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US Equity Strategy | North America

Weekly Warm-up: The Broadening Gains Steam as Semis Lose Momentum

MORGAN STANLEY & CO. LLC

Michael J Wilson
Equity Strategist
M.Wilson@morganstanley.com +1 212 761-2532

Andrew B Pauker
Equity Strategist
Andrew.Pauker@morganstanley.com +1 212 761-1330

Michelle M. Weaver, CFA
Equity Strategist
Michelle.M.Weaver@morganstanley.com +1 212 296-5254

Diane Ding, Ph.D.
Quantitative Strategist
Qian.Ding@morganstanley.com +1 212 761-6758

Nicholas Lentini, CFA
Equity Strategist
Nick.Lentini@morganstanley.com +1 212 761-5863

Our broadening thesis continues to gain momentum as Semis underperform. The steep fall in oil has helped to stabilize rates, which is another driver of the rotation to lagging areas of the market. We favor Consumer Discretionary Goods, Transports, and Biotech.

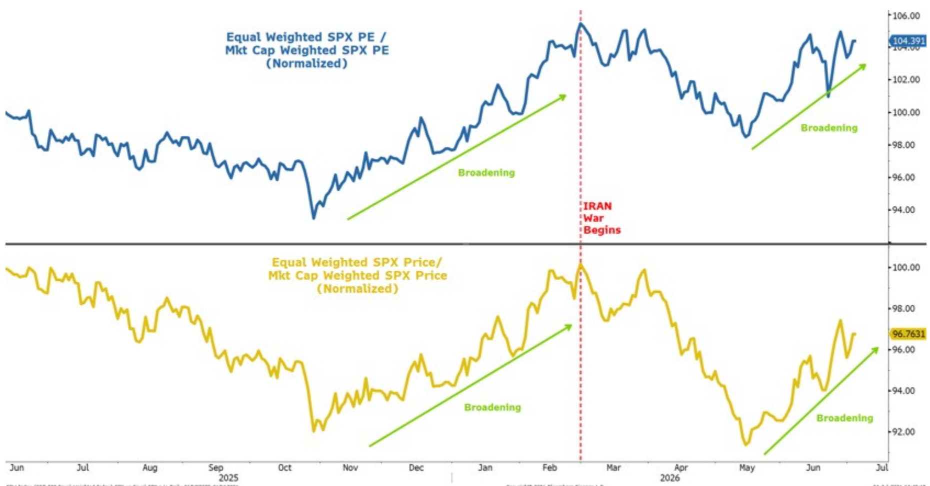
- **Underperformance in Semis Is Helping to Drive the Broadening...**As noted last week, Semiconductor momentum is fading with EPS revisions breadth for the group up against historical highs. Prior underperformance of the Hyperscalers was likely a leading signal for the weaker price action in Semis. The high capex / sales factor is also starting to consolidate, which may encourage more capex discipline in the near-term. We think the Hyperscalers have led in terms of discounting this dynamic and have already gone through their period of underperformance. We also believe this cohort possesses attractive optionality within the AI ecosystem: strong core businesses, the ability to participate in/lead the agentic application layer development and implementation, as well as an underappreciated cost cutting lever. We've seen relative performance oscillate between the various types of AI beneficiaries over the past couple of years and we expect those rotations to continue as the cycle evolves. This is simply the next rotation, in our view—Semis to the Hyperscalers and other broadening trades highlighted in today's report. Given the momentum unwind is happening in some of the larger companies in the index, it's unlikely the major averages will trade well in the near term—i.e., the rotation continues in a choppy / weaker equity market overall.
- **Incremental Signs The Market Is Moving To a Less Hawkish Posture...**Last week, we noted that market expectations had become too hawkish in the context of our house view for core inflation to stay contained this year. On this front, we found it noteworthy that Chair Warsh commented: "inflation risks have come down" at the Sintra Conference last week. He also offered a bit more emphasis on the employment side of the mandate than he did at the June FOMC meeting, saying that "we have a dual mandate and we have to deliver on both the employment side and the stable price side." This comment is more interesting in the context of last week's payroll data, which was weaker than expected, which could also help to temper the hawkish rate expectations for now—aiding the broadening trade.
- **Biotech Should Also Benefit from Broader Leadership...**In addition to Discretionary Goods and Transports, we also see Biotech continuing to outperform. As we have detailed in prior analysis, Biotech is one of the most

rate sensitive areas of the market. In fact, our work shows that Biotech has historically seen nearly 20% annualized returns in falling rate regimes. Given our view that policy rate expectations remain overly hawkish this year in the context of our house call for core CPI to stay contained below 3%, we think Biotech offers an attractive risk/reward opportunity. An M&A cycle that continues to ramp up should also benefit the industry. While the group has already started to outperform, rates likely have further to fall in the context of our view on inflation, which should further drive relative strength.

