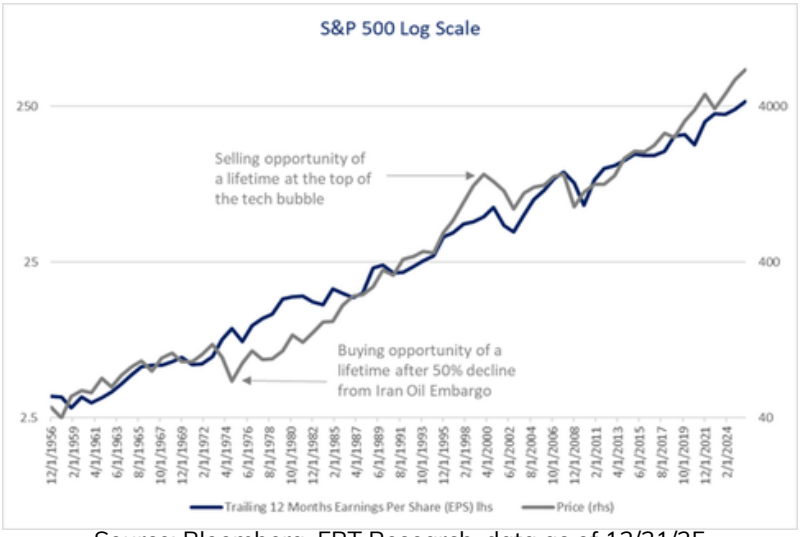
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WHERE DID THE CASH FLOW GO?

"For a couple of years now, we have lamented market valuations were higher than we'd prefer. Of course, our message has remained valuations alone are not a reason to sell, and there have been plenty of places in the market with more reasonable valuations to still earn strong long-term returns.

Why the fixation on valuation? Unbeknownst to many casual observers of the stock market, it is one of the two drivers of stock returns. Stock returns can be broken down much further to granular accounting details, but the first layer of the onion to peel is simple: earnings per share (EPS) and valuations, or the price people are willing to pay for a dollar of EPS. You may have heard of P/E ratios, which capture this fact (caution: there are many nuances). As the chart shows, stock market history is driven by EPS over the very long-term. However, for lengthy periods of time, valuations can cause market returns to deviate from EPS growth.

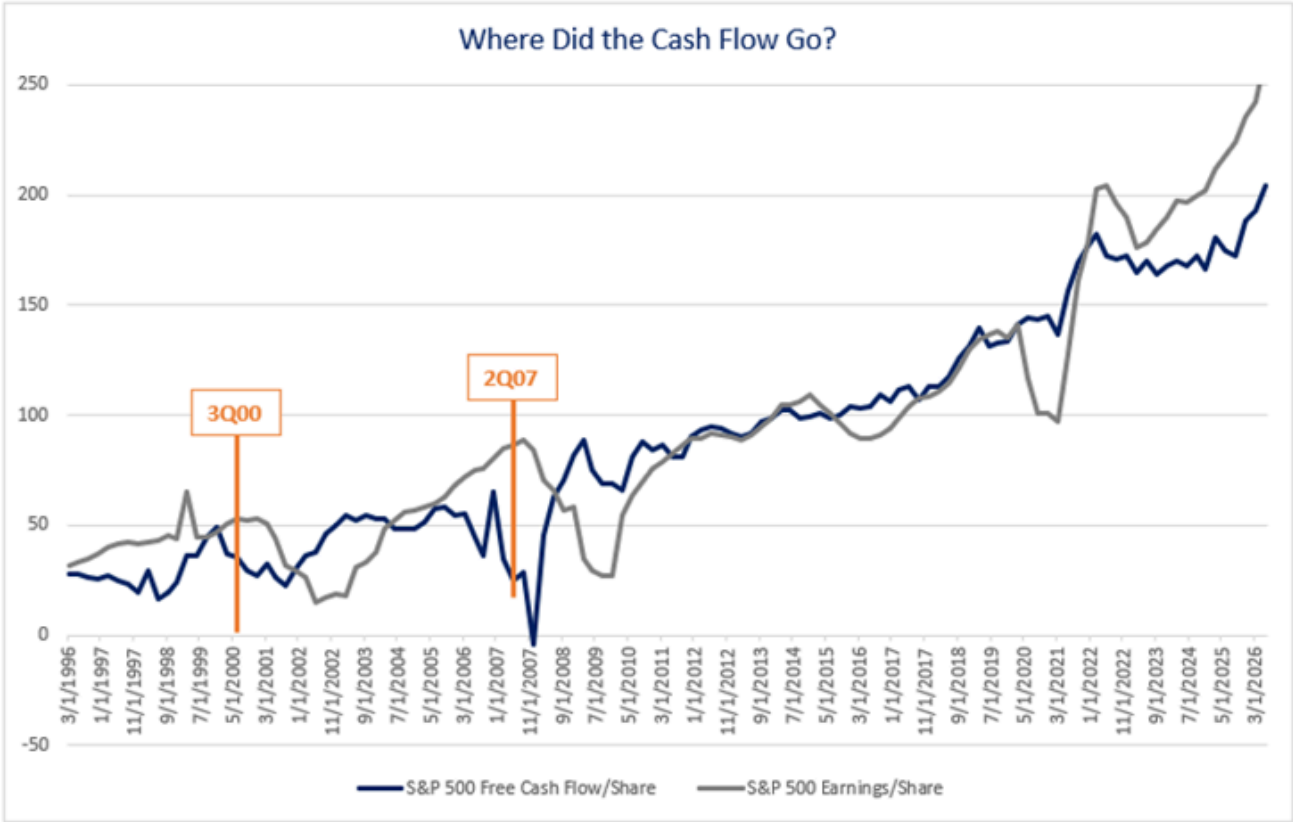


Source: Bloomberg, FBT Research, data as of 12/31/25

One can argue with our scaling, but the historical outcomes from prior deviations lead us to be comfortable with the chart showing the market (price, gray line) deviating pretty far from the blue line, and not in the direction investors want to see.

This chart would suggest we are correct in saying valuations are too high. So that means it is time to go to cash and hunker down, right? If only it were that easy. The weakness of this chart is that it focused on trailing 12 months, and the market is a forward-looking creature (albeit not always very far into the future). Selling based on backward-looking data is often a mistake, and 2026 looks extremely bright for EPS. Wall Street consensus estimates pencil in roughly 27% growth, making that gap much more palatable considering the long history of EPS growth averages ~8%.

A growth rate three times the historical average for EPS? Believe it or not, it certainly seems achievable given a couple of very large powerful forces that have aligned this year: incrementally more insane fiscal policy (bad for future generations but positive for corporations this year) and accounting abnormalities, the latter of which brings us to the title of our newsletter: where did the cash flow go?



Source: Bloomberg, FBT Research, data as of 6/30/26

Before diving into the underlying cause of this gap, it is worth noting that the very bedrock of finance is discounted cash flows. EPS are often quoted due to simplicity (your share of the company's profits) and their strong correlation with free cash flow (most of the time – see chart above). However, the purest way to price a stock is using the discounted value of its future free cash flow per share.

