TRIVARIATE RESEARCH

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Level Set: What Do You Do With Your New Mag 7 Money?

The Lag 7

Last week we recommended that investors reduce their exposure to the Mag 7 (link here). A combination of the stocks being high beta, their aggregate high and increasing capital spending-to-sales, relatively expensive valuation, and above-normal potential for disruption were the catalysts for our more cautious view. In our dozens of investor calls and meetings last week, we really did not get any pushback to this more negative stance. We find that modestly worrisome, as if no investors we met with will benefit from the Mag 7 working in an up tape. In the end, the stand out data points from the Q4 earnings season were the enormous level and increase in the Mag 7 capital spending.

A couple of investors asked us to rank order our views of the Mag 7 from most preferred to least preferred. Our answer to that question reminds us of the Priest in the movie Rudy. "In 35 years of equity studies, I have come up with only two hard incontrovertible facts. There is a God, and I am not him." (www.youtube.com/watch?v=H2Jroh-5KIA)

We don't know how to fundamentally or quantitatively create a back-tested system for rank ordering the Mag 7. We have no idea how to value Tesla, but shorting it seems almost as crazy as buying it today. Apple has many challenges to its growth prospects. Google is losing share in its core product. Nvidia is in a cyclical business at potentially peak growth and peak profits. Everyone loves META even though no one can guarantee the company will exist in 25 years. As an investor wryly said to us last week, what long-only firm has a decelerating growth, margin contraction fund? Gun to our head, we say we would overweight META, AMZN, and MSFT, market-weight NVDA, and underweight GOOGL, TSLA and AAPL. That's our best guess today, but we might change our minds tomorrow. Moreover, we admit we would have ranked TSLA and AAPL poorly last summer when they were the best two performing in Q3 of 2024.

Several other investors responded to our note by asking what they should buy with the money they raise through selling some Mag 7. Others asked us, besides the capital spending numbers from the Mag 7, what did we learn from earnings season.

We have several ideas, but primarily suggest that investors look to select Healthcare, Industrials, and Capital Markets-sensitive stocks to add exposure if they trim some Mag 7 to fund it.

For Healthcare:

1. The sector has very consistent revenue per share growth, and analyst estimates and recommendations embed optimism across each sub-industry despite the headlines from the potential cost-cutting from the new Head of Health and Human Services and the Department of Government Efficiency. Our judgment is that prices of stocks are embedding that there will be dramatic changes to the sector's earnings stream when in reality that is not likely. Hence, we think the sector has above-average earnings estimate achievability.
2. We are attracted to the potential for AI-induced productivity driving higher margins, seeing many Healthcare companies as ripe for efficiency gains, and stocks tend to go up when their margins expand. There are several high revenue dollar,

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high employee count, low margin businesses in Managed Care, Drug Distribution, and Healthcare Services where earnings productivity is likely even in a slowing economy.
3. The M&A cycle should also put a floor in the valuations of some stocks, given over 5% of the Healthcare stocks in the top 1000 market cap. receive a tender offer every 12 months on average.
4. In a world where stocks are ultimately revenue beneficiaries from AI, productivity beneficiaries from AI, impregnable to AI, or disrupted by AI, stocks will have multiple expansion in the beneficiary and impregnable buckets, and multiple contraction in the disrupted bucket. Many Healthcare companies stand to benefit on the productivity side, or are impregnable to AI given the certainty of an aging population requiring more services, potentially driving the sector to have not only surprisingly steady earnings, but also potentially higher multiples over several years. We think there is a reasonable chance Healthcare is the best-performing S&P500 sector over the next ten years.
5. Stocks where we have heard interesting pitches from investors in our recent meetings include GE Healthcare (Ticker: GEHC), Sarepta Therapeutics (Ticker: SRPT), and Mankind (Ticker: MNKD). High-quality growth Healthcare stocks include Boston Scientific (Ticker; BSX), Stryker (Ticker: SYK), McKesson (Ticker: MCK), and VEEV Systems (Ticker: VEEV) among others. For other approaches for idea generation, please don't hesitate to reach out.

