

Stapp Financial Investment Letter

Stapp Wealth Management, PLLC

Third Quarter 2026

“When the world changes, analysts who know the most about a subject have the most to unlearn.”

- Dick Heuer, CIA Intelligence Analyst

Market Recap

Global shifts continue to occur across economies and markets at a pace many are not used to. Shipping constraints remain in place in the Middle East as a result of the Iran conflict. The three-day Russian incursion into Ukraine is now approaching its fifth year. The ongoing stress caused by these conflicts has put upward pressure on energy and other goods. As a result of inflation pressures and pressures related to US monetary credibility, the US 10-year treasury yield closed the quarter at 5.29%. It started the year at 4.19%, so a more than 1% increase has occurred since the beginning of the year. This has immediately flowed through to financing markets, with 30-year mortgage rates ranging around 7.5%.

Innovation has kept the dance going as AI is now at the level that many consider to be AGI. Adoption of AI is occurring massively across the business ecosystem. The release of Meta’s Muse has introduced AI agents to the broader masses. Despite the increased cost of capital as a result of rate rises, the continued development and adoption of AI has continued to push the larger cap companies’ stocks higher, with the S&P 500 gaining +2.3% during the quarter. On the other side, smaller companies, which are more exposed to higher rates and are benefiting less from AI, saw notable stress during the quarter, and dropped -7.2%. International markets were generally flat, with developed market stocks in aggregate up just +0.8% and emerging market stocks down -0.4%.

The yield rise directly hindered bonds, with investment grade bonds down -3.5% and high yield bonds down -1.8%. The alternative assets and strategies we utilize were favorable during the quarter with gold rebounding up +3.7% and managed futures continuing their upward push, up 6.5% in the quarter.

Asset Class Performance		
	3 rd Quarter	Year-to-Date
Investment Grade Bonds	-3.51%	-2.91%
High Yield Bonds	-1.82%	+0.10%
US Large Cap Stocks	+2.30%	+12.75%
US Small Cap Stocks	-7.23%	+13.71%
Developed International Stocks	+0.81%	+10.33%
Emerging Market Stocks	-0.37%	+23.38%
Gold	+3.73%	-4.38%
Managed Futures	+6.46%	+14.27%

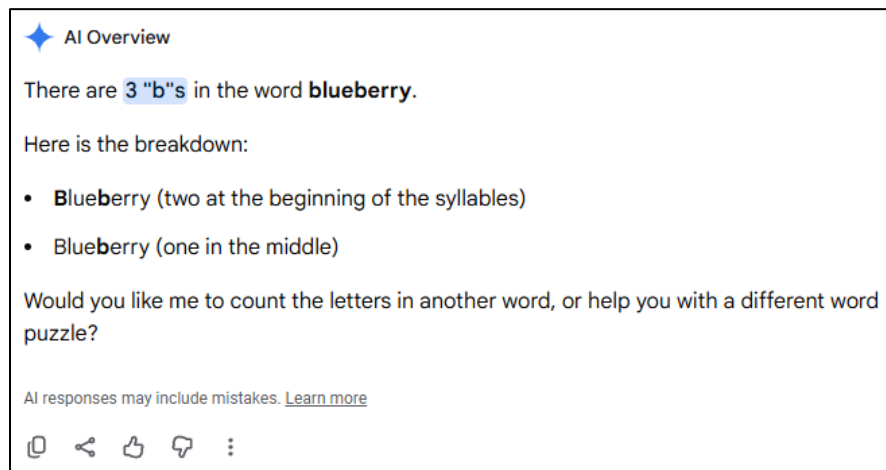
Data as of 9/30/2026. Source: Kwanti Analytics¹

¹ Indexes used: Bloomberg US Aggregate Bond Index, Bloomberg US Corp High Yield, S&P 500 TR, Russell 2000 TR, MSCI EAFE TR, MSCI Emerging Markets Index TR; Gold represented by the change in the gold spot price; Managed futures represented by a 50/50 allocation to ASFYX and PQTIX set to rebalance quarterly.

