Stephens
Investment Management Group

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.

SECOND QUARTER 2026
MARKET OUTLOOK

MARKET OVERVIEW

It was another complicated quarter. Headlines were dominated by the ever-changing conflict with Iran, but the market seemed to shrug off the volatility in oil prices. The World Cup brought the spotlight to the US, and it seems that travelers from the rest of the world were generally very positive on the US economy and hospitality.

Semiconductors stood out as the investment theme of the quarter. The Philadelphia Semiconductor Index was up nearly 88% in the three month period. AI capex is still surging, giving chip manufacturers incredible pricing power.

Kevin Warsh assumed the role as Fed Chairman, and it's clear he has a very different style than Mr. Powell, broadcasting that we should expect much less transparency (more along the lines of Greenspan), possibly a more hawkish view, and less reliance on the Fed's balance sheet. Interestingly, markets were less focused on monetary policy issues as they may have been crowded out by Iran news and AI developments.

Momentum was in charge and returns were strong across the board. The S&P 500® Index was up over 15%. Retail investor enthusiasm was very high. The Space X IPO was met with a great deal of demand, pushing the new stock up 66% in the first few days of trading. An ETF launched in April, focused on memory chips (ticker: DRAM), saw $20B of flows in the remainder of the quarter! This was not a normal quarter.

OUTLOOK

So much happened in this last quarter that I don't think I can incorporate every noteworthy development into the confines of this document. If you're a regular reader, then you already know I frequently talk about elasticities of supply and demand and finding new equilibriums when the facts change. I'm going to use that framework again, because I think it's one of the common threads behind so much of the recent market action and economic developments. If I can make a blanket statement, it would be that so many markets are in a state of disequilibrium. As a disclosure, I am a huge advocate of free markets – I generally believe prices (derived from a free market) convey an incredible amount of information and help an economy appropriately allocate resources. As a corollary, when prices are artificial or are affected by some external force, then misallocation will result.

Let's start with AI. I've said before that the AI foundational model providers seem to believe that AI could result in a winner-take-all market. And their behavior and revealed preferences fit this idea in two distinct manners, both upstream and downstream. They are all spending money at a breakneck pace in order to win by having a more robust model and by scaling up inference. Secondly, there are clear examples where the foundational AI companies are selling compute below their cost, subsidizing the users. On some levels this strategy can make sense. Scale really matters, so more users means more critical mass. Many successful Internet business models started out by giving away the product and figuring out the best way to monetize later, after the battle for users had been won.

There were stories of individuals with "Pro" level subscriptions to ChatGPT and Claude using thousands of dollars of compute while only paying about $200 per month. Sora (OpenAI's image and video generation tool) was free to consumers. Cursor was heavily subsidizing premium users. Customers, both consumer and commercial alike, don't have to worry too much about the ROI case for AI use when it's free or heavily subsidized.

This quarter, we saw an abrupt change. Sora was cancelled. Anthropic and GitHub Copilot aggressively pivoted to usage-based pricing, as firms started abandoning all-you-can-eat subscriptions. In this new regime, it didn't take long for "tokenmaxxing" to have a real and measurable impact to the bottom line. Many corporate AI customers were caught off-guard. Uber acknowledged that they had burned through their entire annual token budget in April. Microsoft cancelled internal Claude Code licenses after they had exhausted their budget. There were rumors that one company inadvertently spent $1B on tokens in a single month.

It gets a little confusing from here, however. Within the quarter we saw some countervailing forces, with even stronger subsidies. Lately, Anthropic, Google, OpenAI, and Cursor have been giving "free" tokens to AI-native startups, sometimes in exchange for equity. After moving to token-based pricing, more recently token prices have fallen a bit. Meta just announced a very inexpensive API that could trigger a price war. All this is to say, the price of AI (inference) does not yet reflect a free and stable market price. This adds an extra layer of complication to companies wrestling with calculating the ROI on AI projects. If we don't know the price of using AI, then it's hard to know the ROI.

Figuring out the price of AI gets even more complicated from here. There are different models, with different pricing, and each with different levels of token usage. Oftentimes users are asking a simple question of the most expensive, cutting-edge, frontier model in deep-thinking mode. I suspect that's how you burn through $1B of tokens in a month, or how Uber blew their budget so quickly. It's analogous to driving a Formula 1 car to the neighborhood store, when you could have just hopped in the Prius for the same result. Remember: It's still early innings.

