



Some Sizzle, Some Steak

Quick Look

- » The AI Boom is in full bloom. Year-to-date, approximately 85% of the S&P 500 gains can be attributed to AI stocks.
- » This quarter, the S&P 500 Index gained 15%. Quarterly gains of this magnitude are often due to initial recoveries from recessions, but this past quarter can be attributed to a stealth rally in the technology sector, which was up 44% during the period.
- » S&P 500 operating earnings for the first quarter of 2026 grew 29%. Not only are profits at records, but profit growth rates are at levels usually only seen during early-stage recoveries.
- » Impressively, one can make the case that earnings fully justify the current bull market. This is an important distinction from the dot-com bubble, when valuation multiple expansion was the primary driver of performance.
- » That said, the current market rally does have some shades of the dot-com era, such as the rally in unprofitable and high-beta stocks, as well as the decline in US market shareholder yield.
- » In summary, stocks are surging thanks to a boost in profits as well as speculative fever. Both dynamics can coexist.

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Quarterly Investment Letter, Q2 2026

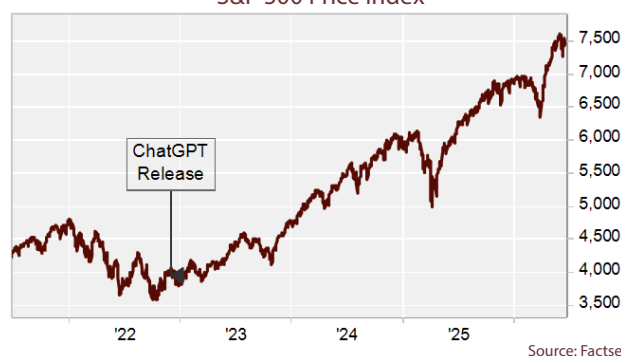
Did you know the largest baby in recorded history was born in Ohio? The baby—born in 1879 in Seville, Ohio—weighed 22 pounds and measured 28 inches long. Not coincidentally, the baby’s parents were the tallest married couple in history; the mother was 7 feet 11 inches tall and the father was 7 feet 9 inches tall. This spectacle had people guessing how tall the baby would grow once it reached adulthood. Could the baby grow 12 feet tall? 20 feet tall? These speculations overlooked the fact that the tallest person in recorded history was 8 feet 11 inches. A height of 20 feet would, inconceivably, be more than double the tallest person ever. But, in fairness to the speculators, no one had ever seen a 28-inch baby before, either.

In June, the most-anticipated IPO this century arrived as SpaceX began trading on the open market. SpaceX’s IPO was easily the largest in history, debuting at a \$1.8 trillion market capitalization. SpaceX stock gained 40% in initial trading, adding another trillion in market cap and momentarily surpassing Amazon and Microsoft to become the fourth-largest company by valuation in the world. SpaceX will likely be joined by the highly anticipated IPOs of Anthropic and OpenAI. Collectively, these three IPOs are expected to be larger on an inflation-adjusted basis than all of the 5,724 initial public offerings combined in the United States in the 1990s.

Famed Depression-era salesman Elmer Wheeler is credited with coining the phrase “sell the sizzle, not the steak.” Two days after the IPO, Elon Musk posted on X that he thinks the company can

make \$1 trillion in annual revenue by 2030. That prediction is ... ambitious, to say the least. SpaceX’s revenues last year were \$18 billion. Reaching \$1 trillion would require revenues to grow 50-fold over the next five years. To help provide the scale of growth needed, consider that NVIDIA, which is the Victor Wembanyama-unicorn level of revenue scaling, has grown its revenues at 20x over the last five years. Musk is truly a historical figure in our current times - both an incomparable entrepreneur and extraordinary salesman, and one who has delivered the steak while never forgetting to sell the sizzle. With Musk, the sky is no longer the limit, both literally and figuratively.

