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Morning Briefing

On Retailers, Small Caps & AI Powered Brains

Check out the accompanying [chart collection](#).

Executive Summary: Retailers' earnings reports offer a window into recent consumer behavior. Tariff-related uncertainty hasn't slowed consumer discretionary spending and perhaps has buoyed it, but consumers do seem reluctant to make big purchases requiring financing, Jackie reports. ... Also: Small-cap stocks have been outpacing their larger counterparts in recent weeks for the first time in a long while. A look at why. ... And: Brain-computer interfaces, controlled by thought, aren't just the stuff of sci-fi: Sam Altman, Elon Musk, and others have firms working on implantable AI devices that operate alongside human brains. The merging of humans and AI is inevitable, says Altman; but when it happens, will humans retain the upper hand?

Consumer Discretionary: Consumers Keep Shopping. Whether US consumers have been shopping briskly despite their concerns about tariffs' economic impacts or because of their concerns about tariffs' inflationary impacts, shopping briskly is what they did last quarter if TJX's strong Q2 earnings report is any indication. Its earnings imply that Target's poor Q2 showing has more to do with Target than it does with the health of the US consumer.

Meanwhile, high interest rates continue to put a damper on the results of companies whose products rely on financing, particularly in the housing sector. Toll Brothers reduced its full-year home deliveries guidance, Home Depot's earnings were flat, and La-Z-Boy's shares tumbled after it reported a sharp drop in both revenue and earnings.

Here's a look at some of the details behind the TJX and Home Depot headlines:

(1) *Consumers love a bargain.* TJX—parent of TJ Maxx, Marshalls, HomeGoods, and Homesense—sharply increased its current-year EPS forecast to \$4.52-\$4.57, up from its prior target of \$4.34-\$4.43. The retailer reported Q2 sales jumped 6.9% y/y to \$14.4 billion and EPS surged 14.6% to \$1.10. Same-store sales were up 4% in total, rising at each of the company's divisions, domestically and internationally.

“The third quarter is off to a strong start, and I am very confident in our position as we enter the second half of the year,” said CEO Ernie Herman in a [press release](#).

(2) *Spending if borrowing isn't required.* Home Depot sales rose 4.9% y/y in Q2 to \$45.3 billion, and US same-store sales rose 1.4% y/y, improving as the quarter progressed: 0.3% in May, 0.5% in June, and 3.3% in July. Results were helped by improving weather, and sales momentum continued in the first two weeks of Q3.

“[W]e have a very healthy customer, right? Our customer is the homeowner or the Pro that serves that homeowner. They're fully employed. They've seen strong income gains over the past several years. They have seen home price appreciation of 50% since 2019. They're sitting on tappable equity of over \$11 trillion, which is double that they were sitting on in 2019,” observed CFO Richard McPhail on the company's earnings [conference call](#).

That said, Home Depot customers generally engaged in smaller home improvement projects last quarter, avoiding larger projects that often require financing. Customers cited economic uncertainty and high interest rates for deferring large, discretionary projects in Q2. Home Depot's Q2 operating expenses and depreciation grew faster than sales, leaving adjusted EPS at \$4.68, in line with last year's \$4.67. Full-year adjusted EPS are expected to be flat as well.

(3) *Some data.* As US consumers earn more, they tend to spend more. The YRI Earned Income Proxy increased 0.6% m/m in July to a new record as average hourly earnings rose 0.3% during the month, while aggregate weekly hours also climbed 0.3%—with private payroll employment up 0.1% and average workweek up 0.2% ([Fig. 1](#)). Retail sales, excluding gas and food, rose as well, 0.7% m/m in July, with sharp increases in Furniture and Furnishing Stores (1.4%), Sporting Goods, Hobby & Book Stores (0.8), Nonstore Retailers (0.8), and Clothing & Accessories Stores (0.7) ([Fig. 2](#)).

The S&P 500 Retail Composite stock price index—which includes a wide variety of retailers, like Amazon, Best Buy, Home Depot and Ulta—is nearing its previous record high of February 4 and has risen 5.9% ytd through Tuesday's close ([Fig. 3](#)). The index's forward operating EPS are at record levels, no doubt helped by online retailer and cloud provider Amazon ([Fig. 4](#)). Earnings are expected to decelerate from 36.4% growth in 2024 to 12.1% this year and next ([Fig. 5](#)).

