



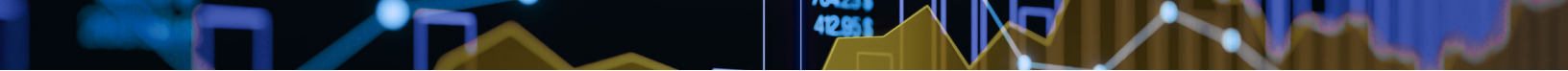
MARKET UPDATE

Economic Market Update - Third Quarter, 2026

October, 2026

Our Key Perspectives for Investors

- **Our base case is “resilient but restrictive.”** The U.S. economy is growing near trend and faster than almost any other developed economy. That strength is also keeping inflation and interest rates higher for longer. We expect growth to hold, inflation to remain elevated for an extended period, and a Federal Reserve more focused on the inflation side of the dual mandate and thus willing to err on the side of a monetary policy stance that is too tight rather than too loose.
- **Inflation likely has not peaked.** Headline CPI is running at 3.4% and core PCE is at 3.0%. Diesel prices, which recently hit a record high, usually reach food and goods prices several months later. A tightening rental market could also push shelter costs up in the second half of 2027. The Fed itself does not expect to reach its 2% target until 2029.
- **The Fed raised rates and said less about what comes next.** The September 16 increase to 3.75%–4.00% was the first since 2023. We believe the Fed will raise rates at least once more before year-end, followed by a hold with the potential for additional hikes in 2027. Chair Warsh has dropped forward guidance, so investors should expect more volatility around each meeting.
- **A 5% 10-year Treasury may be closer to normal than extreme.** Heavy AI-related borrowing and increased geopolitical uncertainty have contributed to the higher premium investors demand to hold long bonds. We think a 10-year yield between 3% and 5% (with occasional drifts outside of that range) should be treated as normal.
- **Earnings are healthy, but less dramatic than the headline suggests.** S&P 500 earnings rose more than 48% in the second quarter. Without one-time gains on private stakes such as Anthropic and SpaceX, growth was closer to 29%. The index’s earnings yield premium relative to the real 10-year Treasury yield has fallen, so future returns will likely need to come from earnings rather than rising valuations. For these reasons, we favor a blend of active and passive exposure and remain cautious on unprofitable small caps.
- **Index diversification is thinner than it looks.** AI is now the main driver of risk in the S&P 500, where the ten largest companies make up about 40% of the index. It also drives mid-cap growth and emerging markets, where three chipmakers account for roughly 30% of the benchmark. Owning more indices does not by itself spread the bet.
- **Bonds are doing their job again.** Starting yields near 5% may improve the ability of high-quality fixed income to provide income and diversification benefits. Given the inflation environment, a modest allocation to TIPS may make sense for some investors, and we favor selectivity in credit and managers with the flexibility to allocate internationally.



Two sets of economic indicators characterize the U.S. economy this autumn, presenting a mixed picture. In the first picture, which is painted by the soft data, Americans say they have rarely felt worse. The Conference Board's preliminary September reading of consumer sentiment fell to 81.9, below the depths of both the COVID crisis and the 2022 inflation spike. The hard data, meanwhile, paints a picture of an economy running hot. Manufacturing and services surveys are firmly in expansion, and S&P Global's composite PMI just reached its highest level in more than five years. Private household and business spending grew at a 4.2% annualized pace in the second quarter. People say they feel terrible, but they are spending as though they feel fine.

Both sets of numbers are telling the truth. Wealthier households, carried by stock portfolios and home equity, keep spending. Families who spend a larger share of each paycheck on gasoline, groceries, and rent feel every price increase directly. And the energy shock driven by geopolitical developments in the Middle East and Eastern Europe has made that pain worse. Diesel, the fuel that moves nearly everything Americans buy, recently set a record, rising above \$6.50 a gallon. On September 16, the Federal Reserve raised interest rates for the first time since 2023 in response to stubbornly sticky inflation. By month's end, the 10-year Treasury yield rose above 5.2%, its highest level since 2007.

That 2007 date is worth pausing on. Anyone who has entered the investment business since then had built their assumptions on a world where safe bonds paid little, inflation stayed near 2%, and the Fed stood ready to cut at the first sign of trouble. Each of those assumptions is now open to question. We see the current environment less as an aberration than as a return to an older set of rules many forgot in the years since the Global Financial Crisis. Under those rules, capital carries a real cost, inflation becomes a meaningful constraint, and markets become pickier about which companies deserve funding.

The pages that follow work through what that means. Inflation looks likely to stay sticky for longer than markets would like. This summer's diesel spike is only beginning to reach goods prices, and a shrinking pipeline of new apartments at a time when higher mortgage rates are making homeownership less attainable could create a shelter problem in 2027. The Fed Chair has stopped offering forward guidance, which puts more weight on each decision and on the data behind it. The AI build-out, the largest single engine of U.S. growth this year, is shifting from cash-funded to debt-funded. That makes it more sensitive to the very higher rates it is helping to create. Corporate earnings, while strong, were enhanced in the second quarter by paper gains that could just as easily reverse.

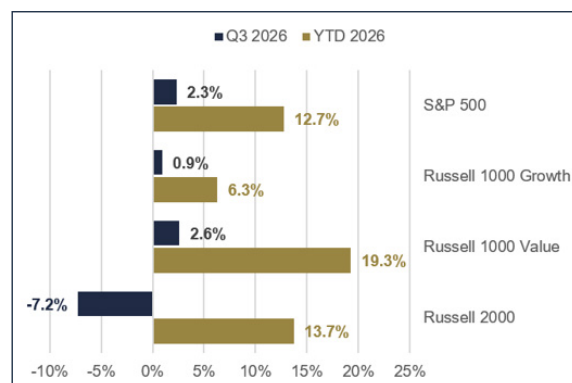
There is good news here too. High-quality bonds pay enough to do real work in a portfolio, both as a source of income and as a cushion if growth disappoints. Profitable companies with pricing power are better positioned than the market's recent enthusiasm for speculative names would suggest. A 5% yield on a 10-year Treasury note is a headwind for stock valuations. It is also, quite simply, a 5% yield, which makes the returns in the safest part of the bond market more competitive than they've been in nearly two decades.