The Broadening Gains Steam

Our call for a broadening in market performance continues to gain momentum thanks to several changing factors. As a reminder, we first made the broadening call in November 2025 as part of our 2026 outlook. The thesis was based on our core view that the economy had entered a new expansion after completing the rolling recession in April 2025. Typically, in a *new* economic expansion, earnings growth turns out to be much better than expected as revenue growth returns to increasingly cost efficient companies—i.e., classic operating leverage. The stock market began to anticipate that trend starting around the same time we made the call in November. This broadening was then interrupted by the Iran War in late February. Oil prices surged and market pricing for Fed cuts turned into hikes. As a result, the broadening faded with market performance centered on AI capex beneficiaries, particularly Semiconductors. We then reiterated our broadening call with our Mid-Year Outlook in mid May on the view that oil prices had peaked and were likely to fall significantly. Since then, oil prices have peaked, and although the bond market still has 1 ½ hikes priced in for the Fed through 1Q next year, the broadening trade has begun to work again (Exhibit 1).

Exhibit 1: The Broadening Has Resumed After a Pause During the Iran Conflict. We Think It Continues.



Source: Bloomberg, Morgan Stanley Research

As discussed last week, the main pieces of information we learned from the June FOMC meeting were: (1) that forward guidance is going to be significantly diminished going forward; and (2) the reaction function is now focused more on inflation. To us, that means much less emphasis on the dot plot and more emphasis on the path of inflation going forward. Our house view is that the combination of falling energy prices and peaking tariff-related inflation, as well as contained services and housing inflation, keeps the Fed on hold as opposed to hiking rates this year. Should this monetary policy forecast play out, it would be a positive surprise for equities via lower policy rate expectations versus what the bond market is currently pricing. Just as the underperformance of Energy stocks was an early signal that crude prices were headed lower, the recent outperformance of several economically sensitive areas and lower rate beneficiaries may be an early indication that policy rate expectations have gotten too hawkish for this year.

On this front, we found it noteworthy that Chair Warsh commented that "inflation risks have come down" at the Sintra Conference last week. He also offered a bit more emphasis on the employment side of the mandate than he did at the June FOMC meeting, saying that "we have a dual mandate and we have to deliver on both the employment side and the stable price side." This comment is more interesting in the context of last week's payroll data, which was notably weaker than expected, which could also help to temper the hawkish rate expectations for now—benefitting the broadening trade.

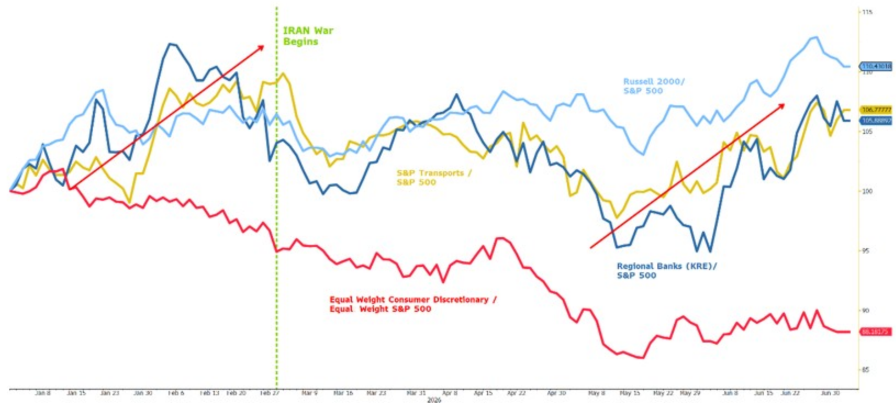
In addition, the Semis trade finally started to *lose* momentum after a historic run since the end of March. As we talked about last week, this trend is likely to help facilitate broader leadership. This underperformance in Semis lines up with our views discussed over the past few weeks (see here and here). The sharp divergence between the performance of the Hyperscalers and Semiconductors was likely unsustainable given the latter is dependent on the former. In fact, these groups tend to ebb and flow in opposite directions near the end of these divergences, which then leads to the inevitable reconciliation as the Hyperscalers either tone down their capex guidance or indicate they might be going in another direction. META did this last week by announcing it would begin to sell its excess capacity to outside customers. This comes as the market has gone through periods of questioning the sustainability of the capex growth acceleration. We discussed the peak rate of change in revisions breadth for Semiconductors as a chief reason for why Semis could enter a correction. META provided the rationale for why that might happen now. To be clear, this doesn't mean the AI capex cycle is over but it can have meaningful resets and rotations along the way. In fact, since ChatGPT was first announced in November 2022, there have been three such corrections in the cycle already. This would be the fourth. We also highlighted the comparison of Semis with Silver stocks earlier this year. The comparison is twofold: 1) both had parabolic moves higher and 2) both are based on the commodity market, which tends to exhibit wide swings in price over time. The analog we first showed in early June appears to be playing out, and suggests the correction in Semis likely has further to go, led by the Memory subsector—typically the most commodity-like of the Semiconductor complex.