[1] *The S&P 500® Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.* *You cannot invest directly in an index.*

If you think that's messy, you should see the pricing of things that go into building an AI data center. Presumably another second-order effect of AI companies believing it's a winner-take-all market is the seemingly inelastic demand for compute/data center. The pricing of just about every component and every service that goes into building a new AI data center has gone up. The most extreme example is the case of DRAM memory and storage, where we've seen prices climb by hundreds of percent. It's had a material impact (third-order effect) on consumer electronics companies that need DRAM or Flash memory as a component. Analysts are anticipating that Apple will be forced to raise prices on the incoming generation of iPhones and iPads. Nintendo already announced a price hike for the Switch 2. GoPro has stated that there is "substantial doubt about the company's ability to continue as a going concern" because of memory prices. The hyperscalers seem entirely unfazed at these memory prices, however. I suspect if more memory was available, even at these extreme prices, the market would soak it up pretty quickly.

What is the equilibrium price of memory? No clue. Because of the significant amount of time and capital that is required to expand memory production, we won't see a supply-response for quite some time. What is the equilibrium price for inference or tokens? No clue there either. It could be years before the market really resolves to a stable and un-subsidized condition – the new equilibrium. Up until recently, we hadn't found any guardrails or limits on either side of this pricing distortion. What's changed is: 1. with OpenAI and Anthropic potentially going public, financials matter a bit more; 2. Hyperscalers' have burned through an enormous pile of cash and are in most cases showing negative cash flows; 3. Customers are tightening up their ROI analysis and limiting or scaling back some marginal projects. With messy pricing, we will likely get a messy allocation of resources. And that probably means a bumpy and volatile market.

I want to stick with this pricing theme a bit longer. Volumes have been written about determining the right price for a stock. And I'm pretty sure no one has solved that problem yet. While it's a cynical take, in the short run I believe the stock prices are set by supply and demand. More buyers? The stock is going higher. More sellers? The next move is probably lower.

When I first entered this business, there were a lot of block trades. Large transactions, sometimes hundreds of thousands of shares or even millions, would be negotiated between a buyer and a seller with a high-touch broker in between. Generally, these were sophisticated institutional investors, both of which were doing some serious analysis on the specifics of that company. The advent of passive investing started changing that dynamic. Now there was a new player in the game, and this one didn't care at all about company specifics. Passive investing is insensitive to company fundamentals or valuation, it's simply seeking exposure to a stock because of inclusion in an index. I wrote a white paper back in 2017 on this phenomenon (reach out to us, if you'd like a copy), in part because the growth in passive investing had reached a point where we could begin to measure the impact of passive flows on stock prices, and partly because I envisioned a future time where if passive investing became too dominant, the market would become far less efficient. A healthy market needs active investors to help set prices. Reductio ad absurdum: if all investors were passive, the market would be nonsense.

This is still an issue today, and I believe my concerns then have largely been validated. There's another, more recent phenomenon that is exacerbating this inefficiency. There are more ETFs today than there are stocks. It's not because firms are launching more passive, broad market products; many of the ETFs created in the last few years are thematic in nature or are levered funds. The thematic funds give investors the opportunity to quickly and easily access a group of stocks that are bound by some common correlation, industry, or exposure. This is also happening at scale in the institutional space. Large brokerage firms create trading baskets, groups of stocks exposed to a particular factor or theme. Here are some examples of baskets: Industrial Renaissance: Reshoring, Drone Ecosystem, Energy Deregulation, Datacenter Buildout, Neocloud, 800V DC Transition, Onsite Power, OpenClaw/Agentic AI Winners, Make America Healthy Risk, Crowded Names, Weak Balance Sheets, Unprofitable Russell. The list goes on and on. Any factor you could dream up, any narrative you like, there's a basket for it. And one quick phone call or mouse click, and your broker is putting money to work, long or short, in that basket. My sources tell me that these have been very popular.

Just like passive investing, money is flowing into these vehicles, and there's essentially no consideration of company-specific fundamentals or valuation of the underlying holdings other than they have some correlation or exposure to that theme. If you read last quarter's Outlook, you might remember what I wrote about the fast-moving market narratives. Did you know that they were so easily tradeable?

There's a third confounding factor as well. With all the data harvesting that goes on, machine learning, AI, high frequency trading, and the like, it has led to a ballooning of the segment of the investment community that almost exclusively focuses on very short-term signals. Most hedge fund pods are highly incentivized to make money this week or this month. Three to five years? Not on the horizon. The portfolio manager may not even be in the seat that long. I suppose you could make the argument that this type of trading might make the market more efficient in the very short run, when pricing in incremental information about scanner data or credit card transactions or how many cars were in the company's factory parking lot on the weekend. But most of that is just noise with respect to the long-term trajectory of a company.

