



AI Melt-Up

Quick Look

- » The S&P 500 Index and other major equity indices all were near fresh all-time highs as the quarter came to an end.
- » With the values of financial assets soaring, household net worth has never been higher, and is up 25% cumulatively since the fourth quarter of 2022.
- » AI related stocks have accounted for 75% of S&P 500 returns, 80% of earnings growth, and 90% of capital spending growth since the November 2022 launch of ChatGPT.
- » The Mag-7 stocks now account for 30% of total profits and 35% of the market capitalization of the S&P 500 Index.
- » AI enthusiasm has brought with it an extraordinary capex spending boom, transitioning these tech giants away from the capital-light model of the last decade that allowed them to generate substantial free cash flow.
- » The AI story helps explain why the stock market currently feels detached from the broad economy, which has slowed this year and feels a bit stagflationary.
- » Though not apparent at the consumer level, the AI boom is clearly impacting the economy, in fact, more than half of the 1.2% first half growth in 2025 U.S. GDP came from investment in information processing equipment.

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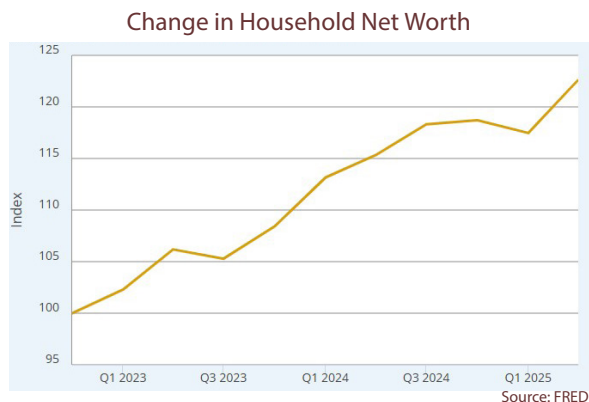
Quarterly Investment Letter, Q3 2025

The melt-up continues. U.S. stocks gained another 8% this quarter, bringing Year 2025 gains to 14%, which would mark the third consecutive year of above-average returns. U.S. stocks have posted gains in 10 of the last 12 quarters. The rally is not just confined to U.S. large stocks, as a majority of major stock indices, including the Russell 2000 Index (small cap stocks), MSCI EAFE (Developed International), and MSCI Emerging Markets, joined the S&P 500 Index in reaching fresh all-time highs.

With the onset of the COVID pandemic having rolled off, any rolling period performance over the last five years looks tremendous. The real gem, however, is the rolling three-year period performance. Check out these annualized asset class returns since the fourth quarter of 2022:

- » U.S. Large Cap stocks up 25% per year
- » U.S. Small Cap stocks up 15% per year
- » International Developed stocks up 22% per year
- » Emerging Market stocks up 18% per year
- » High-Yield bonds up 10% per year

Risk on! Even investment-grade bonds are up 5% annualized over their rolling three-year period, a vast improvement over their negative returns circa 2020-2022. Gold and home prices also hover near all-time highs. Household net worth has never been higher, and is up 25% cumulatively since the fourth quarter of 2022.



U.S. EQUITY RETURNS (%)

| As of 9/30/2025 | Q3 2025 | YTD 2025 | 1-Year | 3-Year | 5-Year | 10-Year |
|---------------------------------|---------|----------|--------|--------|--------|---------|
| S&P 500 | 8.1 | 14.8 | 17.6 | 24.9 | 16.5 | 15.3 |
| Russell 1000 (Large Cap) Growth | 10.5 | 17.2 | 25.5 | 31.6 | 17.6 | 18.8 |
| Russell 1000 (Large Cap) Value | 5.3 | 11.7 | 9.4 | 17.0 | 13.9 | 10.7 |
| Russell 2000 | 12.4 | 10.4 | 10.8 | 15.2 | 11.6 | 9.8 |
| Russell 2000 (Small Cap) Growth | 12.2 | 11.7 | 13.6 | 16.7 | 8.4 | 9.9 |
| Russell 2000 (Small Cap) Value | 12.6 | 9.0 | 7.9 | 13.6 | 14.6 | 9.2 |