For Industrials:

1. Our proprietary Industrial Activity Gauge is now increasing. ISM data looked slightly better last week, and we have seen some signs of green shoots during this earnings season. For instance, Parker-Hannifan (Ticker: PH) commented on improving orders.
2. Last year, the Industrial sector's revenue per share was negative for only the third time in 25 years. The previous two occasions were the Financial Crisis and COVID. Hence, comparisons in the second half of 2025 to the second half of 2024 are easy, and earnings acceleration for the median stock is nearly certain. The stock market tends to anticipate earnings acceleration by one-to-two quarters, making the timing for increasing exposure opportune today, and perhaps explaining the sector's modest year-to-date performance.
3. Inventory-to-sales had been a material post-COVID impediment, but our work shows it is change not level of inventory-to-sales that matters. Many companies in the sector saw an inventory-to-sales peak last year, and while elevated inventory levels largely persist, the reduction from the peak is on average a positive harbinger for stock performance.
4. The sector is also ripe for corporate action. Industrials are the sector with the most spin-offs historically, with headlines from Honeywell (Ticker: HON), and FedEx (Ticker: FDX) on spins grabbing attention in the last two months. We expect more ECM activity in the Industrials sector in the first half of 2025.
5. While we — like everyone else — are attracted to the Electrification theme, we saw the high correlation of that theme's poster child, Eaton (Ticker: ETN) to AI Semiconductors on the "DeepSeek Monday." We would look across multiple Industrial end-markets to add exposure, including Aerospace & Defense, Machinery, Conglomerates, and Electrical Equipment, all of which could cyclically benefit in 2025.

For Capital Markets:

1. JPMorgan (Ticker: JPM) mentioned in it earnings release that its Investment Banking revenue was up 49% year-over-year. That was one of the standout data points of the Q4 earnings season in our opinion.
2. While outside of Blackstone (Ticker: BX), the Q4 earnings season was a shade disappointing for the Alternative Asset Managers like KKR (Ticker: KKR), Apollo (Ticker: APO), and Ares (Ticker: ARES), resulting in modestly downward earnings revisions, the medium-to-long-term backdrop remains strong. Management teams continued to be very bullish on the fundraising environment, KKR's management team talked about M&A picking up in 2025. ARES management team highlighted increasing private credit activity. Moelis (Ticker: MC) discussed early evidence of a pickup in sponsor activity and Evercore (Ticker: EVR) said they anticipate 2025 to be a stronger year for ECM industry-wide.
3. We continue to want to own Financials that benefit from capital markets activity. That includes the above stocks, plus Morgan Stanley (Ticker: MS) and Goldman Sachs (Ticker: GS). We are believers.

Earnings season also provided several data points of interest for the US Consumer. The Consumer Discretionary sector has lagged year-to-date, and is now the worst-performing sector. Much of that is from TSLA. We rate the sector Underweight. The underperforming stocks have not been concentrated in one area, but include Restaurants (Chipotle Mexican Grill, Ticker: CMG is down 5.3%), Home builders (Lennar, Ticker: LEN is down 5.5% and DR Horton, Ticker: DHR is down 6.6%), low-end Retailer Ross

Stores (Ticker: ROST is down 8.3%), Automakers General Motors (Ticker: GM) and Tesla (Ticker: TSLA), down 9.2% and 11.9% respectively, and Specialty Retailers Ulta Beauty (Ticker: ULTA) and Deckers (Ticker: DECK), down 16% and 23.6% respectively. The weakness has been broad-based, and in many sub-categories. However, there have been winners. Tapestry (Ticker: TPR) up 34%, Starbucks (Ticker: SBUX) up 23.3%, and Airbnb (Ticker: ABNB) up 22.8%, are the biggest winners. Stock selection matters, but we think macro trends are weakening, and continue to view this sector with caution.

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney and Ryan McGovern, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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