Exhibit 2: Semis' Analog with Silver Stocks Appears to be in Gear; This Will Help Drive the Broadening

Source: Bloomberg, Morgan Stanley Research

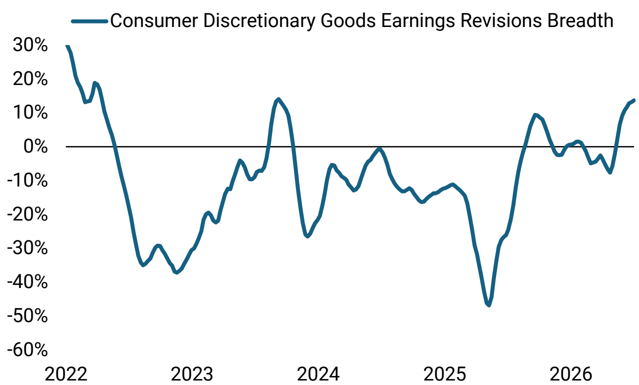
We have favored Consumer Discretionary, Regional Banks and Transports as our preferred ways to play the broadening. Obviously, this implies a preference for the equal weighted index relative to the market cap weighted index, not to mention equal weighted versions of each sub-sector that are most geared to the broadening earnings story. Discretionary Goods remains the most compelling expression of this strategy, in our view, given wallet share shift from services to goods, improving pricing in goods and strong EPS revisions.

Exhibit 3: Discretionary, Transports and Regional Banks Have Outperformed Since Mid-May; Consumer Discretionary Goods Presents the Best Risk-Reward, in Our View, Given the Fall in Oil Prices



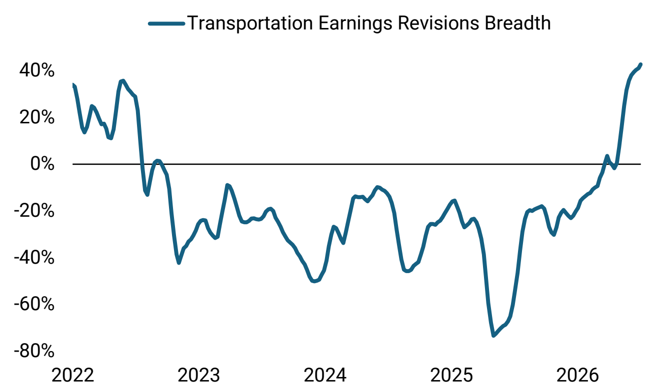
Source: Bloomberg, Morgan Stanley Research.

Exhibit 4: Discretionary Goods...



Source: FactSet, Morgan Stanley Research.

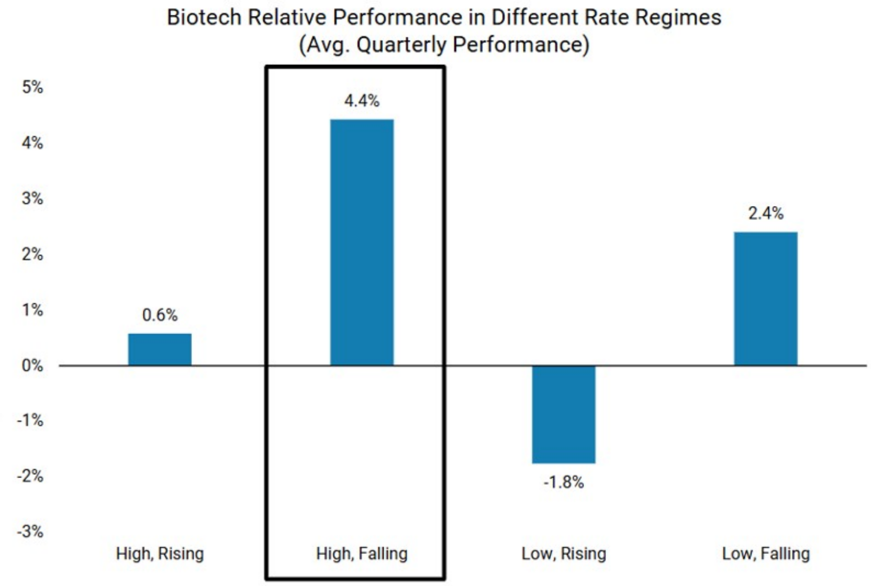
Exhibit 5: ...And Transports Continue to Show Improvement in Earnings Revisions Breadth



Source: FactSet, Morgan Stanley Research.

