



3Q26 Market Overview: Great Expectations

The artificial intelligence (AI) trade remained popular in the third quarter, dragging index-level performance along with it.

Stocks related to the AI buildout saw success during the quarter, but many other risk assets were left behind. The tech-heavy NYSE FANG+ Index surged 13.1% in the third quarter, while the S&P 500 Index and MSCI EAFE Index advanced a respective 2.3% and 0.8%. The Bloomberg Global Aggregate Index lost 3.5% amid a broad bond market selloff.¹

Tight corporate spreads and high equity valuations reflect limited risk perceptions, which have been powered by record operating margins and expectations for earnings to continue growing. However, market leadership has narrowed, implying that losers are outnumbering winners under the surface of positive benchmark performance. Heavy capital spending on the AI race has also weighed on the cost of capital and pushed input prices higher. Meanwhile, rising sovereign debt, borrowing costs and escalating geopolitical conflicts continue to be concerns worldwide.

While the market may appear richly priced from the top-down, a bottom-up perspective may identify selective opportunities.

KEY TAKEAWAYS

- Artificial intelligence-related stocks dominated the quarter as market leadership narrowed and rising interest rates weighed on fixed income markets.
- Risk perceptions remain limited as record profit margins and earnings expectations push valuations higher, but we question the sustainability of current conditions.
- We remain wary of growing fiscal deficits, ongoing geopolitical conflict and economic vulnerabilities.
- We believe selective opportunities can be identified under the surface of benchmark performance, particularly in sectors that have de-rated and geographies that we believe are attractively valued relative to the US.

1. Source: FactSet; data as of September 30, 2026.

A Margin of Comfort

The AI capex cycle continues to suck the oxygen out of the market, pushing up real interest rates and weighing on the other constituents of the classic 60/40 portfolio. We believe this dominance should influence expectations for market performance going forward.

Stock valuations are being powered by earnings expectations for 2026 and 2027, which have continued to drift higher and reflect meaningful year-over-year growth. Record-level margins have been key to these improved outlooks, as consensus estimates call for operating margins to top 20% in 2026 and 2027, up from the mid-teens in 2025.² There are a number of variables supporting this trend.

One is fiscal accommodation and the deficits that result. Public sector deficits translate into private sector income, and the current 6% deficit—which is consistent with the bottom quartile of deficits historically—has been a reliable source of support for corporate revenues and margins.³

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Low household savings rates are another contributor; disposable income that is spent rather than saved typically funnels into corporate coffers. Like the deficit, household savings levels also sit within the bottom quartile on a historical basis.

Last is very high levels of private nonresidential investment, which reached dot-com levels as a percentage of GDP in 2026 and continue rising from there. A fair amount of this is related to the AI buildout; AI-related investment is projected to exceed \$1 trillion globally in 2026 and reach many multiples of that figure in the coming years.⁴

Though the stars have been aligned in support of corporate profit margins, persistence is, of course, not guaranteed. History tells us that the emergence of transformative technologies—from US canals in the 1830s to the internet in the late 1990s—often takes the form of a boom-bust cycle, with excessive investment followed by a sharp correction.⁵ Indeed, we've begun to see frictions emerge in the data-center narrative. While demand for such facilities remains very strong, the marginal economics of supply has come under pressure; higher financing costs and rising input prices are pushing prices higher while political reticence and concerns over potential power shortages have slowed permitting.

Meanwhile, wage inflation may be staging a comeback. As corporate profits have risen, the jobs market has begun to tighten following several years of softening. The rate of job openings is slightly above the unemployment rate, and the Atlanta Fed wage growth tracker has inflected positively alongside rising two-year yields.⁶

Fiscal Follies in the US...

Since the dislocations of Covid-19, we've been warning that the next crisis to face the global economy could be sovereign in nature. The selloff in long government bonds worldwide lends credence to this suspicion. During the third quarter alone, the yield on 10-year US Treasury bonds rose to nearly 5.3%, a 24-year high, from around 4.4%.⁷

Notably, there has been a shift in the mix of Treasury buyers throughout this century, a period during which the amount of Treasury debt outstanding has increased massively. While official sources like foreign reserve accumulators and domestic agencies dominated demand for Treasuries, private actors, including both individuals and institutions, are now the primary sources of government funding.⁸

2. Source: Bloomberg; data as of September 30, 2026.

3. Source: US Department of the Treasury, Bureau of Labor Statistics, Bureau of Economic Analysis; data as of June 30, 2026.

