Level Set - Margins, Software, Industrials, Metals, and Semiconductors

The S&P500 is essentially flat this year, but as we wrote about a couple of weeks ago, this headline "calmness" is not an accurate reflection of the massive moves that have occurred beneath the surface. We have been writing for years that gross margins matter for equity market multiples, and in our 2026 year-ahead outlook we expressed concern about the ability for the median stock to expand gross margins this year. This in part leads us to conclude that the probability the US equity market multiple expands is lower than the probability the market multiple contracts. At the end of January, gross margins fell to 44.9% from 45.9% at the end of December for the median stock in the top 500 US equities by market cap. (see below). This is the largest monthly drop in three years. We are not ready to conclude that this is the beginning of a meaningful downturn, but we would suggest that portfolio managers focus on margin expansion as a key metric for success in 2026.

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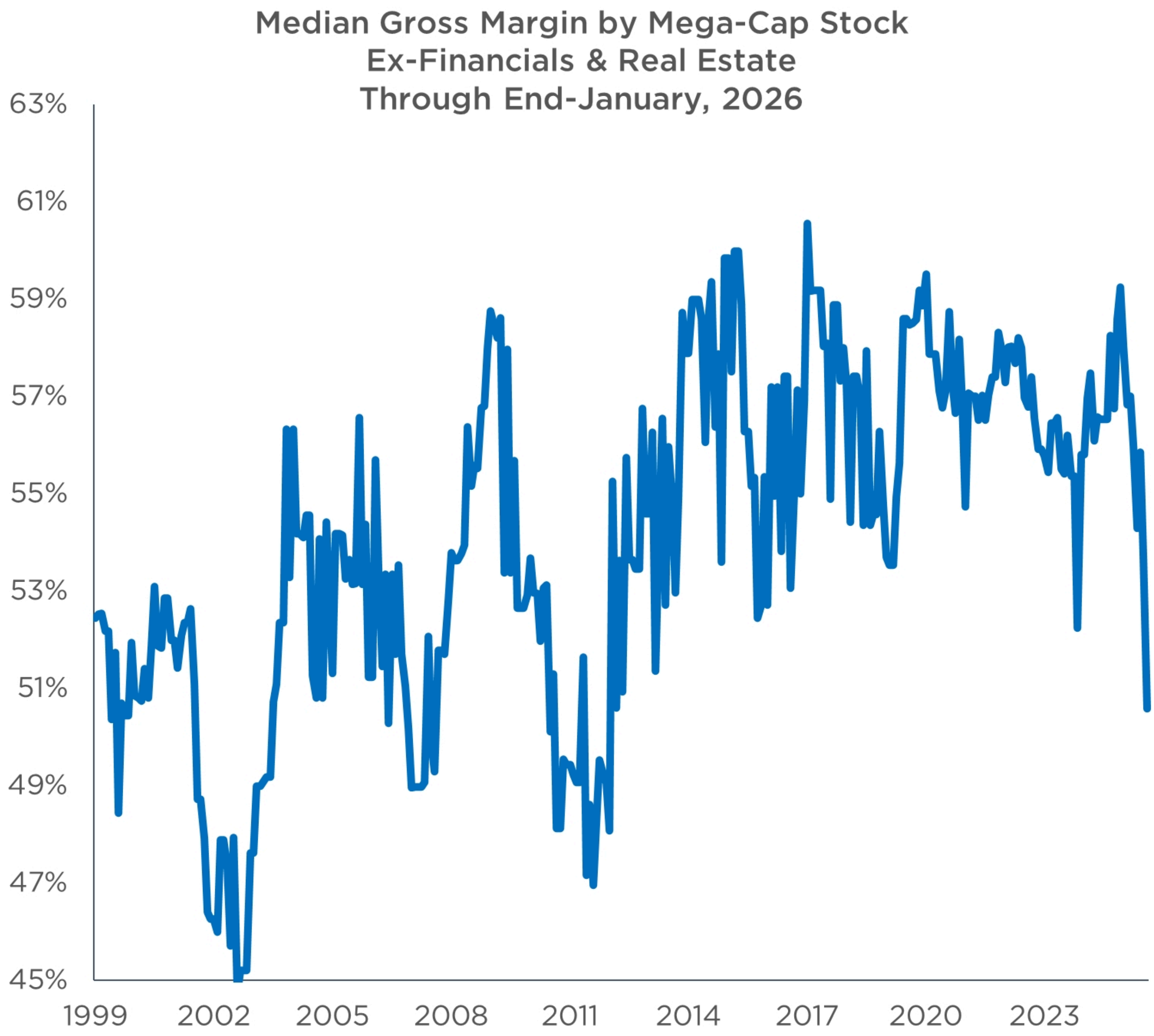
Median Gross Margin
Top 500 US Equities, Ex-Financials & Real Estate
Through End-January, 2026