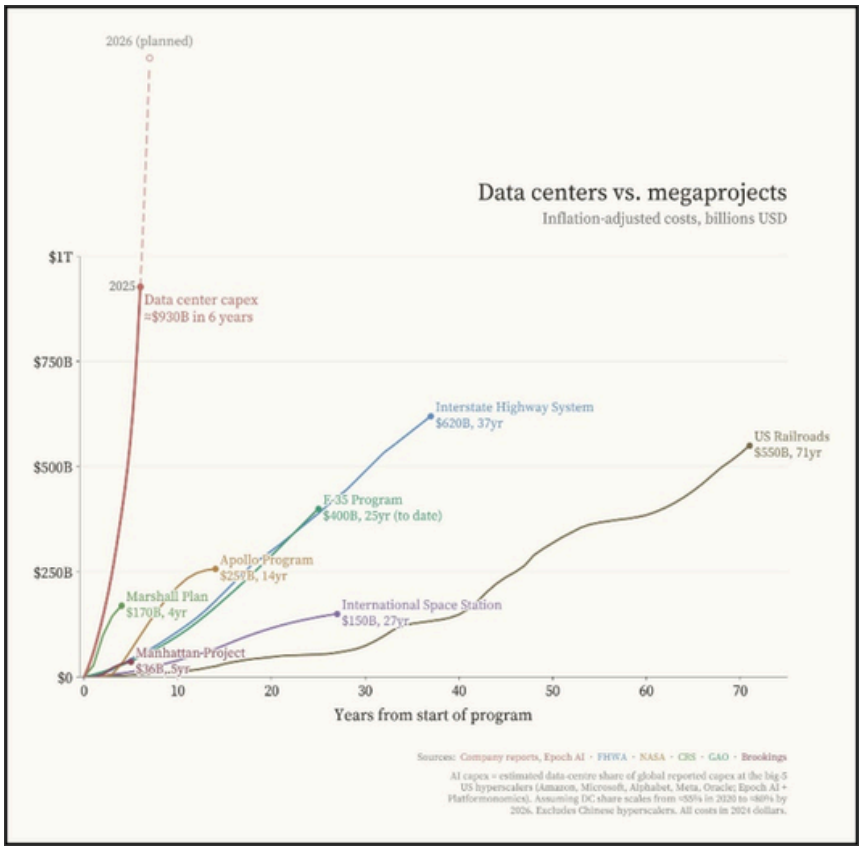




“THE BET OF THE CENTURY”

The chart above arguably gives us more heartburn for the S&P 500 market index than the first chart. There is, here in the short-term, a clear degradation of earnings quality, and we have high valuations riding low-quality earnings. We don’t know with certainty how this gap will resolve, but it will resolve. The same accounting rules that cause EPS and FCF/share to be correlated most of the time will ensure these lines meet again. However, we must remember the market is a forward-looking creature. As such, if free cash flow catches up to earnings, selling out of the market based on current concerns will be misguided.

So what is driving that large gap? Well, as some have aptly called it, The Bet of the Century: Artificial Intelligence (AI). This wording may sound dramatic, but it is not. With estimates approaching a TRILLION dollars in capital expenditures (capex) in 2027 alone, the data center buildout for AI will likely dwarf any other massive project in American history in an incredibly short period of time. So how does the bet of the century impact accounting for a broad market index? The enormity of it (and the enormity of the companies spending the money) is creating a distortion: large capex projects are not expensed through income statements and thus the costs do not hit profits / EPS immediately. The capex is put on the company’s balance sheet in the form of a long-term asset and expensed through the income statement via depreciation over time. But capex does reduce free cash flow as that money is still leaving the company.



Thus, a large part of the gap between EPS and FCF is simply due to a massive step function change in capex and the fact that those depreciation expenses will come later (with risk of EPS catching down to FCF). There are other nuances such as circular financing (as we covered in “What A Tangled Web We Weave” newsletter late last year), mark to market accounting (Google and Amazon last quarter), and some of the cash flow leaving the U.S. public markets for privately held companies or foreign companies in South Korea and Taiwan.

A JUXTAPOSITION IN THE MARKET?

If you haven't fallen asleep reading through this accounting lesson, you will appreciate what comes next. This surge in capital investment has to find a home, of course. And a key beneficiary of the spending of the "Hyperscalers" (Oracle, Meta, Amazon, Google, and Microsoft) has been the entire semiconductor industry. The cash flow changing hands has been staggering:



While a contender for chart of the year, this only looks forward 12 months. That's not very far, but a study of market tops and bottoms suggests that the market might not look very far either. The market might know before Wall Street analysts, but the timeframe between the gray and blue lines tends to be around 6 months, give or take.



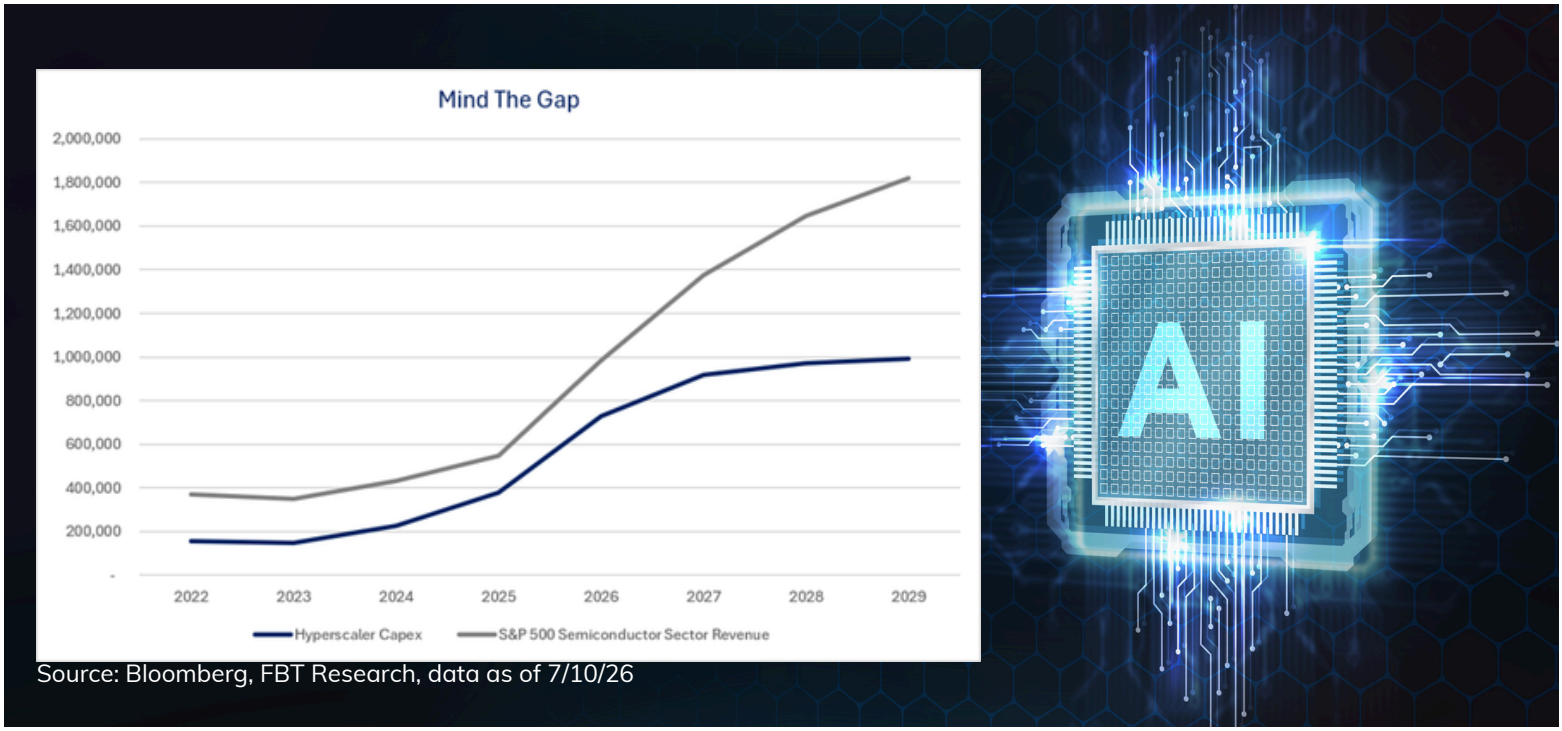
Source: Bloomberg, FBT Research, data as of 6/30/26

Suffice it to say, the market is giddy about the free cash flow change in hands. The SOXX Semiconductor Index doubled from the beginning of the year to the end of June, and the vast majority of that move occurred in the second quarter. Yes, you read that correctly – doubled in value in just three months. Meanwhile, most of the Hyperscaler stocks (Google being the exception) are flat to down since Meta suggested on an earnings call last July that their 2026 free cash flow could go negative.

The market is enjoying this party in semiconductors as are the analysts that cover the sector. We don't proclaim to know how long the party will last but we remain sober-minded and have some questions. For the Hyperscalers, can you generate a strong return on invested capital (ROIC) of a trillion dollars per year? Keep in mind this is a group that collectively is expected to increase their revenues by a little north of $250 billion this year. While an impressive number, returns are generated from profits, not revenues. And if history holds, margins could struggle given the scale of the capital being deployed; as such, ROIC might be going lower. To be clear, some of these businesses view AI as a massive opportunity and some view it as an existential threat. They can both be right and be a bad deal for shareholders. Based on the stock prices lately, it is worth pondering if the market is already telling the Hyperscalers it is too much.



