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BETWEEN THE MARGINS

EMPOWER

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A look at what's happening in the markets and economy with Empower's Marta Norton

Executive summary

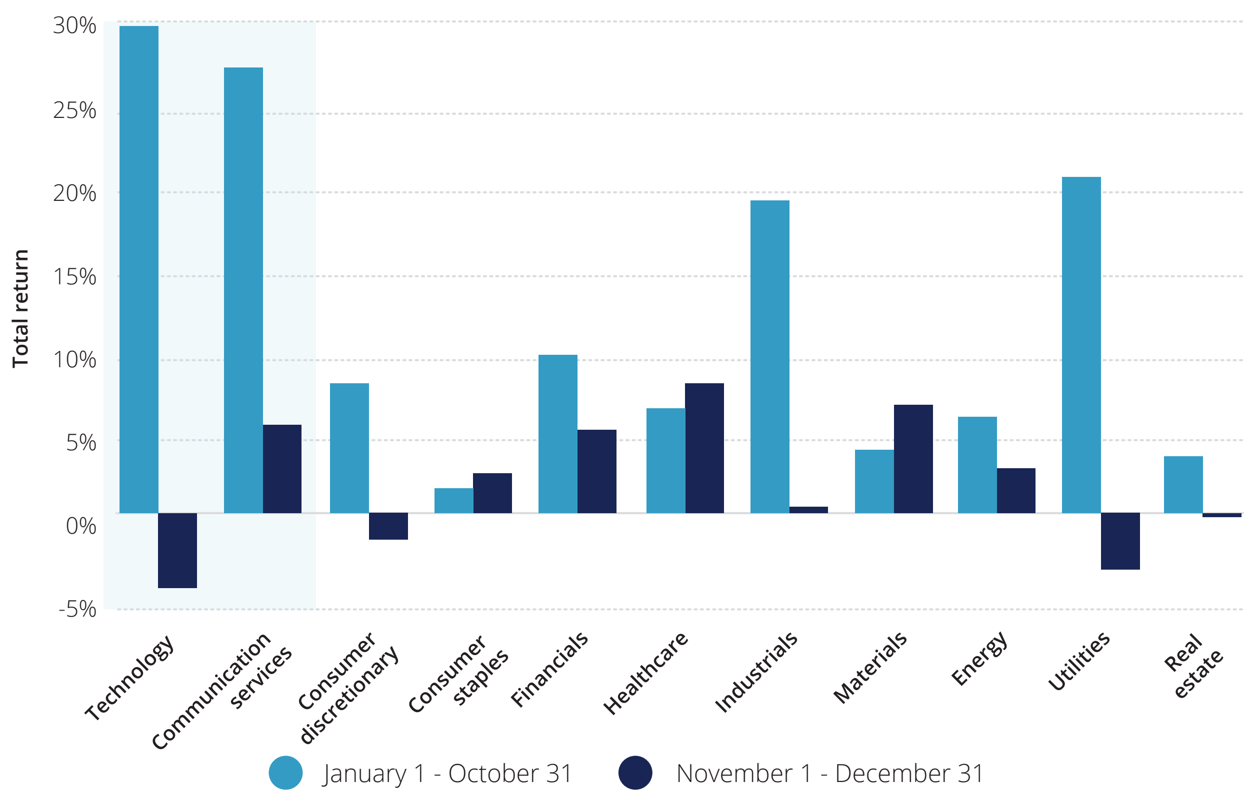
1. The rotation trade — moving away from AI stocks to other sectors — is a consensus call.
2. It's predicated on valuations and earnings growth.
3. At face value, those seem like strong arguments.
4. On closer inspection, it's not as clear cut.

Are we in the midst of a rotation trade?

That's what some are claiming. And the last two months of 2025 saw a reversal from earlier in the year. Take a look below at our Chart of the Month.

