MARKETS & ECONOMY [THORNBURG INSIGHTS]

Considering the Cost of Future Growth

17 Jul 2026 ❖ https://www.thornburg.com/article/considering-the-cost-of-future-growth/

AUTHOR

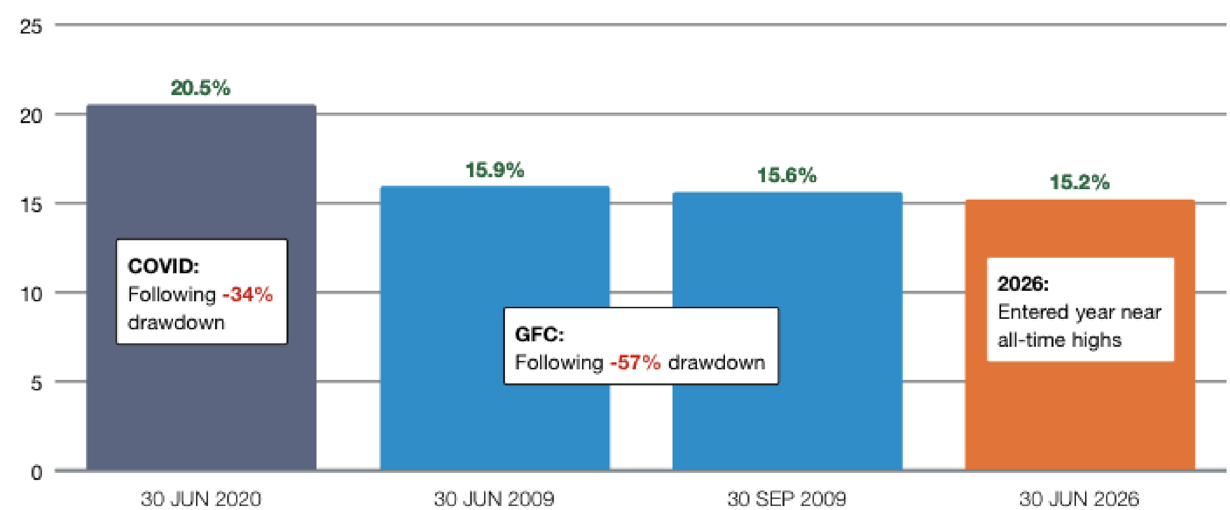
ADAM SPARKMAN, CFA
Manager, Client Portfolio Management and Managing Director

A historic second-quarter rally pushed U.S. equities further above historical valuation norms, making future returns increasingly dependent on earnings growth.

The second quarter produced one of the strongest equity market rallies of the past two decades, with the S&P 500 advancing more than 15%. What makes this rally particularly unusual is not just the magnitude, but the starting point. Historically, quarterly gains of this size have followed periods of significant market stress, when pessimism was widespread, valuations had compressed dramatically, and even modest improvements in the economic outlook could drive a powerful recovery in asset prices.

This quarter was different. Rather than recovering from depressed valuations, U.S. equities entered the quarter already trading near record highs following several years of exceptional performance. As a result, the latest advance has pushed valuations even further above historical norms, leaving future returns increasingly dependent on companies delivering the earnings and cash flow growth already embedded in today's valuations.

S&P 500 Top Quarters – Trailing 20 years

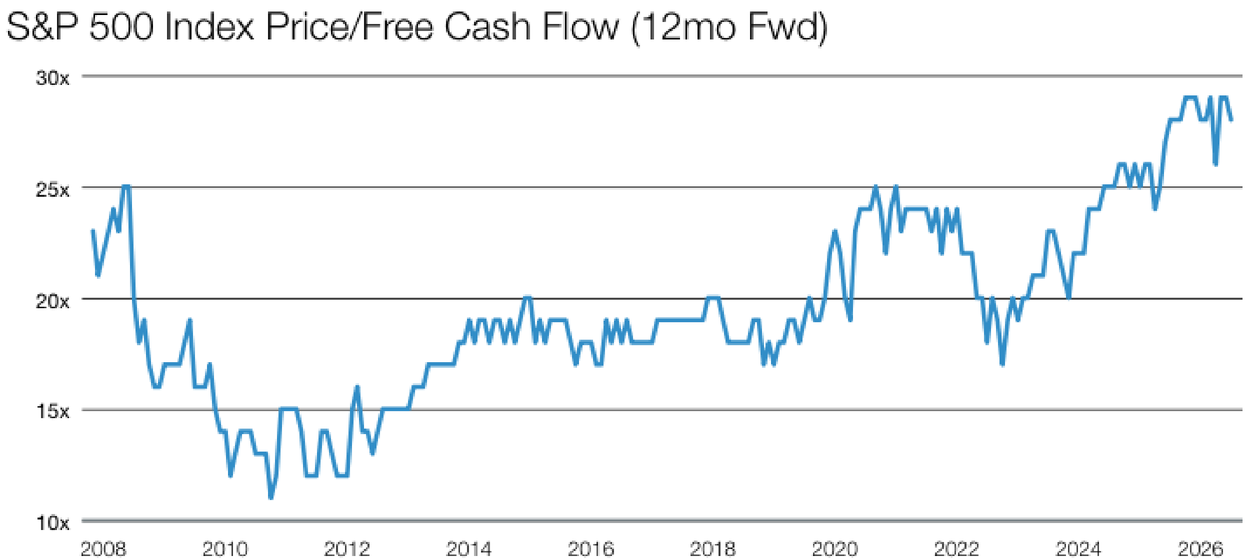


Source: Bloomberg

Much of that optimism has remained concentrated in a relatively small group of AI-related tech companies. Their leadership has been well deserved, supported by extraordinary earnings growth and the potential for artificial intelligence to drive meaningful productivity gains across the global economy. As investors have grown increasingly confident in that long-term opportunity, they have also become willing to pay progressively higher prices for those future cash flows.

