



# HEADWATERS

## CAPITAL

**State of the Markets Q2 2025:  
Most Attractive Opportunity in Small Caps Since 1999**



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# Virtuous Cycle: AI Investment Has Dominated Capital Flows in Capital Markets and the Economy Since 2023

45+ Startups are Building Generative AI Software and Services, and Have Collectively Raised >\$100B

Company	Total Raised (\$M)	Last Est. Pre-Money Valuation (\$M)	Category	HQ Location	Year Founded
OpenAI	\$17,010	\$180,000	Platform	San Francisco, CA	2015
Scale AI	\$16,403	\$29,000	Data	San Francisco, CA	2016
Anthropic	\$14,750	\$58,000	Platform	San Francisco, CA	2021
Databricks	\$14,181	\$52,000	Platform	San Francisco, CA	2013
xAI	\$12,000	\$44,000	Platform	San Francisco, CA	2023
CoreWeave	\$9,085	\$22,350	Deployment	Roseland, NJ	2017
Safe Superintelligence	\$5,000	\$32,000	Platform	Palo Alto, CA	2024
Groq	\$2,500	\$2,200	Deployment	Mountain View, CA	2016
Lambda	\$2,100	\$2,000	Deployment	San Jose, CA	2012
AnySphere	\$2,000	\$9,900	Coding Assistants	San Francisco, CA	2022
Inflection AI	\$1,565	\$4,000	Platform	Palo Alto, CA	2022
Perplexity	\$1,400	\$14,000	Chatbots & Personal Assistants	San Francisco, CA	2022
Mistral AI	\$1,193	\$6,488	Platform	Paris, France	2023
SandboxAQ	\$650	\$5,300	Platform	Palo Alto, CA	2016
Cohere	\$640	\$5,500	Platform	Toronto, Canada	2019
Solid AI	\$600	\$4,500	Platform	Pittsburgh, PA	2023
Clean	\$768	\$7,200	Search	Palo Alto, CA	2019
Cerebras	\$720	\$4,000	Deployment	Sunnyvale, CA	2016
Generative Biomedecines	\$683	\$2,000	Biotech	Cambridge, MA	2018
Clickhouse	\$650	\$6,000	Data	San Francisco, CA	2009
Poolside	\$628	\$3,000	Coding Assistants	Paris, France	2023
Runway AI	\$600	\$3,000	Video	New York, NY	2018
Celestial AI	\$581	\$2,500	Deployment	Santa Clara, CA	2020
Together AI	\$533	\$3,000	Deployment	San Francisco, CA	2022
Aleph Alpha	\$520	N/A	Platform	Heidelberg, Germany	2020
Magio	\$471	\$1,280	Coding Assistants	San Francisco, CA	2022
Abridge AI	\$458	\$5,000	Chatbots & Personal Assistants	Pittsburgh, PA	2018
Builder.ai	\$445	\$553	Application Development	London, United Kingdom	2012
DeepL	\$420	\$2,000	Writing & Editing	Germany	2009
Dialpad	\$415	\$2,200	Audio Search	San Ramon, CA	2011
Adept	\$414	\$1,000	Platform	San Francisco, CA	2021
Grammarly	\$400	\$12,800	Writing & Editing	San Francisco, CA	2009
Hugging Face	\$395	\$4,280	Platform	Brooklyn, NY	2016
Tuin	\$378	\$1,750	EdTech	Oakland, CA	1998
Asapp	\$375	\$1,600	Chatbots & Personal Assistants	New York, NY	2014
Redis	\$357	\$2,000	Vector Tools	Mountain View, CA	2011
GitHub	\$351	\$7,500	Coding Assistants	San Francisco, CA	2008
Temporal	\$350	\$1,720	Deployment	Bellevue, WA	2019
DataStax	\$343	\$1,715	Vector Tools	Santa Clara, CA	2010
LightRicks	\$341	\$1,800	Content Suite	Jerusalem, Israel	2013
AI21 Labs	\$337	\$1,400	Platform	Tel Aviv, Israel	2017
Writer (Jordoba)	\$328	\$1,700	Writing & Editing	San Francisco, CA	2020
Moveworks/ServiceNow	\$308	\$2,100	Chatbots & Personal Assistants	Mountain View, CA	2016
Liquid AI	\$300	N/A	Platform	Cambridge, MA	2023
Stargate Project*	\$500,000	N/A	Platform	Arlene, TX	2025

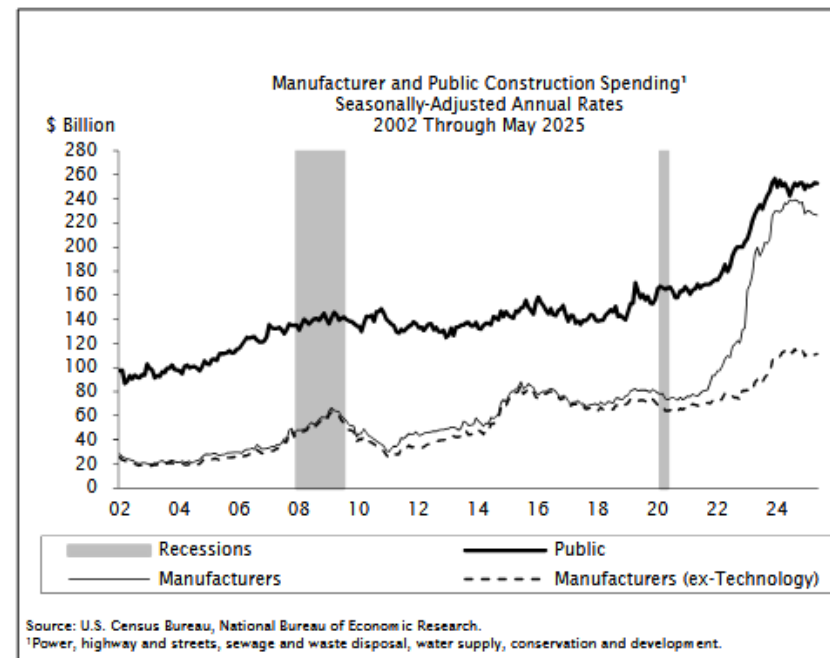
Source: PitchBook Data Inc., \*Data has not been reviewed by PitchBook analysts. Trust Securities Research

\*SoftBank, OpenAI, Oracle and MGX have made the intention to invest \$500B over the next four years, with expectations of deploying \$100B immediately.