Chart of the Month: Sector returns in 2025

Technology had a major reversal in the last two months of the year. And what's going on with communication services? Don't forget, that's home to Alphabet and Meta. Alphabet bucked the artificial intelligence (AI) collapse with its release of Gemini 3.



Source: Empower, Bloomberg. Data as of January 7, 2026. Sectors represented by GICS sectors in the S&P 500® Index.

Making their case for new leadership, commentators point to two things: valuations and earnings growth.

Let's look at both in turn.

The rotation trade: The valuation argument

From a quick eyeball of the data, shorthand valuation metrics such as price-to-forward earnings or price-to-book price are cheaper outside tech.

But they've been that way for years. In fact, take a look at valuations across U.S. sectors over the past 25 years. Tech nearly always has had higher multiples. At least in recent history, investors have tended to pay more for growth.

Exhibit 2: Historical averages for select valuation metrics, 2000-current

The technology sector has had higher price-to-earnings and price-to-book ratios than other sectors over most periods. Not surprisingly, it's followed by communication services. At the bottom of the heap? Financials and utilities.

	Technology	Communication services	Consumer discretionary	Consumer staples	Financials	Healthcare	Industrials	Materials	Utilities
Price-to-earnings	24.54	21.93	22.95	18.76	14.30	17.78	19.04	18.32	16.01
Price-to-book	6.05	4.90	5.20	5.35	1.70	4.43	3.97	2.77	1.89

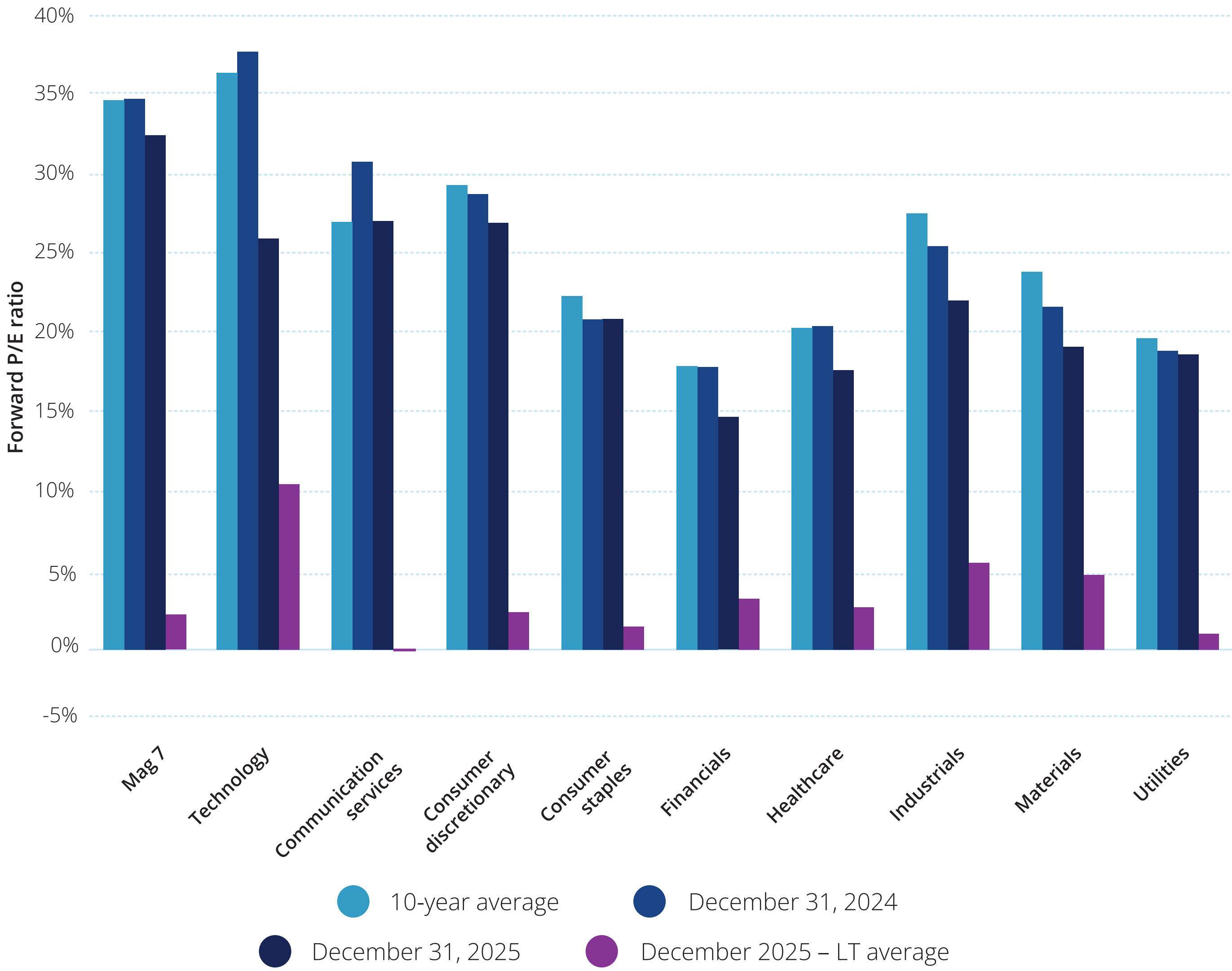
Sources: Empower, Bloomberg. Data as of January 8, 2026. Price-to-earnings is price relative to the earnings expected by Wall Street analysts over the next 12 months. Price-to-book is adjusted price-to-adjusted book. Bloomberg calculates this by taking the price as of the particular date and dividing it by the weighted book value per share.