In addition to Discretionary Goods and Transports, we also see Biotech continuing to outperform. As we have detailed in prior analysis, Biotech is one of the most rate sensitive areas of the market. In fact, our work shows that Biotech has historically seen nearly 20% annualized returns in elevated and falling rate regimes. Given our view that policy rate expectations remain overly hawkish this year in the context of our house call for core CPI to stay contained below 3%, we think Biotech offers an attractive risk/reward opportunity. An M&A cycle that continues to ramp up should also benefit the industry. While the group has already started to outperform, rates likely have further to fall in the context of our view on inflation, which should further drive relative strength.

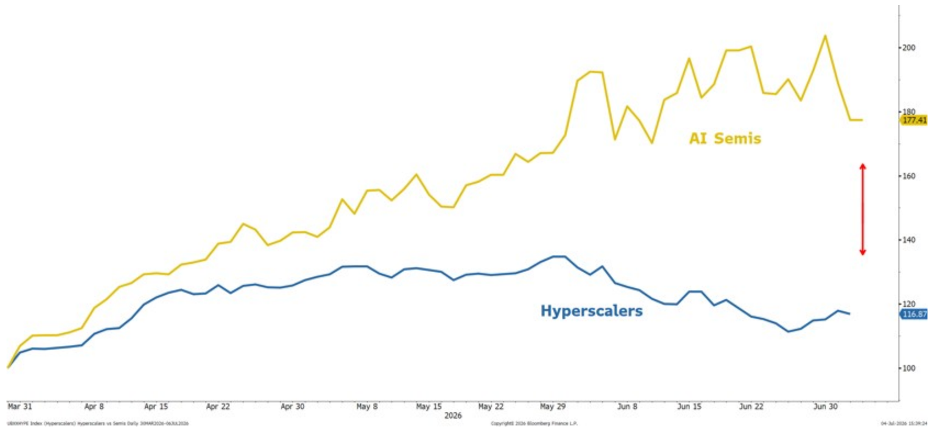
Exhibit 6: Biotech Tends to See Strong Returns in Falling Rate Regimes



Source: Compustat, Bloomberg, MS Research. Based on 10-year yield. High/low rates defined as current level vs. 5-year rolling median. Rising/falling rates defined as quarterly rate of change.

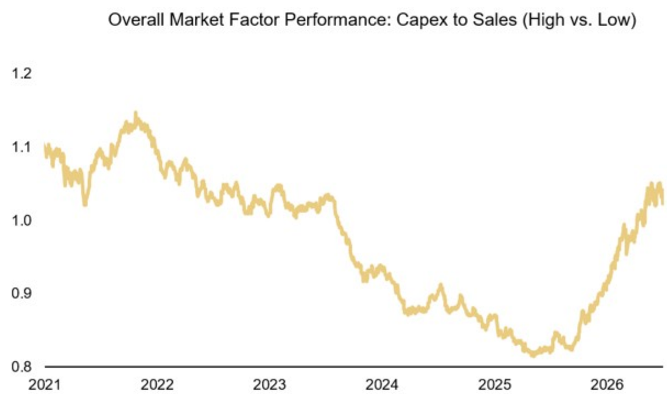
We also recommend the Hyperscalers over Semis for the near term as there is potentially more risk that other Hyperscalers begin to temper expectations on the rate of change on capex growth given the poor performance of their stocks over the past few months as capex expectations continued to ramp. We continue to see the Hyperscalers as having attractive optionality within the AI ecosystem: strong core businesses, the ability to participate in/lead the agentic application layer development and implementation, as well as an underappreciated cost cutting lever. On that note, our high capex/sales factor could be topping for now after a torrid run over the past year. We think the Hyperscalers have led in terms of discounting this dynamic and have already gone through their period of underperformance. Once again, this is a near-term peak rate of change in revisions dynamic, not a peak in the broader capex cycle. We've seen relative performance oscillate between the various types of AI beneficiaries over the past couple of years and we expect those rotations to continue as the cycle evolves. This is simply the next rotation, in our view—Semis to the Hyperscalers and other broadening trades noted above.

Exhibit 7: Divergence between Hyperscalers and Semis Likely to Close As Capex May No Longer Be Rewarded Unequivocally in the Markets for Now



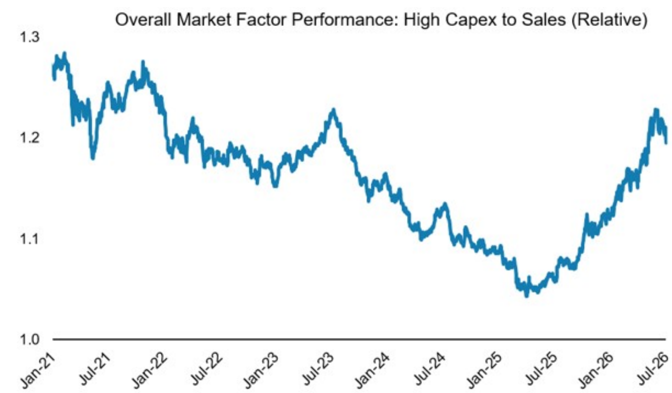
Source: Bloomberg, Morgan Stanley Research