Trust Securities

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- ...There's already been stimulus and tech-led construction spending booms...



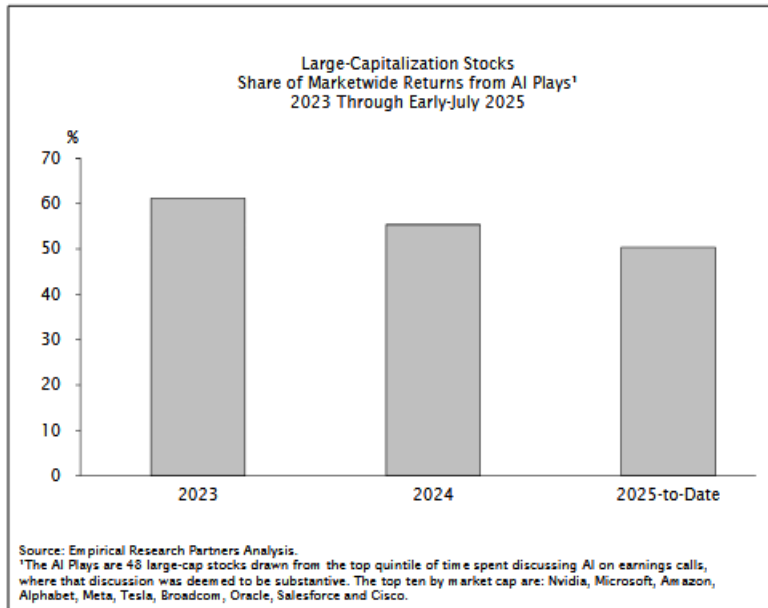
Source: Empirical Research

- Investors have correctly followed the earnings momentum behind AI since 2023
- Ongoing investment has driven strong gains for AI players throughout the value chain: direct AI companies, AI infrastructure providers (data centers, industrials, utilities), AI service providers

# AI Hype Has Led to Concentrated Returns and The Narrowest Market Breadth Since 2000 (Large Caps)

## Market breadth and concentration

**Exhibit 22: S&P 500 52-week market breadth**



Market breadth calculated as the difference between the distance of the aggregate S&P 500 Index from its 52-week high and the distance of the median S&P 500 constituent from its 52-week high. When the aggregate index is much closer to its 52-week high than is the median stock, market breadth is narrow.

Source: Goldman Sachs Global Investment Research

**Table 1: S&P 500 on cusp of 7<sup>th</sup> great breakout since 1990**

S&P 500 breakouts and number of stocks at all-time-highs

S&P 500 breakout	# of stocks at ATH
2/13/1991	51
11/23/1998	66
5/30/2007	82
3/28/2013	97
8/18/2020	54
1/19/2024	67
<b>6/26/2025</b>	<b>22</b>

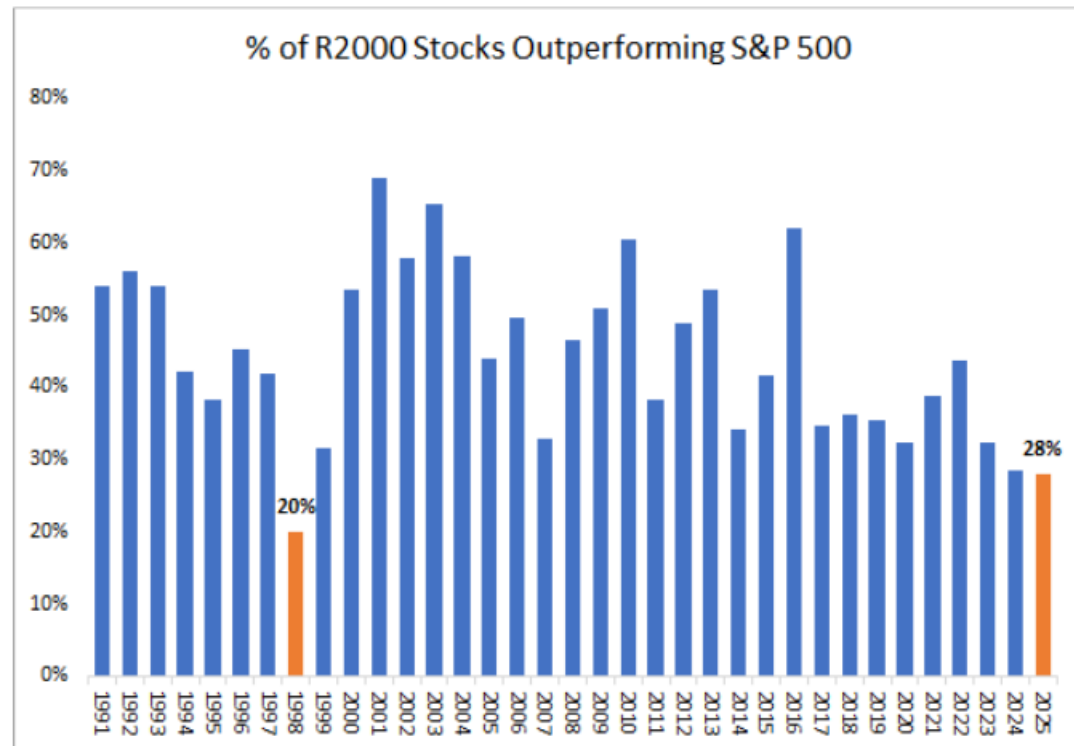
Source: BofA Global Investment Strategy, Bloomberg. Note: 83 stocks in the S&P 500 are currently within 5% of their all-time high, while 146 are within 10%.

