TRIVARIATE RESEARCH

**US Equities**
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# Level Set - The Lack of A Bear Case and a Few Short Ideas

At a dinner this past week with seven cross-asset institutional investors, the group found it challenging to put forth a plausible near-term bear case for US equities. Most of the clients we talk to think that the US equity market finishes the year at least 5% higher from today's levels. While we have been constructive on US equities, we have to admit it is increasingly worrisome now that cross-asset and fixed income investors, who have historically been more bearish, are nearly universally bullish on stocks. During the dinner, we made two jokes about sell-signals. One, was if President Trump said to sell stocks. Obviously when he said to buy stocks it worked well, with the S&P500 up over 33% since he said "It's a great time to buy" on April 9th. Our second joke was that we would get bearish if JPMorgan (JPM) CEO Jamie Dimon got bullish, since he has been consistently bearish on US equities even as his own stock has continued to perform strongly. Everyone laughed at both comments, but it didn't warm up the crowd on truly plausible near-term bear cases.

But even more than not being able to address a believable bear case, it became apparent to us during other meetings this last week that it is challenging **to even know what to monitor to get increasingly bearish.** Investors largely know that the paradigm has shifted with regard to using valuation as a primary or even secondary rationale for security selection. Financial conditions likely concurrently tighten with a market pullback, not in anticipation of one. Monitoring comments from Bank of America (BAC) about credit card and consumer conditions, tracking the monthly data on 90-day credit card delinquencies, looking at employment data from Linkedin, and observing card data at Mastercard (MA) and Visa (V) all seem like reasonable approaches to assessing the consumer, but don't really enable pre-positioning for a downturn without alleviating the fear of missing out on further upside. It's like the only two choices are either you have to admit you will be down when everyone else is down, or not participate at all on the way up. The consumer has been in a solid, but slighting eroding condition all year while the market has ripped from April lows.

Despite the lack of shorter-term negative catalysts, there are three medium-to-longer-term bear cases that surface in our meetings. However, all three seem to take a back seat to the two powerful points supporting the bull case. **Firstly, what are the bull case pillars?** They are simply that the distribution of outcomes from the Fed is skewed toward the dovish, and that AI productivity likely helps margins for many companies over the next couple of years. **A positive perception about growth and a positive perception about Fed dovishness are the pillars to the bullish outlook.**

With those two important bullish points in the forefront, what are the medium-term bear cases that could become increasingly important in the coming weeks and months?

**First bear case - Hyper-scaler capital spending:** Many investors are worried about how to time when the market will care about the massive decline in free cash flow from the AI-related capital spending. As we have published several times, and everyone is fully aware, the biggest ten companies in the S&P500 are now more than one-third of total capital spending, and this likely could go higher if current forecasts are accurate (see below). The depreciation burden on cost of goods sold will grow, gross margins will at least temporarily decline, and then history would suggest that the multiples, mainly enterprise-value-to-gross profit, would also decline. But, many are arguing that the hyper-scaler capital spending could balloon further. Some believe

