

# Part 1

## A Market Changing Seasons



## A MARKET CHANGING SEASONS

Maybe it's a word you remember from a college class, a CNBC segment, or from someone detailing why you shouldn't put everything in one basket. Wherever you heard it, the last few years within equities made diversification feel more like a nice theory than a real-world advantage, mostly because the weather never seemed to change. When one pocket of the market enjoys endless clear skies, the instinct is to stay outside and enjoy the sunshine rather than carry around rain gear.

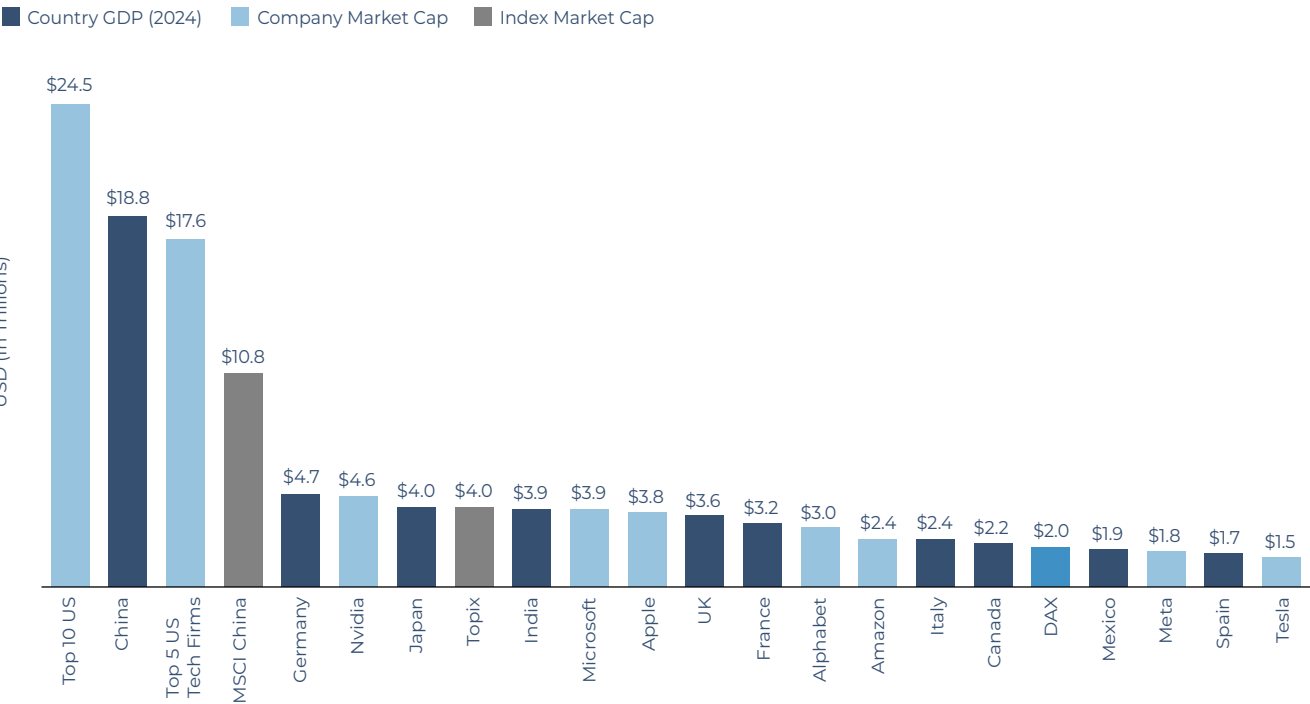
That was the story for much of this cycle. As other parts of the market tried to thaw, US mega cap tech basked in a multi-year heatwave. Foreign equities fell to record low relative valuations, small caps lagged dramatically, and investors continued piling into the same winners. Passive flows amplified the trend, quietly pushing portfolio equity allocations further and further toward a single-season strategy.

The growing outperformance sent the top 5 US tech companies (\$17.6T) atop the mountain with a collective value that exceeds the GDP of Japan, India, U.K., France, and Italy combined (\$17.1T). What was the point of owning more of other segments of the market when these dominant forces kept going higher? When one area only goes up, everything else feels optional.