BofA GLOBAL RESEARCH

- Large cap returns dominated by AI beneficiaries
- Leading to historically narrow market breadth
- Despite S&P 500 reaching new all-time-highs, the majority of stocks are lagging the index.

# AI Hype Has Led to Concentrated Returns and The Narrowest Market Breadth Since 2000 (Small Caps)

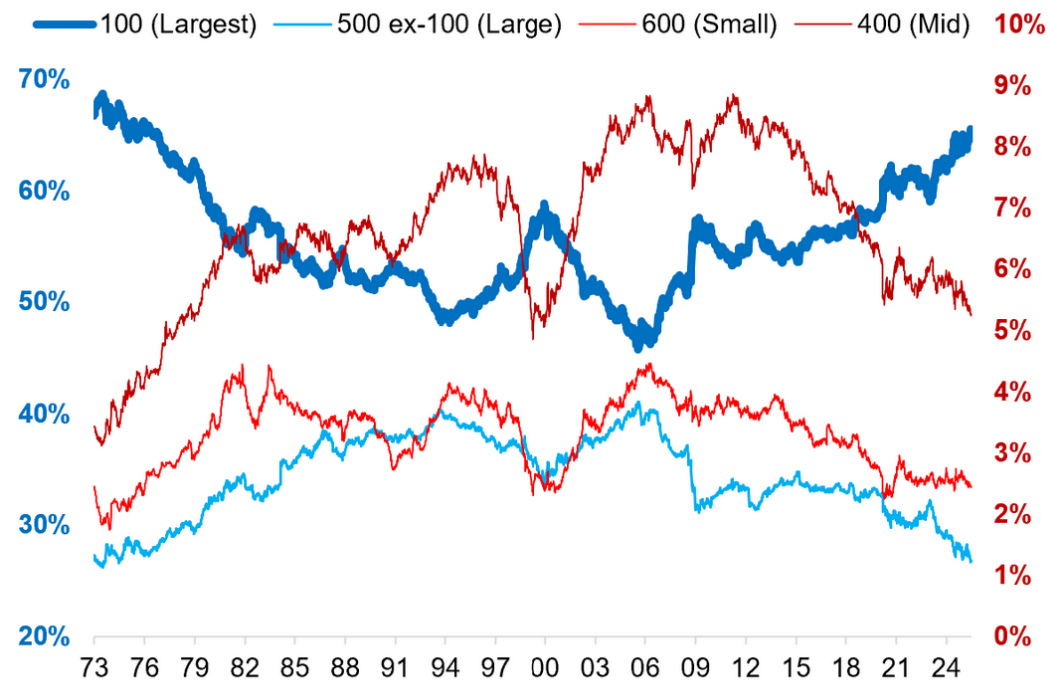
Fig 17. R2000 percentage of stocks outperforming the S&P 500 lowest since '98



Source: Furey Research Partners and FactSet. Based upon R2000 constituents as of 12/31/2024. "2025" is YTD as of 6/30/25.