Strategy: Small-Cap Revival? Don't look now, but small-capitalization stocks are showing some strength, outpacing their larger counterparts for the first time in years. The S&P

SmallCap 600 Index outperformed the S&P LargeCap 500 on Tuesday (S&P 600 0.12%, S&P 500 -0.58%), on the five trading days ended Tuesday (S&P 600 0.34%, S&P 500 -0.53%), and over the past month (S&P 600 2.72%, S&P 500 1.68%).

While the small-cap index isn't exactly setting the world on fire, even a small outperformance relative to large-cap stocks is a major about-face. Over the past year, large-cap stocks' performance has outpaced that of their smaller counterparts by double digits (S&P 600 1.18%, S&P 500 14.32%), and the same is true over the past three years (S&P 600 10.28%, S&P 500 51.62%) ([Fig. 6](#)).

Let's take a look at the makeup of the S&P 600 and what may be driving the outperformance:

(1) *No Mag-7*. The small-cap index lacks the firepower of the mega-cap Magnificent-7, which has rallied 99.0% over the past three years ([Fig. 7](#)). The Information Technology and Communications Services sectors [contribute](#) 38.8% of the S&P 500's market capitalization, while those sectors [represent](#) only 15.8% of the S&P 600's market capitalization.

The small-cap index is much more reliant on Financials (with a 19.5% capitalization share) and Industrials (19.5%). Over the past three years, the S&P 600's lack of tech stocks has held its performance back. Conversely, the index has benefitted relative to the S&P 500 in recent days and weeks, as many tech stocks have stumbled.

(2) *Recovering earnings and low P/E*. The S&P 600 doesn't have the earnings power of the S&P 500. Over the past three years, the forward earnings of companies in the S&P 500 in aggregate has grown by 21.8%, while the forward earnings of companies in the S&P 600 has declined 8.4% despite turning higher recently ([Fig. 8](#)).

The S&P 600 does have one advantage: It's cheap on a forward P/E basis relative to other indexes. The S&P 600's forward P/E is 15.2, well below the S&P 500's 22.3 ([Fig. 9](#)). The lower multiple can help make small-cap names attractive acquisition targets, especially with a Federal Trade Commission that's more lenient under the Trump administration.

(3) *Who's benefitting?* Some of the index's largest constituents have turned in eye-popping performances this year. The largest company in the S&P 600, Mr. Cooper Group, is a mortgage provider and servicer with stock that's jumped almost 100% ytd. Its shares have been boosted by hopes that mortgage rates will fall and by news in March that it's being acquired by Rocket Mortgage.

The second largest constituent in the S&P 600 is Kratos Defense & Security Solutions. Its shares have also soared, by more than 140% ytd, on optimism that the defense department will focus on purchasing drones like the ones Kratos manufactures.

MP Materials' share price has gained more than 300% ytd, reflecting investors' growing appreciation for the rare earth minerals this company aims to mine and refine in the US. The US government recently took an equity stake in MP and provided additional funding to help the company expand its operations.

Good things can come in small(-cap) packages.

Disruptive Technologies: Musk & Altman Vie for Brain Power. Sam Altman, CEO of OpenAI, and Elon Musk, CEO of Tesla, both are involved with companies that aim to create brain-computer interfaces (BCIs). Altman is the more recent arrival to this sphere. OpenAI is expected to be part of a \$250 million funding round for a new company, Merge Labs, which Altman co-founded with Alex Blania, the *FT* [reported](#) on August 12. Musk's team has been working on Neuralink since 2016.

Both men aim to be at the forefront of exploring the deepening connection between human brains, computers, and artificial intelligence (AI) as they see a not-so-distant future (now?) where computers and robots are smarter than humans. Here's a look at what the two competitors are up to, as well as a dive into Singularity:

(1) *Exploring human-AI integration.* Not much is known about Merge Labs beyond its goal of improving upon existing BCIs and the fundraising reported in the *FT*.

Musk, who co-founded OpenAI and launched his own AI company, xAI, also founded Neuralink, which recently raised \$650 million at a \$9 billion valuation from Sequoia Capital, Thrive Capital, and Vy Capital. Neuralink's BCI has 1,000 electrodes on 64 flexible threads that are implanted into the brain's cortex. The device can capture tons of information because its many electrodes are in close proximity to the brain's electric signals. Neuralink aims to have 20,000 implants by 2031.

(2) *What's BCI really for?* Most articles discuss how BCIs will help individuals who are paralyzed harness computers to communicate or move their limbs. While that's certainly a first step, it may not be the endgame. Before there was a company called "Merge," there was [a blog post](#) titled "The Merge" written by Altman in 2017. It discusses a time between

2025 and 2075 when humans and machines would merge and machines would surpass humans' knowledge, heralding "the Singularity."