Q3 2026 MARKET PERFORMANCE

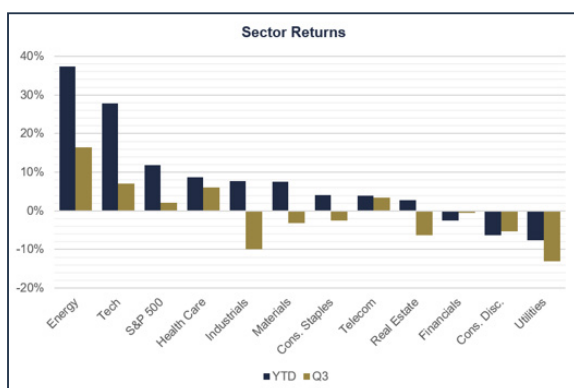
U.S. Equity

U.S. stocks spent the third quarter treading water, with large-cap indices grinding out modest gains while a sharp rise in interest rates did most of its damage below the surface. The S&P 500, the bellwether for U.S. stock returns, finished the third quarter up 2.3%, pushing the index's year-to-date gain to 12.7%. After a 15.2% surge in the second quarter, a pause was not unreasonable, but the path was uneven. The quarter opened with a July pullback as oil prices and bond yields climbed together. Strong technology earnings and a soft inflation report sparked an early-August rally that carried the index to a series of record highs, and the rally then stalled from mid-August onward as the 10-year Treasury yield pushed through 5% and the Federal Reserve raised rates for the first time since 2023. The index's gain, however, was not representative of the typical stock. Roughly three-quarters of S&P 500 constituents declined in September, with Apple, Nvidia, Alphabet, Microsoft and Meta Platforms doing much of the heavy lifting.

Small-cap stocks bore the brunt of the rate move. The Russell 2000 fell 7.2% in Q3, snapping a streak of five consecutive positive quarters and trailing the S&P 500 by 9.5 percentage points, its widest quarterly shortfall since 2020. Small caps still hold a slight lead on the year, with the Russell 2000 up 13.7% YTD against 12.7% for the S&P 500, a cushion built almost entirely during a 21.5% second quarter. The mechanism is not complicated. Many Russell 2000 companies carry floating-rate debt, so a Fed that shifted from expected cuts to an actual hike quickly changed the math on their interest expense, and investors responded; the iShares Russell 2000 ETF recorded \$3.3 billion in outflows in a single week in late September. Mid caps landed in between, with the Russell Mid Cap Index down 3.0% for the quarter and up 11.8% YTD.



Style returns told two different stories depending on which index family one consults. Within the Russell 1000, value edged out growth for the quarter, with the Russell 1000 Growth Index up 0.9% against 2.6% for the Russell 1000 Value Index, and value has been the better place to be all year: large value is up 19.3% YTD while large growth is up just 6.3%. The S&P style indices read the opposite way in Q3, with S&P 500 Growth up 3.4% and S&P 500 Value up 0.9%. The difference comes down to construction. The S&P Growth index is more concentrated in a handful of megacap platforms that regained momentum during the quarter as investors, questioning the sustainability of AI spending, rotated away from data center hardware suppliers and back toward the companies doing the buying. Chip and memory stocks, the clear winners of the first half, were among the hardest hit.



Digging beneath the surface of the Russell style box, the pattern was consistent. Value beat growth at every capitalization, and only the three large-cap boxes finished the quarter in positive territory. Small-cap growth fared worst, down 9.4% in Q3, though it remains up 10.7% for the year, while mid-cap growth has been the weakest corner of the grid all year, up only 1.0% YTD after a 5.8% third-quarter decline. At the sector level, rate sensitivity was the dividing line. Financials were the worst-performing sector in September, falling more than 6% as higher yields raised funding costs and clouded the outlook for loan demand. Energy, meanwhile, continued to benefit from an oil market that has yet to normalize. Shipping through the Strait of Hormuz remained well below pre-war levels for much of the quarter,

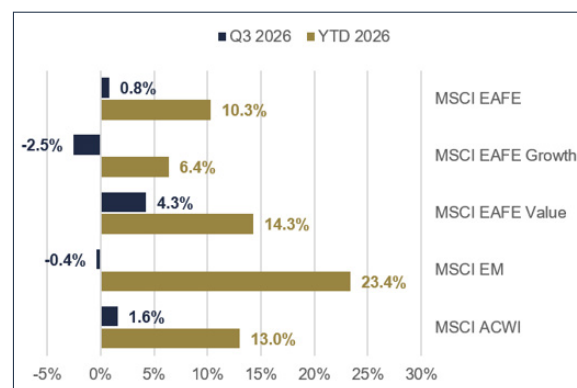
Brent crude traded back above \$100 per barrel, and the Bloomberg Commodity Index gained 16.2% in Q3, lifting its YTD return to 32.9%.

International Equity

International developed markets held up better than U.S. small and mid caps in the third quarter, but U.S. large caps have now reclaimed the lead on the year. The MSCI EAFE Index, which tracks developed international markets, gained 0.8% in Q3 and is now up 10.3% YTD, behind the S&P 500's 12.7%. Currency was a minor factor during the quarter, with EAFE up 0.6% in local currency terms, but it has been a meaningful one for the year. In local currency the index is up 12.4% YTD, so dollar strength, most of it concentrated in the first quarter, has cost U.S.-based investors roughly two percentage points. The value tilt that has characterized international markets reasserted itself. The MSCI EAFE Growth Index fell 2.5% in Q3 and is up 6.4% YTD, while the MSCI EAFE Value Index gained 4.3% for the quarter and 14.3% YTD, a gap of nearly eight percentage points on the year. International small caps fared far better than their U.S. counterparts, with the MSCI EAFE Small Cap Index up 2.9% in Q3 and 10.8% YTD. Europe was the soft spot. The MSCI Europe Index fell 1.6% in Q3 and is up only 6.0% for the year, as energy costs tied to the Hormuz disruption continued to weigh on the region's industrial base.