It's interesting to me that just recently, Ken Griffin, founder and CEO of Citadel (which no doubt makes money trading these factors I've mentioned above) said this in a recent interview:

> *I think there'll be more focus and emphasis on those who have really good vision about what companies are actually creating transformative products that will change society. The market will reward that far more intensely in the future than will a company beat this quarter's earnings or not. I think the question of will a company beat this quarter's earnings has gotten far more difficult over the last 10 years because, for example, the rise of alternative data. I have access to the credit cards of millions of Americans. What are they spending money on? What's that mean for Starbucks revenues this quarter? What's it mean for McDonald's this quarter? This is a decade-old transformation, but the here and now is just becoming far more transparent, far more readily understood and triaged by the combination of really bright people and really good AI technology. Where this will leave us is those who are able to see what is unfolding over years to come will be in a very valued position on a relative basis.*

OUTLOOK

My seventh grade English teacher really drilled into me the Rule of Three – the idea that using three examples, arguments, or concepts (see what I did there?) seems to be a satisfying and effective way to communicate. I'm going to break that rule and introduce a fourth mechanism of mis-pricing: benchmark construction.

I'm sure you don't need me to rehash what happened with SuperMicro, MicroStrategy, Palantir, AppLovin, and Bloom Energy. If you're unfamiliar, each of them became very large weights in one of the Russell indexes in between the annual reconstitution. So big, that many managers were facing single-stock risk on a scale they had never seen in their careers. Over the last couple of years, this subject has been the most frequently asked about with clients and consultants. From those conversations, from holdings data, and from discussions with some of our competitors, it is very clear – some managers are buying positions in these outlier benchmark components simply to mitigate the risk. And to be clear, I'm not saying that's wrong, per se. Just that it is a new phenomenon in the small and mid-cap world.

There are at least two consequences of that course. First is that the incremental buying (from hedging or risk management) pressured the stock higher, which spurs the feedback loop of making it an even bigger position in the benchmark, further incentivizing other managers to capitulate and simply hedge that risk. The other consequence is that you've added yet another market force that is pushing stocks around without regard to company-specific fundamentals. It's such a powerful force that an entire industry has emerged, trying to game Russell's system. Bloomberg just reported that "Two teams focused on trading index changes at Millenium Management … made about $3.7 billion in total last month" (emphasis mine). Does that sound like an efficient market to you?

Take all that together and what you get is a noisy, flavor of the month narrative-driven market, that is hyper focused on short term metrics and increasingly obsessed with minimizing risk against the benchmark. There are more dollars chasing exposure to beta, a theme, or a factor. More dollars trading on super short-term data. More dollars buying stocks just because they happened to land just inside the cutoff between the Russell 2000® and the Russell 1000®. And what those dollars have in common is that they are generally price-insensitive.

We can think about the competitive dynamic in AI and see how firms aren't pricing tokens at their marginal cost and know that the market hasn't found a stable equilibrium price yet. We can see how hyperscalers are price-takers for DRAM and know that that market isn't in a stable equilibrium. Are we also willing to acknowledge that passive investing, narrative-driven themes and baskets, ultra short-term focus of hedge funds, and the increased sensitivity to benchmark risk have collectively resulted in a market where stock prices are frequently pushed around by variables that have little or nothing to do with the long-term fundamentals?

I love the setup for us. Fewer investors and fewer dollars doing what we are doing, in theory should lead to greater alpha potential, over the long run. The trick is having enough freedom to chase the long run. I've said it before and I'll say it again: to most people, opportunity doesn't feel like opportunity in the moment, it feels like underperformance.

In conversations with clients last quarter, the subject of JFrog came up. It was a new position in our small cap growth strategy. We bought our first shares in early January. By mid-February we were down almost 50% from initial purchase. JFrog was a member of some software baskets and a component in some software ETFs. The dominant narrative back then was that AI coding tools would allow firms to vibe code their own software apps, and the logical extension is that software companies will be severely impaired. If you believed this hypothesis, all you had to do was call your prime broker and short the software basket they had already created for you.

The problem is that JFrog's specialty is software that helps you organize and maintain the software binaries you create. If more people and firms are creating their own software, they're going to need systems like JFrog to manage it. The people shorting that software basket or ETF didn't know this. They didn't care. They only wanted to express a bet that was negative on software. Details be damned.