Source: Trivariate Research, LP

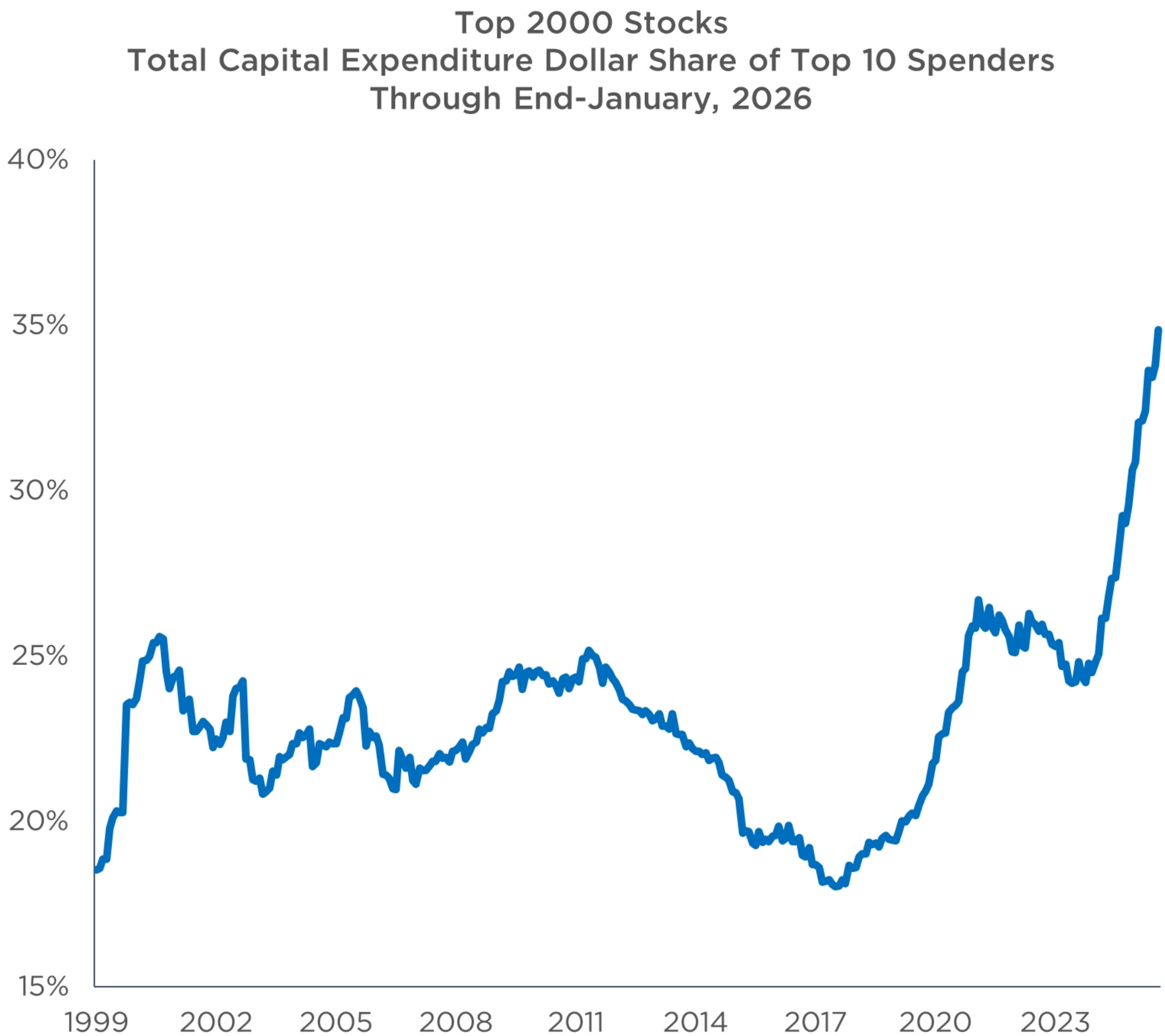
The gross margins among the mega-cap stocks are certainly contributing to the gross margin degradation. The median gross margins among the Top 50 stocks fell from 55.7% in December to 50.6% at the end of January, **the lowest level since 2012!**