- Small caps underperforming large caps by the widest margin since 1998/1999

## US Market Cap Division

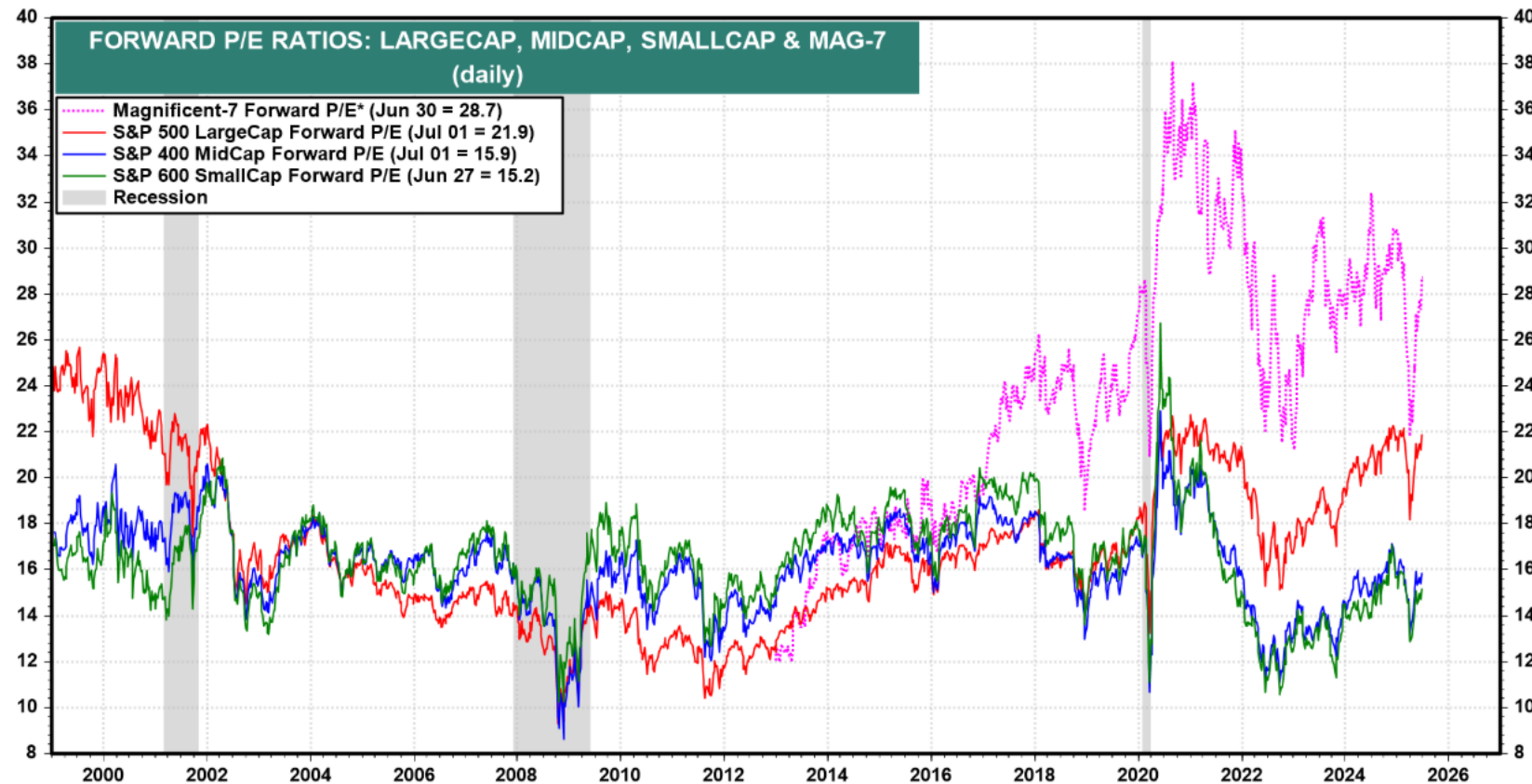


Source: Topdown Charts, LSEG

topdowncharts.com

- Leaving small cap portion of total market cap at lowest level since 2000

# Narrow Market Breadth Is Evident in Historically Wide Valuation Spreads Between AI Winners and Everything Else



Source: LSEG Datastream and © Yardeni Research, and Standard & Poor's.

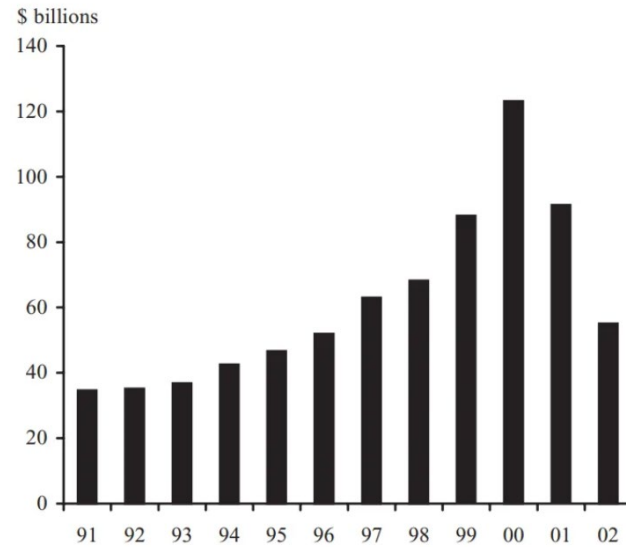
\* Magnificent-7 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, NVIDIA, and Tesla. Both classes of Alphabet are included.

- Large, Mid and Small Cap Indexes are all trading at nearly identical multiples as October 1999!



# But Investors Forget that CAPEX Spend is Cyclical. Will AI & Data Center Spend Prove to Be Different?

FIGURE 4  
CAPITAL SPENDING BY PUBLICLY TRADED  
TELECOMMUNICATIONS SERVICE PROVIDERS

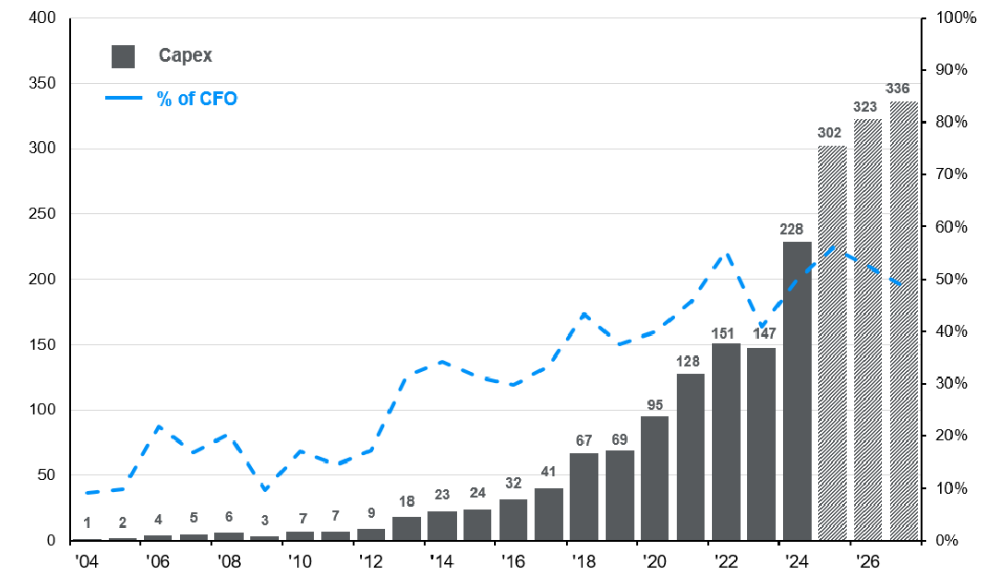


Source: Compustat and author's calculations.

*Source: Fabricated Knowledge*

## The major hyperscalers are doubling down on capex commitments

USD billions; Microsoft, Amazon (AWS), Meta and Alphabet



Source: Bloomberg, J.P. Morgan Asset Management. Data for 2024, 2025 and 2026 reflects consensus estimates. Capex shown is company total, except for Amazon, which reflects an estimate for AWS spend (2004 to 2012 are J.P. Morgan Asset Management estimates and 2012 to current are Bloomberg consensus estimates). CFO reflects cash flow before capital expenditures. Data are as of February 26, 2025.