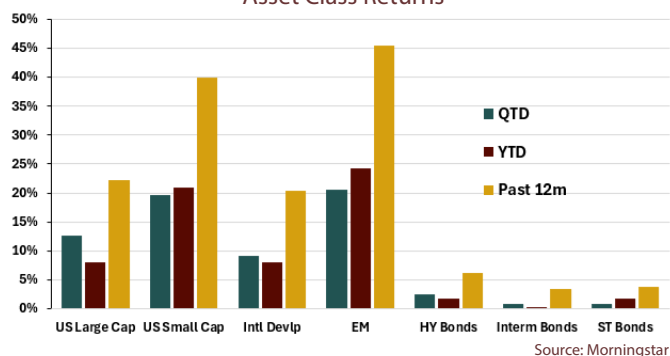
S&P 500 Price Index



The AI Boom is in full bloom. As it pertains to the stock market, AI has become all-encompassing. Since the initial public release of ChatGPT three-and-a-half years ago, the S&P 500 Index has nearly doubled, and according to research from JP Morgan, 42 AI-related stocks (which now account for half of the weight of the Index) have accounted for 75% of these gains. This year, approximately 85% of the S&P 500 gains can be attributed to AI stocks; their influence over the stock market has seemingly muted much of the impact of the War with Iran. As an example, the SOXX Index, which tracks the performance of the 30 largest U.S. semiconductor stocks, is up over 100% since the onset of the War. The semiconductor industry alone accounts for roughly 2/3 of year-to-date S&P 500 Index gains.

This quarter, the S&P 500 Index surged 15%, posting its best quarterly gain since the 2020 bounce-back from the pandem-

Asset Class Returns



U.S. EQUITY RETURNS (%)

As of 6/30/2026	Q2 2026	YTD 2026	1-Year	3-Year	5-Year	10-Year
S&P 500	15.2	10.2	22.3	20.6	13.4	15.5
Russell 1000 (Large Cap) Growth	16.7	5.3	17.7	22.6	13.7	18.6
Russell 1000 (Large Cap) Value	13.9	16.3	27.1	17.8	11.2	11.5
Russell 2000	21.5	22.6	40.8	18.6	7.0	11.6
Russell 2000 (Small Cap) Growth	25.7	22.2	38.7	18.4	5.6	12.0
Russell 2000 (Small Cap) Value	17.2	23.0	43.0	18.7	8.2	10.9

Source: Morningstar

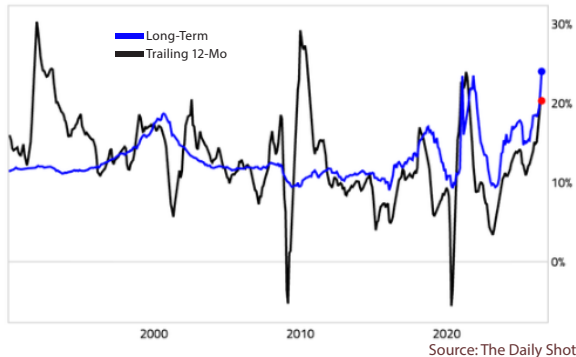
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ic drawdown. Quarterly gains of this magnitude are often due to initial recoveries from recessions, but this past quarter can be attributed to a stealth rally in the technology sector, which was up 44% during the period. AI fervor extends beyond U.S. boundaries; emerging markets were up 24% for the quarter, driven by gains of 45% and 68% for Taiwanese and South Korean markets, respectively. These two markets are heavily driven by AI-specific stocks; TSMC represents 30% of the Taiwan Index, while Samsung and SK Hynix account for half of the South Korea Index.

It is reasonable to wonder whether these robust gains are justified. Is the AI optimism warranted, or is a bubble inflating before our eyes? In our estimation, this rally offers plenty of sizzle, but also some steak.