4. Source: Congressional Research Service; data as of August 28, 2026.

5. Phurichai Rungcharoenkitkul, "The AI Investment Race," Bank for International Settlements (July 2026).

6. Source: Bloomberg, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics; data as of September 30, 2026.

7. Source: US Department of the Treasury; data as of September 30, 2026.

8. Source: Haver Analytics, US Department of the Treasury, Federal Reserve; data as of December 31, 2025.

The increase in sovereign debt outstanding has far outpaced the cumulative total return on Treasury bills since the late 1960s. Though the price of gold has pulled back in 2026 after a massive run-up in 2024 and 2025, the metal has been a more reliable tracker of government borrowing over the long term. The price of gold relative to both the stock of public debt outstanding and the S&P 500 stands at or near its geometric mean since 1970, suggesting to us that investors believe the current fiscal backdrop represents a normal level of risk. We don't share that belief.

...and Abroad

Fiscal deterioration is not limited to the US. At nearly 5%, France's borrowing rate is higher than that of countries like Greece and Italy that were at the epicenter of the continent's previous debt crisis. The rise in rates is coincidental with the government's need to refinance low-rate debt issued during the Covid era, and the country is expected to sell \$380 billion, a record amount, in 2027.⁹

Beyond France's large fiscal deficit and significant debt-to-GDP, political uncertainty has transformed the country into one of Europe's biggest question marks. The upcoming presidential election, in April 2027, appears likely to pit a far-right candidate against a far-left one. Neither have presented a credible plan for fiscal adjustment, and both are likely to inherit a fragmented Parliament that makes meaningful change difficult.

We've learned from the past that international demand for Chinese goods ultimately is met by politicians eager to protect domestic industry.

China's economy remains very weak. Second quarter GDP growth came in at 4.3%, the weakest in more than three years.¹⁰ Real estate activity has continued to decline, bank lending is starting to look deflationary, and retail sales are approaching year-over-year contraction.¹¹ While exports have been buoying China's economy, as evinced by a current account surplus that has reached its highest share of global GDP, except for the global financial crisis when global GDP contracted, China may need to pull some fiscal levers to stimulate activity at home.¹² We've learned from the past that international demand for Chinese goods ultimately is met by politicians eager to protect domestic industry. For example, US tariffs remain ongoing, even if down from their previous highs, and the European Union is considering measures to curb its trade deficit with China.¹³

Finding Bottom-Up Opportunities

To us, current dynamics are reminiscent of the late 1990s tech boom. Risk perception—reflected most notably through tight corporate spreads and equity valuations—remains limited, though rapidly narrowing trading breadth suggests that losers are outnumbering winners in the current market.¹⁴

While the market may appear richly priced from the top-down, a bottom-up perspective reveals more reasonably priced stocks in areas of the market that have derated as the cost of capital has risen—sectors like healthcare, housing and software. International stocks, too, remain very cheap relative to US names, in our view.

We maintain our belief that a diverse collection of scarce, durable assets acquired at sensible valuations may benefit our investors in the long run.

9. Source: *Wall Street Journal*; data as of October 6, 2026.

10. Source: Reuters; data as of July 15, 2026.

11. Source: UBS, CNBS, Peoples Bank of China; data as of August 31, 2026.

12. Source: International Monetary Fund; data as of December 31, 2025.

13. Source: *The New York Times*; data as of October 7, 2026.

14. Source: Bloomberg; data as of September 30, 2026.

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All investments involve the risk of loss of principal.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

Investment in gold and gold-related investments present certain risks, including political and economic risks affecting the price of gold and other precious metals like changes in US or foreign tax, currency or mining laws, increased environmental costs, international monetary and political policies, economic conditions within an individual country, trade imbalances and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold and, accordingly, the value of investments in such securities may also be affected. Gold related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low and general economic conditions are stable. In addition, returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. Investment in gold and gold related investments may be speculative and may be subject to greater price volatility than investments in other assets and types of companies.

There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Past performance does not guarantee future results, which may vary. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur.

Gross domestic product (GDP) measures the total value of all economic output in goods and services for an economy.

Atlanta Fed Wage Growth Tracker is a measure of the nominal wage growth of individuals.

Bloomberg Global Aggregate Index (Gross/Total) measures the performance of investment grade debt from local currency markets worldwide. The multi-currency benchmark includes treasury, government-related, corporate and securitized fixed rate bonds from both developed and emerging markets. A total-return index tracks price changes and reinvestment of distribution income.

Consumer price index (CPI) (Price) measures inflation as experienced by consumers in their day-to-day living expenses by capturing the average change over time in the prices paid for a representative basket of consumer goods and services. A price-return index only measures price changes.

MSCI EAFE Index (Net) measures the performance of large and midcap equities across developed markets countries around the world excluding the US and Canada. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

NYSE FANG+ Index is an equal-weighted equity benchmark designed to track the performance of 10 highly traded growth stocks of technology and tech-enabled companies in the technology, media & communications and consumer discretionary sectors.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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