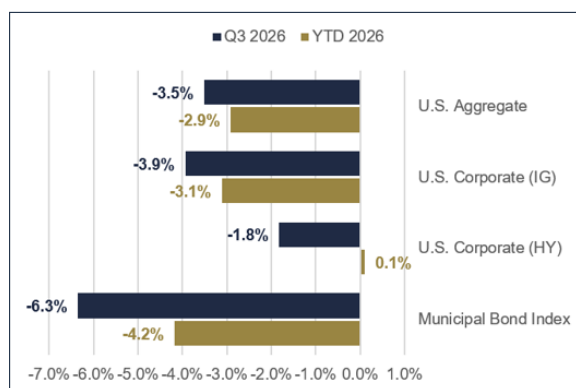
Emerging markets remain the leaders for the year, but the headline hides dispersion that is extreme even by emerging-market standards. The MSCI Emerging Markets Index slipped 0.4% in Q3 and is up 23.4% YTD. Digging beneath the surface reveals that a single country accounts for much of that gain. South Korean stocks, where Samsung Electronics and SK Hynix make up close to half of the market, are up 97.7% YTD on the strength of AI-driven memory demand, yet they fell 9.6% in Q3 as chip stocks sold off globally and competition from Chinese chipmakers intensified. Outside of Korea, the picture is far less positive. Indian stocks are down 14.9% YTD after a further 5.6% decline in Q3, pressured by heavy foreign outflows and concerns about AI disruption to the country's technology services sector.

Chinese stocks rose 3.7% in Q3 but remain down 11.9% on the year. Closer to home, Brazil was the standout among major emerging markets, up 8.2% in Q3 and 18.2% YTD, with its role as a commodity exporter likely helping, while Mexico fell 5.0% for the quarter and is up 5.3% for the year. Summing up the global stock market in Q3, the MSCI All Country World Index, which tracks the global stock market, was up 1.6% and is now up 13.0% on the year.



Fixed Income

The third quarter was the most difficult stretch for bond investors since 2022, as sticky inflation, elevated oil prices, heavy Treasury issuance and the Federal Reserve's first rate hike in three years pushed yields to their highest levels in nearly two decades. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed-income markets in the U.S., fell 3.5% in Q3, its weakest quarter since the third quarter of 2022, and is now down 2.9% YTD. The 10-year Treasury yield crossed 5% in mid-September for the first time since 2007 and finished the quarter near 5.3%. Duration was the most significant detractor from performance. The Bloomberg U.S. Treasury 20+ Year Index fell 8.9% in Q3 and is down 8.3% YTD, while the Bloomberg U.S. Intermediate Government/Credit Index fell a more manageable 1.9% for the quarter and is down 1.5% YTD.



Investment-grade credit, as measured by the Bloomberg U.S. Credit Index, fell 3.8% in Q3 and is down 3.0% YTD. High yield again proved more resilient than its reputation, with the Bloomberg U.S. Corporate High Yield Index down 1.8% in Q3 and essentially flat for the year at 0.1%, as higher coupons and shorter duration absorbed much of the rate move. Municipal bonds, a bright spot in Q2, gave those gains back and then some. The Bloomberg Municipal Index fell 6.3% in Q3, a decline comparable to the first quarter of 2022, and is down 4.2% YTD, while the Bloomberg High Yield Municipal Index fell 5.5% and is down 1.7% for the year. Cash, now earning close to the new policy rate, was one of the few corners of fixed income to hold its value.

International bonds fell less than their domestic counterparts, helped by a slightly softer dollar during the quarter; the Bloomberg Global Aggregate ex-USD Index declined 1.6% in Q3 and is down 2.5% YTD.

What is the bond market pricing? Our sense is that it reflects two things: a Fed that intends to finish the job on inflation before it turns back to supporting growth, and a larger premium for holding long-dated Treasuries against a heavy issuance calendar and a national debt that crossed \$40 trillion this year. The losses are real, but so is the offset. Starting yields this high provide income that was unavailable for most of the last 15 years and a wider cushion against further rate increases than investors have had in some time. **Summing up global fixed income markets in Q3, the Bloomberg Global Aggregate Index fell 2.5% for the quarter and is now down 2.7% for the year through September.**

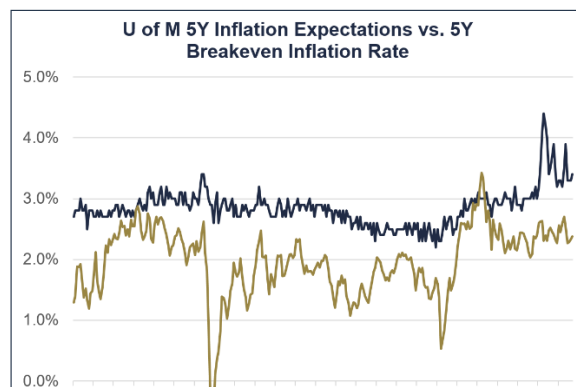
ECONOMIC OUTLOOK

The U.S. economy enters the final quarter of 2026 in an unusual position. It is growing faster than almost any other developed economy, but inflation refuses to settle, and interest rates have moved meaningfully higher.

Inflation: Stickier Than Hoped

Inflation has proved more stubborn than most forecasters expected at the start of the year, and the reasons have shifted over time. But the core point is clear: price pressures remain broad and sticky, and the most important question is how long they stay that way. Headline CPI rose 0.4% (4.9% annualized) in August and 3.4% from a year earlier, with gasoline alone accounting for more than a third of the monthly increase. The Fed's preferred gauge, core PCE, was running at 3.3% year over year in July, unchanged from June, and Chair Warsh put the August figure near 3.2%. More telling than any single print is how widespread the pressure has become. "Too many categories are still posting increases above 3 percent," Warsh observed at his September press conference. So-called "supercore" services inflation, which excludes housing and energy and tracks wages most closely, rose 0.36% (4.4% annualized) in August after 0.07% (0.8% annualized) in July. "Supercore" services inflation between 2.5%-3.0% annualized would be consistent with the Fed's target, as services inflation tends to run slightly hotter when PCE is at 2.0%, so the August spike is material.

The Fed's own projections reinforce that message. Policymakers now expect core PCE to end 2026 at 3.4%, up from 3.3% in their June projections, and do not expect inflation to reach the 2% target until 2029. That would mean the better part of a decade above target. The OECD's interim outlook, released on September 23, projects U.S. headline inflation of 3.6% this year and core inflation of 3.3%, among the highest in the developed world. Consumers have noticed. Year-ahead inflation expectations in the Michigan survey rose to 4.6% in September from 4.0% in August, and five-year expectations edged up to 3.4%. The message is that inflation remains elevated not just in the data, but in consumer expectations as well. In light of how consumers are feeling about future inflation, it is worth noting that market-implied inflation breakeven rates have remained anchored, which suggests investors continue to believe the Fed will credibly be able to tame inflation.