A more critical assessment of valuations looks at how sectors are priced relative to their own histories. On that score, the picture morphs.

Yes, technology stocks are expensive, but they're actually a bit less so than a year ago, despite their strong 2025 showings. Meanwhile, nearly all other sectors are also trading above their 10-year averages, with industrials and materials on the pricier end.

Exhibit 3: Forward price to earnings, current and 10-year average

Technology and communication services both have lower price-to-earnings ratios than a year ago. All other sectors have seen their valuation ratios move higher than year-ago levels.



Sources: Empower, Bloomberg. Data as of January 7, 2026. Sectors represented by GICS sectors in the S&P 500 Index.

And if we take a closer look at technology stocks, we find select names appear more reasonably valued than one might expect. Some of those names are recognizable. For example, the forward price-to-earnings ratio for the Bloomberg Magnificent Seven Index, home to fan favorites Nvidia, Microsoft, Meta, Alphabet, Amazon, Tesla, and Apple, stands at 34, which is moderately above its 10-year average and below its peak on October 29, 2025, of 36.3. You can see the vastly improved valuation picture for the Mag 7 relative to technology in our chart above.

It helps to decompose returns into two primary drivers: earnings and valuations (total yield — dividends and buybacks — and inflation make up the rest of nominal returns).

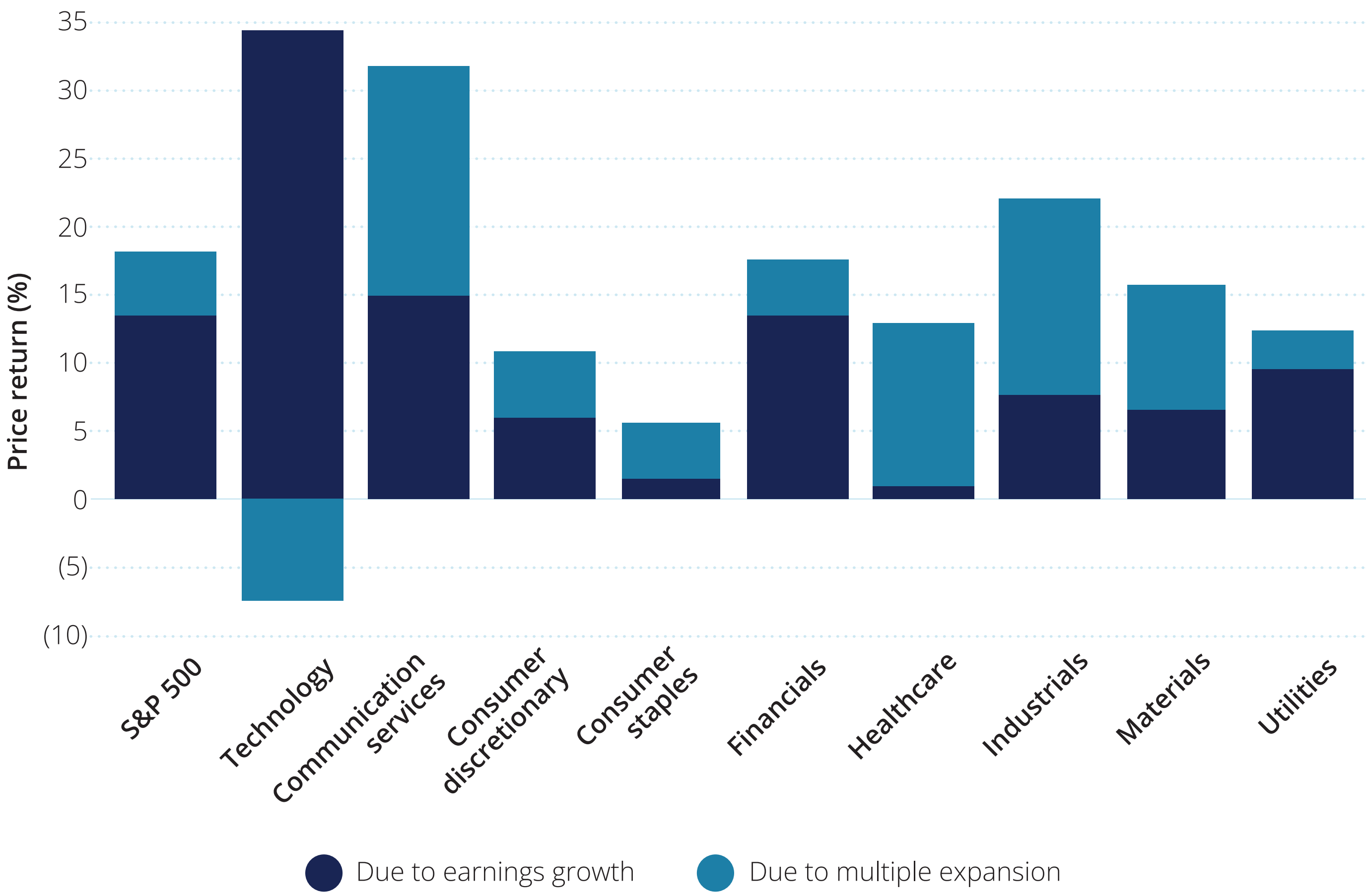
In 2025, earnings drove tech performance, in no small part because of the AI buildout.

Valuations, meanwhile, fell a bit, helping to explain why technology — and select Mag 7 names — look better priced than a year ago.

The same can't be said for other sectors, whose returns were driven by a combination of earnings growth and valuation expansion.

Exhibit 4: Return decomposition

Technology saw earnings drive returns in 2025. Other sectors benefited from valuation expansion.



Sources: Empower, Bloomberg. Data as of January 5, 2026. Sectors represented by GICS sectors in the S&P 500 Index.

All this to say — at least at a broad level — the valuation case isn't airtight. Tech looks expensive, but select names have appeal, and — notably — valuation opportunities don't abound elsewhere.

The rotation trade: The earnings argument

But what about earnings? As established, earnings are a critical component of equity returns. We might find valuations have trouble expanding from here, but investors can still see gains if earnings deliver.