For the semiconductor shareholders, do you believe the Wall Street analysts covering Hyperscalers or the analysts covering the semiconductor sector? The bottoms up math does not agree with top-down intuition beyond the next 18 months (chart below). Do you think the customers, some of the smartest and most well-resourced companies in the world (the Hyperscalers) will sit idly by while their stock prices and ROIC's drop and the semiconductor sector reaches all-time highs in stock prices and gross margins? That answer is no – most of the Hyperscalers have started working to develop semiconductors in house to reduce cost. Betting on continued shortages is de facto betting against innovation – the beauty of human ingenuity is the ability to solve problems like excessive costs and find workarounds. Semiconductors can continue to reach new highs in margins while demand is surging, but this is a famously cyclical industry where double ordering occurs during panic buying (remember, AI might be existential).



Source: Bloomberg, FBT Research, data as of 7/10/26

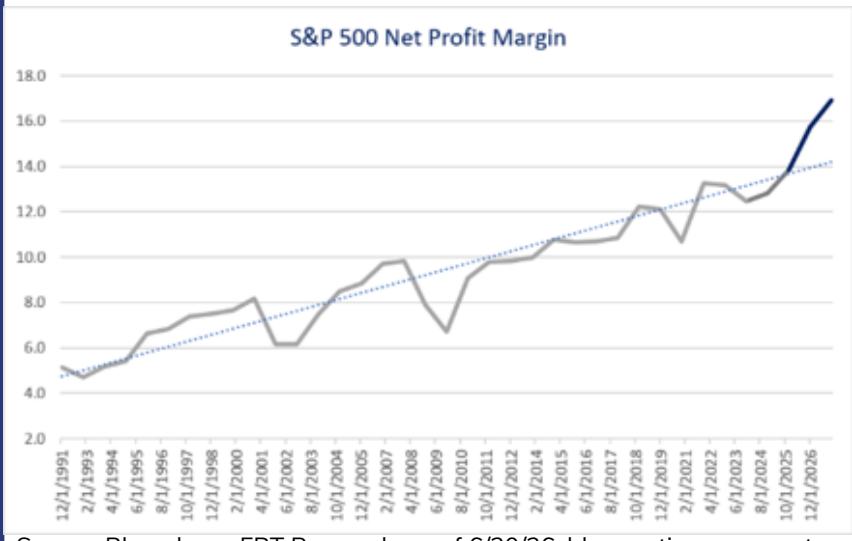
The price action in semiconductors and Hyperscalers show market participants betting heavily on continued growth in AI capex. In fact, one could certainly make the argument the price action in semiconductors is downright bubbly. We are NOT AI skeptics by any means, but it seems to be a good time to ask the bean-counting, finance questions such as addressing head scratching gaps in Wall Street estimates while everyone and their brother announces plans for a data center.

WHAT DOES THIS MEAN FOR PORTFOLIOS?



We are primarily bottoms-up (focused on company fundamentals rather than macroeconomics) investors that try to think in 3-5 year timeframes (which differentiates us from the short-term focus of the market), but we enjoy writing this newsletter from a top-down perspective because when the top-down and bottom-up approaches don't align, there can be a big opportunity.

We've already pointed out earnings expectations for this year and next, collectively, seem lofty; although our suspicions of dubious forecasts lie more with next year than this year (margins to the moon according to Wall Street). We've noted the market doesn't look incredibly far into the future. And now we have a large juxtaposition in the market. At what point in 2027 that sobriety sets in for estimates is a tough guess at the moment. But if that occurs early in 2027, Mr. Market will probably start feeling some indigestion very soon.



Source: Bloomberg, FBT Research, as of 6/30/26; blue portion represents consensus Wall Street forecasts

The amount of leverage and complacency in the market also concerns us. Despite all of this, unlike last quarter, we're a little less inclined to ring the alarm bell. Many stocks are still stagnant or down this year while oil has crashed (as of the end of June). Whether they rebound in short order and support the top-heavy index is, unfortunately, probably still a question of oil and geopolitics. However, we try to have a longer-term view than Mr. Market and think there is some value to be found for those with patience so we return to our cautious bull stance: (1) valuations at the index level are too high but opportunities still exist under the surface, and (2) valuations are not timing tools so stay invested, but high valuations do amplify downside risk so remain disciplined in asset allocation, stay diversified, and don't be afraid to take some profits and incur capital gains.

AI has become all-consuming and when the growth rate falls significantly, it could have an economy-wide and market-wide impact. Whether or not that aligns with our concerns about the sustainability of earnings forecasts in 2027 remains to be seen. It is too early to make that call but it does warrant higher alert and greater willingness to change one's mind in short order than is required in most market cycles, in our opinion. We encourage our clients, as always, to keep in close contact so we can help them navigate a fickle market environment and stay on course for their financial objectives.

Sincerely,

Your First Bankers Trust Team

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Investment products are not FDIC insured, not guaranteed by the bank, and may lose value

CHART APPENDIX

Sources: 3Fourteen Research, AllianceBernstein, Bluekurtic Market Insights, S&P Global, Goldman Sachs Research, Advisor Perspectives, Bank of America, Morgan Stanley, Coatue, BCA Research, Bloomberg, FBT Research, Ned Davis Research, Citadel