Let’s start with the steak, or more specifically to investors, the profits. To borrow from an episode of Seinfeld, they are real, and they are spectacular. S&P 500 operating earnings growth for the first quarter of 2026 came in at 29%, more than doubling initial estimates of 13%. Leading the way were 50% gains combined from the Technology and Communications Services sectors. If you are looking for a rationale for the most recent quarter rally, this is the place to start, as stocks repriced not only for the surprise in earnings growth, but also for higher estimates for future quarters. Earnings for the full year are now estimated to grow 23%, up from 13% last year. Small-cap stock earnings are expected to jump 36% this year, as compared to 5% growth in 2025. Not only are profits at records, but profit growth rates are at levels usually only seen during early-stage recoveries.

US Consensus Earnings Growth



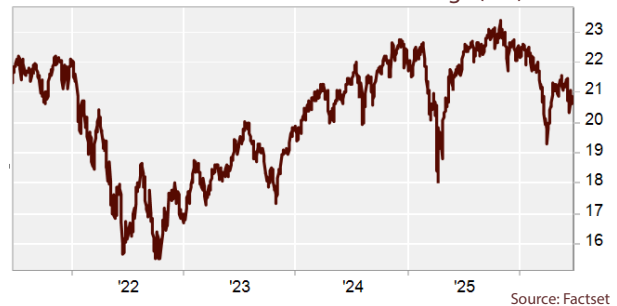
Not to be outdone, profit margins are also at record highs, resulting in historic profitability. Margins are highest in mega-cap tech, and as the Index has increased concentration in those names, it has had an upward effect on profit margins and return on equity. A shortfall in supply relative to demand has given semiconductor stocks strong pricing power, while the Magnificent Seven names generate, on average, \$0.44 of profit for every \$1 of shareholders’ equity. Taken together, this has lifted U.S. return on equity to a record-high 22% and helps to explain why U.S. stocks are commanding a premium valuation versus historical levels.

S&P 500 Trailing Return on Equity (ROE)



Impressively, one can make the case that earnings fully justify the current bull market. The S&P 500 currently trades at 21x forward price/earnings, just a turn below its 22x valuation five years ago. The S&P 500 Index is up cumulatively 75% over the last five years despite a slight compression in the multiple. This is an important distinction from the dot-com bubble, when valuation multiple expansion was the primary driver of performance, while earnings growth accounted for only about one-third of the dot-com bubble gains.

S&P 500 Forward Price-to-Earnings (P/E)



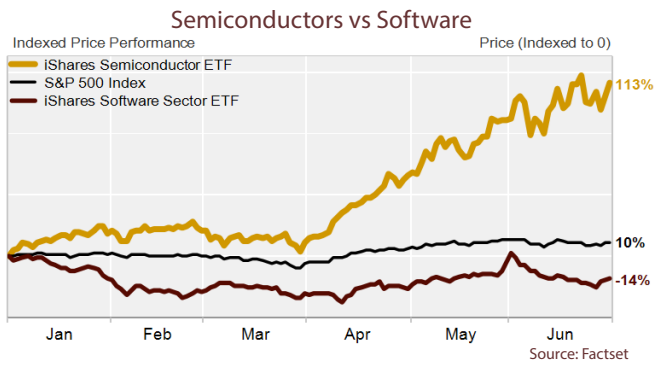
However, there is also some speculative sizzle being sold in this market. Some—dare we say—are shades of the dot-com era. Consider these potential cautionary signs:

- **The rally in unprofitable stocks.** The Goldman Sachs Unprofitable Tech Index is up nearly 60% on the year, widely outpacing the S&P Index. This Index is composed of story stocks which have no earnings but are surging on the prospects of future AI riches. A few of these stocks will survive, but most will be failed lottery tickets.
- **The low-quality rally in small-cap stocks** is even more pronounced. There were more than 300 companies (15% of the Russell 2000 Index) that posted gains of 100% or more this quarter; just under half of these companies are unprofitable. This has led to meaningful underperformance in the Profitability Factor. Historically (and intuitively), high profitability stocks outperform low- and non-profitable stocks.
- Similarly, **high-volatility, high-beta stocks** dramatically outperformed low-volatility, low-beta stocks this quarter. This type of outperformance tends to occur only in either early-stage recessionary recoveries or late-cycle junk rallies such as 2000.

