

VIDEO - Gross Margins Are Rolling Over, But Net Margin Expectations Remain High

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Background: We have focused on the topic of gross margins for many years. We met with an investor recently who told us that analyzing margins was “their thing and that they have been focused on it since 2023.” I was forced to – as the kids say – “flex.” We launched coverage of US large cap. Semiconductors on October 1st, 2002, with a title “Share Gainers and Margin Expanders are Multiple Expanders.” (Mic. Drop). The point is that we have long focused on the drivers of gross margin expansion, with a strong belief that companies that consistently expand gross margins or beat the consensus expectations for gross margins subsequently outperform. This year however, the “Other 492,” as they are known, are forecasted to have a gross profit dollar decline in 2026 but also forecasted to have a collective net profit dollar growth that is quite strong. So, how can that be? Likely because analysts are beginning to embed AI productivity in their forecasted estimates for many companies. With that in mind, in today’s note we take a detailed look at gross and net margins, and analysts forecasts for both, to assess investment opportunities in the US equity market.

Current gross margin trends are turning negative: Gross margins for the median company in the Top 500 by market cap. are slightly lower today than in February 2025, when they last peaked at 46.4%. **The median stock had a gross margin of 45.9%**

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at the end of December, just a touch a touch lower than 46.0% at the end of November, but that fell sharply to 44.9% by the end of January. Generally, lower forecasted gross profit dollar growth companies trade at lower multiples than high gross profit dollar growth companies. On the contrary, the price-to-forward earnings multiple does not appear to have a relationship to net income dollar growth. Stocks with low net income dollar growth trade at the same relative multiple as stocks with high net income dollar growth on average. **We think this dynamic is worth highlighting, because market-wide multiple expansion this year will only happen if the gross margins expand, or if the market starts to change in the way it rewards net income growth!**

But net margin expectations remain high: While gross margins have rolled over, the distribution of net margins, including 20th percentile, median, and 80th percentile are forecasted to be at new highs from the bottom-up analyst forecasts. The median mega-/large-cap. company is expected to have 18.3% net margins in the next 12 months, hovering near the all-time high of 18.6% from November of 2025. **That potentially contradicts the reality of the reported gross margins.**

Consumer Discretionary: It appears the bottom 20% of Discretionary stocks have poor margin trends and serially disappoint expectations. We would look for short ideas among low margin Consumer Discretionary stocks, particularly for those that lose money today but are forecasted to turn a profit in 2026.

Consumer Staples: We are recommending an underweight in Consumer Staples, and analyzing the profit margins makes us feel better about the call. Gross margins have not expanded for 25 years. Net margins estimates for the median stock are consistently above what ultimately gets achieved AND have been trending lower since 2017.

Technology: Interestingly, Technology forecasted and trailing gross margins are generally quite close to each other across the distribution, and trended higher from the TMT crisis 25 years ago until recently. **It appears that across the distribution, gross margins peaked last October for the Technology sector.** Net margin expectations are typically well above what is ultimately achieved in the Technology sector and are particularly high today vs. history for the bottom 20% of stocks, a potential problem for performance in our judgment.

Healthcare: Healthcare gross margins have slowly trended higher for the median stock, even if expectations consistently prove to be too high. Net margins have picked up sharply for the median and top 20% of stocks. We dug into why the gross margins are low but net margins are high for the median Healthcare stock vs. history, and part of it is that Pharmaceuticals percentage of total Healthcare mega-/large-cap. Market cap. has been trending lower for years.

Industrials: Interestingly, for the 80th percentile, net margin forecasts are barely above trailing margins, implying either low expectations, or that margins are “tapped out” for this most profitable group.

Multiple expansion implies upward revisions: In the end, revisions for stocks have driven performance, and stocks where the multiple expands over the previous quarter have a higher probability of subsequently beating estimates than the stocks where the multiple contracts.

Quantitatively-derived long / short ideas: On slide 15, we show long ideas that have had recent multiple expansion, and are forecasted to have margin expansion, but not more net margin than gross margin expansion. This should help with estimate achievability. **Long ideas include MRK, TMUS, MCD, NEE, and UBER, among others.** The short ideas have seen recent multiple contraction, have forecasted gross margin contraction but net margin expansion, reducing estimate achievability. **Ideas include APH, CRM, ANET, and LVS, among others.**

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