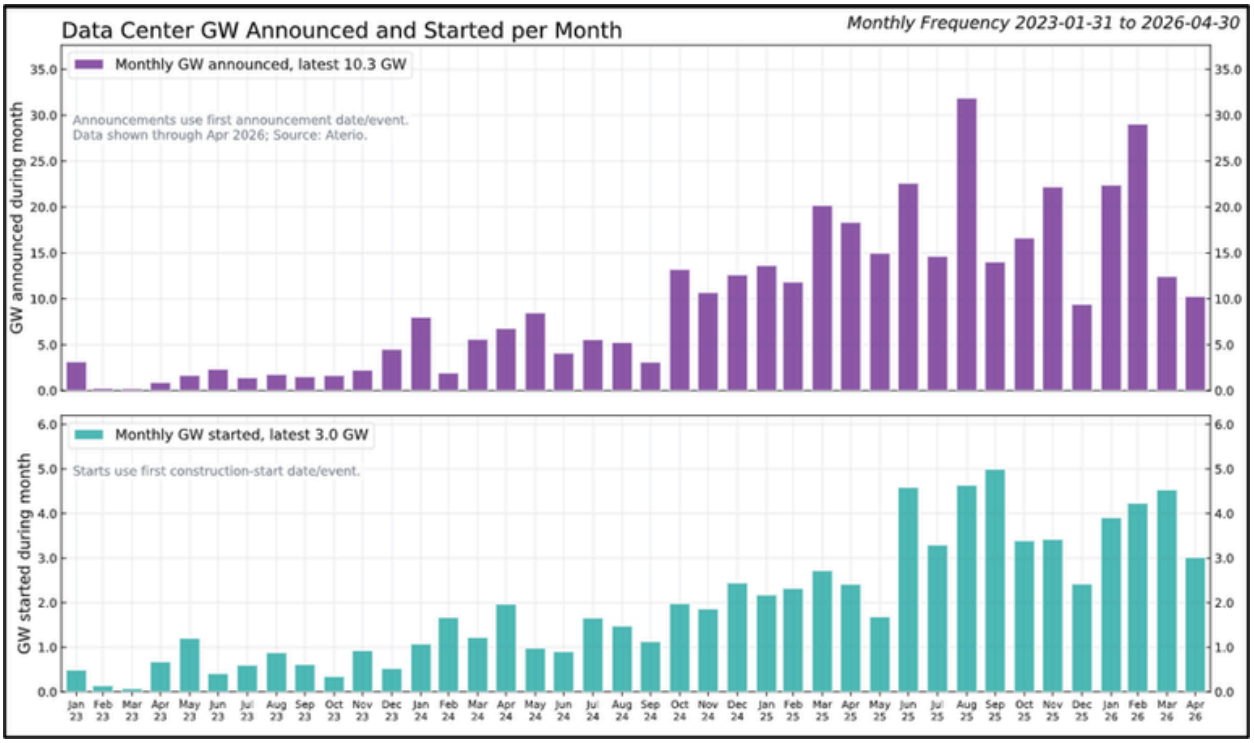
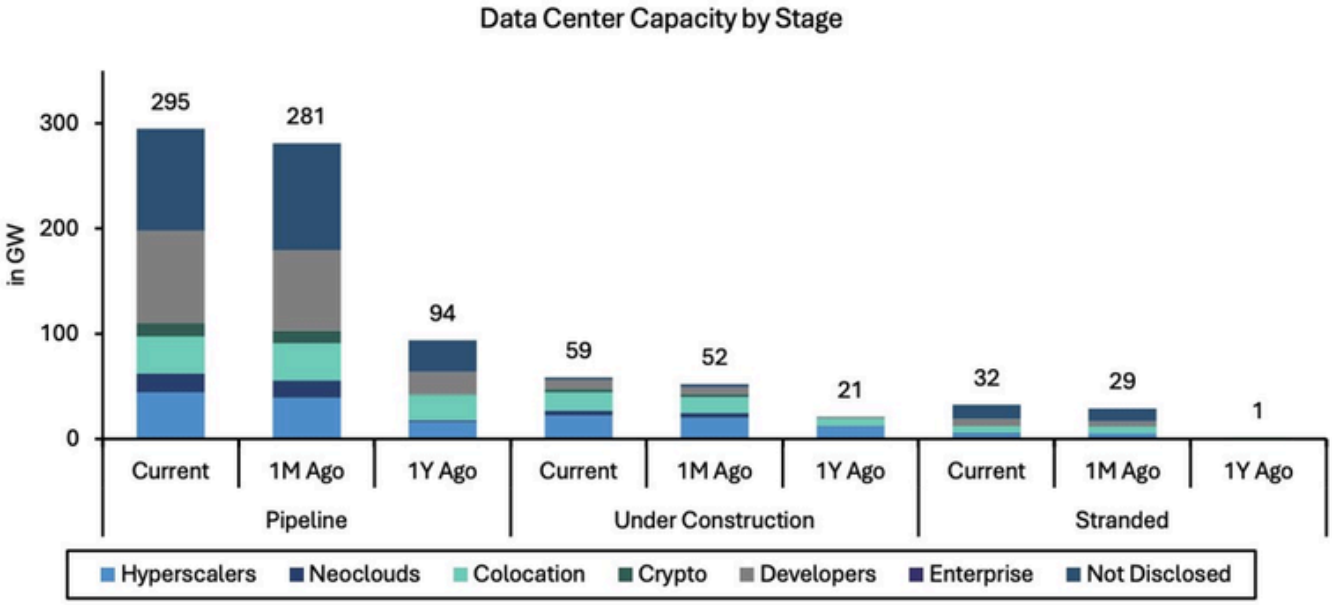
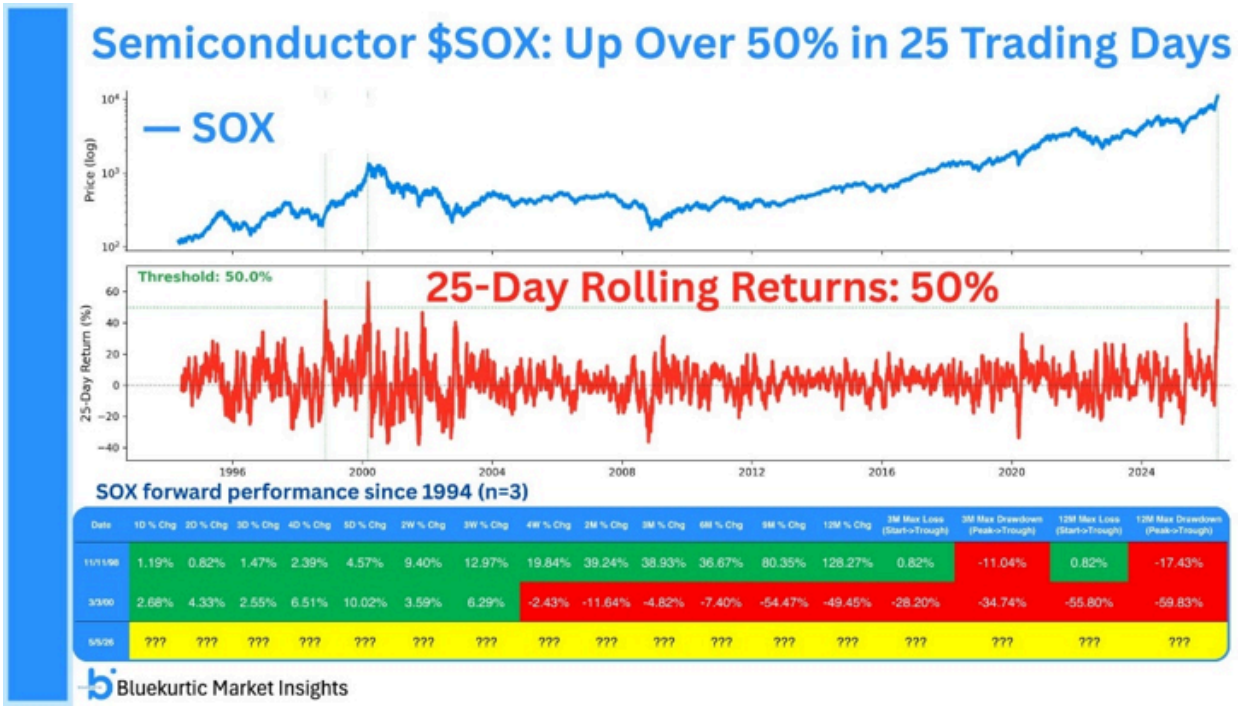