Exhibit 8: High Vs. Low Capex to Sales Factor Performance Pausing



Source: Compustat, Morgan Stanley Research

Exhibit 9: High Capex Leg Starting to Underperform Vs. Overall Market (Top 1000 by Market Cap)

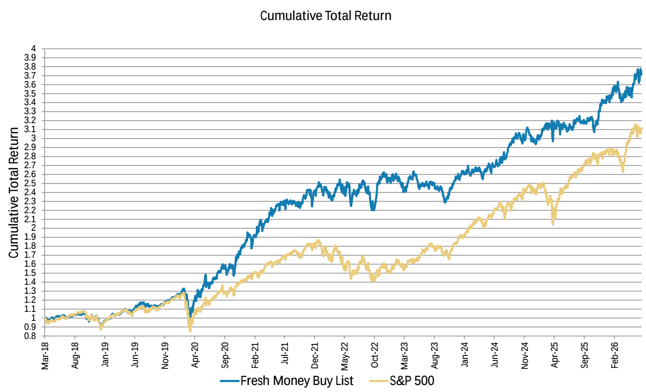


Source: Compustat, Morgan Stanley Research

Bottom line, our view that markets would begin to broaden out as the indices began to consolidate / correct is happening. The recent underperformance of Semis after Micron reported earnings suggests the peak rate of change in revisions is top of mind for markets in the context of an AI cycle that is far from over. Leadership has been oscillating for years among AI winners. This is simply the next rotational development in the cycle, in our view. Meta's unexpected announcement to sell its excess compute to outside customers potentially adds to that dynamic. Now, the high capex / sales factor is starting to consolidate, which may encourage others to temper capex guidance. All of this will encourage the broadening trade, in our opinion, which is clearly in gear.

