

From the Desk of the CIO

Philip Straehl Shares What's Top of Mind: August 2025

**Morningstar Investment
Management LLC**

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Panic has given way to euphoria.

What began as a recovery from the April lows—when US stocks briefly entered bear market territory—has evolved into a full-fledged rally, with equity markets surpassing their previous peaks.

This dramatic shift in market sentiment over just a few months has been fueled by renewed enthusiasm for artificial intelligence spending and a resilient corporate sector. But is this market recovery built on solid ground?

Markets seem to have brushed aside signs of a weakening labor market and ongoing uncertainty around how tariffs will impact global supply chains. Credit spreads sit at record lows, pricing in little to no downside the risk—the notion of a credit cycle appears all but forgotten.

In this CIO letter, I examine the drivers behind recent market movements and assess current dynamics through the lens of our investment approach.

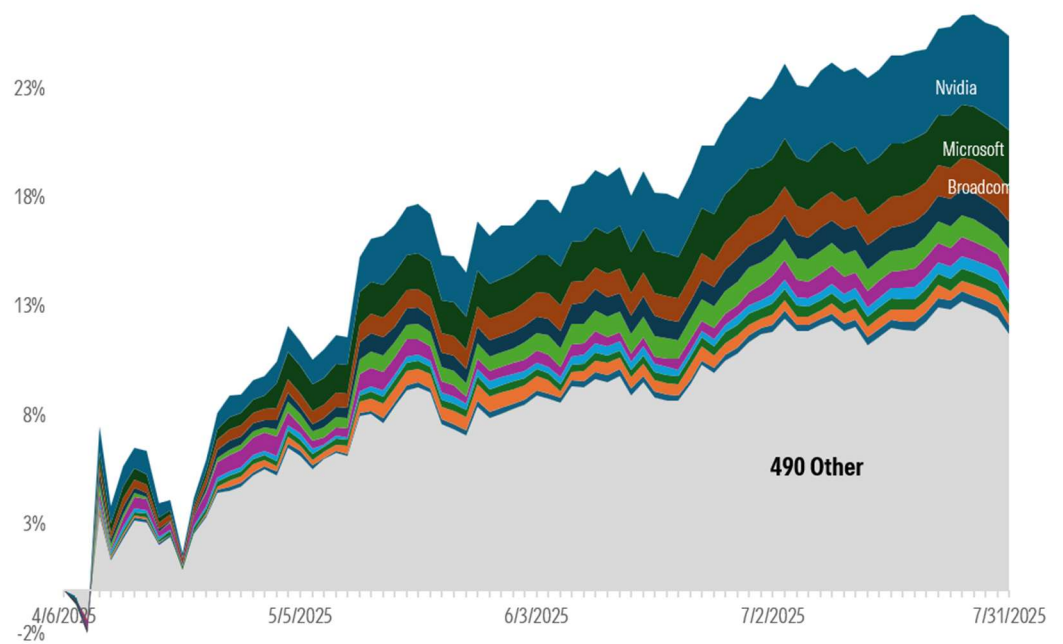
How does the market swing from gloom to elation so quickly? As Ben Graham, the father of value investing, often noted, Mr. Market is prone to emotional swings.

During these periods, the key is remaining grounded in fundamentals. As Warren Buffett put it: “Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful.”

Market Drivers of the Rally

The S&P 500 has risen more than 25% from its April lows. However, the returns were not evenly distributed, pushing select assets to new highs.

Exhibit 1 shows the top performance contributors over this period. AI emerged as the dominant theme connecting the leading performers. Nvidia, Microsoft, and Broadcom—all key players in the rapidly expanding AI ecosystem—together contributed a third of the total return. Overall, the top 10 stocks accounted for more than half of the gains, highlighting the concentrated nature of the recovery.

Exhibit 1: Nvidia, Microsoft and Broadcom Accounted for a Third of the Gains

Source: Morningstar Direct. Data from 4/7/2025 to 7/31/2025. ETF (ticker: SPY) used for performance analysis. Total returns in USD. References to specific securities not an offer to buy or sell. For illustrative purposes.

Another way to view the sharp market turnaround is by comparing US and international performance. Year-to-date through April 6, international developed stocks outperformed the US technology market by a staggering 24%. By mid-August, that gap had narrowed to just 8% as technology stocks staged a strong comeback.

The tech sector delivered strong Q1 and Q2 earnings and committed to significant future AI-related capital spending. But what does history tell us about such heavy investment?