But market climates never stay static. They cycle and hibernate until the right series of events puts the importance of diversification back to the front of investors' minds. We started to see that shift as 2024 ended, urging investors not to abandon what had been working, but to cast a wider net within equities. Then early 2025 delivered the first real weather pattern shift in years. Foreign equity markets snapped awake just as US tech cooled. Investors who had allowed their portfolios to drift into one-season strategies felt how uncomfortable a fast temperature change can be.

### The Top 10 US Companies Dominate The World Equity Market

Top 5 US Tech Firms Alone Have a Collective Value (\$17.6 T) that Exceeds the Combined GDP of the Japan, India, UK, France, and Italy (\$17.1 T)



Source: Goldman Sachs, IBES, FactSet. As of October 8, 2025.

In 2026, we are moving out of a one-season equity market, where the same handful of companies dominated, and into a period where more areas are starting to participate. The mega caps remain powerful leaders, but they're no longer the only story. This isn't about abandoning them, far from it, but it does mean recognizing that equity dynamics are evolving and portfolio construction needs to evolve with them.

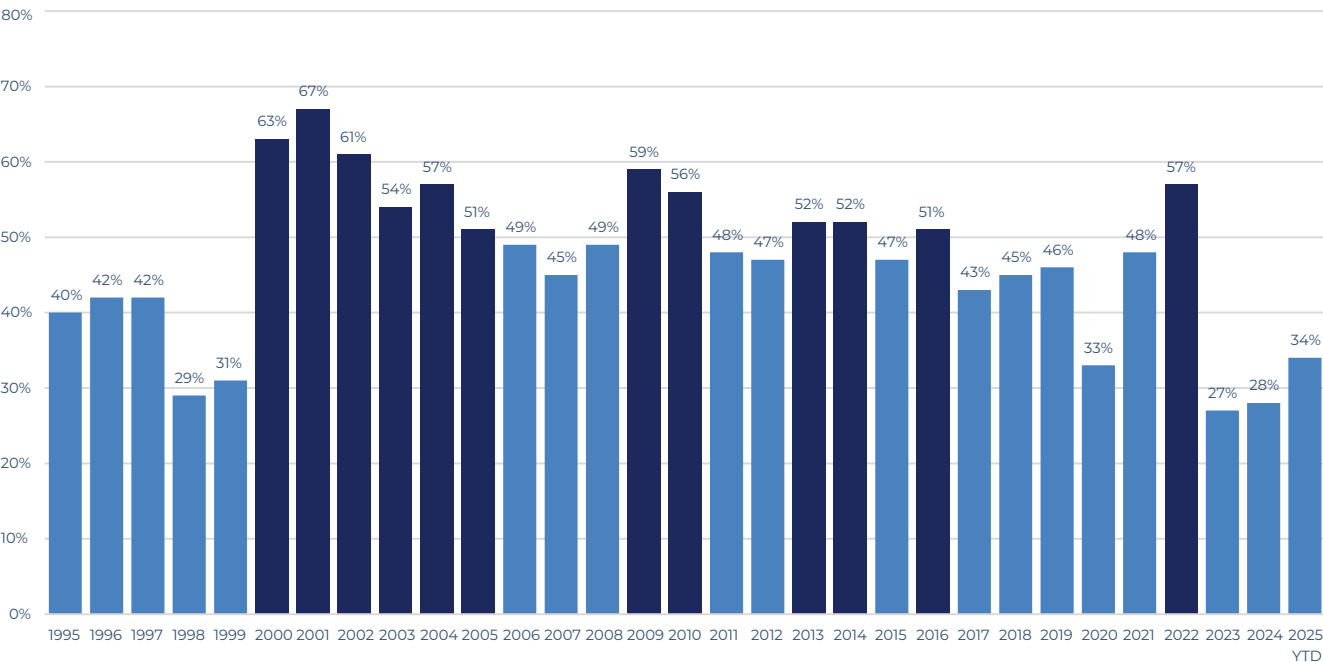
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The topic du jour across the investment community centers around the overconcentration in the Magnificent 7 stocks. After several years of outperformance, valuations have risen and investors are naturally wondering whether the group is due for a meaningful reset. Investors continue to ask: Are we there yet? Is this the point where they finally break? While sentiment has become more cautious, we do not anticipate a dramatic reversal in 2026. Several, though not all, remain well positioned with deep competitive advantages in AI. These are exceptional businesses. But exceptional doesn't mean boundless. Dominant doesn't mean invincible. And strength doesn't eliminate risk.