Our view is that inflation is less likely to spiral than to settle at an uncomfortably high level for longer than markets would like. The key point is that not all stickiness is equal. Part of it stems from the energy shock, which should fade as base effects roll off in 2027. Tariffs, which typically result in a one-time price shift, play a role too. Additional tariff pass-throughs will likely contribute to higher inflation in Q1 2027 as firms reset prices for the new year. But part of it is more durable: a hot economy, firm services pricing, and, as discussed below, a housing market that may be quietly setting up the next leg of shelter inflation. The distinction matters because the Fed can look through the first but not the second.

The Federal Reserve: Fewer Words, More Action

On September 16, the Federal Open Market Committee raised the federal funds rate by 25 basis points to a range of 3.75% to 4.00%. The vote was unanimous, a notable shift from July's 9-3 decision to hold. The statement was brief and direct: "Inflation remains elevated. Today's policy action will support a timelier return to the Committee's 2 percent goal." Sixteen of the eighteen participants who submitted projections expect at least one more increase before year-end, and none expect a cut. The Fed is acting because inflation is still not behaving as desired.

The more consequential change is in how the Fed Chair communicates. Since his first meeting as Chair in June, Kevin Warsh has removed forward guidance from the policy statement, cut the statement to less than half its former length, and declined to submit his own projection to the dot plot. “I’m not in the forward guidance business,” he said in September. He argued that guidance was “not well suited to the current policy conjuncture” and that pre-committing to a path limits the Committee’s ability to respond to the data.

There is a reasonable case for this approach. Forward guidance worked well when the Fed’s challenge was convincing markets that rates would stay low for a long time. It worked poorly in 2021, when it arguably kept the Fed committed to easy policy long after the facts had changed. The trade-off is that without guidance, the Fed’s actions must carry the full weight of its message, and markets must price a wider range of outcomes at every meeting. This can lead, in our view, to somewhat higher interest-rate volatility, a larger term premium on longer maturities, and bigger market reactions on meeting days. That said, other members of the Fed have not been so quiet. While the Chair has offered no official guidance, other members speak frequently, which may further fuel volatility as market participants react to member commentary in the absence of a coordinated narrative. For investors, less guidance is another reason to hold portfolios that don’t depend on correctly guessing the outcome of the next meeting.

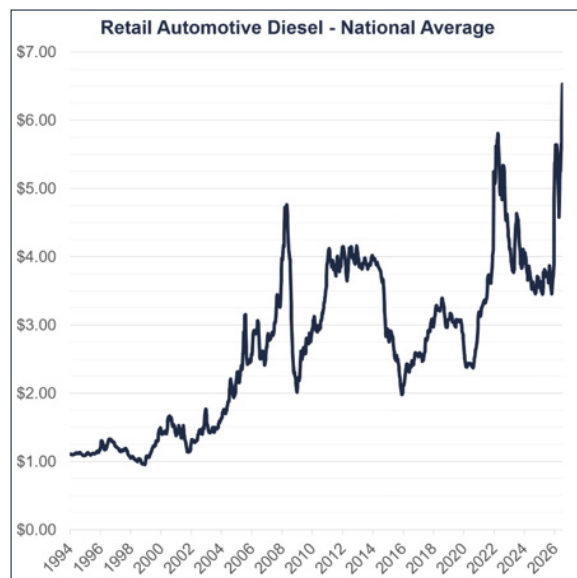
Market consensus generally expects at least one more 25-basis-point increase before year-end, though the odds for two additional hikes have increased in recent weeks. That broadly aligns with the Committee’s median projection of 4.1% and the OECD’s expectation that policy rates remain at 4.00% to 4.25% through the end of 2027. Against that policy backdrop, the key risk is to the upside if energy pass-through and shelter together keep core inflation above 3% into next spring. In other words, the outlook still depends on whether inflation stays sticky.

Energy: The Lagged Pass-Through From Diesel

Energy remains the swing factor in inflation, and the price that matters most right now is diesel, not crude oil. Brent crude traded near \$103 a barrel on September 30, up nearly 50% from a year earlier, as the conflict with Iran continues to constrain flows through the Strait of Hormuz. Refined products are even tighter. The national average diesel price set a record above \$6.50 a gallon in mid-September and ended the month at \$6.38, roughly 70% higher than a year earlier and well above the prior record of about \$5.81 set in June 2022. Diesel has outpaced crude because refining capacity is the bottleneck. U.S. refiners are running near 97% utilization; Russian refining capacity has been damaged; Moscow has banned diesel exports until October; and the Middle East disruption has removed refined product supply as well as crude.

Diesel matters because it fuels the physical economy. It moves goods from ports to warehouses to store shelves, runs farm equipment through the harvest, and powers construction and rail. Analysts at RCM, an energy services firm, estimate that diesel prices explain nearly half of the variation in truck transportation producer prices over the past two decades. The pass-through is real but slow. Freight contracts often include fuel surcharges that adjust with a lag. Many companies hedge, and most try to absorb higher costs for a quarter or two before raising prices. Grocery industry rules of thumb suggest that a 10% to 15% increase in fuel costs eventually shows up as a 2% to 4% increase in retail food prices.

The 2022 episode is a useful guide. Diesel peaked in June of that year; food-at-home inflation did not peak until August, at 13.5% year over year, and remained elevated well into 2023. Today, CPI food prices rose just 0.1% (1.2% annualized)



in August and 2.7% from a year earlier and PCE food prices were flat month over month, suggesting the pass-through from this summer's diesel spike has barely begun. If a similar lag holds, the effect is more likely to show up in food, core goods, and transportation services during the fourth quarter and into early 2027 than in the data we have in hand today. Our takeaway is that the late-summer inflation readings are likely not the peak, and the Fed has good reason to worry that an energy shock could leak into inflation expectations, which are already moving in the wrong direction. The point is that the recent energy shock may still be working its way through the economy and into inflation statistics.

Housing: Higher Rates, More Renters, and the Next Shelter Question

Higher long-term rates are doing what they are supposed to do to the housing market. They are also shifting demand toward renting. The average 30-year fixed mortgage rate rose to 7.23% as of September 30, the highest since May 2024, according to the Mortgage Bankers Association. Existing home sales slipped to 3.98 million annually in August, a 14-month low. For a household hoping to buy a first home this year, the math has become difficult. In many markets, the monthly cost of owning a median-priced home at a 7% mortgage rate is well above the rent for a comparable unit. The larger implication is that higher rates are reshaping housing demand rather than easing it.

