: for the first time in years, **earnings estimates are rising rather than being cut**. Over the past 12 weeks, S&P 500 EPS forecasts have increased 0.4% (FactSet) versus an average 3.2% cut at this point in the year over the last decade. Strong U.S. economic growth (Atlanta Fed GDPNow estimates +3.9%) underpins expectations for further positive surprises in 3Q (+3% to +5%), though smaller than the 10-quarter average of +6.8%.
At this stage, we will focus more on revenue growth than on cost-cutting measures. Elevated valuations mean that any disappointment in top-line growth could be penalized sharply.

3. What about small caps? Will earnings support another breakout?

(-) Small caps (Russell 2000) have outperformed large caps (S&P 500) since the April lows —a positive surprise. However, earnings tell a different story: aggregate small-cap EPS remains 7% below its 2021 peak, while large-cap EPS has risen 22% over the same period.

(+) For 3Q, small-cap EPS is expected to rise ~7%, marking only the third quarter of growth in three years. Estimates are finally stabilizing, but it is still early to call a turnaround.

(-) Structural risks persist: (1) high exposure to regional banks, where any renewed credit stress could quickly hit small caps; and (2) exposure to unprofitable tech and early-stage firms.
On relative strength, large-caps remain fundamentally better positioned, so **we continue to favor large-caps, maintaining only selective exposure to small-caps**.

Kind regards