What matters more is that the market is beginning to show signs of healthier participation. Breadth has been unusually weak for the last few years, but the improvement recently is telling. In 2023 & 2024 only about a quarter of S&P 500 companies outperformed the index. In 2025, that number has risen to 34%. Mega caps still drive a large share of returns, but more areas are contributing - an encouraging development for investors who have been waiting for a broader set of opportunities to return to the market.

Long Stretch of Poor Breadth is Getting Better

Percentage of S&P Members Outperforming the Index



Source: First Trust, Bloomberg, Data as of December 1, 2025

This developing backdrop argues for a steadier, more balanced approach within equities. The question is not whether to own the Mag 7, but how much to rely on them given the homogeneity of performance. Other segments of the market are strengthening and allowing them more room aligns naturally with a healthier diversification framework. AI will remain a formidable force, but the roster of beneficiaries is widening, from companies building the physical infrastructure of AI to firms tied to reindustrialization and cyclical improvement. The leadership within this race is no longer restricted to a single lane.

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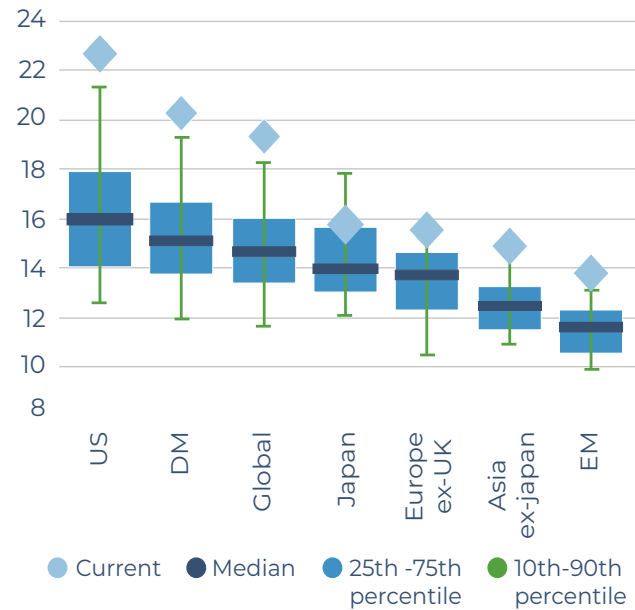
With our call for more broadening, it is important to acknowledge that valuation and earnings trends matter, because what investors pay for growth is just as important as the growth itself. The Mag 7 trade at roughly 30.5 times next year's earnings, reflecting both their quality and the premium investors are willing to pay for it. The rest of the S&P 500 trades closer to 20.8 times, foreign developed at 16 times, and emerging markets sit even lower at about 13.9 times. With valuations elevated across equities, 2026 will be more about earnings growth than multiple expansion.

While the Mag 7 still offer stronger absolute growth, their earnings momentum is beginning to level off. At the same time, expectations for both the broader US market and international equities are improving. The outlook for the coming year is less about replacing the leaders and more about incorporating the growing number of segments now showing signs of renewed strength.

“What investors pay for growth is just as important as the growth itself.”