That household does not disappear. It rents. Demand priced out of ownership shifts into the rental market, and that shift is occurring just as the supply of new apartments falls sharply. Multifamily completions are on pace to decline by about 34% this year, to levels not seen since 2014, as the construction wave financed during the low-rate years of 2021 and 2022 finishes delivering. Starts fell sharply once higher rates made new projects harder to finance, so the pipeline for 2027 and 2028 is even thinner. Apartment absorption earlier this year ran roughly 50% above its long-term average, and national vacancy is expected to hold near 5.3%, below its historical norm. Effective rents are rising about 1.8% nationally, a modest pace today, with supply-constrained markets outside the Sun Belt already firmer.

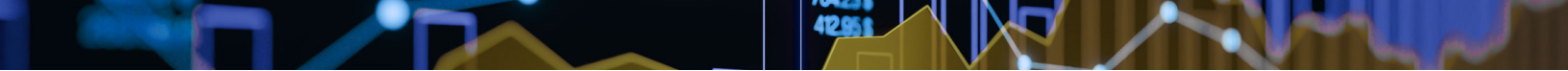
For inflation, this is the part of the story that deserves more attention than it is getting. Shelter makes up roughly a third of the CPI and has been one of the steadiest sources of disinflation over the past two years; it rose 3.0% over the twelve months through August, down from far higher levels in 2023. Over the last few decades, shelter inflation of around 3% has been consistent with PCE levels at or below the Fed's 2% target. The improvement since 2023 rested largely on a surge in new apartment supply that gave renters options and forced landlords to compete. As new supply fades and higher mortgage rates push more households into renting, however, pricing power is likely to shift back toward landlords. Because market rents feed into the official shelter measures with a lag of roughly a year, the effect would appear in the CPI mostly in the second half of 2027. It is plausible, though not our base case, that shelter turns from a tailwind for disinflation into a modest headwind just as energy base effects are fading. Put simply, higher rates may be cooling home sales while quietly making the rental math less friendly, and that is one reason we expect the path back to 2% to be slow.

Hard Data Versus Soft Data: The Mood and the Math

If you read only the survey data, you would conclude the U.S. economy is in recession. The University of Michigan's preliminary September reading of consumer sentiment fell to 47.8, 16% below where it stood in February, before the Iran conflict began, and the expectations component fell to 45.8. Gallup found in April that 55% of Americans said their financial situation was getting worse, the highest share in at least 25 years, and the share naming energy costs as their top financial worry was the highest since 2008.

If you read only the hard data, you would conclude the economy is running hot. The ISM manufacturing index was 54.6 in August, marking its eighth consecutive month of expansion, and the services index was 55.4. S&P Global's flash composite PMI for September rose to its highest level in more than five years. Retail sales jumped 1.2% in August after a soft July. Real





GDP grew at a healthy 2.2% annualized pace in the second quarter, but lower government spending and higher imports held the headline down. Real final sales to private domestic purchasers, a cleaner read on underlying demand, grew 4.6%. Unemployment is 4.1%, and payrolls rose by 162,000 in August.

How can both be true? Part of the answer is that sentiment surveys have become more sensitive to prices and partisanship and less useful as predictors of spending since 2020. Consumers have told pollsters they have been unhappy for most of the past four years while still spending. A more useful distinction is between how people feel about the economy and how they feel about their own circumstances. In the Federal Reserve's most recent Survey of Household Economics and Decisionmaking, 73% of adults said they were doing at least okay financially. At the same time, only about a quarter rated the national economy as good or excellent. Most people report that they are managing, but that the country is struggling.

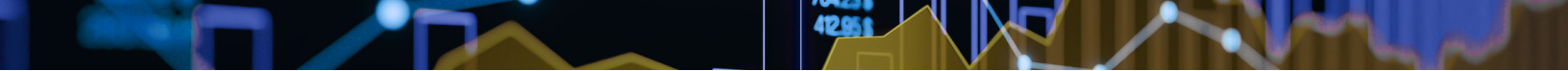
The gap is also a story of a K-shaped economy. Wealthier households, buoyed by stock portfolios and home equity, continue to spend, while lower- and middle-income households, for whom gasoline, food, and rent take a larger share of the budget, feel this year's price shocks directly. In May, the Michigan survey found that sentiment among the wealthiest consumers was at least a third higher than among other groups. Our read is that the hard data deserve more weight over the next several months, but the soft data are telling us something real about vulnerability and have value as well. An economy that leans heavily on high-income spending and corporate investment is more exposed than usual to a decline in asset prices. If equities correct meaningfully, the wealth effect supporting spending could reverse quickly, and the pessimism in the surveys could become hard data.

AI Capital Spending: The Engine and the Question

The single largest force supporting U.S. growth this year is corporate investment in artificial intelligence. The four largest hyperscalers – Amazon, Alphabet, Microsoft, and Meta – have guided to roughly \$720 billion to \$745 billion in capital spending in 2026. Including Oracle, finance leases, and customer prepayments, FactSet estimates the calendar-year total at close to \$800 billion, and third-party forecasts cited by Nvidia put 2027 hyperscale spending above \$1 trillion. One estimate based on the BEA's information processing equipment and software categories puts AI-related investment at roughly three-quarters of U.S. GDP growth in the first quarter. The OECD credits the build-out with partially offsetting the drag from the Middle East conflict, and it is a meaningful reason the U.S. is expected to grow about twice as fast as Europe and the U.K. this year.

The more pressing question is whether the current trajectory is sustainable. For most of this cycle, the hyperscalers funded their build-out with operating cash flow. That is no longer the case. Alphabet recently reported its first negative free cash flow since its 2004 IPO and raised more than \$80 billion in new equity. Meta halted share buybacks and took on nearly \$25 billion in new debt. Amazon's trailing 12-month free cash flow has turned negative. According to FactSet, incremental debt has risen from about 9% of hyperscaler capital spending in fiscal 2024 to about 32% over the past year. Goldman Sachs expects hyperscaler gross debt issuance to climb from roughly \$260 billion this year to about \$420 billion in 2027.