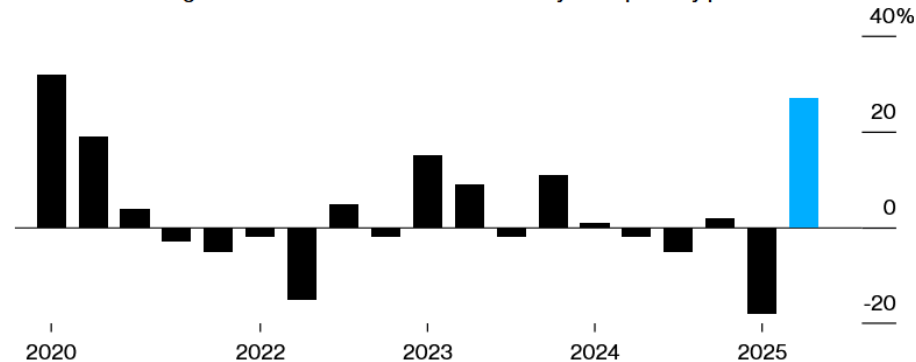
- While AI appears to have real benefits, history suggests that major technology shifts are prone to overinvestment.
  - Note the chart on the right does not include spend from Oracle (\$21B of CAPEX in 2025) or the Stargate project (\$500b over the next four years)
- If fundraising or AI spend decelerates, earnings estimates and valuations for AI companies need to recalibrate

# Outside of AI, Investor Risk Appetite is Frothy: Typical Late Cycle Behavior

## Seeking Risk

High-beta stocks are breaking out relative to low-vol peers

■ Invesco S&P High Beta ETF - Invesco S&P Low Volatility ETF quarterly performance



Source: Bloomberg

## Russell Midcap

### Exhibit 32: Russell Midcap Performance Attribution Analysis

1m, 3m and YTD performance attribution (as of 6/30/2025)

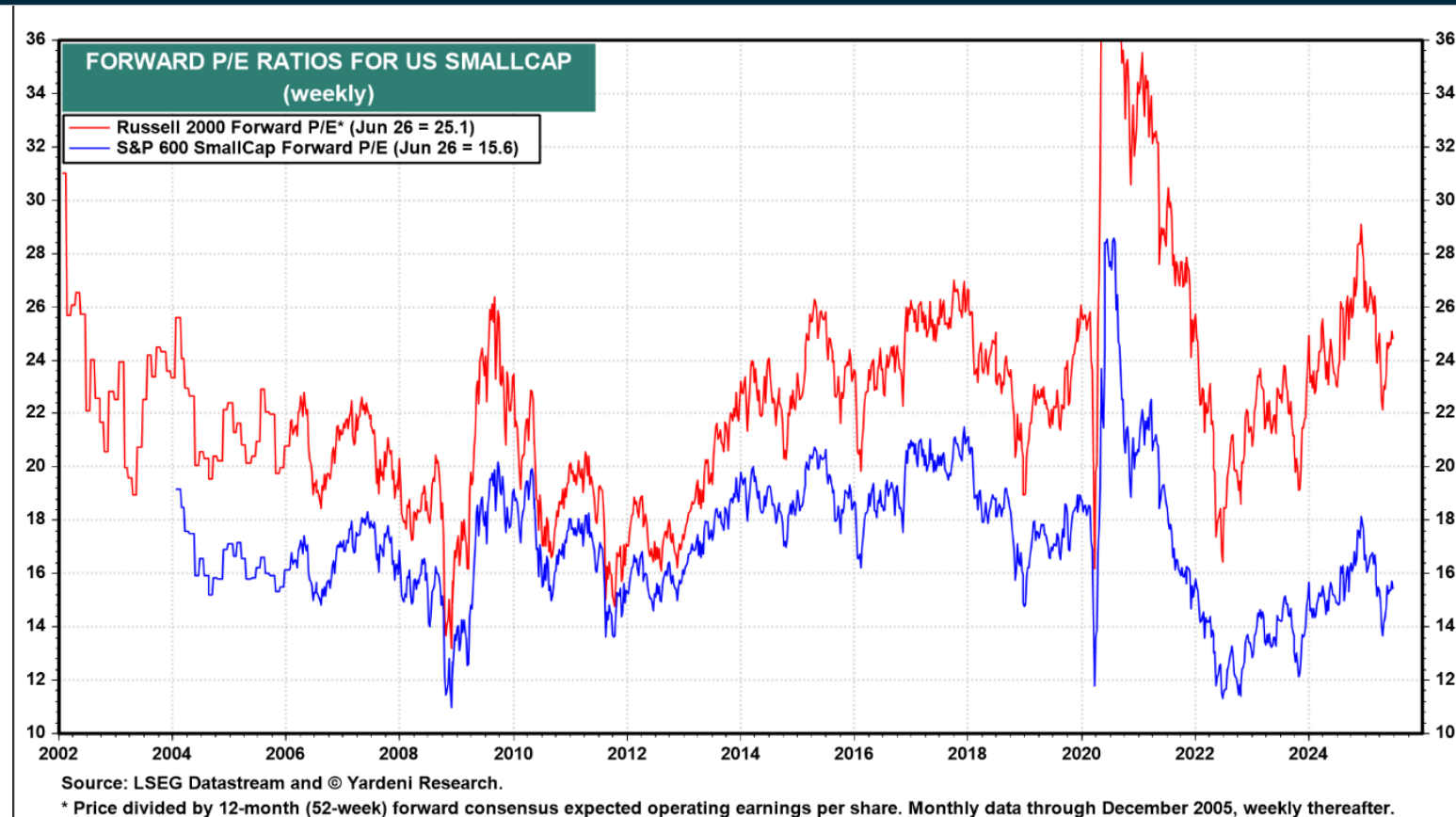
	June		Last Three Months		Year to date		Weight
	Return	Contrib.	Return	Contrib.	Return	Contrib.	
<b>Core Index</b>	3.7	—	8.5	—	4.8	—	
<b>Market Cap Size Quintile</b>							
Q1 (Largest)	4.1	2.1	11.4	5.7	8.9	4.6	51.5
Q2	3.6	0.8	6.6	1.5	3.3	0.8	22.5
Q3	3.4	0.5	6.1	0.8	-0.2	0.0	13.2
Q4	3.4	0.3	4.3	0.4	0.3	0.0	8.6
Q5 (Smallest)	4.8	0.2	5.4	0.2	-3.6	-0.2	4.1
<b>P/E Quintile</b>							
Q1 (Lowest)	4.6	0.5	3.3	0.4	0.9	0.1	11.9
Q2	3.0	0.5	6.2	1.1	2.7	0.6	17.9
Q3	3.9	0.8	6.1	1.2	6.1	1.1	19.5
Q4	2.6	0.5	5.7	1.3	1.5	0.4	20.8
Q5 (Highest)	4.4	1.2	17.1	3.9	8.6	2.3	26.2
Nonearnings Stories	9.0	0.3	22.5	0.8	21.3	0.8	3.7