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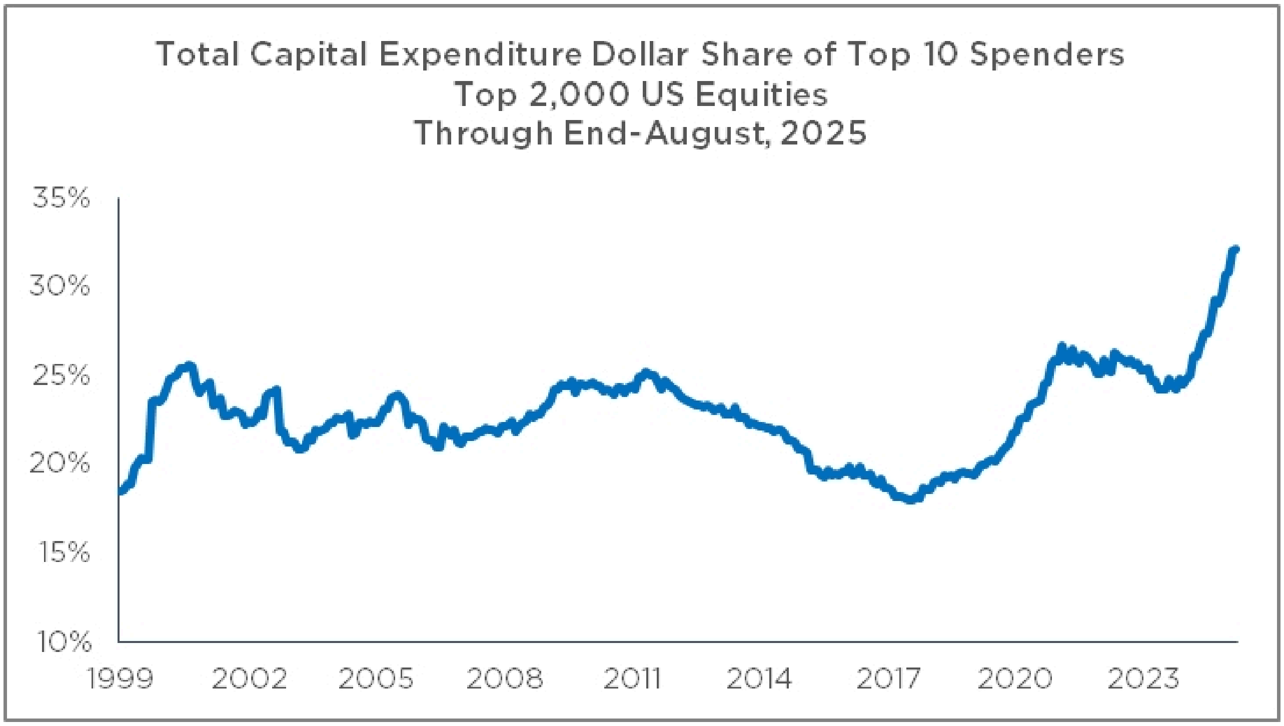
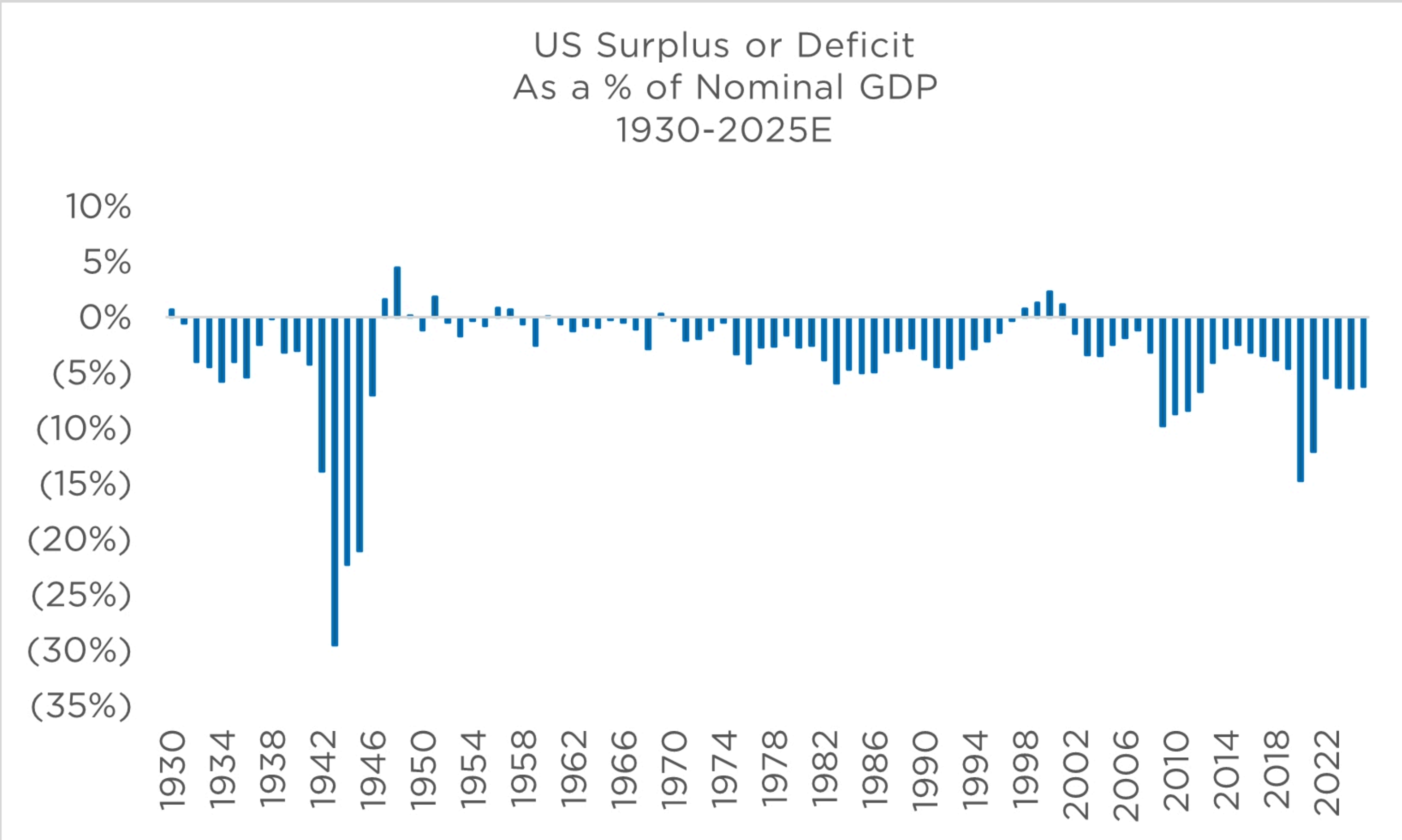
the return for the spending is incredibly high. This past week, one investor told us that Microsoft (Ticker: MSFT) gets its return back in one year. Another investor said that the aggregate return on hyper-scaler capital spending breaks-even in 3 years, has an ROIC of 15-20% in year four, and a 30-40% return in year five. This means reasonable people in the investment world, in addition to those at the companies, believe that for now, even more capital spending could be justified. Our conclusion, for now, is that investors will remain - probably a few more quarters - in “innocent until proven guilty” mode on the capital spending, believing that productivity coming in 2027. If that remains true, investors are likely to continue to reward - or at least not overtly punish - this spending.




