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Pending Mega IPOs Could Curb Passive Positive Feedback Loop

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Key Takeaways

- ▶ Feedback, whether positive or negative, is arguably the main engine that drives markets in the long cycle arc between fear and greed and gives dimension to the structural changes constantly shaping markets.
- ▶ Steady inelastic buying by passive investment vehicles is causing positive feedback to become so dominant there is not enough liquidity from negative feedback to absorb volatility — this could ultimately lead to the market no longer functioning effectively.
- ▶ Fortunately, two new sources of negative feedback are emerging: the disappearance of net share buybacks as free cash flow is increasingly being absorbed by AI capital spending, and the pending mega IPOs of SpaceX, Anthropic and OpenAI.

Passive Buying Fueling an Equity Market Megafire

One of the most important lenses we apply in studying financial markets on a systems level is feedback. Feedback is, arguably, the main engine that drives markets in the long cycle arc between fear and greed. However, feedback also helps dimension the structural changes that are constantly shaping markets — something that we as active managers must continually adapt to. Feedback can ultimately take two forms: positive feedback amplifies moves and can push markets to extreme divergences; negative feedback, on the other hand, we see as a stabilizing force that prevents extreme moves and keeps markets in a sustainable range. However, there is one important caveat: delayed negative feedback can be very destabilizing when a system is pushed to extreme levels and feedback reverses.

The early years of our investment careers were defined by active value managers, with a collective belief built on mean reversion around value. This, naturally, created negative feedback as market prices often stayed anchored to a shared belief around underlying value. However, we believe that the nature of feedback has changed over the past few decades. This has created material changes in markets and resulted in a career-defining moment for active managers like us. We have seen this active negative feedback continually eroded by the emergence of increasingly powerful positive feedback from inelastic passive buying. With active consistently losing 2% to 3% annually to passive, passive investing captured the dominant share of invested assets in 2024.

We believe that much of this growth in the power of positive feedback can be explained by the Inelastic Market Hypothesis (IMH) — which suggests that for every \$1 invested in the market, the aggregate market capitalization increases by \$5. Michael Green, Chief Market Strategist at Simplify, and whose presentation we attended in the fall of 2025, argues that the IMH is a growing risk to the functioning of capital markets and

that this multiplier has increased to at least 8x. If the hypothesis is true, this will continue to increase until markets reach an unsustainable extreme.

This critical level is estimated to be 65% passive share of U.S. equity AUM — a level which, by several estimates, is only two to four years away. At 65% passive, there is no longer enough active capital to absorb the volatility that emerges from increasingly dominant passive flows, and we risk a cascading market collapse. Basically, positive feedback becomes so dominant that there is not enough liquidity from negative feedback to absorb volatility, and the market quits functioning effectively. As a result, the delayed negative feedback, which we warned about, feeds on itself and creates intense pressure weighing on markets.

A similarly destructive example of these dynamics was the U.S. Forest Service's policy of aggressively extinguishing small wildfires, which allowed large parts of forests to build up dry and highly flammable detritus. The unforeseen consequence could be seen from space — larger, more destructive (albeit less frequent) fires that have caused tremendous devastation across the Western U.S. over the last few years. The determinant for whether a fire remained a localized response or a multi-state emergency can be attributed to one simple variable: a spark in the wrong place. The similarities are striking — a policy that traded a series of smaller, uncorrelated events for large, concentrated events that fed on itself. Too much passive investing is building up fuel in market systems that used to clear more regularly from active negative feedback. When regular volatility can no longer be cleared easily, we run the risk of a megafire in markets.

Fortunately, we may not have to test this critical market threshold, as two new sources of negative feedback are emerging: first, the disappearance of net share buybacks as free cash flow is increasingly being absorbed by AI capital spending, and second, the pending mega IPOs of SpaceX, Anthropic and OpenAI.

Prior to this year the U.S. equity market had been consistently and increasingly "de-equitizing" — effectively shrinking across two important dimensions. The first is that the actual number of listed companies has dropped by over 50% over the last two decades, and the second being that net share issuance was negative over the last few years as companies bought back more equity than they issued, to the tune of over \$100 billion over 2024 and 2025.

On the new equity supply side, things are also about to shift dramatically. This week SpaceX expects to raise \$75 billion in the largest IPO in history, while Anthropic and OpenAI have filed to raise an estimated minimum of \$25 billion in each of their IPOs tentatively scheduled for the fall. In addition, Alphabet unexpectedly raised \$80 billion in new capital last week, which will very likely be followed by more large equity raises from competing hyperscalers as the ante of the AI high-stakes poker game rises.