- High beta is a good proxy for more speculative stocks. Recent performance reminiscent of 2020/2021 meme stock craze

- Risk appetite is also evident in performance of non-earnings companies and companies with high P/E (both in Q2 and YTD)

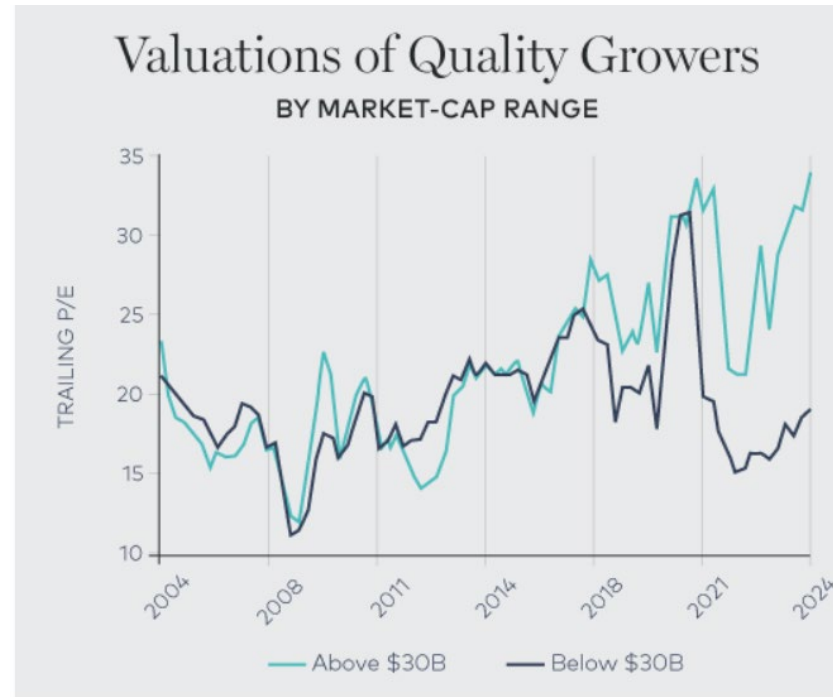


# Appetite for Speculative Stocks is Reflected in Historically Wide Valuation Spreads for Quality v. Unprofitable



- Valuation premium for lower quality Russell 2000 is historically wide, nearly the same as 2021 meme stock frenzy
- Note the S&P 600 includes only profitable small caps whereas ~40% of Russell 2000 members are unprofitable