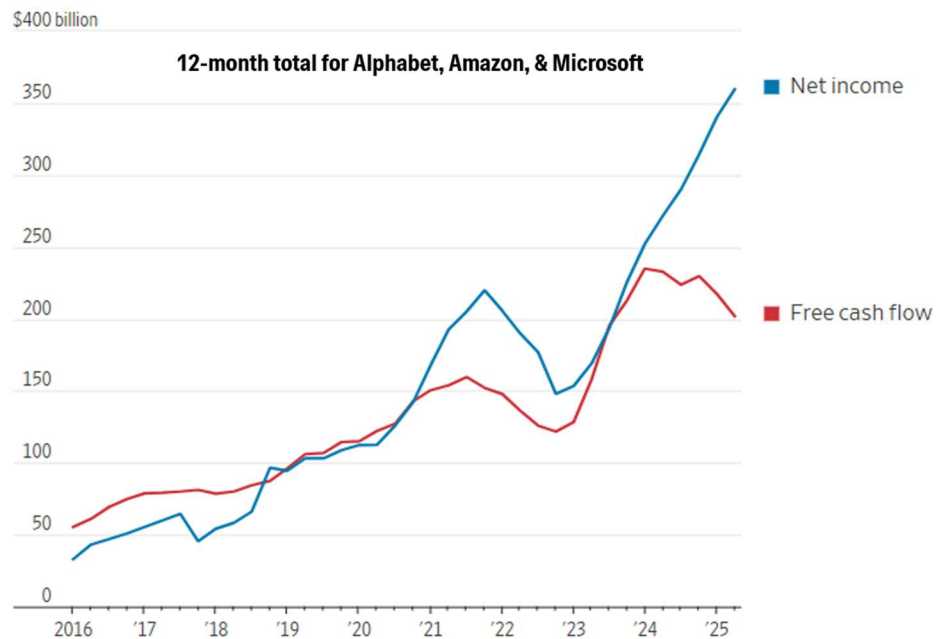
AI Spending Binge

During the Q2 earnings season, some of the largest technology firms—Amazon, Alphabet, Microsoft, and Meta—increased their expected AI spending for fiscal year 2025 to \$364 billion, up \$39 billion from prior estimates. Markets largely welcomed this development, a sharp contrast from a year ago when capital expenditure news weighed on these stocks.

Despite AI's groundbreaking potential, investors should approach the spending spree with caution for the following reasons:

1) Rising Capital Intensity: High capital outlays have increased the capital intensity of these businesses, putting pressure on free cash flows—the cash available to return to investors—as shown in Exhibit 2. A widening gap has emerged between net income and free cash flow, with investors betting that these investments will eventually deliver meaningful returns.

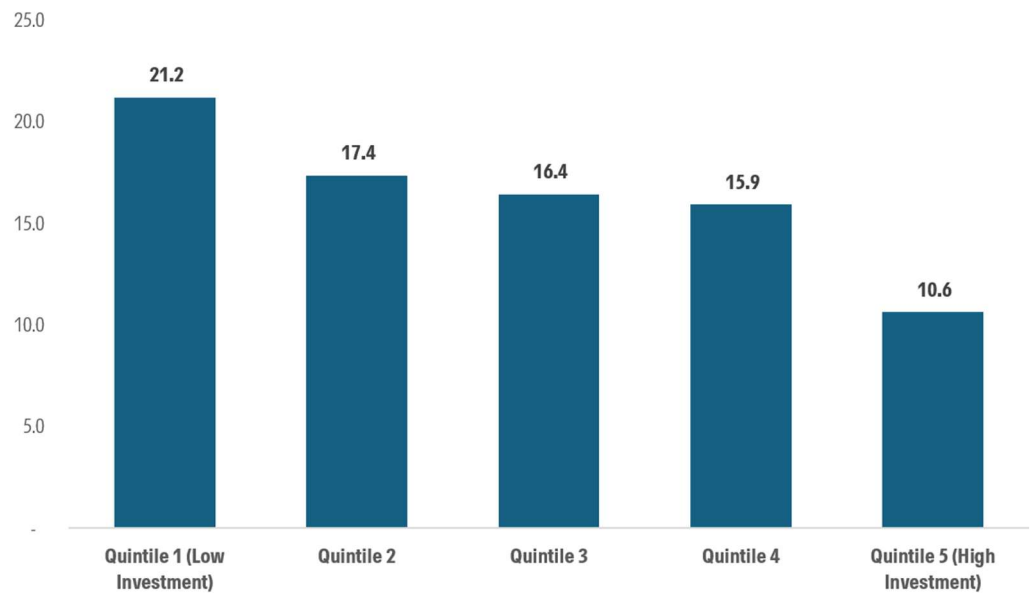
Exhibit 2: Free Cash Flow Slows Down



Source: Wall Street Journal, FactSet. Data as of August 2, 2025. References to specific securities not an offer to buy or sell. For illustrative purposes.

However, we believe the path to monetizing AI investments remains highly uncertain. Our concern is that the profit motive appears to be taking a back seat to the strategic goal of winning the proverbial AI arms race.

2) Historical Patterns: History provides ample evidence that high levels of capital investment are often associated with lower future returns. According to the capital cycle theory, heavy investment typically increases supply, which in turn depresses profitability and overall returns. Exhibit 3 illustrates this dynamic, showing portfolio returns sorted by investment intensity over the past 60 years. The evidence is clear: on average, higher investment levels tend to produce lower subsequent returns.

Exhibit 3: High Investment Often Means Lower Returns

Source: Fama French Data. Quintiles sorted on investment. Average return data from 1964—2024, returns equally weighted. Past performance no guarantee of future results. For illustrative purposes.

Leaning Against the Tide

A core tenet of our investment philosophy is that the price paid for a given cash flow should be the primary driver of investment decisions.

This valuation discipline acts as a steady anchor in markets that often swing between fear and euphoria. In April, this framework led us to increase allocations to some of the most beaten-down areas of the market and take on additional credit risk.

Today, however, we are once again reducing risk and are content to remain on the sidelines, awaiting more attractive opportunities.

In a recent interview with Goldman Sachs President John Waldron, renowned investor Seth Klarman emphasized the importance of going against the grain as central to a valuation-driven approach:

"To be a value investor, sometimes I think you need a bit different wiring. Wiring that makes you want to buy in a down market, where most people are scared and selling into it. [That same wiring] makes you want to sell into a really strong bull market, where most people are getting more excited the longer it goes on."

It's rare for markets to test buying and selling discipline in such quick succession. But as the saying goes: practice makes perfect.

While it remains uncertain how long the current wave of optimism will last, one thing is certain—we will be ready to redeploy capital when the time is right.

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