Source: Trivariate Research, LP

Goldilocks Capital Spending

Part of the reason is assuredly one of the big data points of this past week, the hyper-scaler capital spending. Amazon announced $200 billion in capital spending and Google said it would spend between $175 and $185 billion. **Already, the largest ten companies are spending 35% of all of the capital spending dollars of the Top 2000 US companies - and that is clearly poised to massively rise given the guidance from the largest companies.** This has to be a problem. As we pointed out a couple of weeks ago, a legitimate bear case for US equities is a lack of "Goldilocks" on hyper-scaler capital spending. Too little, and it is concerning that companies don't think the return on investment is merited. Too much, and it results in an inevitable data center overbuild. **We know prior market peaks are defined by hubris and debt and if hubris and debt were a stock, it would be up a lot in the last six months.**



Source: Trivariate Research, LP

Software Context

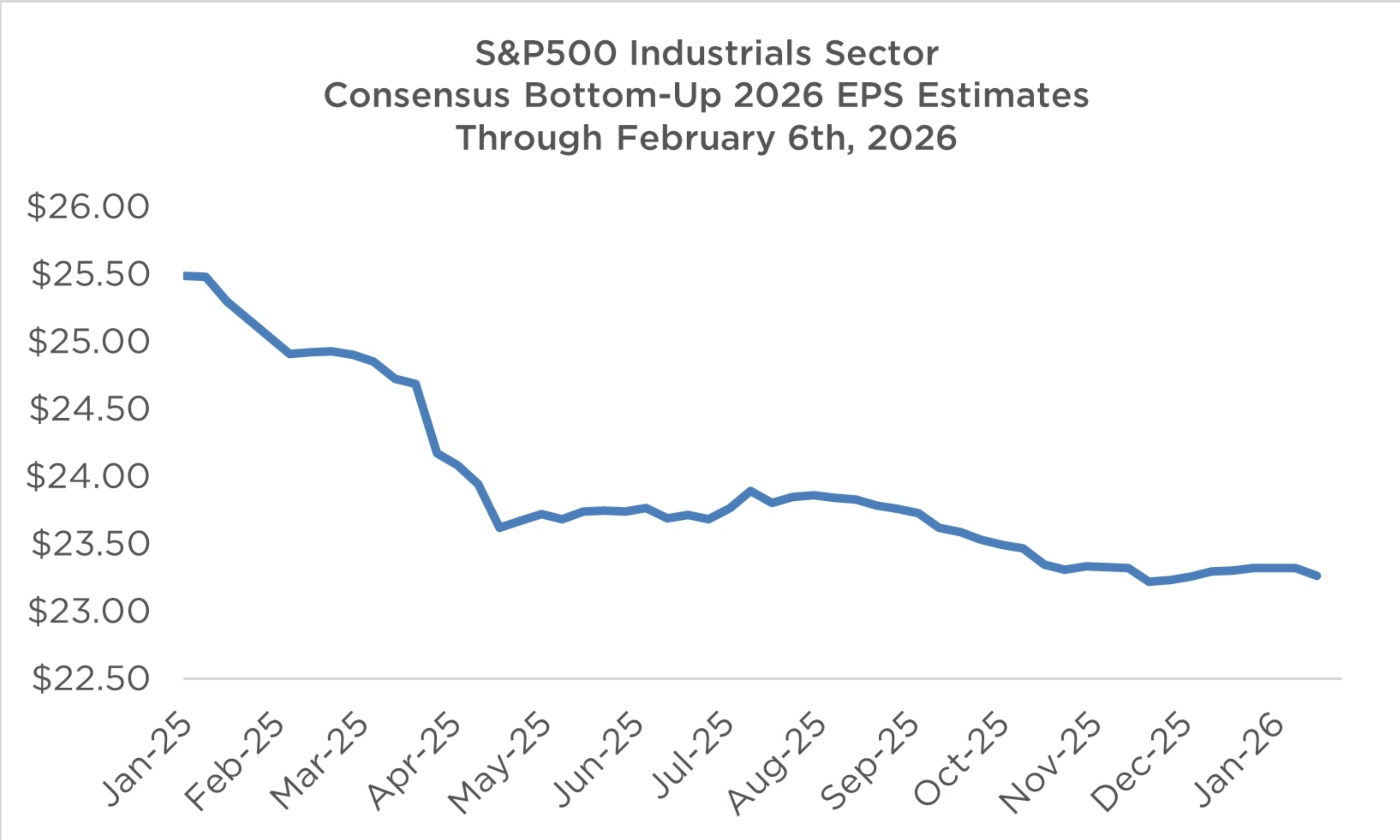
Besides the hyper-scaler capital spending, the next issue of concern has been Software, and once again this past week during a stock idea dinner, our monthly webcasts, our one-on-one meetings with investors and our incoming client requests, Software-related questions dominated. **There are 30 stocks in the S&P500 Level 2 GICS Software and Services Industry, and 25 of the 30 are down more than 10% year-to-date, with Akamai (AKAM) the only stock in the green.** Thirteen of the 30 stocks are down at least 20% this year, with the biggest Software losers being APP, INTU, NOW, ORCL, CRM, PLTR, WDAY, and ADBE. The strong sell-off in Software that continued this week, while not surprising, has many investors questioning whether there is an epic opportunity. We remain cautious on Software, believing that the multiple contraction means that it is very likely that the forward estimates are meaningfully too high.