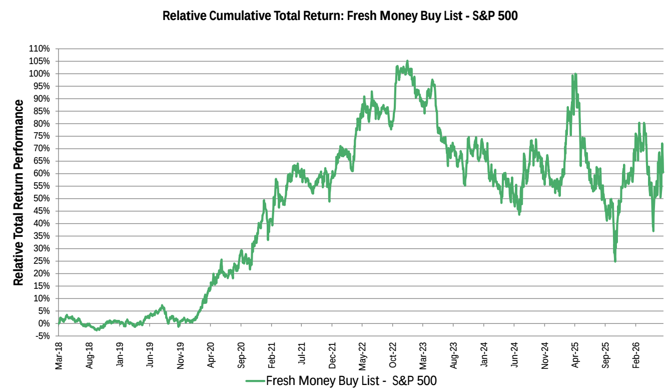
Fresh Money Buy List

Exhibit 10: Fresh Money Buy List & S&P 500 Cumulative Total Return



Source: Bloomberg, Morgan Stanley Research

Exhibit 11: Fresh Money Buy List / S&P 500 Cumulative Relative Return

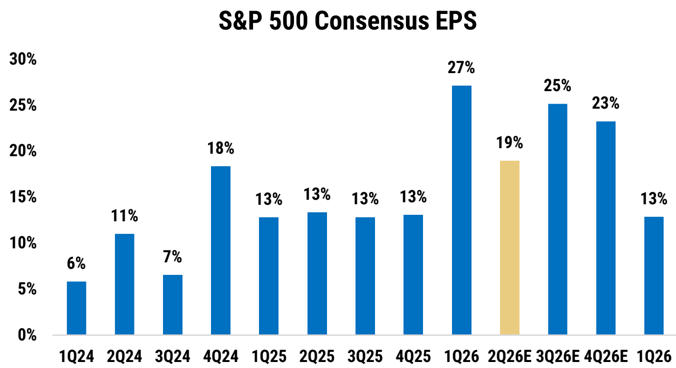


Source: Bloomberg, Morgan Stanley Research

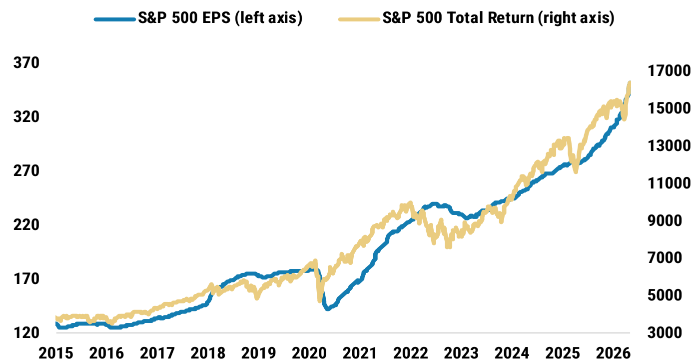
Weekly Charts to Watch

Exhibit 12: US Earnings Snapshot

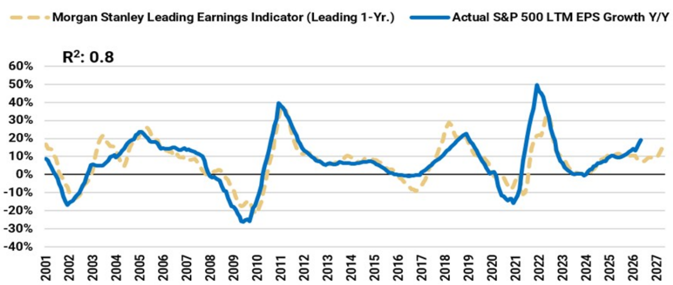
S&P 500 Y/Y EPS Growth



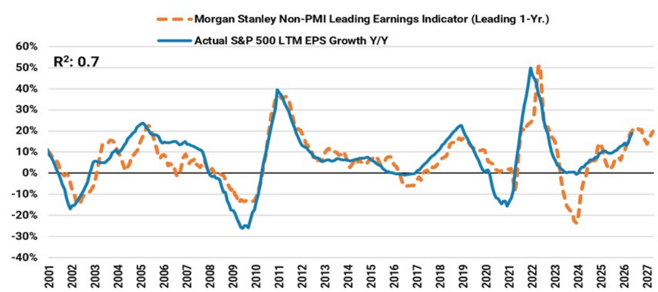
S&P 500 NTM EPS vs. Total Return Level



US Leading Earnings Indicator



US Non-PMI Leading Earnings Indicator



Source: Refinitiv, FactSet, Morgan Stanley Research. Top: As of July 2, 2026. Bottom left as of May 31, 2026. Bottom right as of May 3`, 2026. Government data has delayed further updates. Actual S&P 500 LTM EPS as of 5/31/26. The LEI is a top down macro indicator consisting of the Inventory/Sales ratio, ISM Manufacturing PMI, ISM Manufacturing Employment PMI, Consumer Confidence and credit spreads. MS Non-PMI Leading Earnings Indicator inputs: Philadelphia Fed economic activity, Creighton U. business confidence, Chicago Fed supplier deliveries, Atlanta Fed wage tracker (inverse signal), NFIB small bus. most important problem inflation (inverse signal), and Brave-Butters-Kelley cycle component of monthly GDP. Weightings are fixed over time.

Exhibit 13: Morgan Stanley US Equity Strategy Forecast Table

						MS Top Down EPS Estimates				Bottom Up Consensus EPS Estimates			
	Current Price	MS Next 12M Price Target	MS Next 12M Price Target % to Current	Current P/E	MS Next 12M P/E Target	2026	2027	June 2028	2028	2026	2027	June 2028	2028
Bear	7,483	5,900	-21%	20.4x	19.0x	$299	$300	$311	$322	$341	$398	$427	$456
Growth						*9%*	*0%*	*4%*	*7%*	*24%*	*17%*	*16%*	*15%*
Base	7,483	8,300	11%	20.4x	20.5x	$339	$380	$404	$429	$341	$398	$427	$456
Growth						*23%*	*12%*	*13%*	*13%*	*24%*	*17%*	*16%*	*15%*
Bull	7,483	9,400	26%	20.4x	21.0x	$352	$416	$448	$480	$341	$398	$427	$456
Growth						*28%*	*18%*	*17%*	*16%*	*24%*	*17%*	*16%*	*15%*

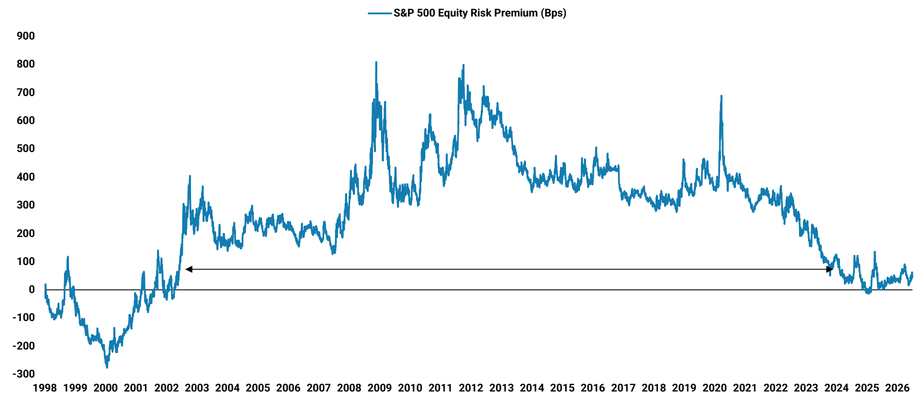
Source: FactSet, Morgan Stanley Research.