Source: Trivariate Research, LP

**Second bear case - Government deficit:** Many investors have commented in the past that the high levels of government deficit and debt could hurt the outlook for US equities in two ways. One, is that bond supply comes online and isn’t met by demand, causing yields to back up. The other, is that the US runs at a wartime spending deficit, and any austerity could be a net negative for investing. On the first point, we are and remain skeptical. For years the bond vigilantes have been arguing that 10-year US government bond yields will back up, causing multiples to contract for equities. Yet, each time there was a Quantitative Easing, or other periods of bond supply, the 10-year yield on average went LOWER, because when investors are faced with a risk-off mindset, they buy the long-dated bonds. So, maybe that’s about to change, but we will take the other side of that argument for now. The bigger challenge to the bull case is that the government deficit, projected to be at 6.2% of nominal GDP by the CBOE this year (see below) is still well above long-term average levels and has been elevated for the better part of 20 years. We are worried about this, but we don’t know how to time when it will matter, and positioning for its inevitability would have destroyed returns nearly every year for two decades. If the political environment materially changes, this could be an issue. Some argue that the tariffs, while perhaps bad for the economy in the near-term, are a good remedy for some of this imbalance in the long-term. That remains to be seen.

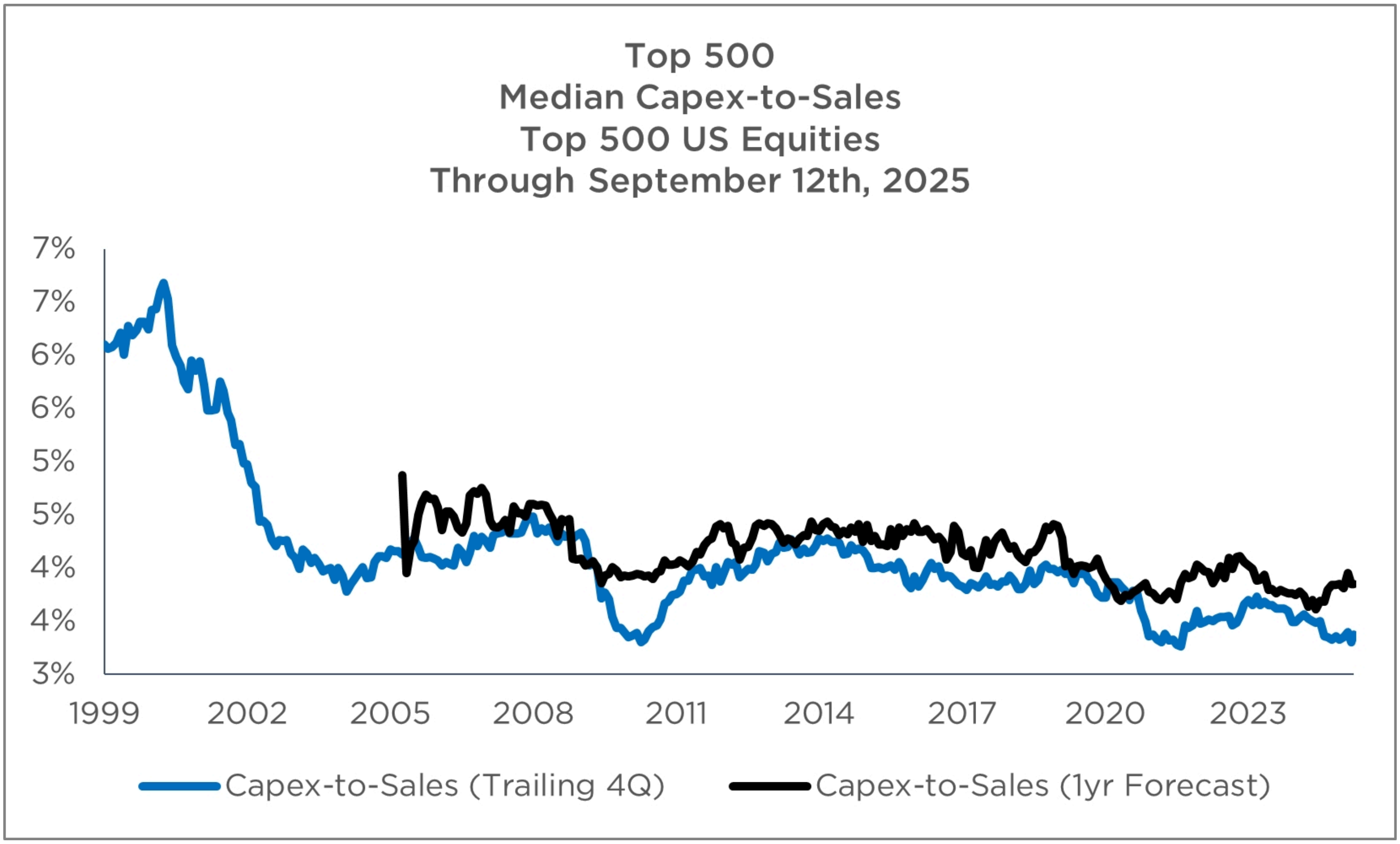



Source: CBOE, Federal Reserve Bank of St. Louis, Trivariate Research, LP

**Third bear case - AI productivity impacting unemployment:** The last bear case that surfaces arises out of fears that AI efficacy will eliminate the need for a lot of white-collar workers. Recent data have indicated higher-than-normal unemployment from recent college graduates. The truth is we do not have a great answer for this, other than that every other technological innovation and cycle that focused on productivity caused labor to be deployed in new and different areas. AI does feel like it has the potential to be different, but for now, we think what is good for margins for the top 500 US equities will probably matter much more for US equity investing than long-term higher unemployment, if in fact that surfaces. We asked ChatGpt, and here's what we got back: "*Technological progress tends to transform existing jobs rather than eliminate them. For example, the rise of computers and the internet has led to the creation of entirely new sectors, such as information technology and digital marketing, while also enhancing productivity in traditional industries. This transformation requires workers to adapt and acquire new skills, but it does not necessarily result in long-term unemployment*." We are fully aware of the irony of asking an AI application about this issue, but that doesn't mean that the answer is wrong.