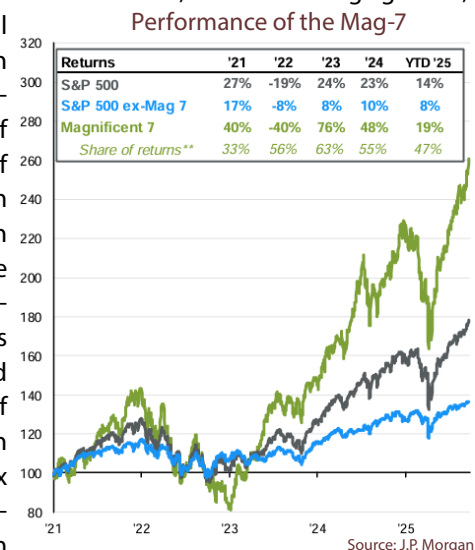
Source: Morningstar

What was the catalyst, given how bleak things looked three years ago? Here are some key events from the end of 2022:

- » On October 13, 2022, the September CPI report showed that core inflation had peaked. Not coincidentally, this began day one of the current three-year bull market.
- » On October 17, 2022, a Bloomberg Economics model predicted a 100% probability of a U.S. recession, which ultimately never occurred. Consumer sentiment surveys at this time were even lower than during the 2008-2009 Great Financial Crisis.
- » On November 30, 2022, ChatGPT, developed by OpenAI, was released to the public.

Looking back, Q4 of 2022 provided some key ingredients necessary to turn sentiment in a positive direction – improvement of economic data, overly pessimistic expectations that had compressed equity multiples, and technological innovation – and marked the origins of Magnificent-7 leadership and the stock market's increasing focus on artificial intelligence.

Per Michael Cembalest of JP Morgan, AI related stocks have accounted for 75% of S&P 500 returns, 80% of earnings growth, and 90% of capital spending growth since the November 2022 launch of ChatGPT. The bulk of these numbers stem from the seven tech stocks that comprise the Mag-7, a consortium of hyperscalers that have accounted for more than half of the returns in the S&P 500 Index during this time. Unlike their dot-com

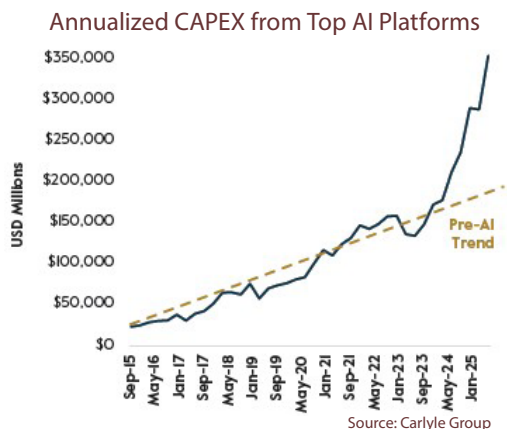


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forefathers, these companies have been cash flow kings, funding future investment through profits rather than borrowing. Mag-7's net income has doubled in the last three years, whereas the other 493 stocks in the Index have largely seen their bottom lines stagnate. The Mag-7 now account for 30% of total profits within the Index.

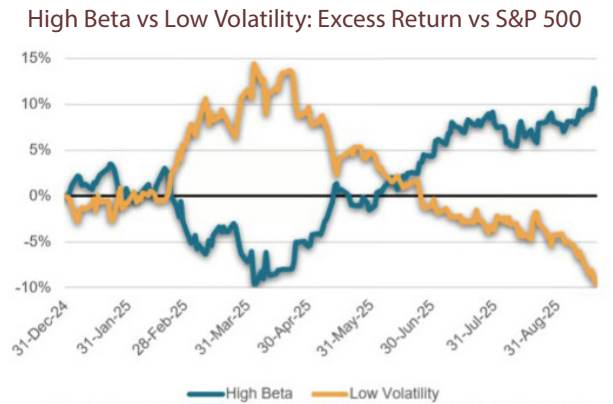
Thanks to these three years of outperformance, the Mag-7 stocks now make up 35% of the market capitalization of the S&P 500 Index. Nvidia alone has watched its market capitalization skyrocket from \$300 billion to \$4.3 trillion over the last three years, a surge that, frankly, is hard to find a historical precedent, as the stock now represents 8% of the overall Index. For comparison's sake, three years ago Nvidia was smaller in market capitalization than Procter & Gamble. Now, Nvidia is more than 10x the size of P&G, and annual free cash flow for the company has grown from \$6 billion to \$72 billion in three years. Simply incredible.

