The dawning of the "profit productivity era"

2025 ECONOMIC OUTLOOK FROM WINSLOW CAPITAL

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Large-cap growth stocks are poised to continue their leadership, driven by disproportionate Artificial Intelligence (AI) tailwinds, particularly strong "Magnificent 7"[1] ("Mag 7") fundamentals and the "profit productivity" driver. Whereas economic productivity is output per hour worked, the term "profit productivity" refers to profit per hour worked. And since stocks are fractional ownership in companies' profits, "profit productivity" improvements are very good news for investors of large-cap growth stocks.

"Profit productivity" was born from the ashes of an extended period of zero interest rate policy ("ZIRP") and Silicon Valley venture capital group-think around growth at any cost. In 2022, when the cost of money normalized, the markets sent a strong message to public company CEOs and venture capitalists to run the companies more efficiently and to focus on scaling up profits, not just revenue. The silver lining of the heavy investment period is that it left many large-cap growth companies with enviable competitive positions from which to begin a period of sustained profit monetization. Some extreme examples include Spotify and Uber (**Figure 1**), which secured competitive moats but reported significant operating losses during ZIRP and have since changed course. We believe there is a long runway ahead for this new era. Even venture capitalists have pivoted toward profitable growth — and the new mindset has gone viral.

In general, large-growth companies have the easiest time turning on profitable levers because they are often already at scale and have many latent efficiencies at the ready to exploit. AI is also helping as it already had a huge impact on the need for software engineers through more effective coding tools. Large companies are the early winners from AI given they have the technical know-how and large customer bases that can be leveraged. The current profit productivity winners are listed below in **Figure 1**.

Figure 1: Operating profit margins

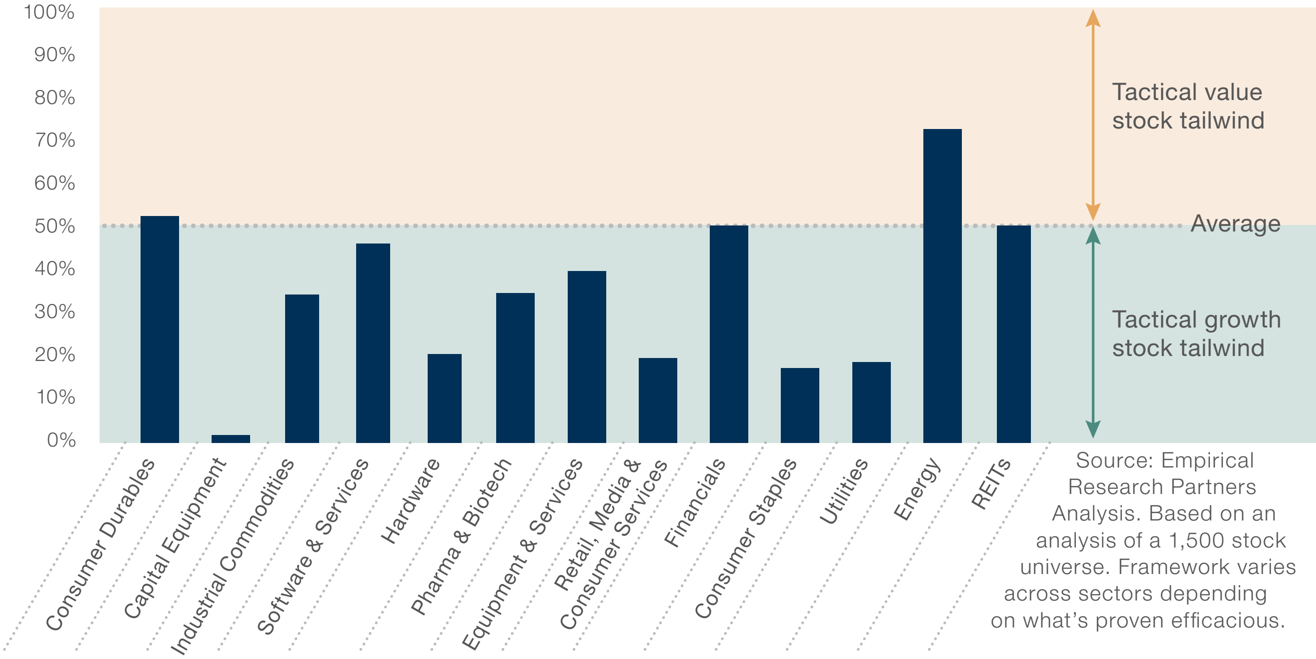
	2022	2025 est.	% change
Amazon.com Inc	2%	11%	357%
Uber Technologies Inc	-6%	11%	296%
Spotify Technology SA	-6%	11%	291%
NVIDIA Corp	34%	65%	93%
Palo Alto Networks Inc	15%	28%	83%
Meta Platforms Inc	25%	40%	61%
Netflix Inc	18%	28%	58%
MercadoLibre Inc	10%	15%	53%
Salesforce.com Inc	23%	34%	50%
ServiceNow Inc	26%	30%	19%
Arista Networks Inc	39%	44%	13%