We believe the key question for investors is no longer whether artificial intelligence will create meaningful economic value, but rather where that value actually accrues, how quickly it translates into durable free cash flow, and how much of that future success is already reflected in today's prices.

Given the importance of free cash flow generation for long-term value creation, forward price-to-free-cash-flow provides a particularly useful lens through which to evaluate the level of optimism already embedded in today's valuations. Unlike price-to-earnings multiples, free cash flow reflects the cash remaining after a company funds both its operations and the investments required to grow the business. This is the cash ultimately available for dividends, share repurchases, or to pay down debt. As the market's largest tech companies commit unprecedented amounts of capital to AI infrastructure, that distinction has become increasingly important. Given rising investment requirements, the S&P 500 now trades at a higher forward price-to-free-cash-flow multiple than pre-Global Financial Crisis.

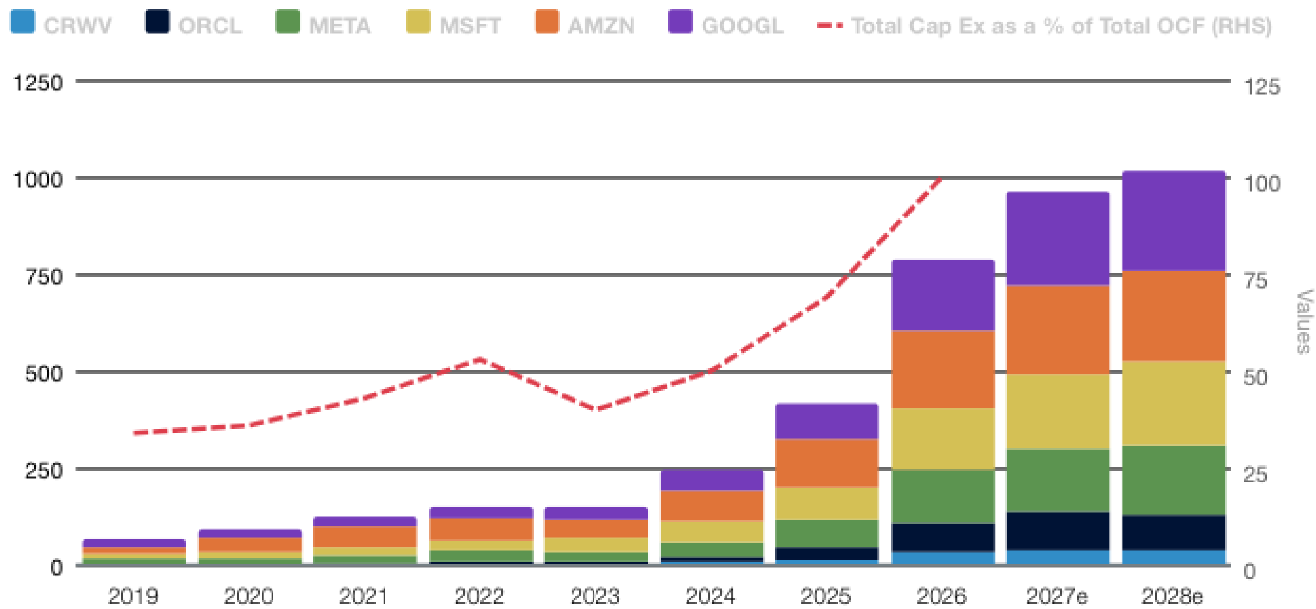


Source: Morningstar

The growing importance of free cash flow reflects a broader structural shift taking place within the technology sector itself. Historically viewed as an asset-light industry, today's AI leaders are investing unprecedented amounts of capital to build data centers and the computing capacity required to support the next generation of AI applications (the monetization of this investment spend). Aggregate capital expenditures among the hyperscalers are expected to increase severalfold over the next couple years and are estimated to consume nearly 100% of the operating cash flow of the leading hyperscalers as early as next year.

While these investments *may* ultimately generate substantial long-term value, they also represent a meaningful change in the economics of the sector. In other words, the cost of producing tomorrow's cash flows has risen dramatically, even as investors are paying near-record prices for those future cash flows today.

Hyperscalers' Aggregate Capital Expenditures



Source: Bloomberg

We are not suggesting the level of investment being made is unwarranted. Artificial intelligence has the potential to create enormous economic value over time. Rather, it highlights how much future success investors already appear to be pricing into today's market. When future returns become increasingly dependent on a narrow set of expectations, we believe there is value in broadening the opportunity set and remaining disciplined in how much investors are willing to pay for future growth. History has consistently shown that market leadership evolves over time, often in ways few investors anticipate. Maintaining a diversified portfolio with the flexibility to allocate capital across regions, sectors, and asset classes where expectations remain more balanced can help reduce dependence on any single investment theme while positioning investors to capitalize on opportunities as they emerge.

Important Information

TL1086