"We are already in the phase of co-evolution—the AIs affect, effect, and infect us, and then we improve the AI. We build more computing power and run the AI on it, and it figures out how to build even better chips. This probably cannot be stopped. As we have learned, scientific advancement eventually happens if the laws of physics do not prevent it," Altman wrote in the blog.

And then it gets creepy. He writes: "[U]nless we destroy ourselves first, superhuman AI is going to happen, genetic enhancement is going to happen, and brain-machine interfaces are going to happen. ... The merge can take a lot of forms: We could plug electrodes into our brains, or we could all just become really close friends with a chatbot. But I think a merge is probably our best-case scenario.

"If two different species both want the same thing and only one can have it—in this case, to be the dominant species on the planet and beyond—they are going to have conflict. We should all want one team where all members care about the well-being of everyone else. ... We will be the first species ever to design our own descendants. My guess is that we can either be the biological bootloader for digital intelligence and then fade into an evolutionary tree branch, or we can figure out what a successful merge looks like."

Over the years, Musk has also discussed AI becoming more intelligent than humans, warned of its dangers, and discussed the benefit of having humans with a Neuralink tapping into the intelligence of AI on computers to [expand human potential](#) and give us a fighting chance to remain dominant in a world filled with AI-infused machines.

So while we've been focused on humans using BCIs to tell machines what to do, it's also highly likely that Musk and Altman are interested in seeing what happens when a computer tells a human what to do. In other words: Will humans with BCIs simply tap into the AI that resides on computers, remaining in control—and the dominant "species"? Or will AI-enabled computers tap into humans to control their minds and actions, wresting control over humans? That's certainly the stuff of nightmares.

(3) *A brain operating system.* Altman and Musk aren't alone. Blackrock Neurotech has put its BCI in more than 40 patients since 2004 with the goal of helping aims to help folks walk, talk, hear, see, and feel again. The company has raised capital from Peter Thiel and cryptocurrency company Tether. Tether's \$200 million investment makes it Blackrock

Neurotech's majority stakeholder.

Tether CEO Paolo Ardoino believes Blackrock Neurotech is much more advanced than Neuralink, a June 25 [article](#) in The Block reported. He sees Blackrock developing an open-source "brain operating system," which over the next 15-30 years will become the next smartphone.

"It will be one of the most important technologies for the survival of humanity in the future. Because when AI and robotics become so advanced, I believe that humans will need a mathematical co-processor in their brains to remain relevant and compete with artificial intelligence and robots," Ardiono [told](#) CNBC on June 4.

Calendars

US: Thurs: Leading Indicators -0.1%; Initial Claims 227k; Philadelphia Fed Manufacturing Index 5.9; Existing Home Sales 3.92mu; S&P Global M-PMI & NM-PMI 40.9 & 53.3; Bostic.
Fri: Fed Chair Powell speaks from Jackson Hole. (Source: FX Street)

Global: Thurs: Eurozone, Germany & France HBOC M-PMIs 49.6, 48.8 & 48.5; Eurozone, Germany & France NM-PMI 50.8, 50.5 & 48.6; Eurozone Consumer Confidence -15.0; UK M-PMI & NM-PMI 48.2 & 51.9; UK Gfk Consumer Confidence -19; Buba Monthly Report.
Fri: Germany GDP -0.1%q/q, 0.4%y/y; France Business Climate Index Manufacturing 96. (Source: FX Street)

Strategy Indicators

S&P 500 Earnings, Revenues, Valuation & Margins ([link](#)): During the August 14 week, the S&P 500's forward revenues jumped 0.2% w/w to its third straight record high. Forward earnings rose 0.1% to a new record high too. The forward profit margin was steady w/w at a record high of 13.8% and is now 3.7ppts above its seven-year low of 10.3% during April 2020. The consensus expectations for forward revenues growth was steady w/w at a 35-month high of 6.0%. It has gained 3.7ppts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast was steady w/w at a