Our assessment is that spending remains sustainable through 2027. The companies undertaking the majority of this spending remain highly profitable, have ready access to capital, and are engaged in a competitive race that none believes it can afford to lose. However, the nature of the risk is changing. Capital expenditures funded through surplus cash represent a commitment of the company's own resources; expenditures financed through new debt and equity depend on the continued support of the capital markets. This makes the cycle more sensitive to interest rates and investor patience, both of which are currently being tested. History offers a relevant reminder. The railroad expansion of the 1800s and the fiber-optic expansion of the late 1990s both produced enduring infrastructure while generating substantial losses for many of the investors who financed them. We do not believe this cycle has reached that stage, but we are monitoring the transition from internally funded to externally funded growth most closely.



EQUITY MARKETS

Earnings: Strong, With an Asterisk

Earnings have been a significant driver of stock market growth this year. S&P 500 earnings rose more than 48% year over year in the second quarter, while companies beat estimates by about 7%, well above the historical average surprise of roughly 4%. Beneath the surface, however, operating earnings growth has been more modest. A considerable portion of the quarter's growth resulted from upward revaluations of private investments rather than increased sales of goods and services. For example, Amazon recorded a pre-tax gain of approximately \$53 billion on its stake in Anthropic, increasing reported net income by 243%, even as operations-driven income grew by closer to 14%. Similarly, Alphabet reported about \$98 billion in other income from SpaceX's June IPO and Anthropic's latest capital raise, turning core business growth in the mid-20% range into reported net income growth of nearly 300%. Excluding these investment gains, one analysis estimates that S&P 500 second-quarter earnings growth was closer to 29%. That still represents an excellent quarter. It is also substantially different from 48% and more accurately reflects the underlying health of corporate America.

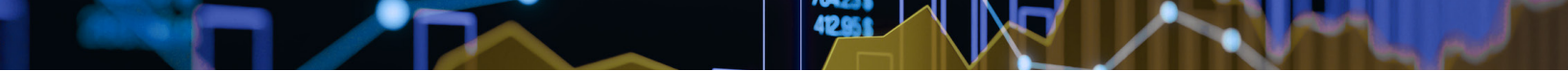
These gains have not yet been realized and may be reversed. Anthropic is reportedly preparing for an initial public offering this fall at a valuation substantially exceeding the \$965 billion valuation from the firm's last capital raise in the second quarter. Once the company is publicly listed, Amazon's and Alphabet's stakes will be valued at the prevailing public-market price each quarter, making these line items a source of volatility in reported earnings rather than a consistently positive contribution. Investors should therefore treat a one-time revaluation as temporary, not recurring profit.

A second, slower-moving accounting question concerns depreciation. Over the past several years, the hyperscalers have extended the assumed useful lives of servers and networking equipment to five or six years. Longer useful lives reduce annual depreciation expense and boost reported earnings during a period of rapid investment. Analysts estimate that this could understate industry depreciation by roughly \$176 billion between 2026 and 2028. Others argue, reasonably, that useful lives are company-specific estimates rather than manipulation, and that the effect corrects itself over time. We land in between: nothing is improper here, but with AI chips being replaced on shorter cycles as each new generation arrives, it is fair to assume that some of today's reported margin will be given back as depreciation catches up with spending. For the largest AI spenders, reported earnings are likely to overstate cash earnings for the next several years. Accordingly, valuation work should lean on free cash flow at least as much as on earnings per share.

Is the trend sustainable? We expect earnings growth to remain positive and reasonably healthy into 2027, supported by strong nominal GDP growth and real productivity gains in parts of the economy. However, reported growth in the first half of 2026 was enhanced by nonrecurring items, and year-over-year comparisons will become harder from here. As a result, we expect growth to slow toward a more normal high-single-digit to low-double-digit pace, with a widening gap between companies delivering operating earnings and those relying on investment gains, accounting choices, or financial engineering.

From AI Investment to Return on AI Investment

The market's relationship with AI spending has shifted this year. From 2023 through much of 2025, announcing a larger capital budget was rewarded as a signal of ambition. In 2026, investors want to see the receipts. The clearest example came in late July, when Microsoft and Meta reported similar levels of AI spending but received opposite verdicts. Microsoft rose roughly 7% after showing that Azure had crossed \$100 billion in annualized revenue and that net income had grown 31%. By contrast, Meta fell roughly 7% as net income declined and quarterly free cash flow shrank to less than \$1 billion. Alphabet's report days earlier sparked its own sell-off over spending, despite core growth in the mid-20% range.



This shift is constructive. It moves the discussion from how much is being spent to the returns generated by that expenditure, which is what determines stock prices over time. We expect the market to continue to classify companies exposed to artificial intelligence into three categories: those with a clear link between expenditure and revenue and cash flow; those that continue to request patience; and those whose artificial-intelligence narrative has advanced well beyond any demonstrable economics. The first category should continue to receive favorable market recognition. The second will be evaluated quarter by quarter. The third presents the greatest risk, and that is the key distinction for investors.

Concentration: One Theme, Many Indices

The AI theme is no longer limited to a small group of mega-cap technology stocks. It has become the principal driver of risk across most major equity benchmarks, often in ways that investors may not fully recognize. Within the S&P 500, the ten largest companies now represent approximately 40% of the index, nearly twice their share a decade ago, and generate approximately 32% of its earnings. During previous periods of market concentration, the largest companies were distributed across the oil, industrial, and consumer staples sectors. By contrast, today's market leaders share a single theme.

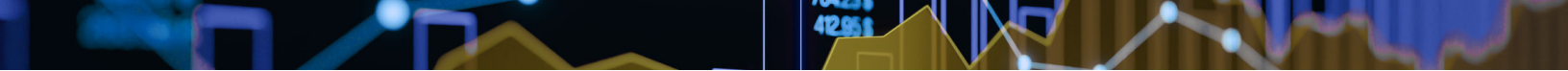
The same pattern has spread across the capitalization spectrum. This year's Russell reconstitution shifted AI-sensitive stocks heavily into mid-cap growth, where AI beneficiaries gained roughly nine percentage points in index weight. In small caps, the AI trade appears through power producers, data center suppliers, electrical equipment makers, and speculative AI-adjacent names. Emerging markets have effectively become a semiconductor index with several countries attached. TSMC alone is over 15% of the MSCI Emerging Markets Index; together with Samsung and SK Hynix, the three account for roughly 30%. Taiwan and South Korea combined make up close to half of the benchmark.