And here comes the second half of the rotation narrative: *"The earnings gap between technology and everything else is expected to narrow in 2026."*

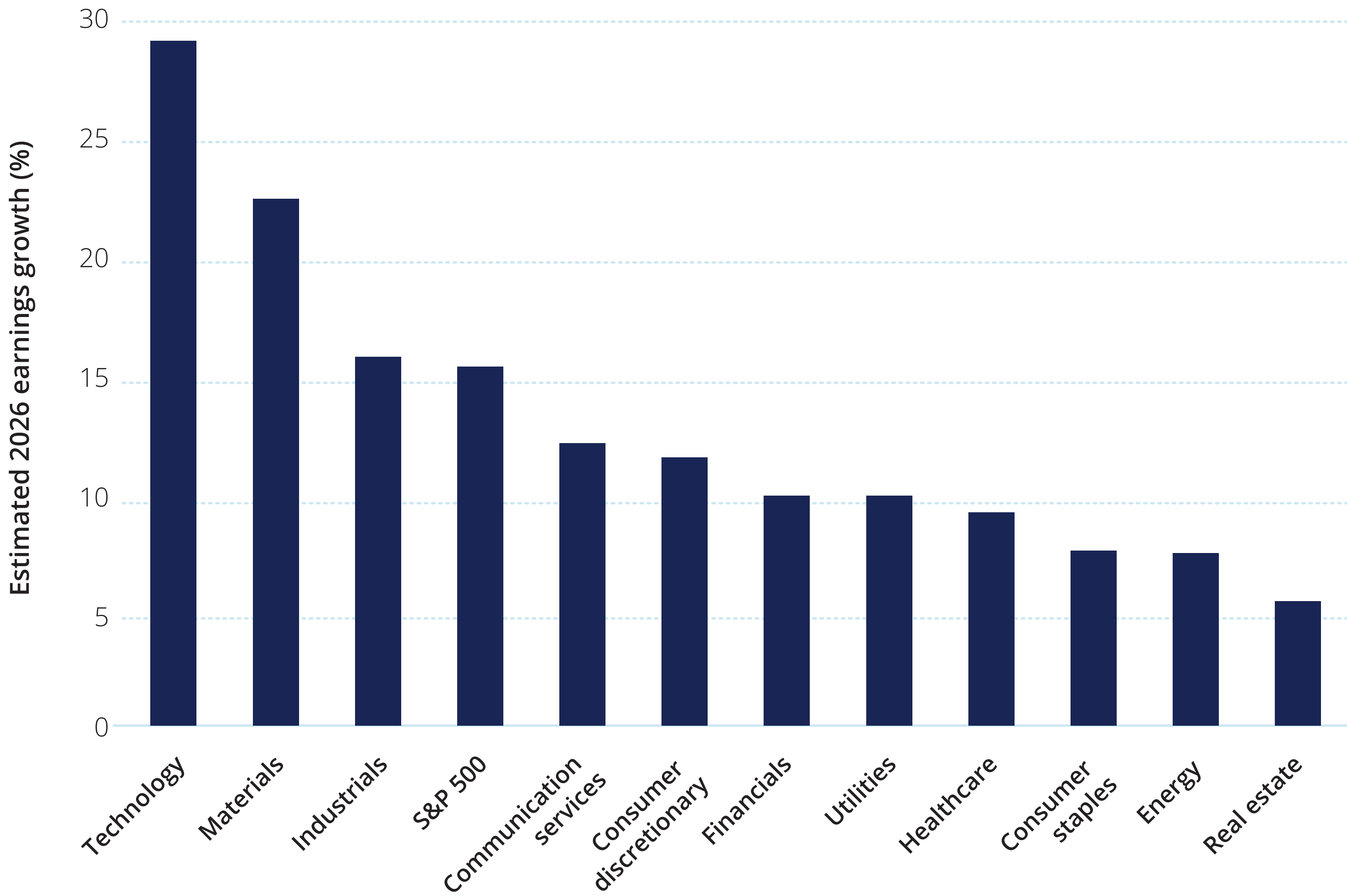
Ah, the elusive "broadening out" that investors have anticipated for the past year. Or five years. Or 10 years.