Source: FactSet estimates as of 9/30/2024. Operating profit margins defined as earnings before interest and taxes. Universe defined as the Russell 3000® Index and the MSCI North America IMI. Companies shown meet the following constraints: market cap >$50B, average daily trading volume >$500M, 2025 expected operating income (EBIT) >$2B, percentage (%) change in dollar operating income >1.0x (2022-2025E), GICS sector Information Technology, Communication Services, Industrials, Consumer Discretionary and GICS industry name exclude Wireless and Diversified Telecommunication Services.

Regarding the 2025 outlook, while many forecasters point to asset classes other than large-cap growth as poised to lead because of better valuation starting points or the election outcome, we find the large-cap growth fundamental outlook difficult to beat. First, we observe very few valuation anomalies in the U.S. market, and we note that small valuation anomalies in the market favor growth companies as their growth advantage tends to shine brightest. Second, calls for small caps outperformance need to consider that 40% of small-cap companies have a negative free cash flow margin.[2]

Figure 2: U.S. stocks intra-sectoral valuation spreads

Current readings compared to long-term history percentiles (from 1970 through November 2024).



Source: Empirical Research Partners Analysis. Based on an analysis of a 1,500 stock universe. Framework varies across sectors depending on what's proven efficacious.

Figure 3: Russell 1000® Growth Index price-to-free cash flow ratio relative to Russell 1000® Value Index

Source: FactSet as of 9/30/2024

We believe that value does not have a tactical advantage currently, and remind investors of the secular leadership of large-cap growth stocks enabled by a substantial profitability advantage.

Figure 4: S&P 500® stocks share of free cash flow from technology & interactive media sector