Exhibit 14: Sector Ratings

Morgan Stanley Sector Recommendations			
Overweight	Financials	Industrials	Consumer Discretionary Goods
Equal Weight	Tech	Comm. Services	Health Care
	Materials	Utilities	Consumer Services
	Energy		
Underweight	Staples	Real Estate	

Source: Morgan Stanley Research

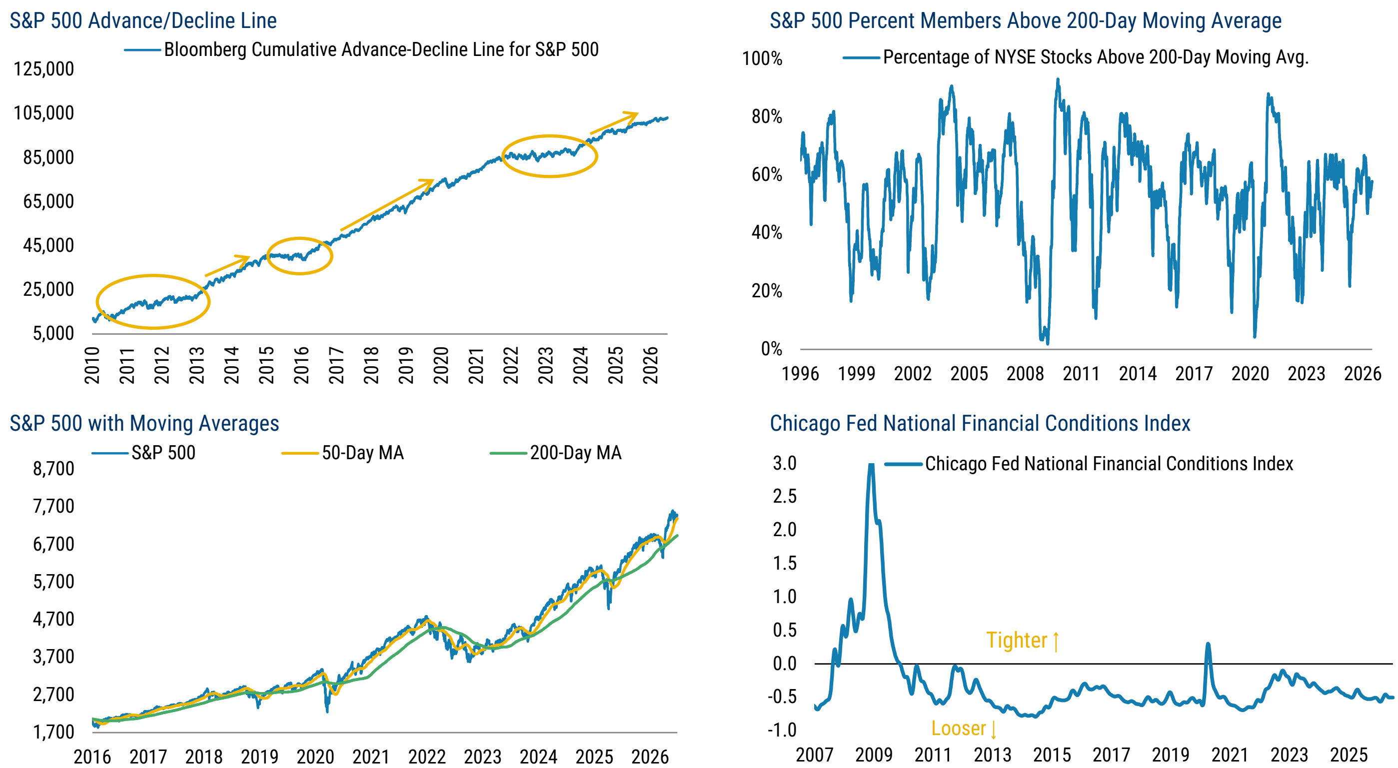
Exhibit 15: Equity Risk Premium



Note: Equity risk premium is calculated as the S&P 500 forward 12M earnings yield minus the nominal 10-Year Treasury.