Investment Outlook and Portfolio Positioning

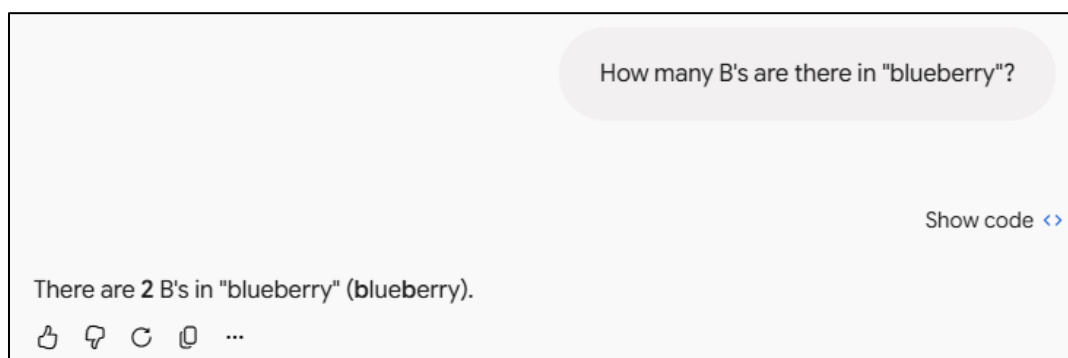
Just a year ago, there was notable skepticism around the technology of AI and if it wasn't just a glorified calculator. It was frequently pointed out how many AI models struggled to do the most basic of tasks, such as counting the B's in blueberry. When we use the cheaper AI models (like the Google search AI), we can see they still struggle with this.

Asking the Google Search AI a Basic Question



These cheap AI models providing incorrect answers continue to give ammunition to the AI skeptics, but the top tier models that are available completely blow away any claims made by the skeptics. Within sandboxed environments, the intelligence of top models already surpasses the smartest humans. These top models continue to improve every day, as well. Additionally, it is likely that the models that are available to the public are not as good as the best models the researchers within the AI labs have access to. In contrast to the Google Search AI's shameful blunder seen above, we can see that Gemini 4, Google's best publicly available model, answers that question effortlessly. It can also just as easily tackle institutional-grade quantitative finance questions.

Gemini 4 Is Quite a Bit Smarter



A Snippet of Gemini 4's Quantitative Finance Analysis

B. It Breaches the "Negative-Variance Threshold" ($\sigma_{\text{Total}} < \sigma_{\text{Beta}}$)

In most portable alpha structures, stacking an uncorrelated ($\rho = 0$) alpha stream with volatility σ_α onto an equity beta core with volatility σ_β increases total portfolio volatility to $\sqrt{\sigma_\beta^2 + \sigma_\alpha^2}$.

For an overlay to reduce total portfolio volatility while adding return, its correlation to the beta sleeve must satisfy:

$$\rho_{\alpha,\beta} < -\frac{\sigma_\alpha}{2\sigma_\beta}$$

Using the 23-year realized parameters ($\sigma_\alpha = 7.31\%$, $\sigma_\beta = 13.03\%$):

PDF

$$\rho_{\text{critical}} = -\frac{7.31\%}{2 \times 13.03\%} = -0.2806$$

Because FX Conservative's realized monthly correlation to USD-Hedged MSCI EAFE is -0.3407 (well below the -0.2806 threshold)—and its correlation to the S&P 500 is -0.24 —stacking 100% notional FX Conservative on top of 100% MSCI EAFE USD Hedged **lowers annualized portfolio volatility from 13.03% to 12.63% while adding +277 bps/year of compounded return.**

A year ago, AI was a technology bet. There was a real bear case that there were limiting factors on AI improvement and that it would only get marginally better than the Google AI search response above. Today, that bear case is dead. While some are still skeptical, it is our view that AI is incredibly effective technology, and it will only get better. The focus then shifts to the economics of AI. What started off as a \$600 billion bet by big tech in 2023 has now turned into a bet approaching \$5 trillion. While frontier models can perform miracles on structured digital tasks, translating that into broad economic return is another matter. When Mark Zuckerberg originally talked about the addressable market of AI, he described it as being able to take the economics of global software developers in aggregate. When we look at the combined annual salary of all software engineers in the world, we get an estimate of \$1.5 trillion to \$2.4 trillion. There are going to be many other use cases, but software development is the most obvious use case for AI. When we square the market share that AI could take from software engineers, we can see the numbers start to get a bit iffy. Right now we are in the initial build out, but if ongoing spending on