EXHIBIT 4: **Data Center Capacity (in GW) by Stage of Development**

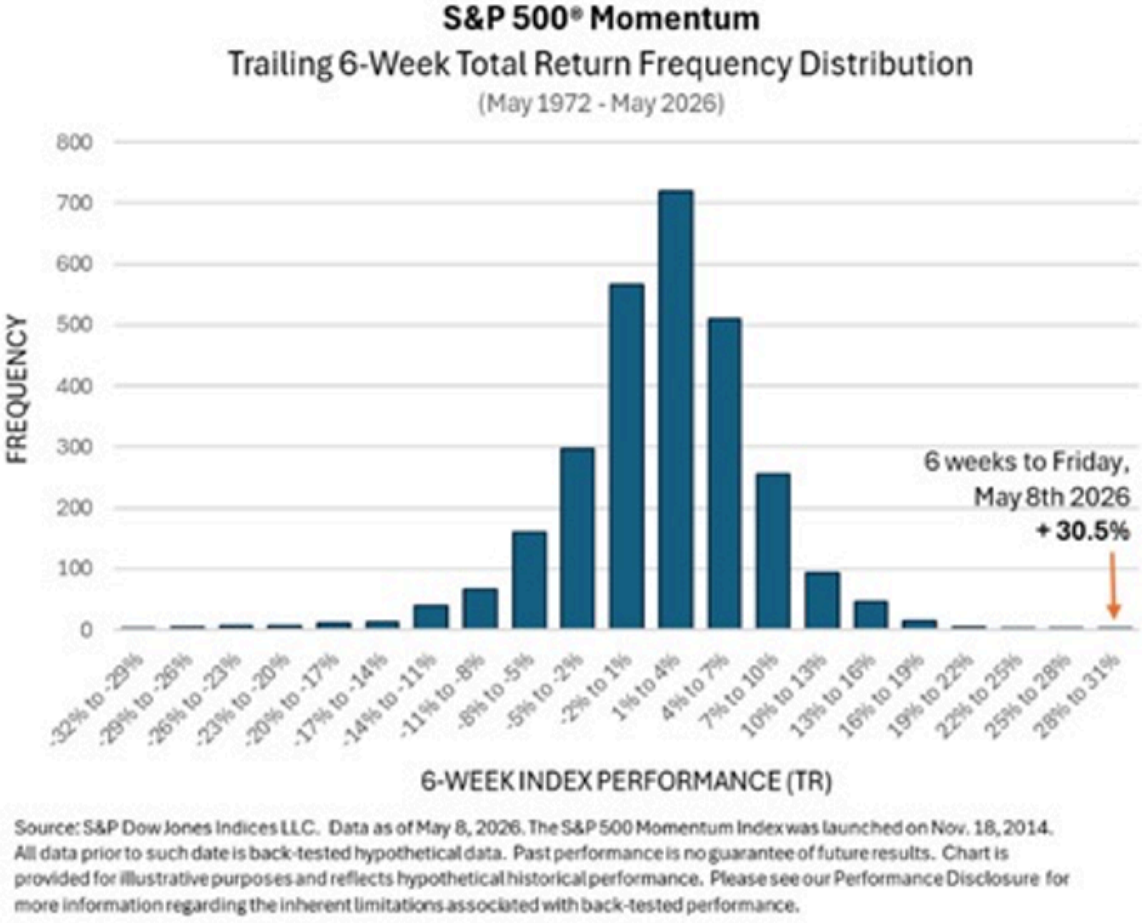


Stranded capacity = delayed + cancelled + not approved/withdrawn capacity
Source: Aterio, Bernstein analysis

CHART APPENDIX



Date	1D % Chg	2D % Chg	3D % Chg	4D % Chg	5D % Chg	2W % Chg	3W % Chg	4W % Chg	2M % Chg	3M % Chg	6M % Chg	9M % Chg	12M % Chg	3M Max Loss (Start->Trough)	3M Max Drawdown (Peak->Trough)	12M Max Loss (Start->Trough)	12M Max Drawdown (Peak->Trough)
11/11/98	1.19%	0.82%	1.47%	2.39%	4.57%	9.40%	12.97%	19.84%	39.24%	38.93%	36.67%	80.35%	128.27%	0.82%	-11.04%	0.82%	-17.43%
3/3/00	2.68%	4.33%	2.55%	6.51%	10.02%	3.59%	6.29%	-2.43%	-11.64%	-4.82%	-7.40%	-54.47%	-49.45%	-28.20%	-34.74%	-55.80%	-59.83%
5/5/26	???	???	???	???	???	???	???	???	???	???	???	???	???	???	???	???	???



Source: S&P Dow Jones Indices LLC. Data as of May 8, 2026. The S&P 500 Momentum Index was launched on Nov. 18, 2014. All data prior to such date is back-tested hypothetical data. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see our Performance Disclosure for more information regarding the inherent limitations associated with back-tested performance.

CHART APPENDIX

Exhibit 8: Momentum and AI have recently been very correlated

Momentum (GSMEFMOM) and AI vs. AI risk (GSTMTAIP vs. GSTMTAIR)

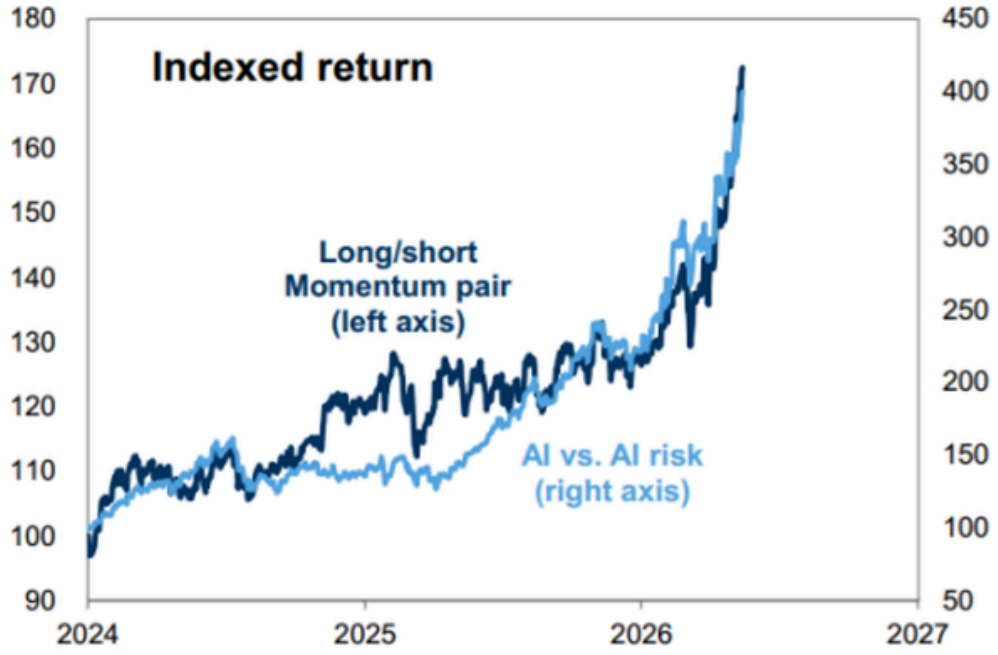
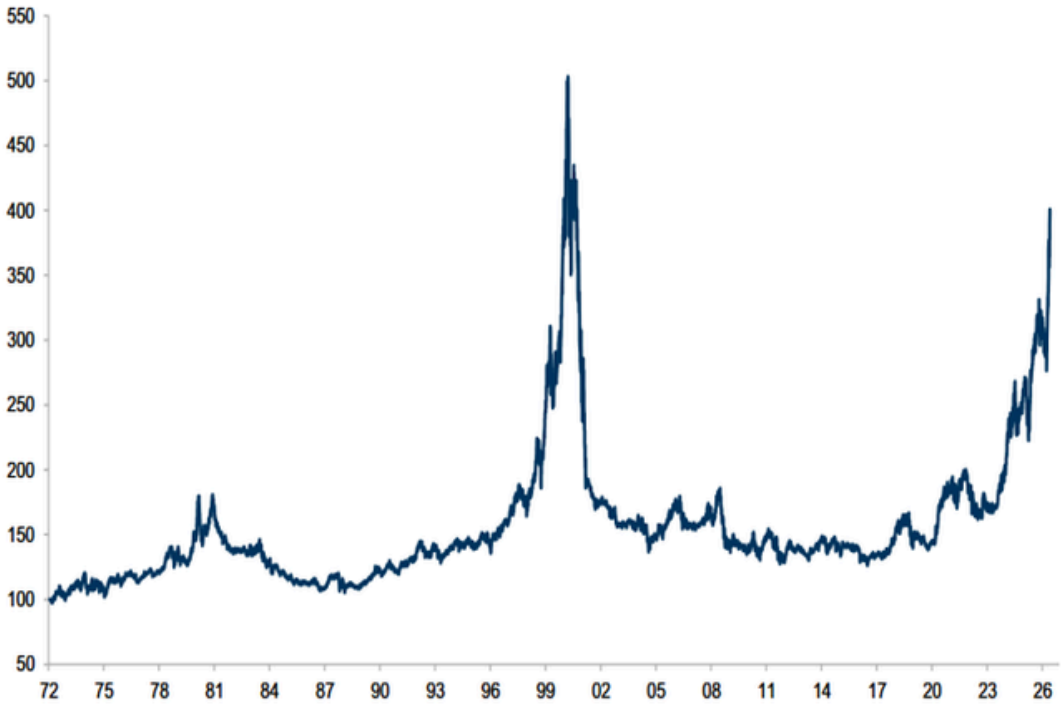