The practical consequence is that diversification across size and geography does less than it appears to. An investor who owns U.S. large caps, mid caps, and emerging markets may believe risk is spread across thousands of companies and dozens of countries, yet much of the portfolio is a set of correlated bets on AI capital spending. When the theme is working, concentration boosts returns. When sentiment turns, as it briefly did around the July earnings reports, it can produce drawdowns that hit every part of a portfolio at once. For investors, the takeaway is to look through holdings to the underlying exposures. For us, this is one more reason to favor a balanced mix of passive strategies supplemented by active managers who can control position sizes and are not required to hold the largest names at full index weight.

The Junk Rally and the Case for Quality

One of the more unusual features of the past eighteen months has been the performance of unprofitable companies. Russell 2000 stocks with negative earnings rose about 60% from April 2025 through mid-2026, while profitable small caps gained about 38%. Roughly 47% of the companies in the Russell 2000 have negative trailing earnings. The market environment is abnormal when companies with negative earnings continue to outperform those with positive earnings, and the current small-cap environment has much in common with the 1990s tech cycle. Other late-cycle markers include heavy equity issuance, including the SpaceX IPO and large share sales by established companies; a boom in corporate borrowing; and price-to-sales ratios at record highs, even as the S&P 500's forward price-to-earnings ratio sits just under 20. The takeaway is clear: this rally has favored lower-quality names in ways that look hard to sustain.

Low-quality rallies are common early in a recovery or when investors expect rates to fall. This one was fueled in part by expectations of Fed easing, which have now reversed. Because unprofitable companies tend to carry more floating-rate debt and rely on capital markets to fund operations, they are especially sensitive to the current environment. Analysts estimate that each 25-basis-point rate increase reduces Russell 2000 operating earnings by roughly 2%. In the days following hawkish remarks from Chair Warsh in late summer, the Russell 2000 fell more than 3%, while the S&P 500 fell about 1.3%, a small demonstration of that sensitivity.



Given the current environment, we believe that supplementing passive exposure with a quality tilt in small cap is the right orientation for long-term investors, and the evidence supporting that view spans decades. Research by Asness, Frazzini, and Pedersen, as well as by Novy-Marx, finds that companies with consistent profitability, strong balance sheets, and stable returns on capital have historically delivered better risk-adjusted returns than the broad market, with their advantage most pronounced during periods of tightening financial conditions and slowing growth. Quality does not win every year, and it clearly lagged during parts of this rally. Even so, a quality tilt aims to own companies that can fund themselves, raise prices, and survive a range of outcomes without relying on the capital markets to cooperate. With Treasury yields near 5%, that ability matters more than it did when money was nearly free. Chasing the lowest-quality corner of the market after a 60% run is effectively a bet on an easing cycle the Fed has told us it is not planning.

Higher Rates and the Outlook for Equity Returns

Higher rates affect equities through three channels: they raise the discount rate applied to future earnings, they increase borrowing costs, and they give investors a credible alternative. With the S&P 500 trading just under 20 times forward earnings, its earnings yield premium over the yield on a risk-free 10-year Treasury has decreased, resulting in a thinner cushion than investors have been used to since before the financial crisis. That does not predict a decline, but it does limit the room for valuations to expand further. In an era of higher real rates, the composition of equity returns should shift away from rising valuations and toward earnings growth.

Our base-case outlook for the next 12 months is positive, with more moderate equity returns driven primarily by earnings rather than multiple expansion, and greater dispersion across sectors, investment styles, and individual companies than in recent years. Some of the areas most vulnerable to a further rise in interest rates are companies characterized by long-duration cash flows priced at elevated multiples, those dependent on external financing (including unprofitable small-cap companies) and the most speculative artificial-intelligence stocks. The best-positioned companies are profitable businesses with pricing power, along with segments of the financial and energy sectors that benefit from higher interest rates and commodity prices. We continue to favor U.S. equities as the core holding of growth-oriented portfolios, with a bias toward quality and a prudent awareness of how much the index is now influenced by a single theme.

FIXED INCOME MARKETS

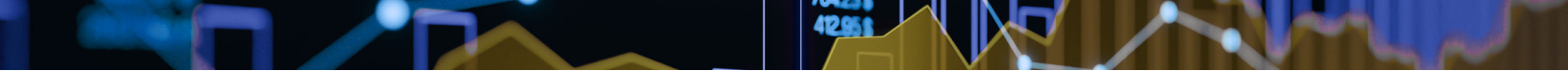
Starting Yields Are the Story

The most reliable predictor of a high-quality bond portfolio's return over the next five years is its current yield. Historically, the starting yield of the Bloomberg U.S. Aggregate Index has accounted for most of its subsequent five-year return, as coupon income tends to make up most total returns over time, while price fluctuations generally offset one another. This relationship also helps explain why the past several years have been particularly challenging for bond investors. Entering the 2022 tightening cycle with yields below 2% left little protection against rising interest rates.

Today, the picture is very different. As of quarter end, the 2-year Treasury yielded about 4.9%, the 5-year about 5.1%, the 10-year roughly 5.3%, and the 30-year close to 5.6%, with investment-grade corporate bonds trading at a spread. At these levels, income alone can do most of the work, and yields provide a meaningful buffer against further price declines. As a rough illustration, an intermediate-duration portfolio yielding near 5% could absorb a rise in yields of roughly 80 basis points over a year before posting a negative total return. The asymmetry has improved as well: if growth weakens or an equity sell-off triggers a flight to quality, today's yields leave room for bonds to rally, restoring the diversifying role that was missing in 2022.

A Role for TIPS

Treasury Inflation-Protected Securities deserve a modest place in most fixed-income portfolios today because the inflation case is straightforward. The 10-year TIPS yield about 2.9% above inflation, among the highest real yields available since 2008. Subtracting that real yield from the nominal 10-year Treasury yield implies a breakeven inflation



rate of roughly 2.2%, the average inflation rate the market implicitly assumes over the next decade. That looks low relative to the environment described above.

In other words, TIPS are priced for an inflation outcome better than what policymakers, consumers, and our base case expect. If inflation averages between 2.5% and 3% over the life of the bond, TIPS should outperform comparable nominal Treasuries. If inflation quickly reverts to 2%, the cost of that insurance is modest because investors still earn a real yield above 2.5%.