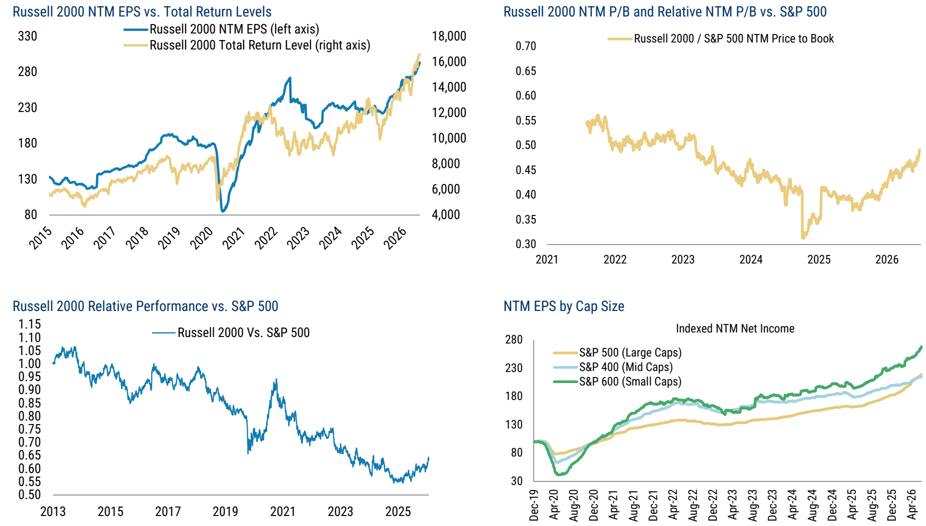
Source: As of July 2, 2026. Bloomberg, Morgan Stanley Research

Exhibit 16: US Equity Market Technicals and Financial Conditions



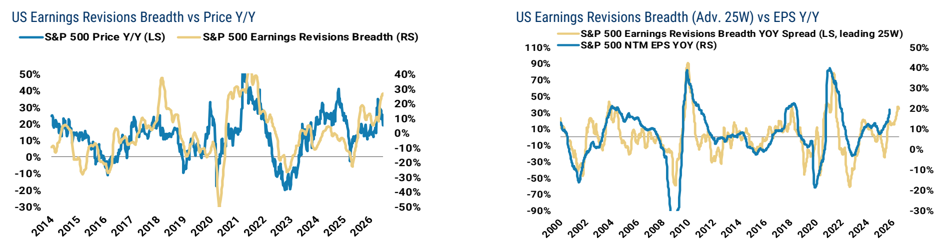
Source: Bloomberg, Morgan Stanley Research. As of July 2, 2026

Exhibit 17: US Small Cap Equities



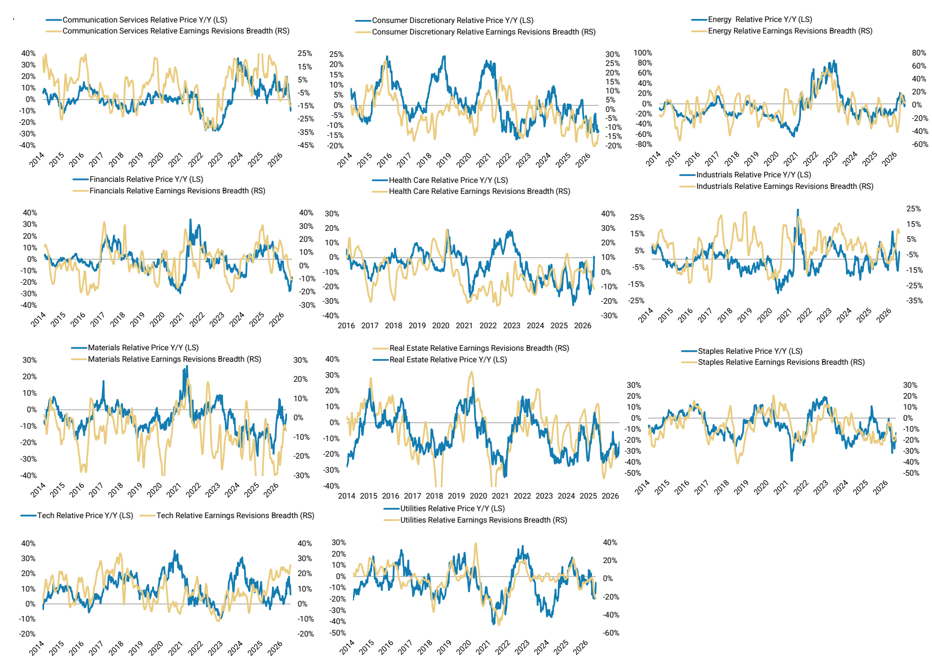
Source: FactSet, Morgan Stanley Research. As of July 2, 2026

Exhibit 18: Earnings Revisions Breadth



Source: FactSet, Morgan Stanley Research

Exhibit 19: Earnings Revisions Breadth vs YoY Performance



Source: FactSet, Morgan Stanley Research. As of July 2, 2026

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(as of June 30, 2026)

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Stock Rating Category	Coverage Universe Count	Coverage Universe % of Total	Investment Banking Clients (IBC) Count	IBC % of Total IBC	IBC % of Rating Category	Other Material Investment Services Clients (MISC) Count	MISC % of Total Other MISC
Overweight/Buy	1544	42%	453	49%	29%	757	44%
Equal-weight/Hold	1577	43%	390	42%	25%	769	44%
Not-Rated/Hold	3	0%	1	0%	33%	1	0%
Underweight/Sell	544	15%	89	10%	16%	204	12%
Total	3,668		933			1731	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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