Actually, I'm not completely dismissive of this view.

Analyst earnings estimates from FactSet do show a tightening between 2026 expectations for technology vis-à-vis expectations for other sectors.

Exhibit 5: FactSet calendar-year earnings estimates

Earnings growth continues to favor the tech sector, though other sectors look set to see a pick-up from 2025 levels.



Source: FactSet. Data as of December 19, 2025.

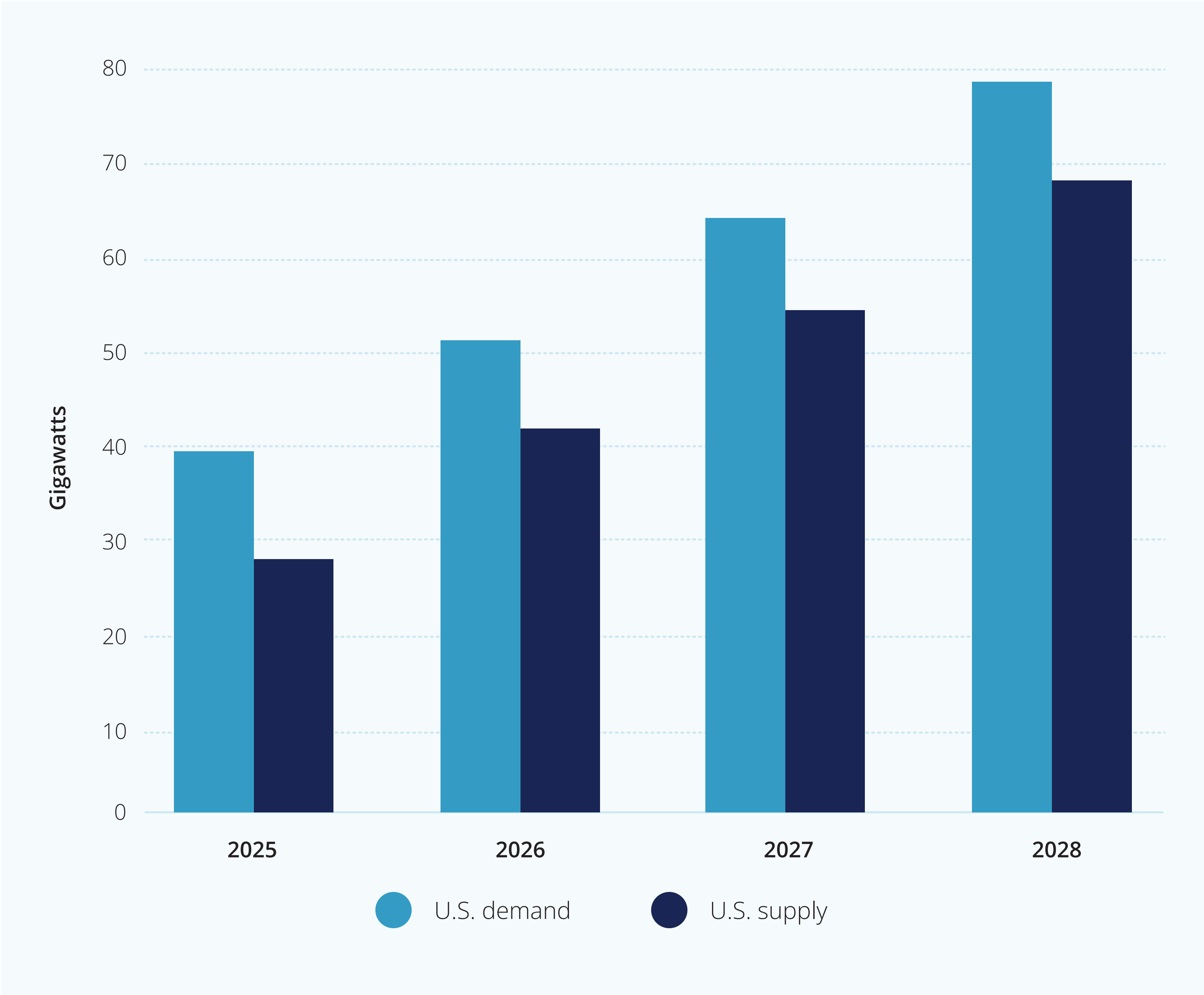
This isn't a matter of earnings growth coming down for the Mag 7. In fact, analysts expect the Mag 7 cohort to generate earnings growth modestly above that of 2025 levels. However, they also anticipate notably stronger growth coming from the remaining 493; more than 12% for calendar year 2026 versus an estimated 9% for 2025 (Q4 results are just beginning to roll in now).