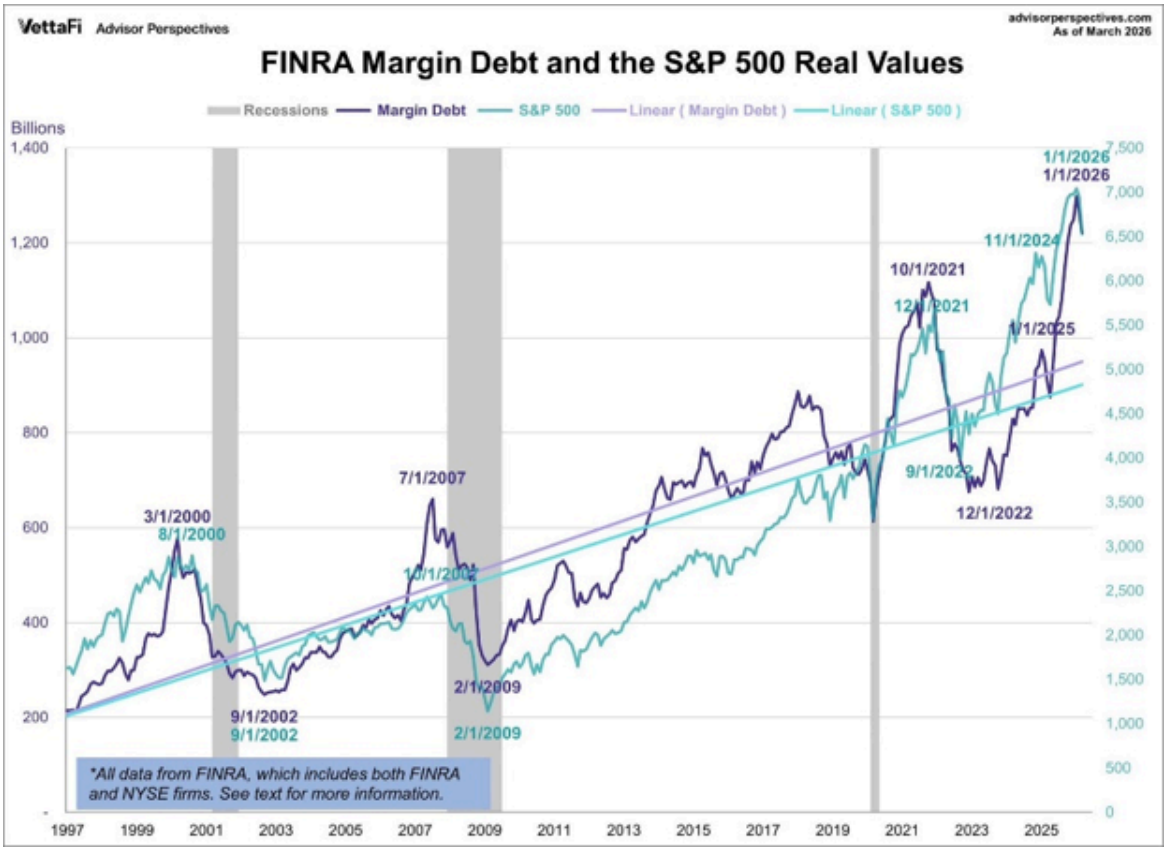
Exhibit 3: The ratio of S&P 500 momentum vs. low volatility stocks is nearing Tech Bubble peaks

Relative total return performance S&P 500 momentum vs. low volatility stocks



Source: Bloomberg, Goldman Sachs Global Investment Research

CHART APPENDIX



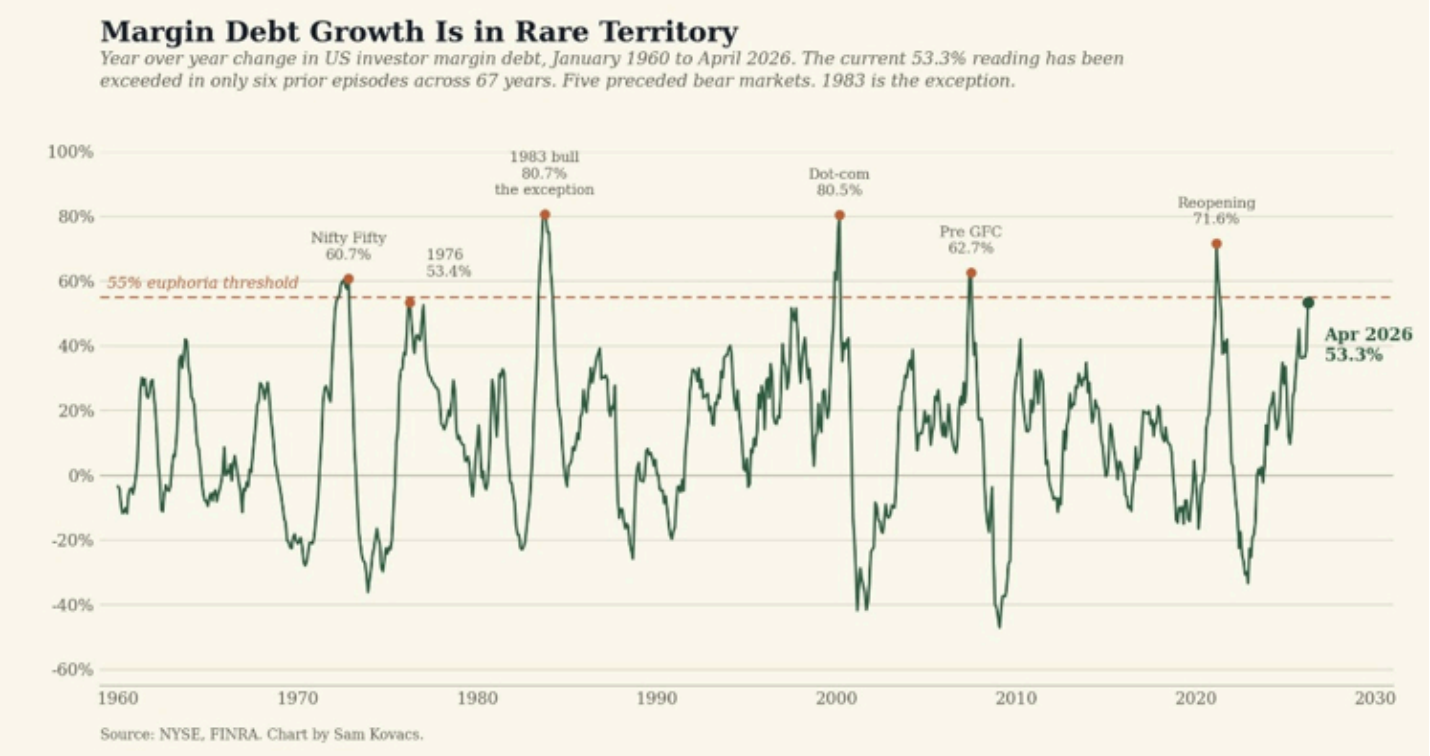
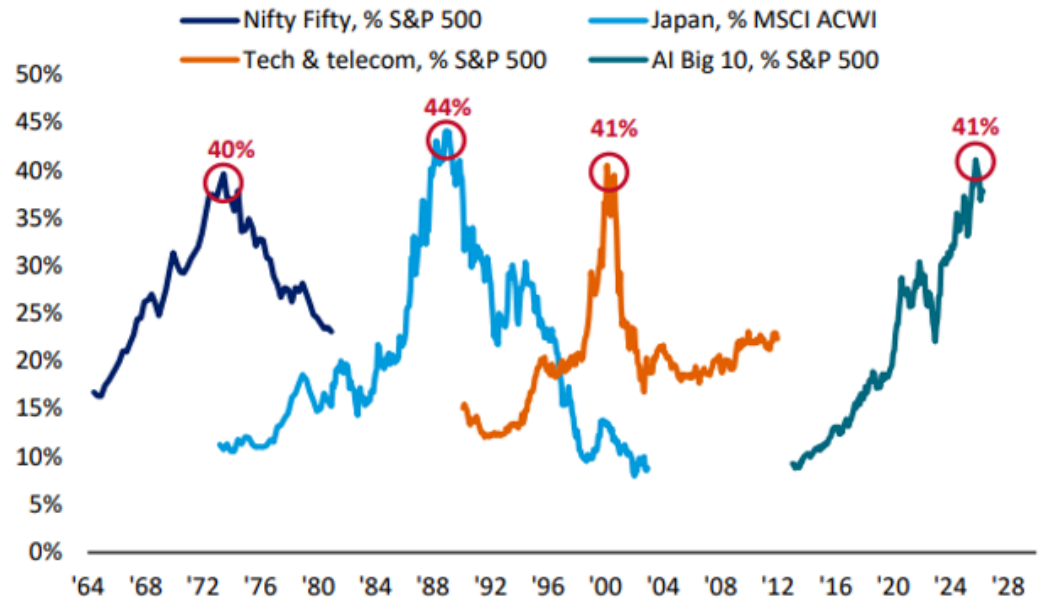