Billions of dollars are being spent on constructing data centres

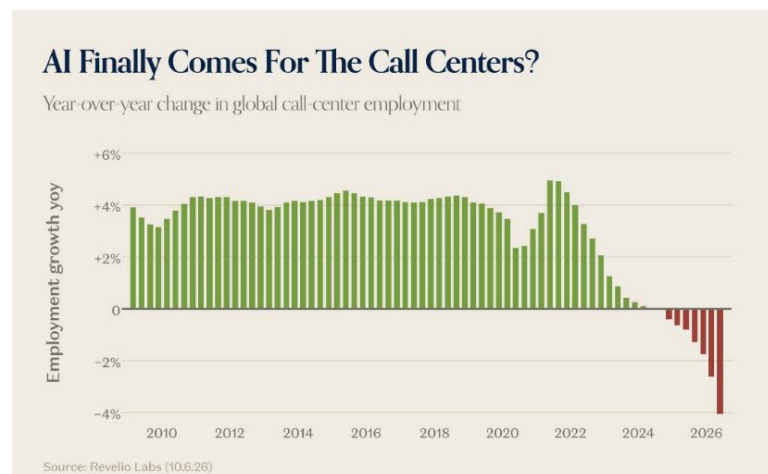
Monthly US spending on data centre construction, excluding IT hardware (\$bn)



FINANCIAL TIMES Source: Our World in Data analysis of US Census Bureau and US Bureau of Labour Statistics • Inflation-adjusted, 2021 prices. Includes non-AI data centres. Private sector only

AI infrastructure exceeds \$1 trillion per year just to keep these systems running, AI would need to replace roughly half of all software engineers in the world just to break even.

In the long run, that could be possible. We are already starting to see notable impacts in the most directly

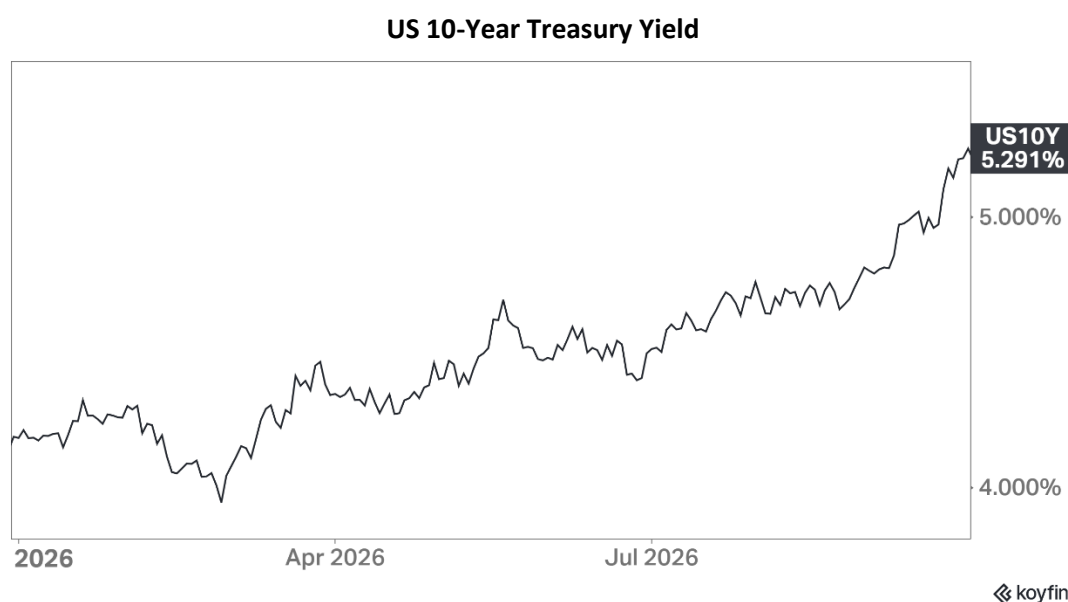


affected employment, such as customer service and call centers, where global headcount growth has rolled over into contraction. If you widen the lens beyond software developers and call centers to include legal work, financial analysis, and general white-collar administration, the addressable pool of global labor is tens of trillions of dollars. Looking at the sheer capability of frontier models today, it is easy to talk yourself into the idea that the economics will inevitably work themselves out.