This goes along with stronger revenue and net-profit expectations. There are a number of explanations for broader earnings growth, including base effects (stronger growth due to weaker levels a year ago), incremental AI deployment, fiscal and monetary stimulus, and economic strength.

My take? I don't take issue with any specific catalyst, though I do question the magnitude a bit, particularly as it relates to AI implementation. We could certainly see incremental gains as companies begin to put AI to work, not as generalized solutions but as customized applications within company-specific workflows. But don't forget: We're still very supply constrained. For AI demand to roll out in a transformative way akin to fire (see Sundar Pichai: "AI is more transformative than electricity or fire"), the hyperscalers need to build more capacity, not just in 2026, but in 2027 and potentially 2028 as well. That will keep members of the Mag 7 still very much at the epicenter of the AI trade. Combine that with better valuations among members of the Mag 7, and I think there's still a case to be made that some of the top contributors last year will continue to compete for leadership this year, though they perhaps won't dominate to quite the same degree as in 2025.

Exhibit 6: Capacity constraints in AI

Despite massive spending, estimates suggest AI remains capacity constrained.



Source: FactSet. Data as of December 19, 2025.

Let's level set

To be clear, I don't expect smooth sailing in 2026. Valuations are high across the board. Meanwhile, a technological revolution that requires huge capital commitments, long timelines, and a massive infrastructure transformation is bound to give investors "moments of doubt" along the way. It's these "moments of doubt" that I believe can offer opportunities to add exposure at better prices. I find it far more appealing to move into select AI names today than I did in, say, September, when investors were largely ignorant of circular financing and debt issuance.

One last thought on the broadening-out trade. A lot of commentators describe 2026 as a year to pivot away from the AI suppliers and toward the AI deployers. I think this is a harder call than it may seem. AI has the potential to transform the breadth of the U.S. economy; few industries are AI immune. However, there's no easy way to identify those who will succeed in putting AI to work first. All companies whitewash their earnings calls with AI jargon, and it's a trial-and-error process when it comes to implementation. With that in mind, a focus on the broad market may help diffuse the risk and cast a wide net.

Etc., etc., etc.

Apologies for not writing about Venezuela or Greenland. Or, for that matter, Ukraine, Iran, or Israel. Geopolitics looms large in 2026 and is of course very important to the world stage, to say nothing of the individual people affected. But my remit is markets and the economy from the perspective of the U.S. investor. And the geopolitical developments so far this year don't directly impact the U.S. investor's portfolio. A potential topic for another day: When do geopolitics matter? Hint: When it comes back to cash flow (which often means earnings).

So what to keep an eye on over the next month?

With fourth-quarter earnings season upon us, we'll get a look as to whether the expected catalysts are at work. We'll also get another chance to hear Fed thinking at the January decision. Fed drama looms large regardless due to the subpoena of Fed chair Jerome Powell. Relatedly, 2026 is shaping up for Washington-induced volatility, given President Trump's recent announcements on credit cards, mortgages, and more. As was the case in 2025, it looks like we'll have to keep a close eye on Washington's impact on the markets. Speaking of Washington, I wait with bated breath for the U.S. Supreme Court tariff ruling. The decision and market reaction will be fascinating. Until February!

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