# The Result is a Vacuum of Interest in Quality Small Cap Businesses and Historically Attractive Valuations

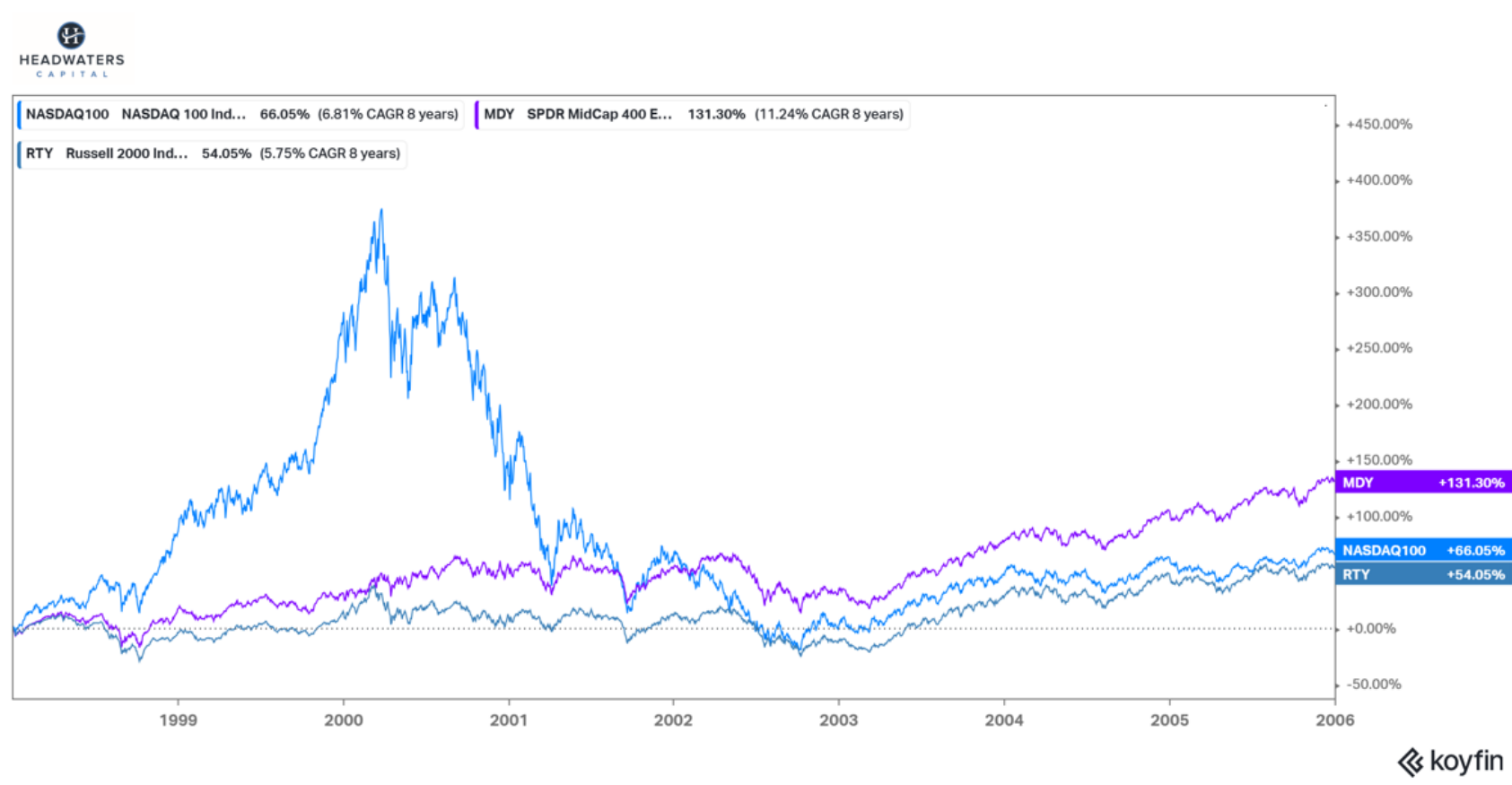


Source: FactSet. Trailing P/E ratio, quarterly from 12/1/2004 through 12/1/2024, harmonic average. The universe includes all listed U.S. companies as defined by the MSCI Country Classification with a market cap above \$100 million, an average 3-year ROA above 7% and annualized sales growth above 7%. Past performance is no guarantee of future results.

Source: Wasatch Advisors

- Normalizing for growth and profitability illustrates the valuation disconnect between quality large caps and quality small caps

# 1999/2000 Refresher: Internet Bubble Had Two Cycles



- Cycle 1 (1998- September 1999): Hype led to extended (not bubble) valuations. NASDAQ outperformed Mid and Small Caps by +145% and +127% respectively during this time.
- Cycle 2 (October 1999-March 2000): Market euphoria and bubble valuations.



# AI Cycle Has Parallels to First Cycle of Internet Bubble



koyfin

- Similar to 1998/1999, the Nasdaq has led the market higher since the AI trade began in 2023. Current valuations are stretched, but not at bubble levels.
- Within small and mid cap indices, low quality stocks have led these indexes higher
  - MDY and IJR include only profitable firms in Mid and Small Cap universe – both have lagged comparable indices that include unprofitable companies

# If Approaching Bubble Territory, Can Investors Make Money?

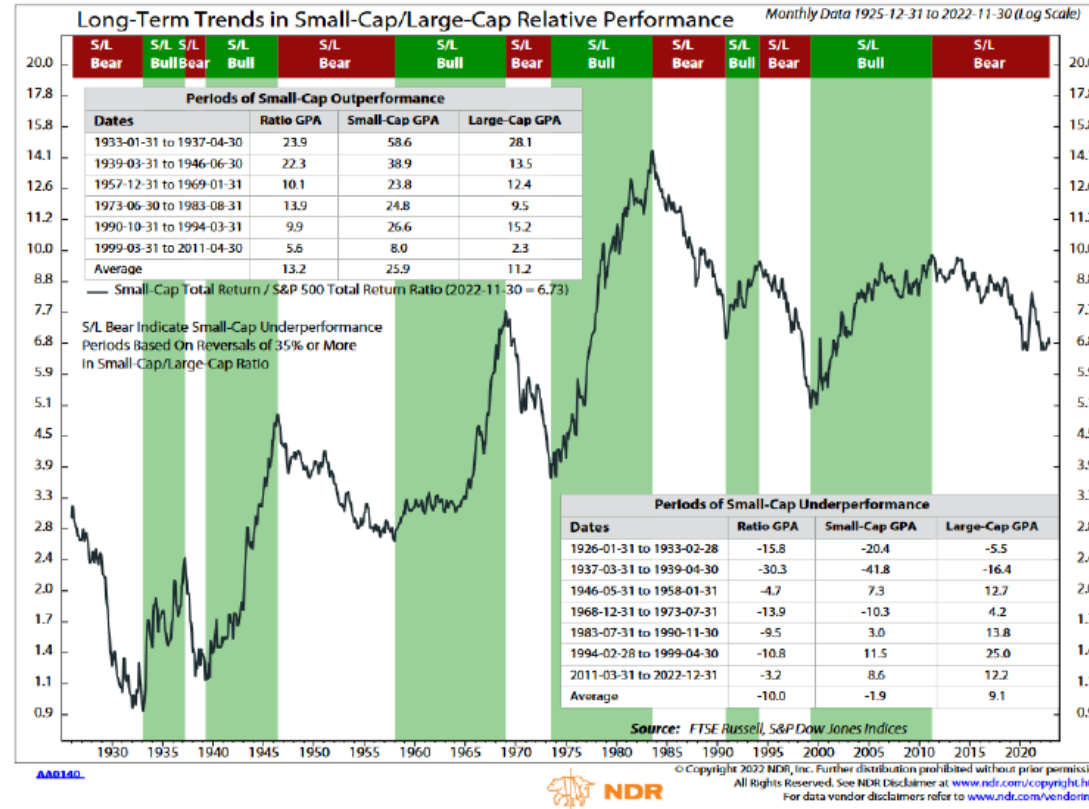
## Yes, in Quality Small Caps

### Forward Returns if Invested on 10/1/1999

	2 Year Return	5 Year Return
NASDAQ	-52%	-56%
S&P 500	-15%	-5%
Russell 2000	-5%	29%
S&P 600 (Profitable Small Cap)	16%	71%
S&P 400 (Profitable Mid Cap)	8%	46%