### 12-Month Forward P/E Ratios

x, multiple

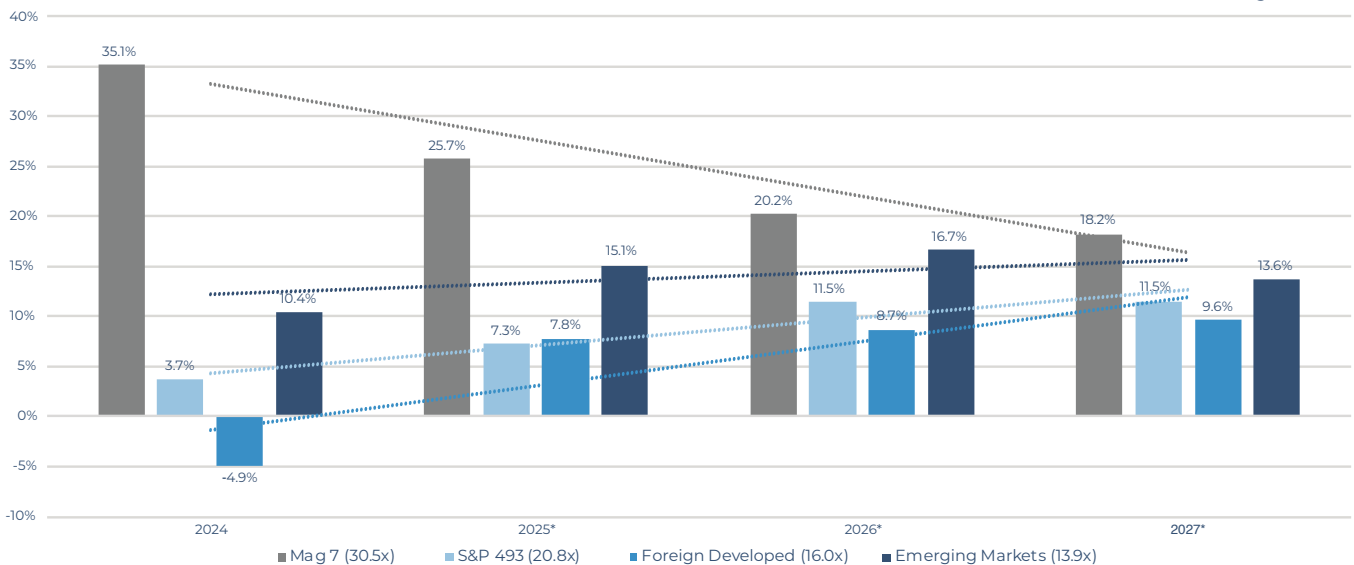


Source: FTSE, IBES, LSEG Datastream, MSCI, S&P Global, Tokyo Stock Exchange, J.P. Morgan Asset Management. Asia ex-Japan, China, DM, EM, Europe ex-UK and Global are MSCI. Japan: TOPX; UK: FTSE 100; US: S&P 500. Valuation is price to 12-month forward earnings, as published by IBES. Range and median calculated over last 20 years. Data as of 31 October 2025.

### What are you Paying for Growth?

Mag 7 Earnings Still Growing, Rest of the Market Catching Up

YOY Earnings Growth



Source: Bloomberg. Waterloo Capital. Bloomberg Magnificent 7 Index, Bloomberg 500 ex Magnificent 7 Index, MSCI EAFE Index, MSCI Emerging Markets Index. Data as of December 9, 2025