The chorus of buyers just don't seem trustworthy at this point, as they are the management teams themselves, or private credit or equity investors with a dog in the fight. Of course, all Software is not the same, and we were asked many times what if any Software is likely oversold. We would like to say Cybersecurity (PANW and FTNT) and Electronic Design Automation (CDNS and SNPS) but these stocks are still very far from compelling valued. For instance, the consensus bottom-up EPS expectations for PANW for its FY2027 are for $4.33 on a *pro forma* basis and $2.67 on a GAAP basis. At $159.32, that's 36.79x "adjusted" EPS and 59.67x GAAP earnings. The stock offers a 4.59% FCF yield on the consensus FY27 free cash flow numbers. While that is certainly cheaper than it has been, it is not exactly "LBO math." The story is similar with CDNS. Consensus forecasts 2027 EPS of $9.16 on a *pro forma* basis and $6.61 on a GAAP basis. That's a price-to-forward earnings (on 2027 numbers) of 30.95x "adjusted" and 42.89x GAAP. These are likely the more defensible business models than some other Software stocks, but far from over-corrected on a pure valuation basis in absolute terms. The stocks that are becoming more compellingly cheap are CRM, NOW, and INTU. Let's pick CRM. At $191.35 per share on Friday's close, the pro forma and GAAP bottom-up EPS estimates for 2027 of $13.19 and $8.43, respectively, implying the stock trades at 14.5x and 22.7x the out-year earnings. That is pretty cheap if the consensus expectations of 11% and 9.5% top-line growth come to fruition. The consensus has fiscal 2028 (which is mostly calendar 2027) free cash flow estimates of $17.017 billion, meaning the EV-to-fiscal 2028 FCF is 10.55x.

Our suspicion is that there could be a bounce in some of these names, which Friday's risk-on price action indicates. However, we think the estimates for most legacy Software companies will prove to be way too high for the full year 2027, and that the case for multiple expansion will be challenging at the Industry level, unless a broad swath of incumbents are able to show acceleration in their revenue and upside to expectations. **We would stay cautious.**