CHART APPENDIX

Chart 6: Historical concentration peaks

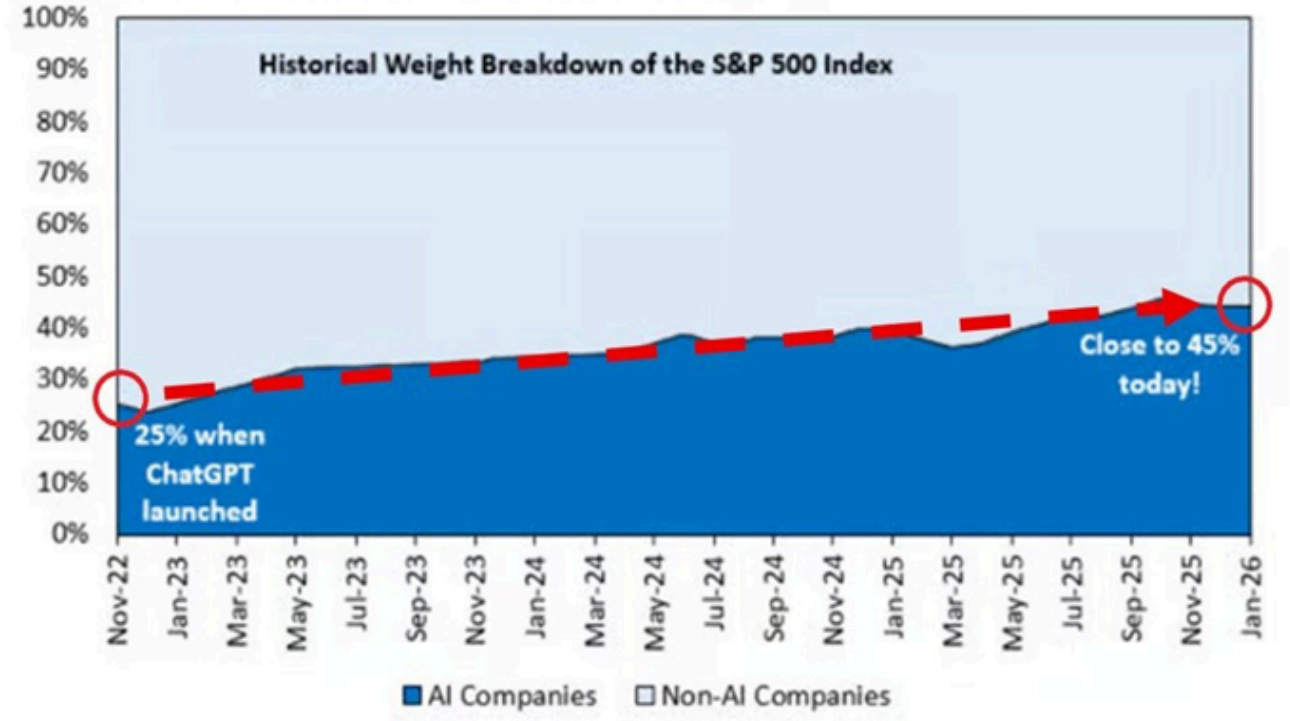
Concentration of Nifty Fifty in '70s, Japan in '80s, Tech in '00s, AI in 2020s



Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data, BofA Global Research Investment Committee.

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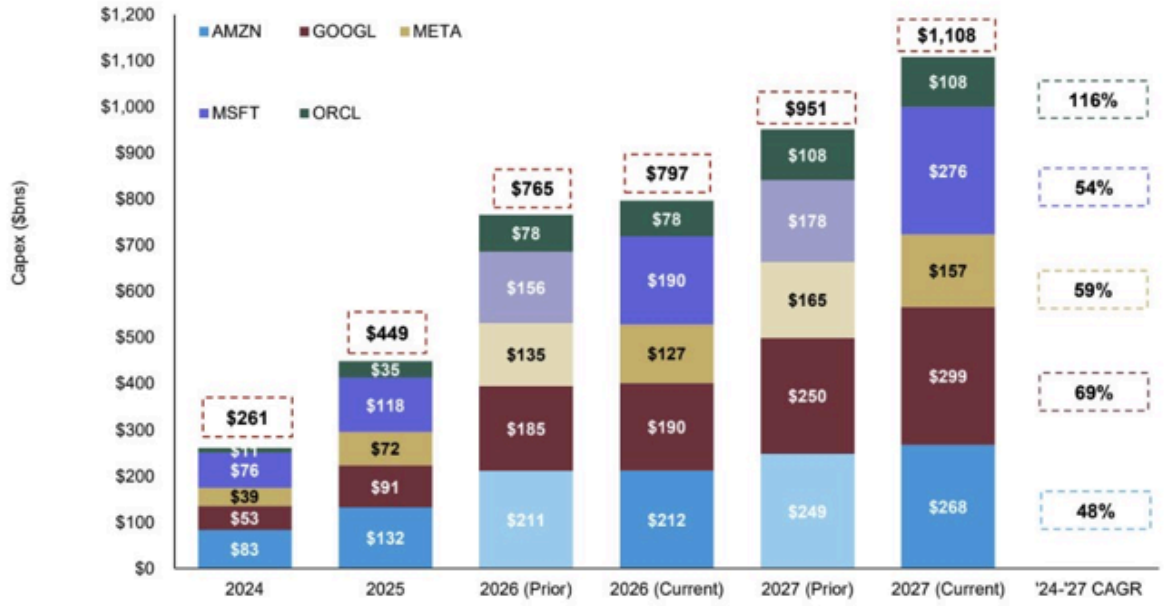
The weight of AI companies in the S&P 500 now sits at 45%



Source: Goldman Sachs FICC & Equities, as of Feb 2026. Past performance is not indicative of future results

CHART APPENDIX

Exhibit 1: We now see Hyperscaler capex approaching $800bn/$1.1trln in '26/'27 vs $765bn/$950bn prior