AI Issuance and the Competition for Capital

The AI build-out has created a new, very large borrower in the bond market, and that matters for the broader supply-demand balance. U.S. corporate bond issuance reached about \$1.9 trillion through August, up roughly 30% from a year earlier, according to SIFMA. Hyperscalers and their partners account for a growing share, and that supply is not easily absorbed. AI-related issuers now pay about 115 basis points over Treasuries on average, compared with about 78 basis points for the broader investment-grade market. Alphabet had to offer a notable concession in its August debt sale. “Investors are only able to digest so much, so fast,” as one portfolio manager at Thornburg, a well-known fixed income firm, put it.

The effect extends beyond corporate spreads. Every dollar a hyperscaler borrows competes with the Treasury, mortgage borrowers, and other companies for the same pool of savings. Chair Warsh named this directly in September, citing economic strength, competition for capital from hyperscalers raising funds, and geopolitical tensions as drivers of higher long-term yields. The OECD reached a similar conclusion, warning that heavy borrowing by AI companies is pushing yields higher and could leave markets vulnerable if AI profits disappoint. Layering this corporate demand on top of \$2 trillion in federal deficits creates a persistent source of upward pressure on the term premium, one that is unlikely to fade as the build-out continues.

Credit: Get Paid for the Risk You Take

Credit markets remain calm, but valuation is the issue. The high-yield option-adjusted spread spiked in the last week of the month to finish at 311 basis points on September 30, but it remains near the tight end of its long-run range. Investment-grade spreads jumped to end the month as well, but remain below 100 basis points. Fundamentals are generally sound, defaults in public markets are manageable, and strong nominal growth supports corporate cash flows. Tight spreads mean investors receive limited compensation for default risk and for the possibility of wider spreads if growth slows or rates keep climbing.

Credit still plays an important role in portfolios, both as a source of incremental income and as a way to diversify the drivers of fixed-income returns beyond interest rates. At current spreads, though, selectivity matters more than broad exposure. We favor managers with the flexibility to add exposure if spreads widen and choose wisely among issuers.

International Fixed Income: Diversification Through Flexibility

International bond markets now offer both attractive yields and meaningful diversification, a combination that was difficult to find throughout much of the past decade. Japan’s 10-year yield exceeded 3% in September for the first time since 1996; German Bund yields reached their highest level since 2011; and U.K. gilt yields rose to levels last recorded in 2008. The factors driving these yields are increasingly diverging across regions. Central banks are at different stages of their policy cycles, fiscal pressures vary significantly, and the effects of an energy shock differ between importers and exporters. Currency movements add another source of return and risk that does not necessarily move in tandem with U.S. interest rates.

That dispersion is why we access international fixed income through managers with broad, unconstrained mandates rather than through a fixed-index allocation. These managers can select among countries, currencies, sectors, and

maturities, increasing exposure where yields and monetary policy appear attractive while reducing exposure to markets where fiscal or inflationary risks are accumulating. At a time when the correlation between U.S. Treasuries and U.S. equities has been less consistently negative than it was for most of the past two decades, the ability to hold interest-rate and currency exposures driven by differing economic conditions is valuable. The objective is to hold fixed-income investments whose returns are not all dependent on the same outcome for U.S. inflation and the U.S. deficit. In that mix, flexibility is the edge that can turn dispersion into resilience, and resilience is the goal.

BASE CASE AND RISKS TO THE OUTLOOK

We find scenario thinking more useful than point forecasts in such a fluid environment, and the weight of the evidence currently favors our base case, though the range of plausible outcomes remains wide.

Case	Scenario	Potential Market Implications
Base Case Resilient but Restrictive <i>(most likely)</i>	Growth holds near 2%. Energy prices stay elevated but stop rising; core PCE remains elevated through mid-2027. The Fed could hike rates by an additional 25 to 50 basis points, then holds. The 10-year trades between roughly 4.5% and 5.25%.	Positive but modest equity returns led by earnings; quality and profitability outperform. Bond returns driven by income; intermediate maturities and TIPS do their jobs.
Upside Energy Relief <i>(plausible, not our base case)</i>	A durable reopening of Hormuz and restored Gulf pipeline capacity bring crude and diesel down sharply. Inflation improves faster than expected, and the Fed stays on hold.	Yields fall toward 4.5%; bonds rally. Equity leadership broadens beyond AI; small caps and cyclicals benefit. Consumer sentiment recovers.
Downside Inflation Broadens <i>(the risk we are watching most closely)</i>	Diesel pass-through and firmer rents keep core inflation elevated in 2027. The Fed could hike several more times; the 10-year moves above 5.5%.	Valuations compress; unprofitable small caps and long-duration growth stocks lag. AI financing becomes costlier. TIPS and short-to-intermediate bonds hold up best.
Tail Risk Disorderly Repricing <i>(low probability, high impact)</i>	A fiscal scare or poorly received Treasury auctions, an abrupt pullback in AI capital spending, or a wider Gulf escalation triggers a sharp tightening of financial conditions and recession.	Meaningful equity drawdown and wider credit spreads. High-quality bonds rally if inflation is not the trigger. This is a scenario diversified portfolios are built to survive.

The developments that would move us between these scenarios are observable. We are watching the pace of diesel and food pass-through in the producer and consumer price data, the trend in new-lease rents as apartment completions fall, the 10-year Treasury's behavior around 5% and the reception of long-dated auctions, the ratio of debt to cash flow in hyperscaler financing, and, above all, the status of shipping through the Strait of Hormuz.

CLOSING THOUGHTS

Periods such as this test discipline in both directions. Strong economic growth and a rising stock market can make it tempting to pursue the market's most speculative segments. Conversely, record-low sentiment and 5% Treasury yields can make it tempting to retreat altogether. History suggests that neither impulse serves long-term investors well. The more constructive response is to ensure that each component of the portfolio fulfills the purpose for which it was designed: balanced equity exposure through a mix of passive strategies supplemented by active strategies meant to manage risk; bonds that once again compensate investors for holding them; a measure of inflation protection; and genuine, rather than merely nominal, diversification.

We remain committed to focusing on your long-term financial goals and priorities, and to the disciplined, professional management that has served our clients through far more difficult periods than this one. As always, please reach out to your Fulton team with any questions. We wish you and your family a healthy and enjoyable autumn.

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