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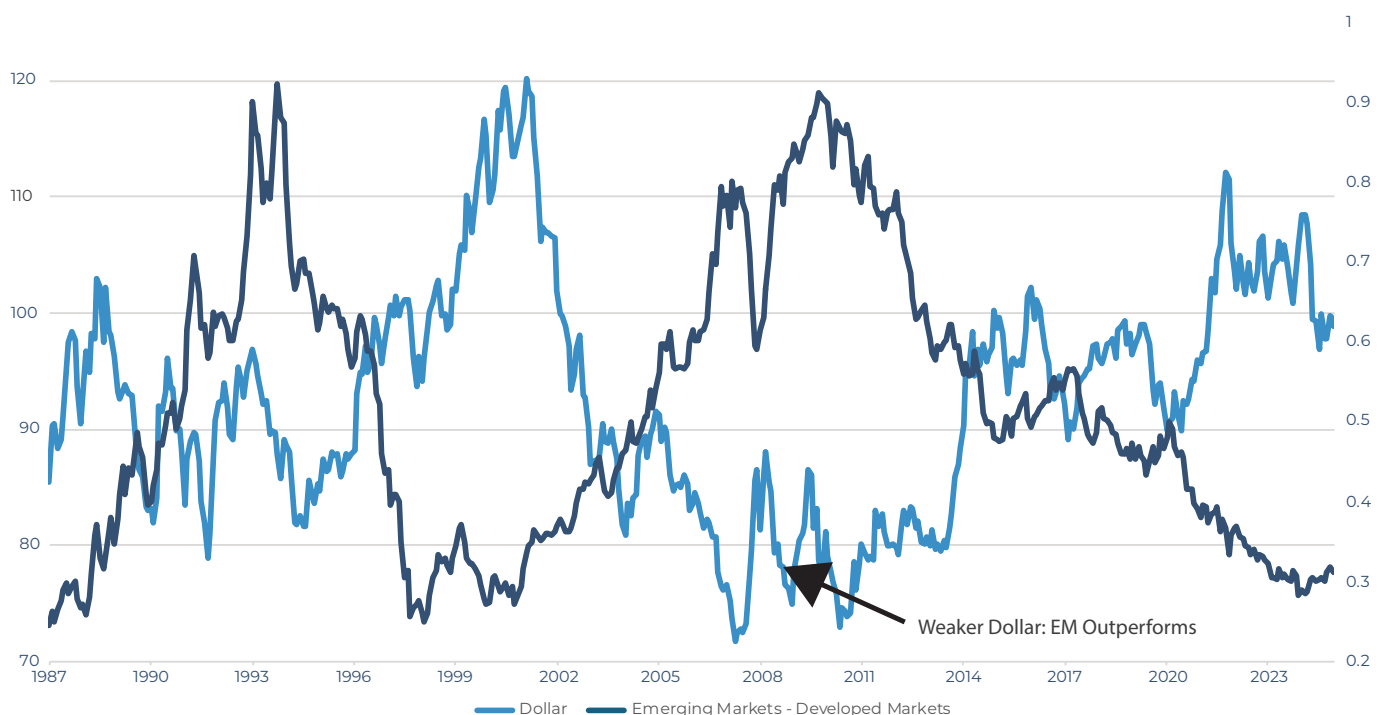
Simultaneously, smaller companies have shown early signs of renewed momentum. A stable domestic economy, Federal Reserve tailwinds in terms of lower rates and liquidity, fiscal incentives tied to reindustrialization, and an expanding set of AI-related opportunities all support a better environment for lower capitalization names. These areas will still require selectivity, a rifle's accuracy rather than a broad allocation, but the dispersion creates room for well-chosen companies to benefit as leadership broadens. For investors accustomed to this one-season market dominated by a handful of mega caps, small caps once again offer exposure to drivers that differ meaningfully from large cap technology.

“When growth outside the megacaps is accelerating at a lower cost, the relative value case becomes harder to ignore.”

As leadership broadens at home, the opportunity set abroad is shifting as well. Even after a strong year for international markets, most investors remain meaningfully underweight global equities. We continue to favor US markets at the core of portfolios given our call on domestic exceptionalism, but the magnitude of that tilt should be moderated - especially as the driving force of American markets faces more scrutiny. As global capital flows rebalance, the international landscape should feel a bit less like an afterthought and more like a region riding a steadier breeze, especially in emerging markets where valuations and currency dynamics remain supportive.

Several emerging markets offer compelling structural stories, and parts of Asia appear poised to benefit from the next phases of the AI buildout. The key companies powering semiconductors, cloud infrastructure, and robotics meaningfully expand the opportunity set, as technology already accounts for more than 25% of the market compared with only 9% for their developed European counterparts.

### US Dollar Weakness Has Historically Been a Tailwind for Emerging Market Equities



Source: Bloomberg. Waterloo Capital. Data as of December 11, 2025.

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Also, even accounting for the slide in 2025, the US dollar is historically expensive on several measures, and the valuation gap between US equities and international markets, notably emerging, remains wide. If global conditions continue to stabilize, that gap offers additional room for relative value abroad. But the more important shift comes from fundamentals. Even with price outperformance, international earnings were subdued last year, constrained by tariff volatility and stronger local currencies that weighed on exporters. Looking to 2026, the setup is more constructive. Companies should benefit from resilient global demand, fewer tariff surprises, and more predictable global monetary policy as inflation steadies.