Source: Company data, Morgan Stanley Research estimates

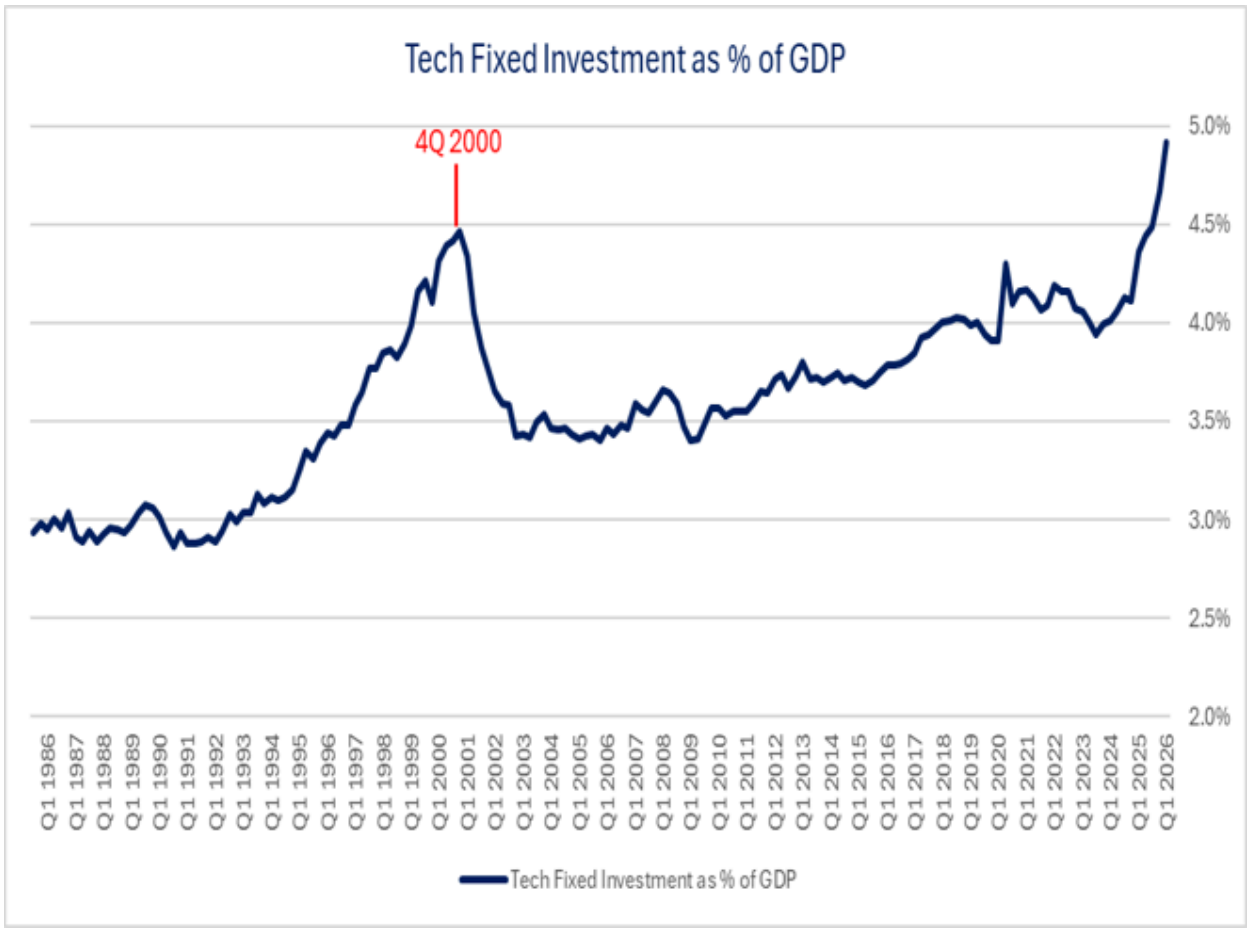
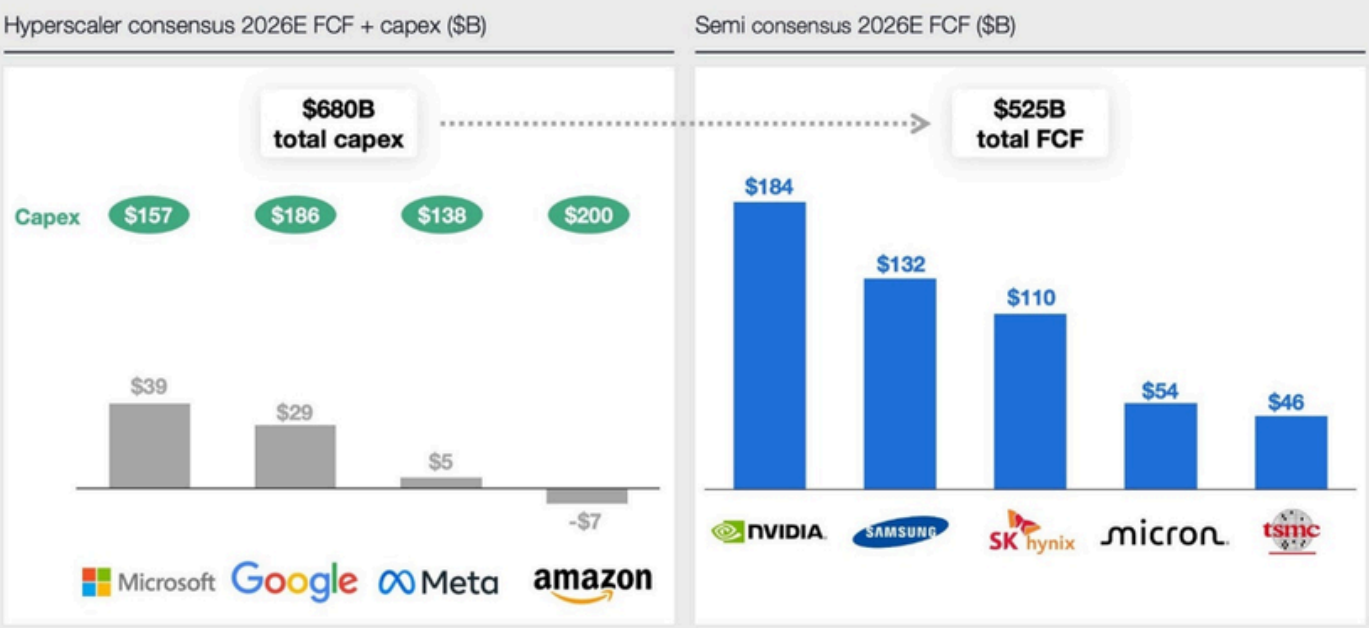


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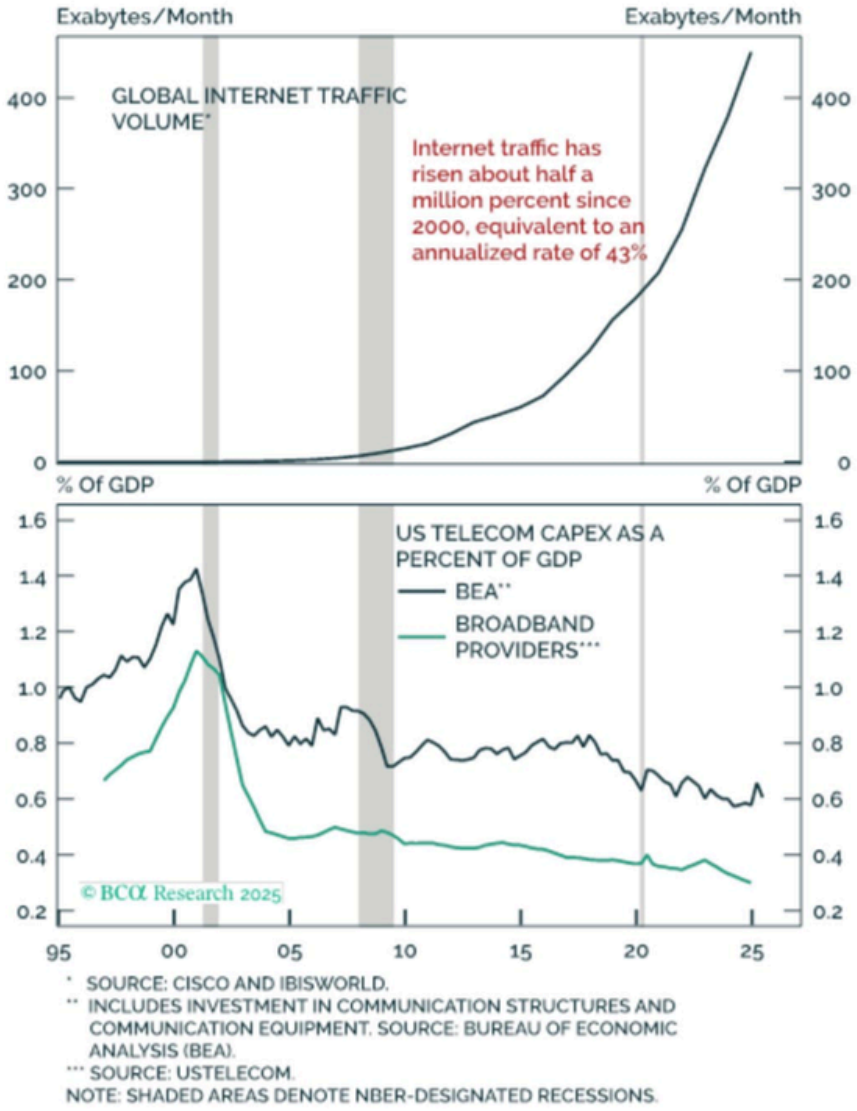


CHART APPENDIX

US Equities in Rare Winning Streak

S&P 500 set for rare four-year streak of double-digit gains

Streak	S&P 500 Index
Current	—
2026*	20%
2025	16%
2024	23%
2023	24%
Bubble	—
1999	20%
1998	27%
1997	31%
1996	20%
1995	34%
Peace	—
1952	12%
1951	16%
1950	22%
1949	11%
War	—
1945	31%
1944	14%
1943	19%
1942	12%

Note: *2026 gains are annualized
Source: Bloomberg