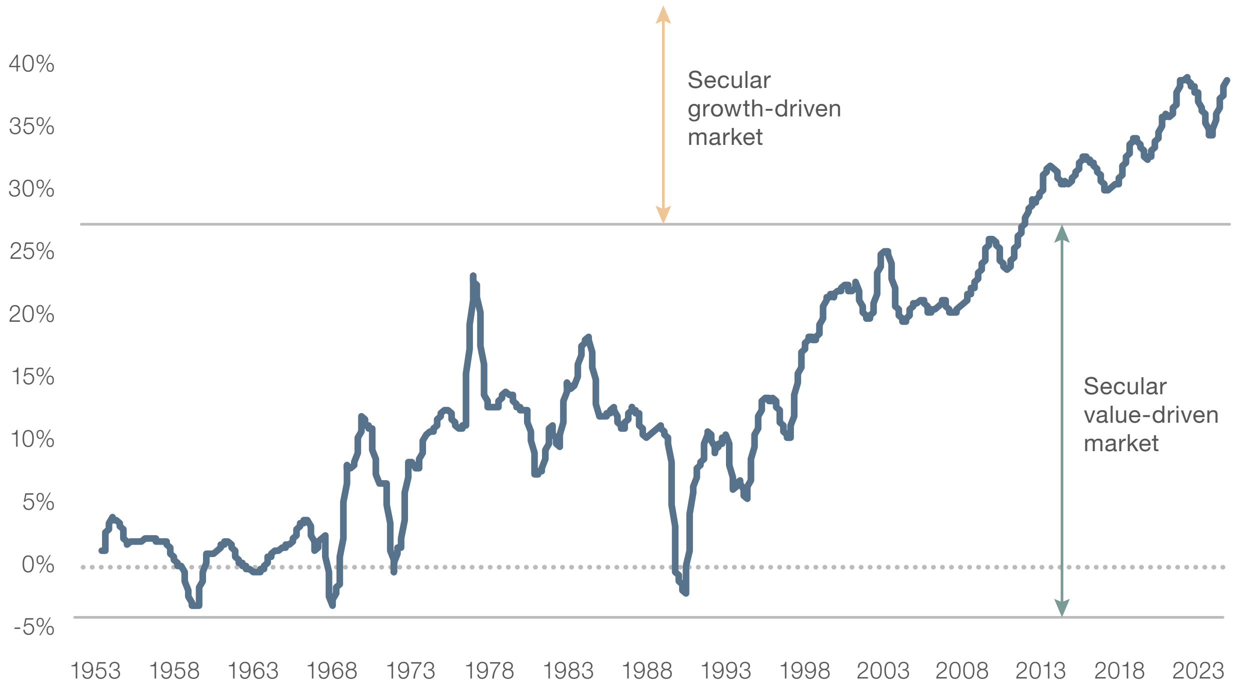


Figure 5: Estimated 3-year forward EPS growth

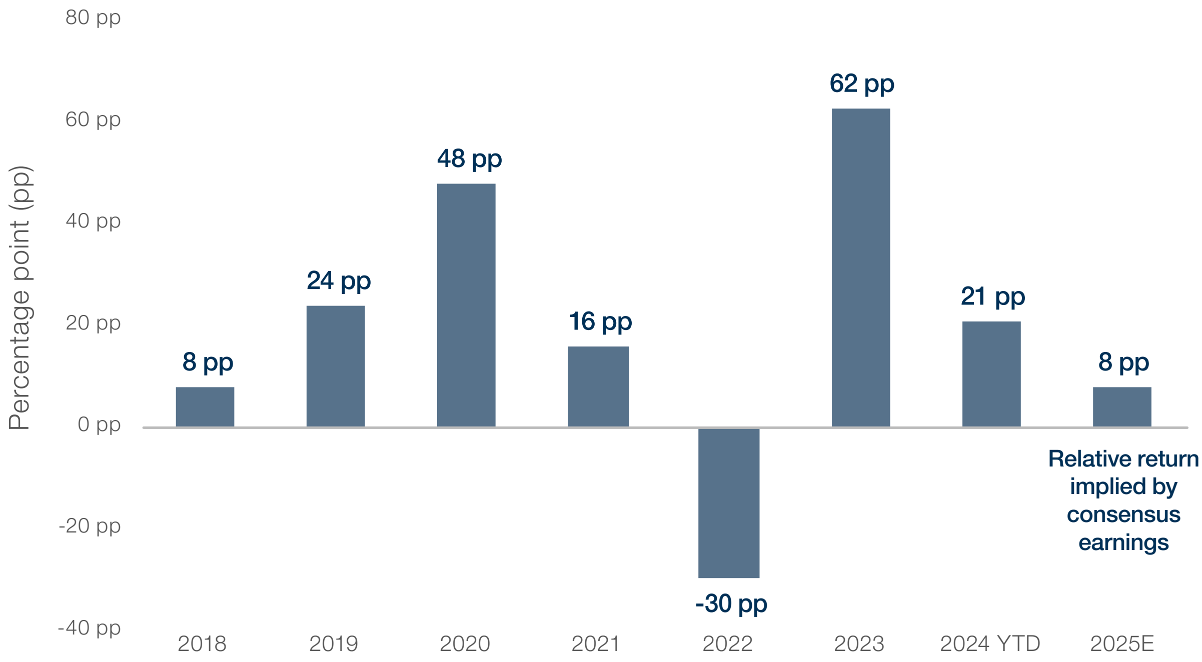
Russell 1000® Growth Index	**16%**
S&P 500® Index	12%
Russell 1000® Value Index	9%

Figure 4 source: Empirical Research Partners, National Bureau of Economic Research, Corporate Reports. Based on trailing four-quarter data; measured as aggregates and smoothed on a trailing six-month basis. Excludes financials and REITs. Data shown for the period January 1953 (start of available data) to August 2024 (most recently available data).

Figure 5 source: FactSet consensus estimates as of 9/30/2024.

Finally, we believe that "Mag 7" fundamentals still look extremely attractive. While the growth premium does look set to compress compared to the rest of the market, there still is a notable premium. In other words, "Mag 7" may not win the game 8-0 but 3-1 would still be a nice win. Perhaps the new Microsoft is... *Microsoft!*

Figure 6: Magnificent 7 vs. S&P 493 relative return



Source: FactSet as of 11/30/2024. Relative performance for calendar years 2018 – 2024 YTD calculated based on actual annualized returns for the Magnificent 7 vs. the S&P 493. 2025E is based on the implied consensus growth rates for the Magnificent 7 vs. the rest of the 493 constituents in the S&P 500. The relative outperformance is based on the EPS growth gap.

In conclusion, we believe that with the dawning of the "profit productivity" era, along with existing large structural advantages for the asset class, large-cap growth looks set to remain very much in style.

1. “Magnificent 7” is defined as the top seven holdings in the Russell 1000® Growth Index as of 12/31/2023: Alphabet, Amazon.com, Apple, Meta, Microsoft, NVIDIA, and Tesla.

2. Source: Empirical Research Partners Analysis as of early-November 2024.

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