In fact, we continue to think the chance that the median US company has gross margin expansion for the next few quarters is above normal. Pricing has held up in many areas of the economy, despite tariffs and fears of a slowing consumer. We are modestly worried about the fact that investors are at peak complacency about tariffs, and that a handful of corporates have mentioned at recent investor conferences that some tariff impacts are coming. We think there are some politics for CEOs of companies around publicly mentioning the tariffs that may create a slightly worse environment and slowdown than investors currently anticipate, but we are still overall of the mindset that the S&P500, constituted at 58% Technology, Communication Services, and Financials, is more immune from tariffs than we previously thought. A good way to guard against worse-than-currently-expected tariff impacts is to stay underweight vulnerable Consumer Discretionary and Consumer Staples stocks in our judgment, as the consumer platforms have more power than the brands. On the cost side, less wage pressure, lower inputs costs like Oil and other Commodities, and lower capital spending and depreciation burdens (see below) should help gross margins for the median company for the coming quarter or two. A weaker dollar also on the margin helps US earnings, all else equal. **Moreover, we think it is increasingly true that the number of US equities with deflationary business models, or perishable inventory, is just lower than it used to be.** In the past, excess inventory meant a large manufacturing-focused group of US equities had to cut pricing to stimulate demand. Today, pricing holds up even if demand is weak for a large swath of

US companies. Why does that matter? Because the median stock's bear case margins and earnings have less downside today than in the past. That alone probably means valuation will be elevated in the future relative to the past.




Source: Trivariate Research, LP

What is another possibility? We had more than one meeting this week during which a Technology-focused investors suggested to us that it is entirely possible that capital spending will materially grow from the hyper scalers, that data-center spending will grow, and that the large US Technology companies will get materially bigger. That "pain trade" could be a problem for most 40-Act funds, making them more underweight with no allowable way to participate in the biggest Technology companies in their funds even these companies are growing their revenue much faster than the overall market. In fact, one fear a bullish Technology investor mentioned is that the math is so good on return on today's capital spending that MSFT or Meta (META) might actually spend materially more or all of their free cash flow. While that math might prove to be good in 12-24 months, the stocks might all sell off first, and shift the innocent until proven guilty current AI mantra, to a guilty until proven innocent one. We don't think that's a near-term worry, but one to keep an eye on.

**CONCLUSION:**

As we talked to investors this week, a few mentioned that **one pinch point for them is lack of short ideas**. Many investors share our bullish view on equities, but also worry that everyone else is bullish, so that they are consensus. Moreover, the correlation of the growth themes, from Power to Electrification to Alternative Asset Managers to AI Semiconductors is all so high, meaning there is increasing value in diversifying ideas. **As such, we went back and scoured our frameworks for short ideas, and reiterated our view that low and declining free cash flow conversion is a good place to fish for fundamental short ideas.** Below we show stocks with poor price momentum, that have less than 10% short interest, that have poor and declining free cash flow conversion. Maybe this list is a good place to start some fundamental research, if you aren't involved already.

## Short Ideas Right Now

| Short Ideas<br>Poor and Declining Free Cash Flow Momentum, Poor Price Momentum, Less than 10% Short Interest<br>As of September 19th, 2025 | | | | | |
|---|---|---|---|---|---|
| Ticker | Company | Sector | Industry | Market Cap (US $ Bil.) | YTD Return |
| SRE | Sempra | Utilities | Multi-Utilities | 53.87 | (4.2%) |
| FANG | Diamondback Energy, Inc. | Energy | Oil, Gas & Consumable Fuels | 43.06 | (7.3%) |
| PCG | PG&E Corporation | Utilities | Electric Utilities | 33.58 | (24.0%) |
| NCLH | Norwegian Cruise Line Holdings | Consumer Discretionary | Hotels, Restaurants & Leisure | 11.23 | (3.5%) |
| UHAL.B | U-Haul Holding Company | Industrials | Ground Transportation | 10.35 | (18.3%) |
| SARO | StandardAero, Inc. | Industrials | Aerospace & Defense | 8.86 | (0.6%) |
| AAON | AAON, Inc. | Industrials | Building Products | 6.76 | (29.4%) |
| VNOM | Viper Energy, Inc. | Energy | Oil, Gas & Consumable Fuels | 6.75 | (15.2%) |
| KNF | Knife River Corporation | Materials | Construction Materials | 4.59 | (20.3%) |

Source: Trivariate Research, LP

# 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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