The third quarter of 2026 marked another quarter of strong equity returns despite geopolitical unrest and negative developments in energy markets. Equity markets remain enamored with the buildout and potential of AI, looking through rising costs of capital, resurging inflation, and the war in Iran. The strength of this bull market -recently reaching its fourth birthday- should not be underestimated. Quarter-to-date returns for the S&P 500 and the Bloomberg Aggregate Bond Index were 2.3% and -3.35%, respectively.

A longer-than-expected conflict in Iran has stoked inflation in the US, primarily driven by energy prices, although some spillover effects on goods are emerging from higher diesel costs. An orderly sell-off in global bonds has also heightened fiscal concerns for heavily indebted nations running persistent deficits, including France, Japan, the UK, and the US. As a result of these economic developments, industries outside of AI, especially rate-sensitive ones like autos and housing, are experiencing serious contractions in profits and activity. Housing activity is at recessionary levels, as homebuilders are cutting production and offering concessions to buyers amid mortgage rates nearing 7.5%, which have amplified affordability concerns. The International Monetary Fund recently warned that a sharp drop in the AI boom could cut global GDP by 1.1% by 2028. The US economy is looking increasingly bifurcated, as recent shifts highlight the economy's reliance on the AI buildout.

Real GDP growth remained steady at 2.2% in Q2, as the AI buildout and wealth effect have fueled growth. The job market appears stable, as fears of AI-driven displacement seem overblown in the near term. Meanwhile, retiring baby boomers and immigration trends have lowered the labor force participation rate and effectively placed a temporary lid on unemployment, which currently sits at 4.2%. New Fed Chair Kevin Warsh appears to have taken a more hawkish stance, with a 0.25% rate hike at the September meeting. Additionally, markets are currently signaling more hikes by year-end. The Fed has a mandate to return inflation to or below its 2.0% target. That said, balancing this task without tipping the economy into a recession may prove difficult, as the current backdrop -including political pressure, the war in Iran, surging bond yields, and above-trend inflation for 67 consecutive months- poses significant obstacles to effective monetary policy.

Bonds experienced particularly painful returns this quarter, especially longer-duration bonds, as evidenced by the 20+ year bond ETF (TLT), which posted a return of around -8% in Q3. In fact, bonds have performed poorly over the past six years, marking the longest bear market in bonds on record. With the benefit of hindsight, this rut in bonds seemed predictable, as the impact of excessive monetary stimulus during the COVID-19 pandemic and zero-interest-rate policy

A copy of Form ADV, our registration statement with the Securities and Exchange Commission, is available at the FINRA website.

created what may have been a multigenerational trough in US bond yields. Today, yields look much more appropriate given high inflation and on-trend growth. On the corporate side, AI hyperscaler debt issuance has flooded bond markets and added to concentration risk in passive bond investment vehicles, making this no longer a phenomenon exclusive to stock indices. Credit spreads remain tight, but there has been some recent widening among lower-tier borrowers, such as CCC-rated issuers, as well as idiosyncratic leveraged AI companies. Widening spreads deserve close attention, as they tend to have negative spillover effects on broader markets. All in all, yields are beginning to look attractive, especially in short-duration, high-quality corporates.

Equities remained resilient in Q3 despite a myriad of headwinds. Performance leadership in Q3 returned to the mega-cap tech companies that have driven this bull market since its inception in October 2022. The market's very high concentration, a direct result of the narrow group of tech stocks holding it up, has led to the ten largest stocks in the US accounting for roughly 40% of the S&P 500. Market breadth, or participation across sectors, has worsened since Q2, as small caps, utilities, and real estate have cooled off due to higher interest rates. Energy and tech were the top-performing sectors in the quarter, a fitting data point given the current economic backdrop. Cash flows at AI hyperscalers are being depleted as these companies rush to spend on AI capex. That said, earnings and profit margins remain at record levels, supporting equity valuations in this rather turbulent environment.

We believe today's market environment provides ample opportunity for prudent active management. We hope you had a wonderful summer. As always, please do not hesitate to contact us with any questions or concerns, or to schedule a portfolio review.

A copy of Form ADV, our registration statement with the Securities and Exchange Commission, is available at the FINRA website.