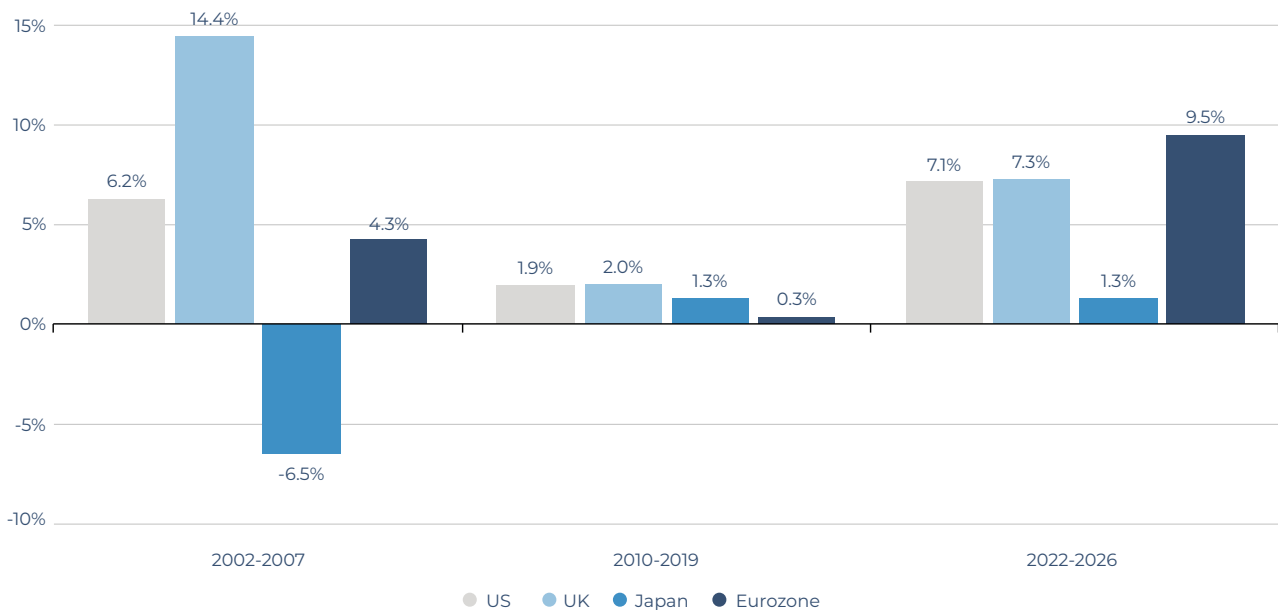
Another meaningful shift is emerging on the fiscal side of the coin. Europe, and Germany in particular, is moving away from the tight spending constraints that defined the past decade.

Governments across the continent are preparing to deploy significant capital into defense and infrastructure, with several countries planning outlays approaching 5% of GDP. This increased fiscal impulse and initiatives out of Europe should help contribute to European economic growth, narrowing the gap with the US. Much of this has been on the road map, but 2026 is when actual spending begins in earnest.

Japan is also pivoting given multiple positive tailwinds. More stable monetary policy and direct fiscal support from a new Takaichi led government should provide more building blocks for stronger corporate capex and consumer spending in 2026. The corporate governance reforms we wrote about last year should continue unlocking shareholder value via increased dividends and share buybacks. For the first time in years, fiscal policy outside the United States could serve as a sustained source of demand rather than a drag.

### Unlike The Post GFC Period, Fiscal Authority Has Been Left Behind Across Regions

Nominal Government Investment, Average Annual Growth Rate



Source: OECD, J.P. Morgan Asset Management. \*2022-2026 includes OECD forecasts. Eurozone is a GDP-weighted average of France, Germany, Italy and Spain. Government investment is fixed capital investment by government entities in long-term assets such as infrastructure, buildings, machinery and equipment, intended to support public services and economic development. Data are as of November 13, 2025.

Markets drift through seasons just like everything else. The last few years have felt like an extended summer for mega cap growth, but the early signals of a new season are already visible: broader participation, improving relative valuations overseas, and renewed momentum in smaller companies. In 2026, investors don't need to predict the exact moment when the weather will finally turn, they simply need to be prepared for it. It means building portfolios that can thrive better across seasons, not just during one long, warm stretch. The opportunity set ahead is broader than in recent memory, and portfolios that adapt stand to benefit the most.

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