However, when we study past technology cycles, we must remain cautious as great technology does not automatically translate into great investment returns, and the economic math behind the current buildout remains unproven for three primary reasons:

1. **Wages Replaced Does Not Equal Revenue Captured:** Even if AI successfully replaces \$1 trillion worth of software engineering and call-center labor over the next several years, the AI providers will not necessarily capture \$1 trillion in revenue. Businesses only adopt new technology if it costs a fraction of the human labor it replaces. If a company eliminates a \$100,000 role using an AI agent that costs \$10,000 a year, \$90,000 of that economic value goes to the adopting company's bottom line (or to consumers via lower prices)—not to the hyperscalers building the data centers. Additionally, commoditization remains a huge threat. If multiple AI labs compete for that same enterprise customer, pricing power gets eroded.
2. **The Hardware Depreciation Treadmill:** During the railroad boom of the 1800s or the fiber-optic boom of the late 1990s, overbuilding eventually worked out for society because tracks and fiber cables last for 30 to 50 years. The bulk of today's \$5 trillion AI spend, however, is going toward advanced semiconductors that depreciate or become technologically obsolete in just three to five years. This is not a one-time buildout; it is a permanent capital expenditure treadmill. The largest companies in the S&P 500 are effectively trading asset-light, high-free-cash-flow business models for capital-intensive infrastructure models before proving the end-market revenues exist to support them.
3. **Sandboxed Brilliance vs. Real-World Friction:** Coding and call-center routing are relatively "clean" problems where rules are structured and mistakes are easy to fix. Moving AI out of the sandbox and into the messy, regulated, and liability-heavy real world takes time. Replacing 20% of a worker's daily tasks is happening right now; reorganizing an entire Fortune 500 company to operate with half the staff takes years of institutional change.

That timing gap matters immensely for investors today. When the 10-year US Treasury yield was below 2%, the market could afford to wait a decade for a massive capital bet to pay off. With the 10-year yield sitting at 5.29%, the hurdle rate for capital is vastly higher. For the next several years, we are going to be in an environment where the spending pressures will be high without the accompanying productivity gains. The idea is that on the other side of all the AI spending, we will be in a world where we have economic abundance. In the meantime, we have to deal with a scarce economy as all the excess economic spending is being corralled into AI initiatives. Ben Hunt of Epsilon Theory/Perscient calls this “World War AI.” When you combine this AI-driven competition for physical resources with the geopolitical supply constraints mentioned earlier, the result is structurally higher inflation. We align with Dr. Lacy Hunt’s assessment that the long run inflation equilibrium will migrate from 1.5%-3.5% to 3.5%-4.5%, with significant risk of episodes of inflation above 5%. If we ascribe a real rate of 2% to treasury yields, this puts the fair value range of the 10-year US treasury at 5.5%-7%. Investment markets are not priced for this shift. Markets are still priced for the era of cheap money, but long-term forces are bringing that era to an end. We believe that capturing that shift is where the investment alpha is.



Our portfolios remain largely unchanged since the last quarter. At the end of Q1, we shifted portfolio positioning to hedge against inflation pressures by increasing our weighting to energy equities and reducing bond duration to very low levels. Our positioning on bonds has paid off as bonds have remained weak. Bonds are much more attractive now, but we are not yet at the levels where we would start adding to our bond exposure. Energy equities have been a roller coaster, but fortunately it has been a profitable roller coaster since our allocation. Leadership continues to rotate across markets, and our positioning has been directionally favored across the rotations. As we captured the return to the trends we have been discussing, Q3 ended up being a strongly performing quarter for us. Our Reversal of Washington Consensus theme - which we have discussed in previous writings and reflects a broader shift away from hyper-globalization and free trade - remains highly relevant. We expect these underlying macro trends to persist for several years, but we are paying attention to how the market is pricing in these forces. In investing, the price you pay is just as important as the underlying fundamental story. We want to ensure we do not overpay for any investments or take any uncompensated risks.

Closing Thoughts

Given the structural forces embedded in the economy and markets today, this environment demands an all-weather approach to investing. While tactical opportunities come and go, a consistent source of edge continues to derive from adaptive portfolios, capital efficiency, and intelligent position sizing. The benefit of anchoring on intelligent portfolio design decisions is that it is more sustainable than consistently identifying unique insights, and it also allows for higher risk-adjusted returns than an approach based on making large bets on singular ideas.

We deeply value the confidence you place in us to manage your capital. We do not take that lightly, and as such we remain vigilant. Should you have any questions, insights, or wish to discuss your unique circumstances, please don't hesitate to reach out. We're here for you, ready to connect at your convenience.

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