When JFrog reported earnings in May, their CEO said this:

> *As AI makes human-to-technology interaction nearly costless and soft cost itself increasingly commoditized, binaries become king. Organizations are actively encouraging developers to utilize AI coding agents as well as explore agentic capabilities, causing software output to accelerate, resulting in more compiled code, a true AI-fueled tsunami of binaries.*
>
> *Observing our customers' consumption trends, we noticed that this growth is not tied to one package type or a specific AI native workload. It is not a spike in usage or a one-time increase in open-source caching. It is the result of a fundamental shift in how software is being generated, delivered, and consumed across the software supply chain.*
>
> *We are seeing an acceleration in the volume of compiled software flowing through the JFrog platform. This trend, which began taking shape in 2025, is driven by two major forces. First, developers are being supercharged by AI coding agents. Simply put, the world is creating more software packages. In this AI mass adoption reality, we see organizations willing to accept budget overruns until they gain better clarity on long-term usage requirements and prior to increases in annual commitment.*
>
> *Second, as AI drives more software creation, it is also accelerating the flow of all open source components. Open source consumption by developers and AI agents is rising across nearly every software package we support. And as the ultimate Switzerland of binaries, JFrog sits at the center of this growth.*

OUTLOOK

Oops. Maybe this software company isn't the same as the others! Who would have guessed a software company could be an AI coding beneficiary? While the price of JFrog was being dominated by investors trying to express a bearish bet on software, with disregard for the uniqueness of their business model, we had the conviction and discipline to lean into the weakness. We had been buying JFrog all the way down in Q1 and in the first month of Q2. It was one of our top contributors to performance this quarter, as the market finally began to understand this distinction. To the outsider, what I call "opportunity" looked like underpeformance until that earnings release and statement from the CEO. I don't mean to cherry pick our winners (to be clear, we won't always get it right), but I think it's a great example of what we are seeing.

It's important to note that in a world without all these short-term trading trends, without the short thesis on software, we would not have been able to accumulate the same position at the low prices caused by the software selloff. JFrog would have worked well as a trade, but not this well. The same is true for some of our trading around cybersecurity stocks. So please note: I'm not complaining about these trends or the noise, it's a genuine source of alpha! It just takes time.

I don't want to pretend that extracting this alpha is easy. It is not. In my opinion, it requires discipline. The word is beyond cliché in our industry. I like to joke that I have yet to find the investment manager that advertises an "undisciplined" process. Everyone claims discipline, but surely there is a spectrum of actual adherence to it. To me, discipline involves doing the things you don't want to do. Doing the things that are hard. Fighting human nature. Not relenting or giving up, even when the cards seem stacked against you.

I would argue that when a manager takes an 8% position in Palantir because the benchmark has an 8% weight, that's not discipline, that's capitulation. Discipline is sticking to a process and a philosophy. If you did enough mental gymnastics to convince yourself it's within your process to put 8% in Palantir, how does that fit your sell strategy now? You compromised your buy discipline, and now you're holding something you wouldn't have otherwise owned. My guess is that your sell decision is now entirely in the hands of benchmark composition. This is active management? Sounds like index plus to me (and maybe that's what people want?).

Mike Tyson famously said, "Everyone has a plan until they get punched in the face." Every manager claims discipline until the market moves against them. I don't mean to single anyone out, but the universe just handed me a prime example of this phenomenon. I don't need to belabor the point here, have a look at this article if you want the details. The point is that this dynamic and challenging market, combined with these issues I've described above is pushing managers (and their clients) to the point where they feel something has to change. Time will tell if it was the right move or not, but however you describe it, it's not discipline.

In closing, I want to share with you what we've been focusing on. While these narratives of the week come and go, we want to keep our eyes on the trends and themes we believe will matter over the next several years, not just the next several weeks.

1.AI is transformational.
a.We still haven't hit a wall in terms of the scalability of generative AI.
b.Productivity gains are happening and should be compounding.
c.AI capex spending is pushing computing hardware prices and electricity prices higher, but AI itself should be very deflationary.
d.Business models everywhere are being disrupted – there will be winners and losers.
e.Media will never be the same. (AI image generation tools are so good now, it seems impossible to distinguish AI images from real.)
f.The robotics revolution is being powered by AI and is at an inflection point.

2.Inflation, or at least asset inflation and the debasement of the dollar is happening, and will continue for the foreseeable future. Don't be fooled by better CPI or PCE readings.
a.Conventional inflation metrics are flawed. They measure the change in price of the prior standard of living. The faster technology changes, the more CPI understates inflation. (See our 3Q24 and 3Q25 commentaries)
b.The government essentially has no choice but to inflate. Lower CPI and PCE readings give cover for more inflationary policy.
c.Goods and services which the government subsidizes will continue to see the most inflation (e.g. healthcare and education).
d.Asset inflation is part of what is fueling the split in a K-shaped economy.

3.Globalization peaked, and the pendulum is headed the other way.
a.There is a manufacturing renaissance here in the US.
b.Energy independence is a global issue.

Things are moving so quickly, I suspect it will be a while before we find these new equilibriums. Stay disciplined, my friends! Embrace the signal and use the noise to your advantage.