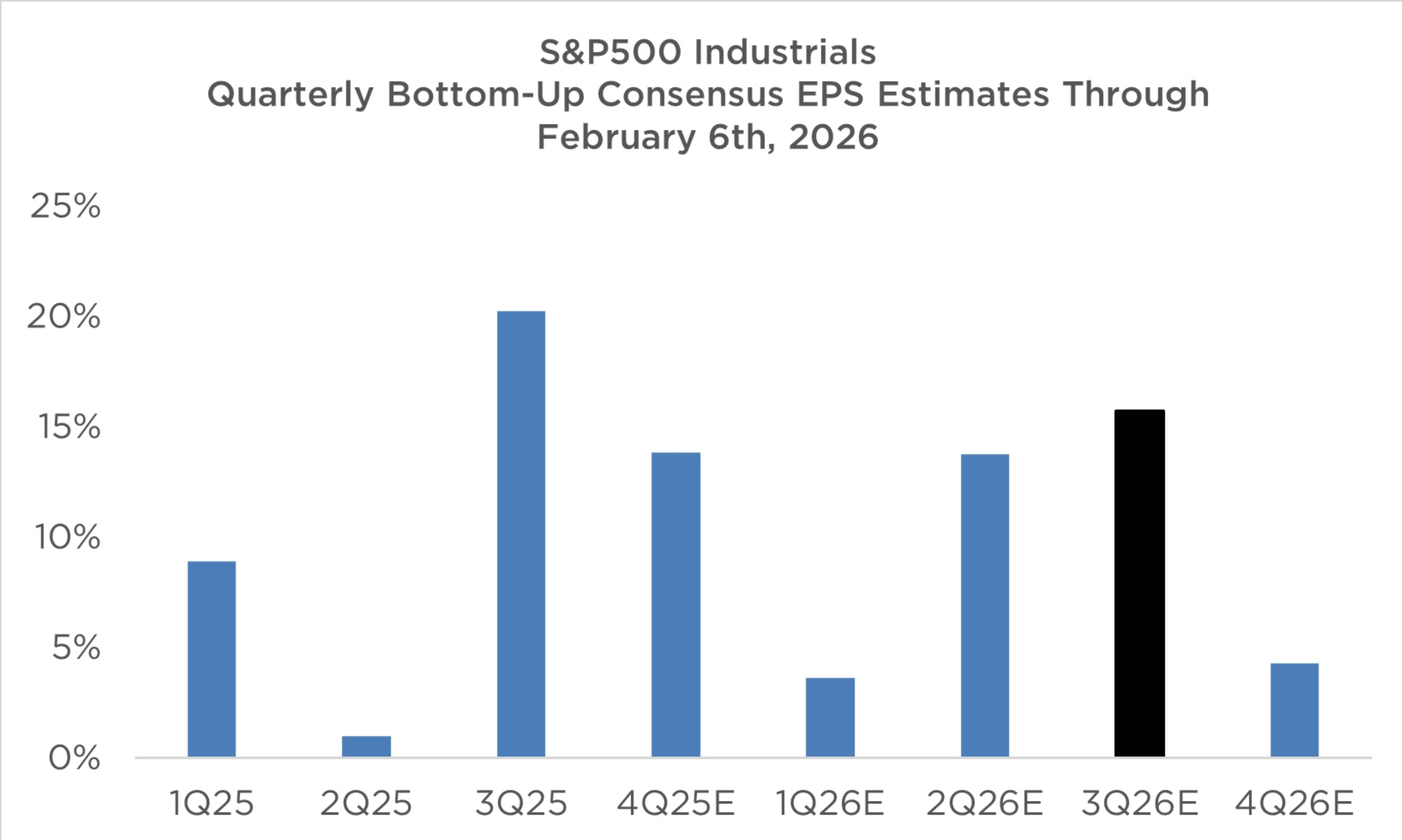
Industrials

The spike in the ISM was deemed a bullish data point by many investors this past week. We aren't that surprised that some of the industrial economy data points are improving, but we remain concerned that the earnings expectations for many Industrials are very high. We continue to think that waiting for economic data is useless. Asking an Economist for their GDP forecast to help you with your view of US equities is backwards. The stock market leads the GDP. Similarly, there are a group of stocks that lead the ISM. Industrials-heavy Semiconductors like MCHP, TXN, and ADI have been appreciating meaningfully for months, anticipating the improvement in the ISM now finally in evidence. MCHP was up 19% in both December and January. After being down for three straight months, last week's ISM was up 9.8%. It isn't that surprising. What is surprising to us is the shape of the earnings expectations. The bottom-up consensus 2026 EPS estimates for Industrials have steadily declined over the last 13 months (see below), even though the S&P500 overall estimates have increased -due to Technology - over that time frame. While results have been strong in some pockets, they have been mixed-to-weak in others, causing a slow and steady decrease to the consensus outlook for this year for Industrials.