- Today's valuations for profitable small and mid caps is similar on both an absolute and relative basis as October 1999 (see slide 6)
- Returns in the profitable small and mid cap space led the market over the following 2- and 5-year periods
- Valuation spreads and normalizing AI spend are the catalysts for small cap outperformance -> valuations and fundamentals have reached historic extremes
- Cash flow profile of large cap AI winners likely insulates these companies from the magnitude of underperformance seen post-2000, but lofty expectations and valuations makes ongoing outperformance more difficult

# As a Reminder, Regime Changes Tend to Persist



Nod Davis Research

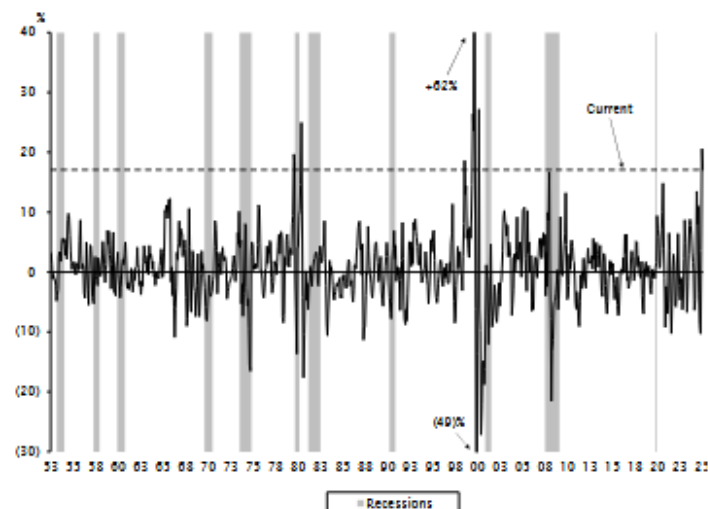
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- Valuation extremes and internet euphoria ultimately normalized in 2000 and drove a 12-year period of small cap outperformance
- Similar market set-up today given current valuations and hype around AI



# Early Signs of Momentum Trade Unwinding?

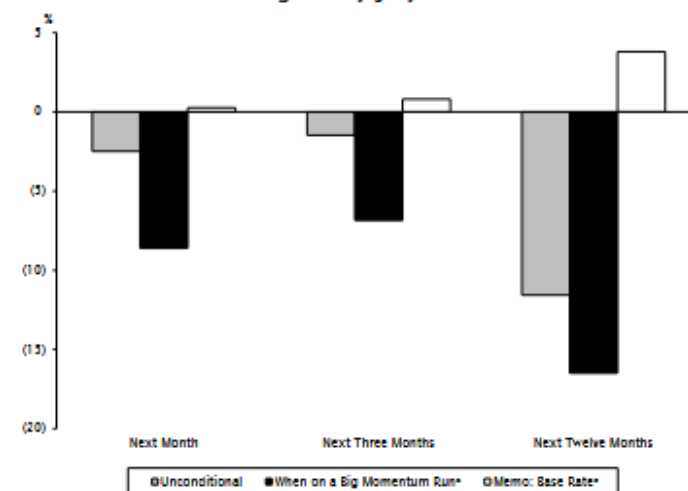
**Exhibit 6: Large-Capitalization Stocks**  
The Highest Quintile of Nine-Month Price Momentum  
Trailing Three-Month Returns<sup>1</sup>  
Relative to the Highest Quintile of Fundamental  
Stability  
1953 Through Early-July 2025



Source: Empirical Research Partners Analysis.

<sup>1</sup> Equally-weighted data, unannualized.

**Exhibit 12: Large-Capitalization Stocks**  
The Highest Quintile of Nine-Month Price Momentum  
*Subsequent* Relative Returns Following a Day  
When the Relative Return Was Less Than (2)%<sup>1</sup>  
1952 Through Early-July 2025



Source: Empirical Research Partners Analysis.

<sup>1</sup> Equally-weighted data. Forward returns excluded the loss day itself.

<sup>2</sup> A big momentum run is when the trailing three-month relative return to the highest quintile of nine-month price momentum is greater than +10%. That situation has occurred in 2.2% of all days.

<sup>3</sup> Base rate is the average across all periods, irrespective of the day's momentum return.

- The momentum trade is currently outperforming by the widest margin since 1999/2000. As shown previously, this led to poor future returns.

- On 7/1/25, the momentum's underperformance ranked in the top 1% of all trading days. Relative returns of this magnitude have historically signaled poor returns going forward.

# Outside of Concentrated Performance and Valuations, Qualitative Market Activity Suggests Late Cycle Behavior

- AI Capital Markets Activity
  - CoreWeave IPO (AI infrastructure provider); stock price increased 4.5x within 3 months of IPO
    - NVDA generates significant revenue from CRWV and invests in the IPO -> reminiscent of internet days of funding customers
    - CRWV uses highly valued stock after IPO to purchase bitcoin miner/data center operator
- Speculative IPO activity increasing
  - Circle ("CRCL") – stablecoin issuer and corresponding 8.5x stock price increase within one month of IPO
  - Chime ("CHYM") – unprofitable consumer bank
  - Rumored IPOs: Gemini (crypto exchange), Klarna (BNPL), Cerebras (AI chipmaker)
- SPAC activity increasing
- Crypto performance
- PLTR is currently worth more than Lockheed Martin, Northrop Gruman, General Dynamics and L3 Harris combined
  - Reminiscent of internet companies worth more than old economy companies in 1999 (AOL>Time Warner, etc)
- Growing presence of new retail trading platforms and new trading tools, helping to fuel speculative trading behavior
  - 1999: eTrade: lower commissions and the rise of day traders
  - 2025: Robinhood, Coinbase: 2x levered single stock daily ETFs, 0 day til expiry options, tokenized stocks, Robinhood providing access to IPOs such as CRWV
- META hiring *individuals* for \$200mm in an aim to create superintelligence

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