

WisdomTree MINDS ON THE MARKETS



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The Mag Seven's Free Cash Flow Withers

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Stocks' rally off the March 30 lows has been nothing short of wild, with internal market dynamics showing some performance divergences that we haven't seen for decades. For example, in the first 6 weeks of the rally, the S&P 500 Growth index beat the S&P 500 Low Volatility Index by more than any other 6-week window on record. The prior extreme was set in March 2000, the month of the infamous NASDAQ tech bubble peak. It doesn't mean the rally has to end (similar outperformance was witnessed in both 2020 and 2025), but this is not the type of stuff we see every day.

With the hyperscalers jumping over each other to build out their AI capabilities, the system is being fueled by burgeoning capital expenditures. Morgan Stanley recently upped its estimate for the hyperscalers' combined capex to a figure "approaching \$800 bn" in 2026, up from \$261bn and \$449bn in 2024 and 2025, respectively.

Subtract capex from operating cash flow to derive free cash flow, the financial metric that is the foundational principle in equity valuation. That is because the value of any stock is mathematically equal to the net present value of all such future flows.

The problem for some Magnificent Seven members is there isn't much free cash flow to speak of, at least not now. Between Amazon, Alphabet, Tesla and Meta, they only mustered \$6.6 billion of it in Q1. These four companies have a collective market cap of \$10.9 trillion.

Consider Microsoft, which once had capital expenditures amounting to a single-digit percentage of revenues. Today, that figure is up to 37%. This is the type of number you see in oil & gas, or railroads. The market will have to decide if it is comfortable with once capital-lite companies suddenly sending off the same vibes as industrial conglomerates.

A common view: the cash gusher is coming in some out year. An issue we keep coming back to: if windfalls are forthcoming, wouldn't that be because these players are set to experience monopoly-style profits? But when we think of major business lines, from cloud storage to advertising to self-driving vehicles, the Magnificent Seven members are more often than not competing with other giants.

Use Alphabet as a head-scratching valuation example. With a \$4.67 trillion market cap, the company trades for 72.4 times free cash flow, even though that metric has been moving sideways for a couple years now. But when you think about Google Cloud, that business competes with both Microsoft and Amazon. Waymo? It plays against Tesla. As for Gemini, it will have to compete with, well, everyone.

We come across a lot of investors who want to stay the course in US equities, but are struggling to find something that is cheap. How about healthcare? The S&P 500 Healthcare index has drifted to a 58% discount to the S&P 500 on a price-to-sales ratio basis, even though the sector has the same profitability profile as the market (they both have a Return on Equity of 18.5%). With Healthcare's price-to-sales spending many years grinding lower, the current ratio of 1.47 is lower than it was in August 2008. In contrast, the S&P 500's P/S ratio is 3.50, higher than the 3.21 registered at the 2021 peak.

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