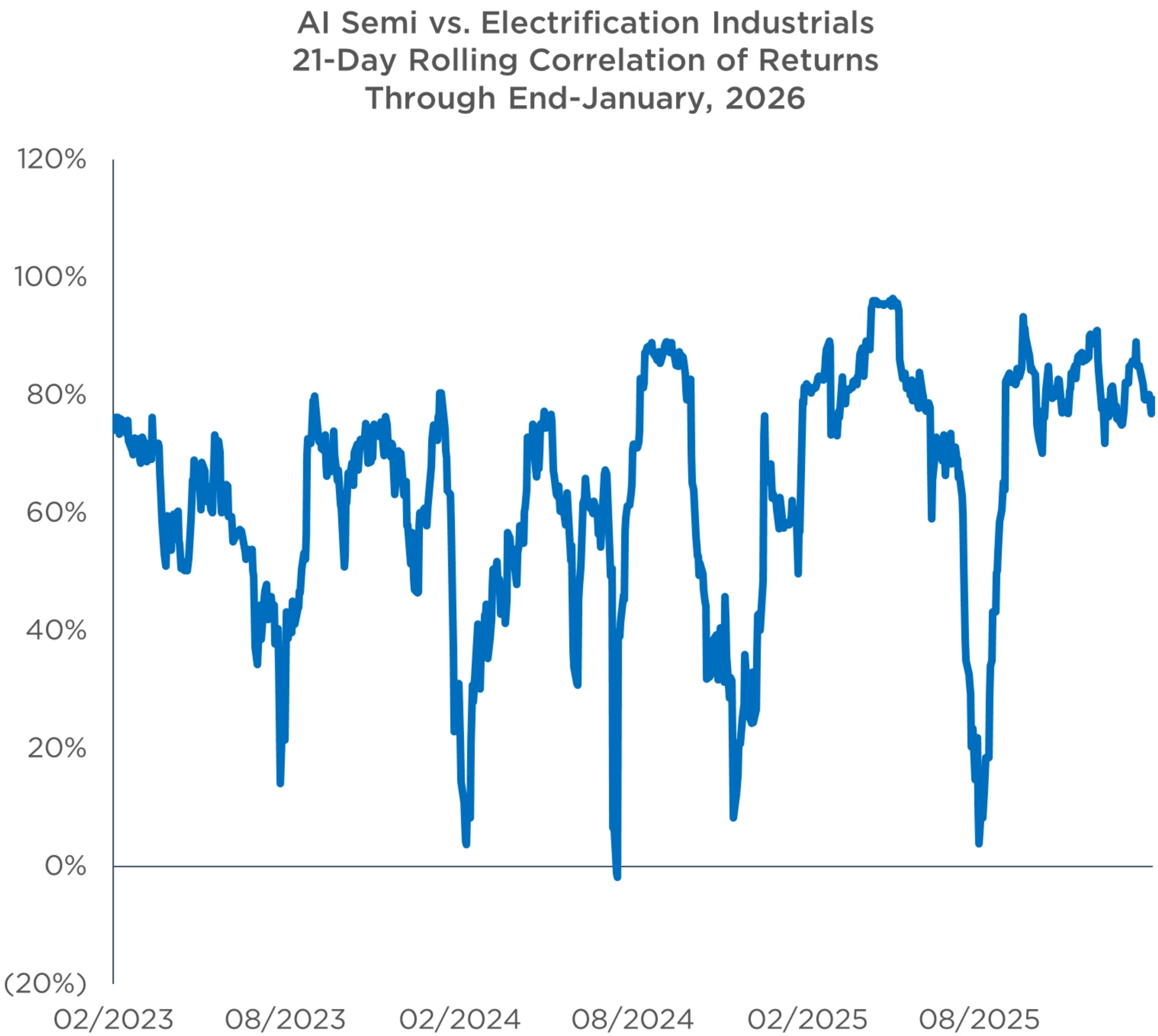
Source: Trivariate Research, LP

However, the bottom-up expectations embed a strong rebound, particularly in Q3 this year, when the comparison to Q3 2025 is strong (see below). Given equities are typically three-to-six months anticipatory, we are getting increasingly concerned about the potential for downward revisions in Industrials - most likely in the April to July time frame.