- **The proliferation of AI-based and leveraged ETFs** has been noticeable. More than 40 AI-based ETFs were launched this quarter, many using derivatives to amplify daily performance by 200% or 300%. Within a week of the IPO, at least 10 leveraged and/or inverse single-stock SpaceX ETFs hit the market.

- The hyperscalers’ massive spend of their free cash flow has come at the expense of share buybacks, **plummeting shareholder yield**. The dividend yield on the S&P 500 Index has fallen to 1.05%, which is lower than its dot-com trough. History has shown that companies that return excess cash to shareholders outperform high capex spenders over the long term.

- **Dispersion of winners and losers within the Tech Sector.** As can be seen in the chart below, while the semiconductor industry has more than doubled this year, software is down 14% year-to-date, making it the worst-performing industry in the S&P 500. Perhaps AI will render some of these software stocks obsolete, but dispersion within the Tech sector has not been this pronounced since March of 2000.



In summary, stocks are surging thanks to a boost in profits as well as speculative fever. Both dynamics can coexist. AI’s potential is undeniable, but that alone does not make for a great investment, as markets have already accounted for some level of future growth. The question is how much? Two years? Ten years? This lesson was learned 25 years ago, as more than a decade’s worth of growth was priced into the shares of Microsoft, Cisco, Intel, and others. From 2000 to 2010, Microsoft’s revenues grew more than 170%. However, its P/E ratio fell from 70x in 2000 to 10x by 2010. Microsoft’s growth largely materialized as promised,

INTERNATIONAL RETURNS (%)

As of 6/30/2026	Q2 2026	1-Year	3-Year	5-Year	10-Year
Int’l Developed ex US	10.8	20.2	16.4	9.1	9.7
Emerging Markets	24.1	43.5	23.0	7.2	10.1

Source: Morningstar

but it took more than a decade for the company’s earnings to finally catch up to its 2000 price. Its shares from 2000 to 2010 fell roughly 50%, as growth expectations were just unrealistic.

Weighting of Semiconductors in the S&P 500 Index



Our recommendation is to own AI (if you own the Index, you own AI) but be discerning with regard to price. The insatiable demand for chips has allowed semiconductor firms to reach new highs in profitability but also quadruple their collective price-to-sales ratio over the last three years, pushing the industry’s weight to nearly 20% of the S&P 500 Index (see chart above). Perhaps this time is different, but the margins on chips historically have been highly cyclical and are susceptible to any slowdown in the AI infrastructure buildout or an eventual equilibrium between supply and demand. Should some of the helium come out of the AI trade, factor tilts towards profitability and shareholder yield will likely help mitigate some of the drawdown. In short, eat the steak, but also diversify with a salad—it should not just be steak.

As a final thought, consider the simple yet critical importance of maintaining discipline within asset allocation. With the S&P 500 Index up 100% over the last three years, equity gains have shifted a 60/40 portfolio closer to 70% stocks. Rebalancing is needed to keep investors from unnecessarily and unknowingly increasing risk. A quantitative rebalance was a common occurrence for many of our portfolios during the past quarter.

Happy 250th to the United States! Fun fact: if Paul Revere took his midnight ride this year, he could stop at seven Dunkin’ Donuts locations. We appreciate your partnership and hope your summer sizzles.

FIXED INCOME RETURNS (%)

As of 6/30/2026	Q2 2026	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	0.7	3.8	4.2	0.1	1.5
Muni	2.1	6.2	3.9	1.1	1.9
Int’l Bonds	1.7	1.9	4.4	-0.3	1.0
High-Yield	2.4	5.5	8.1	3.8	5.1
Short-Term	0.9	3.7	5.4	2.4	2.4
90-Day T-Bill	0.9	4.0	4.8	3.8	2.5

Source: Morningstar