This combined change in equity capital flows is dramatic. We estimate that the combined net swing in equity supply in 2026 will range from \$300 to \$500 billion, or possibly even more. Using the previously mentioned IMH multiplier of 5x, the resulting negative feedback on market cap would be \$1.5 to \$2.5 trillion, or 2% to 4% of total U.S. equity market cap. This may not seem like much, but the last big IPO year of 2021 was followed by a less than stellar return year in 2022. In addition, in an April podcast of *Invest Like the Best* with Patrick O'Shaughnessy¹, famed investor Paul Tudor Jones mentioned that his call on the 1987 crash was partly precipitated by a flood of new equity issuance. When lockups from that year's IPOs hit the market with new supply, portfolio insurance created a dramatic example of a violent reversal in feedback.

Not surprisingly, the new IPOs are coinciding with changes in index inclusion, which have been relaxed to allow much earlier entry. The explicit motivation here seems to fully capture the increase in share price as passive strategies mechanically buy up the shares. This takes the greater fool dynamic to a whole new level and creates the risk that the market will one day soon only include fools tied to passive flows. This may be a big test of the fools, who seem largely blind to this potential risk given recent speculative buying fervor.

¹ O'Shaughnessy, P., & Tudor Jones, P. (n.d.). *Invest Like the Best with Patrick O'Shaughnessy - Lessons From 50 Years in Markets*. Colossus. <https://podcasts.apple.com/us/podcast/paul-tudor-jones-lessons-from-50-years-in-markets/id1154105909?i=1000763993727>

To be perfectly clear, we are not forecasting an equity market crash. However, we are observing this change in feedback dynamics very carefully, and we expect the one-way momentum market we have experienced so far in 2026 to face some real tests over the coming months.

Finding Opportunity in the Shift

Our first priority is positioning ourselves to minimize direct exposure if IMH feedback dynamics result in selling pressure. We are actively positioned with a smaller size bet than our benchmark. While the primary reason for this is that we continue to find more absolute value opportunities down the market cap spectrum, it is doubly advantageous as the IMH is directly correlated with size and is most pronounced at the top of indexes. This helps balance this risk, especially if capital flows become more dispersed.

Additionally, these massive capital raises also clearly signal the desire for massive increases in capital-intensive compute capacity. Solving the AI compute bottleneck is arguably the dominant driver of current markets, and we have benefited by investing in stocks like Micron Technology, where AI demand triggered acute shortages and resulted in massive price increases. We think the dynamic of rolling AI-investment-driven shortages will continue, but also that it will evolve to include areas that lower burgeoning AI usage costs. This includes areas like software where legacy programs are tied to AI, rather than being replicated by the new models. This helps explain our recent purchase of Microsoft, as attaching existing office licenses to AI functionality may be a catalyst to drive further usage.

We continue to own some of the hyperscalers given they own the compute that AI so desperately needs. However, we are sticking with the best capitalized and vertically integrated players, like Alphabet. We did not love seeing the capital raise, even though the 2% dilution was minimal. However, like Berkshire Hathaway, we think Alphabet is in the strongest position to win the AI capital war.

In general, though, we believe that the most attractive long-term investment opportunities remain where capital investment remains disciplined: real assets, and particularly in energy, given the continued closure of the Strait of Hormuz. The demand for real assets continues to increase, driven by the AI buildout, securing local supply against geopolitical risks, and material (no pun intended) demand for global infrastructure. Even if an agreement is reached and the Strait reopened, a huge new demand for capital will emerge as the Middle East rebuilds. All these factors will put upward pressure on inflation — another large risk factor that is seemingly being ignored by equity markets near all-time highs. We have been adding to these areas, and our combined position in energy and materials remains the portfolio's largest active bet.

We think that energy is particularly attractive right now given its great upside convexity, or risk/reward. Generally, energy stocks have high single- to low-double-digit free cash flow yields, as their free cash flow has been greatly enhanced by higher oil prices. Despite the ongoing crisis and dramatic reductions in global oil inventories, stocks are discounting roughly \$70 long-term oil prices. Current spot prices of roughly \$100 reflect commercial inventories, but these inventories will likely continue to drain over the summer to levels that support much higher oil prices.

This upside risk is not incorporated in current equity prices, and we think it is a very important risk hedge for all portfolios. Not only is the higher oil price risk being ignored, but sentiment around oil is also incredibly negative — something that we welcome given that our definition of edge is having a different set of probabilities than consensus. We think consensus is very contrary to current supply and inventory facts, which is something we try to avoid at all costs. Incidentally, the last time oil sentiment was this negative was during COVID, which proved a great time to invest in oil and energy stocks.

We are currently observing a lot of changes that the market seems to be ignoring. Perhaps this bliss in the presence of change simply reflects the increasingly inelastic and willfully blind nature of markets in a world dominated by passive investing. Nevertheless, we believe that some big challenges await investors over the coming months.

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