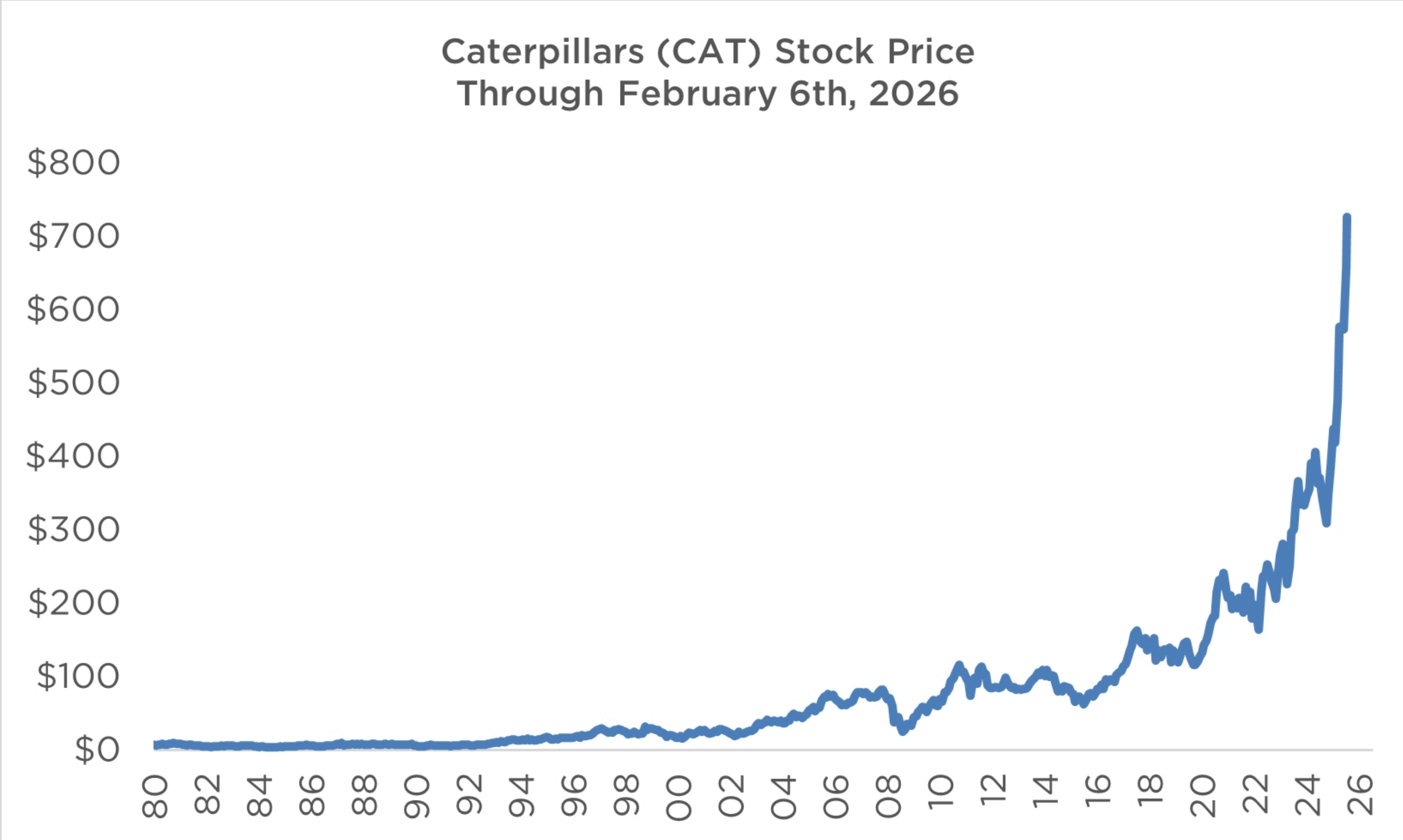
Source: Trivariate Research, LP

Particularly so, because Industrials are up 11.6% year-to-date, beating the S&P500 (up 1.27%) handily. Of the 80 stocks in the S&P500 in the Industrials GIC, **33 of them are up more than 15% this year!** That is a huge move. A portfolio strategy concern we have is that many of the Industrials remain highly correlated to the AI Semiconductor trade, so owning a stock like ETN or CAT is not any different from owning NVDA or AVGO (see below).



Source: Trivariate Research, LP

If someone asked us to show a chart about what makes us nervous about the US equity market, we probably would just plot CAT's price chart, and mention that we heard it pitched twice this week as a long idea! That's probably enough to make us nervous.



Metals

Another industry that hasn't historically been correlated to Semiconductors but now seems to be I is Metals. The huge volatility in Gold, Silver, Platinum and Copper caused us to search every US company's transcript for any mentions of these words. Below we show companies where Copper was mentioned, and our sense is that there is the most demand / supply related logic for owning Copper-related securities of the Metals. Some companies are hurt when Copper rises, so we thought it was important to flag the Copper-related securities for investors wondering which companies - positively or negatively - are impacted. TT (Copper is an input), and FLR have been hurt by rising Copper prices. Miners have done well.