Much of Nvidia's growing cash pile derives from its Mag-7 brethren, as AI enthusiasm has brought with it an extraordinary capex spending boom, transitioning these tech giants away from the capital-light model of the last decade that allowed them to generate substantial free cash flow. Collectively, Alphabet, Amazon, Meta, and Microsoft are set to spend \$350 billion this year on capex, which is more than double their capex spend in 2022. This amount of spend is staggering, and is beginning to eat into their combined free cash flow. Additionally, more than half of this spending is going to Graphics Processing Units (GPUs), which only have a lifespan of 2-3 years before replacement. Nvidia currently holds a near-90% market share in the data center GPU market.



There has been a notable vibe shift over the last two quarters, as market leadership morphs from strictly Mag-7 into a broader "all things AI" vibe. Apple is the lone Mag-7 constituent yet to fully enter the AI race, and its share price has spent the majority of the year in negative territory. Taking its place in leadership has been a host of more AI-centric plays such as Palantir, Broadcom, and a resurgent Oracle. Another shift has been the surge in unprofitable

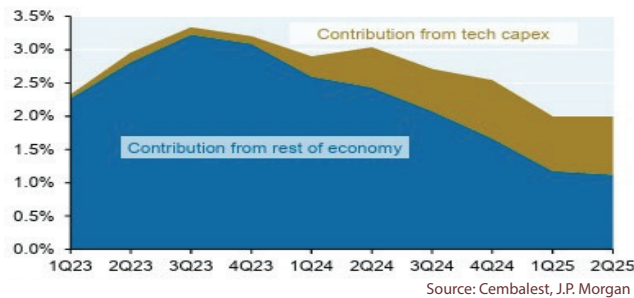
Tech stocks (or as the group prefers, "pre-revenue stocks"); the Goldman Sachs Index of this basket is up nearly 80% over the past two quarters. As seen in the chart below, high-beta stocks such as unprofitable Tech are hot, whereas low-volatility stocks such as P&G are not. Risk On!



To this point, AI capital spending has been covered entirely by Mag-7 operating cash flow, but less-prosperous entrants to the arms race will likely need to tap into external financing, which is when the dot-com era capex overbuild begins to parallel. Both Sam Altman and Mark Zuckerberg, who run OpenAI and Meta, respectively, have acknowledged the potential of an AI bubble forming, referencing the capex spend, extreme company valuations, and investor enthusiasm. Interestingly, Zuckerberg stated that risk of overinvestment is worth the cost of the alternative, which is not winning the AI race. Alphabet and Microsoft appear to share this same goal, which is to win the race at all costs, regardless of ROI. Markets continue to enthusiastically reward announcements of new AI-capex commitments, but at some point, sentiment could change once investors begin demanding tangible evidence of a return on their capital.

The AI story helps explain why the stock market currently feels detached from the broad economy, which has slowed this year and feels a bit stagflationary. Three consecutive slumping payrolls reports prompted the Fed to cut the funds rates by a quarter of a percent in September, despite inflation remaining stubbornly above the Fed's 2% target. Interestingly, despite the strong growth in household net worth over the past three years, consumer sentiment has not improved much from its 2022 doldrums, likely due to the persistence of inflation. This is particularly true at lower income levels, which have benefited less from the surge in financial assets. Per Moody's, the top 10% of earners now account for half of U.S. consumer spending.