19-week high of 12.3%, up 1.4ppts from its 15-month low of 10.9% during the May 29 week. From a longer-term perspective, that's a bit stronger than its 20-year average of 11.4% and slowing from a 38-month high of 14.3% during the December 12 week. That's also down from its 23.9% reading at the end of April 2021, which was boosted by the recovery from the pandemic to its highest reading since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 5.4% in 2025 (unchanged w/w) and 6.1% in 2026 (unchanged w/w), compared to a 4.9% rise in 2024. They expect an earnings gain of 10.8% in 2025 (up 0.1ppt w/w) and a 13.2% rise in 2025 (down 0.1ppt w/w) compared to 2024's earnings gain of 11.3%. Analysts expect the profit margin to rise 0.6ppt y/y to 13.1% in 2025 (unchanged w/w) and 0.9ppt y/y in 2026 to 14.0% (unchanged w/w), compared to 2024's 12.5%. Looking at valuation data as of August 7, the S&P 500's weekly forward P/E rose 0.4pt w/w to a 55-month high of 22.5, and is up 3.3pts from its 16-month low of 19.2 during the April 17 week. It's now 7.2pts above its 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio rose 0.06pt w/w to a new record high of 3.10. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Revenues, Earnings, & Margins ([link](#)): During the August 14 week, forward revenues rose for eight of the 11 S&P 500 sectors, and five sectors posted gains in their forward earnings. These six sectors had record-high forward revenues this week: Communication Services, Consumer Discretionary, Consumer Staples, Industrials, Information Technology, and Real Estate. Also close to record-high forward revenues are these three sectors: Financials, Health Care, and Utilities. Energy's remains depressed at 29.7% below its September 2008 record. Materials' has improved to a 12-month high to 4.2% below its June 2022 record high. These four sectors had record-high forward earnings this week: Communication Services, Financials, Information Technology, and Utilities. Health Care remains 2.3% below its April 3 record, and these three sectors are 1% or less below their recent record highs: Consumer Discretionary, Consumer Staples, Industrials, and Real Estate. Forward earnings remains depressed for the last two sectors, Energy and Materials, but have improved in recent months to 39.4% and 23.7% below their respective highs during 2022. Looking at the forward profit margin, one sector rose w/w, and three fell. These two sectors were at record highs: Financials and Information Technology. These four sectors remain close: Communication Services, Consumer Discretionary, Industrials, and Utilities. Energy and Materials are improving somewhat from their recent multi-year lows, but these two sectors are at or barely above cyclical or record lows: Consumer Staples and Health Care. Here's how the S&P 500 and its 11 sectors rank based on their current

forward profit margin forecasts along with their record highs: Information Technology (27.7%, at a record high for a second week and for the first time since September, prior to low-margin Dell's addition to the index, which lowered the margin 1.3ppts then to 26.3%), Financials (20.8, up 0.1ppt w/w to a new record high), Communication Services (19.4, down 0.4ppt w/w from its 19.8 record high), Real Estate (16.7, at a five-month high and down from its 19.2 record high in 2016), Utilities (14.7, 0.1ppt below its 41-month high during the July 10 week and 0.4ppt below its April 2021 record high), S&P 500 (13.8, up 0.1pt w/w to a new record high), Materials (10.7, down 0.1ppt from a 27-week high and up 0.3ppt from 51-month low in late February and down from a 20-month high of 11.6 in July 2023 and a 13.6 record high in June 2022), Consumer Discretionary (9.3, down from a record high 9.4 in early April), Energy (8.8, down 0.1ppt w/w and up 0.3ppt from a 55-month low of 8.5 during the during the May 15 week and down from its 12.8 record high in November 2022), Industrials (11.2, down from its 11.3 record high in early January), Health Care (8.1, at a record low and down from its 11.5 record high in February 2022), and Consumer Staples (6.7, a 21-month low and down from its 7.7 record high in June 2020).

Global Economic Indicators

Eurozone CPI ([link](#)): The *Eurozone's CPI* was unchanged at 2.0% y/y in July, after inching up from 1.9% in May; it was at 2.5% at the start of this year. The rate was at 1.7% last September—which was the lowest yearly rate since April 2021. Meanwhile, the core rate eased from 2.7% in April to 2.3% in May—and remained there through July. The headline and core CPIs are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. *Looking at the components*, the *services* rate eased from 4.0% in April to 3.2% by July—hovering between 3.2% and 3.3% since May. The rate for energy prices was at -2.4% y/y in July, narrowing from -3.6% in both April and May; it had climbed from a recent low of -6.1% last September to 1.9% by January. Meanwhile, the rate for *food, alcohol & tobacco* continues to move above 3.0%, from 2.7% in February to 3.3% by July. The rate for *non-energy industrial goods* accelerated 0.8% y/y in July after fluctuating in a narrow band between 0.5% and 0.6% since last October. July's yearly inflation rate moved higher in only one of the four *largest Eurozone countries*. Spain's rate (to 2.7% from 2.3%) moved higher, while the rates in both Germany (1.8 from 2.0) and Italy (1.7 from 1.8) eased, while France's was unchanged at 0.9%.

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