Companies Where Copper Was Mentioned on Latest Earnings Call
As of February 2026

Ticker	Name	Industry	Market Cap ($US Bil.)	6-month return
TT	Trane Technologies plc	Building Products	93.3	(4%)
TEL	TE Connectivity plc	Electronic Equipment, Instruments & Components	65.4	9%
CRDO	Credo Technology Group Holding Ltd	Semiconductors & Semiconductor Equipment	22.6	12%
RGLD	Royal Gold, Inc.	Metals & Mining	22.2	75%
ALV	Autoliv, Inc.	Automobile Components	9.1	10%
LFUS	Littelfuse, Inc.	Electronic Equipment, Instruments & Components	8.1	27%
FLR	Fluor Corporation	Construction & Engineering	7.4	(19%)
ALGM	Allegro MicroSystems, Inc.	Semiconductors & Semiconductor Equipment	6.8	18%
GNTX	Gentex Corporation	Automobile Components	5.0	(12%)
VSH	Vishay Intertechnology, Inc.	Electronic Equipment, Instruments & Components	2.7	25%
UNIT	Uniti Group Inc.	Diversified Telecommunication Services	2.0	(6%)
MUX	McEwen Inc.	Metals & Mining	1.3	138%
ECVT	Ecovyst Inc.	Chemicals	1.2	23%

Source: Trivariate Research, LP

US equities where both Gold and Silver were mentioned have generally been strong stocks (below). From the US equity perspective, we can see owning some Metals & Mining, but would be cognizant this is correlated to AI Semiconductors at some level, and may unwind if we get a more Democratically run Congress in the mid-term elections.

Stocks With At Least One Mention of Both Gold and Silver On Their Last Earnings Call As of February 6, 2026				
Ticker	Name	Industry	Market Cap ($US Bil.)	6-month return
TEL	TE Connectivity plc	Electronic Equipment, Instruments & Components	65.4	9.0%
RGLD	Royal Gold, Inc.	Metals & Mining	22.2	74.7%
HL	Hecla Mining Company	Metals & Mining	15.1	292.6%
LFUS	Littelfuse, Inc.	Electronic Equipment, Instruments & Components	8.1	26.6%
GNTX	Gentex Corporation	Automobile Components	5.0	(12.1%)
OSCR	Oscar Health, Inc.	Insurance	3.8	2.1%
VSH	Vishay Intertechnology, Inc.	Electronic Equipment, Instruments & Components	2.7	24.6%
GOLD	Gold.com, Inc.	Distributors	1.3	145.6%

Semiconductors

We are doing more work on the Semiconductor industry in the coming weeks, but we are currently viewing the group as FOUR disparate entities: Memory, Industrial, AI revenue beneficiary, and Semiconductor Capital Equipment. Our judgment is to own Industrials (TXN, ADI, MCHP), then Semi Cap. Equpment (ASML, KLAC, AMAT, LRCX), then Revenue Benficiaries (NVDA, AMD, AVGO), then Memory (MU, SNDK), in that order. We would sell strength in Memory to fund Industrials Semis, and would rather own Industrial Semis than Industrials themselves in most cases. We will be addressing this more in the coming weeks.

Conclusion

Lastly, we were looking at the chart of Sea Limited (SE) this week, thinking that when it was up on Thursday while everything else was down, perhaps there was some information in this price action. We know we are going to end up liking certain stocks at WAY higher prices than we used to not like them at, and so we understand investors are looking for ideas this way. But our take is it is generally too early, and that the volatility in the market is not yet over. Second half of the year EPS estimates likely need to be downwardly revised, so we think looking for stocks with decent fundamentals, that are up 10% or more in the last six months, that are NOT correlated to AI Semiconductor is prudent. The below screen has some large-cap ideas including XOM, NEE, and LMT, among others.

Stocks With a 0.2 or Lower 6-Month Daily Trading Correlation to Trivariate's AI Semiconductors Basket & Up >10% In Last 6m As of End-January, 2026

Ticker	Company	Market Cap. (US$ Bil.)
WMT	Walmart Inc.	949.6
LLY	Eli Lilly and Company	928.6
XOM	Exxon Mobil Corporation	590.9
JNJ	Johnson & Johnson	547.5
ABBV	AbbVie Inc.	394.1
CVX	Chevron Corporation	356.2
KO	The Coca-Cola Company	321.8
PM	Philip Morris International Inc.	279.3
MRK	Merck & Co., Inc.	273.7
UNH	UnitedHealth Group Incorporated	259.9
PEP	PepsiCo, Inc.	212.5
AMGN	Amgen Inc.	184.1
NEE	NextEra Energy, Inc.	183.1
GILD	Gilead Sciences, Inc.	176.1
TJX	The TJX Companies, Inc.	166.4
DHR	Danaher Corporation	154.7
PFE	Pfizer Inc.	150.3
LOW	Lowe's Companies, Inc.	149.8
LMT	Lockheed Martin Corporation	145.9
MDT	Medtronic plc	132.0

Source: Trivariate Research, LP

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Colin Cooney, Chang Ge, Jesse Goodman 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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