U.S. Real GDP Contribution from Tech CapEx



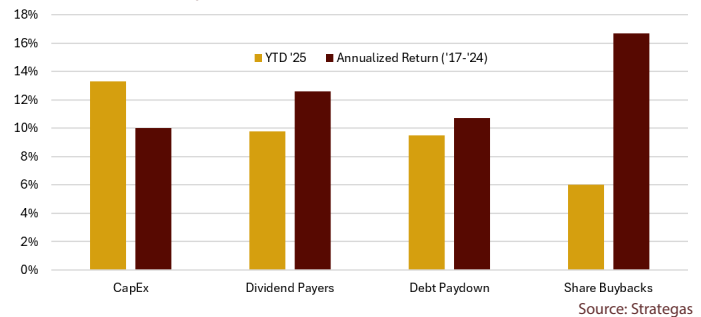
Though not apparent at the consumer level, the AI boom is clearly impacting the economy. In fact, more than half of the 1.2% first half growth in 2025 U.S. GDP came from investment in information processing equipment. This has helped prop up the economy as personal consumption has slumped to 0.7% through the first half of this year. Fed Chair Jay Powell has noted that the U.S. was witnessing “unusually large amounts of economic activity” in building out AI capabilities. Unfortunately, data center builds have not, thus far, translated to a boon in general construction jobs, as the BLS jobs data shows only 6,000 net new jobs in the sector were added from January through August, though a deeper dive into the data does show a demand bump for specific-skill expertise like electricians and HVAC technicians. Conversely, the AI boom appears to be adversely affecting recent college graduate hiring, particularly those looking for entry-level computer programming work.

Our take is that investors should be excited about the technological potential of AI and its ability to boost productivity measures, but also recognize that the bet has become highly concentrated and sentiment is skewed towards positive outcomes. Our greatest historical technological breakthroughs, be it the railroads, radio, computers, or internet, all experienced some form of overbuild cycle. At the very least, we expect a reversal of leadership away from the companies with the highest capex spending, and back towards traditionally favored companies that focus on returning free cash flow back to their shareholders via share repurchases, dividend payments, and/or or debt paydowns.

INTERNATIONAL RETURNS (%)

| As of 9/30/2025 | Q3 2025 | 1-Year | 3-Year | 5-Year | 10-Year |
|-----------------------|---------|--------|--------|--------|---------|
| Int'l Developed ex US | 4.8 | 15.0 | 21.7 | 11.2 | 8.2 |
| Emerging Markets | 10.6 | 17.3 | 18.2 | 7.0 | 8.0 |

Source: Morningstar

S&P 500 Performance by Cash Usage
(Top Quintile of Cash Outlet Performance)

The current stock market rally could still have more innings to play, as it is backed by strong momentum and accommodative monetary policy. Powell recently stated that “equity prices are fairly highly valued”, and while that will likely prove a headwind to returns over the next decade, valuations have no correlation to stock returns over the next year. We think an optimal way to position U.S. equity exposure is with a half core exposure to the S&P 500 Index, which is roughly 40% AI-related and allows an investor to cheaply capture market beta. The other half should be factor-tilted towards Value, Profitability, and Shareholder Yield, all of which have historically delivered their largest premia during pre-recession or recessionary periods. This 50/50 mix provides plenty of Mag-7 and AI-related exposure, but at a modestly diluted measure.

In the long run, the stock market and the economy are intricately linked, as equity returns are driven by the combination of dividends and corporate profits, and corporate profits mirror nominal GDP growth. But in the short run, sentiment is the primary market driver and is often disconnected from economic reality. In late 2022, a change in sentiment helped to ignite what has been a vigorous three-year rally in risk assets. Robust returns of this magnitude often only occur after sentiment is at its bleakest. Sentiment today looks far better than late-2022, and therefore, paradoxically, likely portends to lower returns in the future, particularly for U.S. stocks. Diversification into other asset classes, such as International stocks and bonds, can help to balance the twin objectives of capital preservation and growth while riding the AI wave.

FIXED INCOME RETURNS (%)

| As of 9/30/2025 | Q3 2025 | 1-Year | 3-Year | 5-Year | 10-Year |
|-----------------|---------|--------|--------|--------|---------|
| Aggregate Bond | 2.0 | 2.9 | 4.9 | -0.5 | 1.8 |
| Muni | 2.6 | 1.8 | 4.6 | 1.0 | 2.0 |
| Int'l Bonds | 1.0 | 3.9 | 6.6 | 0.1 | 1.6 |
| High-Yield | 2.4 | 6.9 | 10.2 | 5.2 | 5.3 |
| Short-Term | 1.5 | 4.7 | 5.6 | 2.2 | 2.4 |
| 90-Day T-Bill | 1.1 | 4.5 | 5.0 | 3.2 | 2.2 |

Source: Morningstar



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